



BUSINESS & SOCIAL ENTERPRISE: FUNDAMENTALS

# Business Fundamentals: What is a Limited Liability Company (LLC)?

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A Limited Liability Company (or “LLC”) is the easiest and most straightforward separate business entity to establish, and is also often times the next “step” in the business start-up progression after the “sole proprietorship.”

Contrary to a sole proprietorship, the formation of an LLC **does** create a legal entity separate from owner or owners, typically termed “members” in the business’ operating agreement. Because of this, LLCs in California are subject to the state’s annual \$800 minimum tax.

The Limited Liability Company arose from business owners’ desire to utilize a business structure that would allow them to operate like a traditional partnership, but with the liability protection of a traditional “corporation.” Thus, the LLC is really a business “hybrid.” Like a partnership, the LLC is able to distribute income to the LLC’s members (who then report it on their individual income tax returns). Further, like a corporation, the LLC is able to protect the members from personal liability for the business’s debts (unless they are personally guaranteed).

While it may be tempting to think that an LLC is just a simpler way to establish a business rather than setting up an S corporation, there are also distinct advantages to the LLC over the S corporation. For example, while S corporations are allowed to only issue one class of the company stock, LLCs can offer several different classes with different membership rights. Furthermore, S corporations are limited to a maximum of 75 individual shareholders (who must be U.S. residents), whereas an unlimited number of individuals, corporations, and partnerships may participate in an LLC.



However, there is also a significant disadvantage of the LLC that may make a corporate structure more attractive for many entrepreneurs. Specifically, the ownership interests in the LLC are not transferable without restriction. This restriction makes the LLC structure unworkable for larger businesses seeking to attract large sums of capital, as their corporate stock must be easily transferable in the stock exchanges or to venture capitalists interested in an equity stake. Usually this restriction isn't problematic for smaller companies, where stock ownership transfers take place relatively infrequently, and thus makes the LLC often times the entity of choice.

The advantages of a Limited Liability Company:

- Pass through tax advantages;
- Liability protection for owner-members;
- No need to follow "corporate" formalities.

The disadvantages of a Limited Liability Company:

- Ownership interest not easily transferable;
- Limited access to capital investment.