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IN BOX

Tax Issues for LLCs and Their Owners

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Question: How should members of a limited liability company be compensated? I understand it may be better for tax purposes for the LLC to be treated as a corporation. Is that true?

Answer: A limited liability company is one of many ways — including corporations, partnerships and sole proprietorships — that a business can be organized.

Limited liability companies are taxed as partnerships, and they are popular with small-business owners. Owners, or members, of LLCs are treated as employers for tax purposes. Earnings and losses pass through to the owners and are included on their personal tax returns.

When it comes to compensation, LLC members do not receive a W-2 form. They are not subject to income tax withholding, and they are not eligible for certain tax-favored fringe benefits that are available only to employees, such as some health benefits.

Since 2003, however, self-employed people can deduct 100% of their medical insurance premiums on their individual income tax returns.

When LLC members get paid for services rendered to the company, the payments are considered "guaranteed payments" for tax purposes, meaning they are reported on a Schedule K-1 at the end of the company's tax year.

"The LLC members will need to make quarterly estimated tax payments on their Schedule K-1 income to avoid estimated tax penalties," said Stephen Kunkel, a certified public accountant and Southern California director of taxes at CBiz, a national business service firm.

Some limited liability companies elect to be treated as corporations for tax purposes so that their members can avoid the self-employed treatment and the unfavorable fringe benefit rules, Kunkel said.

However, making the decision to treat a limited liability company as a corporation involves tax drawbacks as well and should be done only with the advice of a knowledgeable professional.

"This strategy may not make sense in many situations and should only be undertaken after full consideration of all the consequences," Kunkel said.

"It would be giving up many of the benefits that caused you to choose an LLC in the first place."

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Being Self-Employed Has Its Benefits

Q: My fiance has established a sole proprietorship for consulting purposes. I'm also a consultant. Would it be better for me, tax-wise, if I worked for his company?

A: Self-employed people get tax benefits that are not available to employees. For instance, you probably write off certain expenses, such as your home office or business use of your car, that employees cannot.

If you go to work for your fiance's sole proprietorship, you would no longer get those tax benefits.

On his end, he would have to establish an employer identification number for his firm and pay you a salary.

"If you are interested in both having the tax benefits of being self-employed, then it might make more sense for you to each run your own business and have two separate sole proprietorships," said Danielle Hewitt, president of Invisible Accountant in Irvine.

If you and your fiance really want to work together, you could establish a partnership. This would mean that your income would go into the same bank account under the same business name.

"With that comes the necessity of filing a partnership income tax return and — if you're wise — a written partnership agreement," Hewitt said.

If you go this route, get some professional advice on whether to form a general partnership or a limited partnership.

Each has benefits and drawbacks that will need to be evaluated in light of your specific situation.
