

Limited Liability Companies and Taxes

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Over the last 30 years, limited liability companies have become a very popular choice as a business entity among small businesses. While the entity is a good choice, there are some tax issues that must be considered.

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The entity known as the limited liability company [LLC], was created by a legislative act in Wyoming in 1977. Instead of immediately becoming popular, the entity just kind of sat for 10 years. The primary reason for this was a tax issue. Simply put, the IRS took some time to getting around to inspecting it and then wasn't really sure what to do with it. The problem was the entity looked like a corporation, but the law indicated it was to be taxed as partnership. Since state law is not binding on the IRS, a federal agency, a complex quandary was created.

In 1988, the IRS issues guidance that it would tax the new entity as either a corporation or a partnership with the business being allowed to choose. This favorable ruling resulted in most states moving to pass their own laws creating and allowing for the use of LLCs within their borders. In this mad rush to create laws allowing the entity to be used [and fees to be collected by states], the finer points of the IRS guidelines were missed. As a result, many of the acts allowing for the use of LLCs within a state created problems for owners that exist to this very day.

When looking at the LLC, the IRS was confronted with an entirely new business entity that did not fit comfortably within the boundaries of then existing tax law. The IRS was faced with the equivalent of trying to put a square block in a round hole. At first, it re-acted by putting forth complex guidelines regarding how ownership was held and business was conducted to determine whether the entity would be taxed as a corporation or partnership. All hell broke loose and the agency realized their approach simply didn't work. The business entity was supposed to help small businesses, not pile tax regulations on them. The IRS soon dropped the regulations and went to a check box strategy. Simply put, you checked a box on a form telling the IRS if you wanted to be taxed as a corporation or a partnership. For practical reasons, nearly every LLC chooses to be taxed as a partnership. Another problem soon arose.

In their gusto to help the little guy and create a new revenue source, state governments often included legal clauses allowing for single owner LLCs. Simply put, this meant a sole proprietorship could become an LLC and be protected from personal liability for business debts just like large, publicly traded business. The IRS staff must have groaned. A huge problem had been created.

In general, the legislative process does not produce intelligent laws. The compromises between democrats and republicans often lead to bizarre laws that contradict the basic premises of some area. With LLCs, this was clearly the case. The problem lies in the partnership tax classification and single owner designation.

By definition, a partnership is two or more people pursuing a business activity. How then, could a single owner LLC be taxed as a partnership? The various state governments had blown it again. Surprise, surprise. The friendly chaps at the IRS reported this back to the states, which of course did nothing. The IRS was in a real quandary. Single owner LLCs were about to get a shock. The IRS decided they could not be taxed as a partnership.

If you form an LLC and are the sole owner, you need to understand what happens when it is time to pay taxes. For tax purposes, the IRS ignores your LLC designation. It will not accept partnership tax filings for your business. Instead, it is going to treat you a sole proprietor. This means you are going to pay self-employment tax and other little nasty taxes that you probably were not expecting when you formed the LLC. When the state fees and such are added up, you actually pay far more than being a simple sole-proprietorship. The advantage, however, is you have the shield protecting you from personal liability. At the end of the day, however, the cost may not make a single owner LLC worth the effort.

If you are considering starting a single owner LLC, you need to sit down and talk with an attorney or accountant. It is vital that you understand what you are getting into to avoid a very ugly surprise when it comes time to pay taxes. While there is hope that the IRS will address this issue in the future, chances are slim considering 30 years have passed since the creation of the entity. Gerard Simington is with FindAnAttorneyForMe.com - an online attorney directory.