LLC Resource Guide

(How to Operate Your LLC Effectively)

An Informational Resource Created by

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Tax & Accounting

Plain English Edition

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OVERVIEW

This guide will give you the day-to-day knowledge of how to properly operate your Limited Liability Company (LLC). LLC ownership is not complicated because LLC's do not have a long list of regulations to follow like their corporate alternatives. In fact, properly managing an LLC is really just practicing fundamental accounting & recordkeeping principles and not so much learning a new set of rules. For that reason, many of the principles discussed in this guide are basic small business accounting practices that apply to all small business owners regardless of their entity type. Adjusting to these new habits can take time for new business owners; however, this guide is designed to help you understand the value of adopting these habits and make the process as smooth as possible.

ACCOUNT SEPARATION

"Co-mingling funds"

The main reason LLC's are favored over other entities is that their liability protection is not contingent upon compliance with a list of corporate regulations. There is, however, one practice that will jeopardize the liability protection of any entity: co-mingling funds. Co-mingling funds means that you use business and personal funds and/or assets interchangeably without any separation. Examples include:

1. Making personal purchases with business funds.
    a. Ex: Buying groceries for home with your business credit card.
2. Making business purchases with personal funds with no reimbursement.
    a. Writing a personal check for supplies delivered to the business and not documenting it as a loan. (Documentation will be covered in the next section)
3. Including personal assets on business asset spreadsheets.
    a. Including your personal vehicle on your business spreadsheets without documentation that the vehicle belongs to the business.
4. "Paying" yourself with undocumented money from the business account.
    a. Taking a weekend bonus of $200 out of your business cash fund without documentation as a distribution.

Losing liability protection due to co-mingling funds is a very real possibility. Imagine that you have been seriously wronged by another business and have been awarded damages against them for one million dollars. When their records are brought forward, you see they only have a single bank account which holds all of their personal and business funds, a total of one million dollars. Rather than paying you the damages in full, they claim that less than $100,000 actually belongs to their business and that their LLC protects the rest. The few records they provide are minimal and do not show any clarity as to what money is personal and what is business. In this situation, would you believe their claim that their LLC should protect 90% of their co-mingled cash? Neither do real world judges. Likewise, IRS auditors will also disallow any tax benefits if your records don't show strict separation between personal and business finances.

Separating accounts is a lot easier to understand in theory than it is to apply, especially since it involves more than simply having separate bank accounts. Most small business owners start off using personal assets such as desks, computers, vehicles and cell phones long before their business is able to cover those expenses for itself. Lack of cash flow often creates situations where personal funds must be injected to purchase inventory, make payments on time or simply keep the business afloat. Most entrepreneurs will naturally co-mingle funds to some degree; however, proper documentation can separate the transactions and maintain the integrity of the entity.

Create a bank account for your LLC

The first step in separating your funds is to open a business bank account. Go to a bank or credit union which specializes in small business banking and open a business account under your LLC's name. You will be required to provide documentation that the business is legally organized before you can open the account. Each institution varies with their requirements; however, your Employment Identification Number (EIN) and a copy of your Articles of Organization stamped at the Department of Commerce will generally suffice. Other institutions may require the official LLC registration card that the Department of Commerce will mail you following approval of our LLC. For ease of managing your money, be sure that your business bank account can be accessed online and that you can easily transfer funds between your business and personal accounts.

Personal Loans

If you are a single owner of an LLC, it can be difficult to understand and apply the proper separation between personal and business funds since all of the money in your personal and business bank accounts "belongs to you." This mentality is the main contributor to improper use and poor documentation of business funds. To help you understand how you should view and manage your business funds, imagine for a moment that your business belongs to your neighbor and not you. Would you ever just step in and pay for his supplies with your money? No. If in some dire situation he asked for your help and you made the payment, you would see the payment as a loan and expect to be paid back, right? Absolutely. You must treat your personal and business accounts the same way. If you pay for any business expense with personal money, document it as a loan. When revenue is generated, repay the loan before any other money is distributed to the owner(s). The majority of startup entrepreneurs overpay their taxes every year because of poor documentation of personal loans. In most cases, these entrepreneurs spent small increments of personal money and used personal assets over an extended period of time without documenting them. If personal loans, whether lump sums or collective values of small purchases are not properly reported, the taxable income of the business will be over-reported by the amount of the loans. You wouldn't believe the number of entrepreneurs who, figuratively speaking, invest $1,000 into their business, sell $150 worth of goods and services and report a taxable profit of $150 to the IRS instead of an $850 loss!

How to record/reimburse personal loans

If you invest personal funds into your business or are forced to use personal funds for random business expenses, do the following steps to document and repay the loan:

1. Document the purchase as a "Loan/note from _(Owner's Name)_" in your company books. (See Documentation section)
2. When repaying the loan, make an electronic transfer labeled as "Repayment of Loan/note from _ (Owner's Name)_ (Date of original loan).*"
3. Document that the loan was paid back in full in the company books after the final payment is transferred.

*The repayment is not limited to electronic transfers, but they provide an easy to follow paper trail.

How to reimburse business loans

Opposite of the previous scenario, if your business account pays for personal items, do the following steps to document and repay the loan:

1. Document the purchase as a "Loan/note from __ (Name of business) __to__ (Owner's Name) _" in the company books.
2. When repaying the loan, transfer the amount from your personal to business account labeled as "Repayment of Loan/note from __ (Name of business) __ to _ (Owner's Name) _."
3. Document that the loan was paid back in full in the company books after the final payment is transferred.

How your LLC gets paid by clients

When you perform services for clients, normally they will pay you with cash, check or credit. Have your clients start making payments to your LLC, not you personally. If you have been doing work for the same individuals prior to setting up the LLC, make sure they know to make the switch. If your clients pay with cash, record the sale and be sure and deposit the money into your business bank account. If a client does write a check to you and not your LLC, simply deposit the check directly into your LLC account. You could also cash the check personally and then deposit the cash into your business account.

If you work as an independent contractor for other companies, complete a W-9 tax form and give it to your employer. This form provides your employer with your business EIN, allowing them to pay your LLC in place of you personally. It is imperative that you get a completed W-9 to your employer immediately after creating an LLC. If you fail to do so, your income will be linked to your Social Security number and not your business and you will be taxed as a Sole Proprietor and not as an LLC. You can find a W-9 form on MainStreet's website at www.msftaxes.com/forms.

DOCUMENTATION

Value of documentation

Since the key to LLC management is separation of funds, there must be clear records of all money transfers between you and your LLC. Remember that you will pay taxes on the profits of your business. The more expenses you record through the year, the less taxable income you will report and the less tax you will pay.

While it may seem elementary, failing to report expenses costs many business owners thousands, even tens of thousands of dollars each year. See the following example:

> Jim has a business refurbishing antique cars. He made $200,000 selling finished cars but spent $100,000 on shop rent, tools, labor and purchasing cars to refurbish. His gross revenue was $200,000, but his net income was only $100,000. If Jim had not recorded all his expenses and only reported spending $50,000 instead of $100,000, he would have taxable income of $150,000 rather than only $100,000.

How to keep financial records

Ideally, you should maintain your company records using small business accounting software, such as QuickBooks™. If you feel that your company is not yet to a stage to justify purchasing software, be aware that the cost to transfer records from a spreadsheet or a notepad into QuickBooks can be far more expensive than the software itself. If you are going to be in business for the long haul, start right. If you are simply dabbling in business ventures and not pursuing a long term opportunity, we recommend creating a basic spreadsheet to document your income and expenses. Do not let anything related to your business go unreported, regardless of whether or not you think it will "help you." While online banking provides a valuable paper trail of purchases and income deposited, it does not replace the need for a set of company records. Company records show a complete history of all company transactions. Bank accounts cannot tell you how much your clients owe you, or how much you still owe your suppliers. Bank accounts also do not provide information on cash that was received but not deposited or checks that were written but not cashed.

Frequently compare your bank statement with your books to ensure that the records match up and that no expenses or income has been left out. After recording transactions, file the receipts and other documentation in an organized accordion file or file cabinet. Do not simply throw receipts and documentation in a box and try and organize it later, it will cost you severely in time and money.

What you need to record

Basically put, you should record every financial transaction of your company. Record all money that comes into the business, whether from customers, interest, loans from your personal funds, etc. Record all money spent for the business including rent, supplies, operating costs, gas, utilities, labor, distributions, etc. The records do not need to be fancy or eloquent, just organized and thorough. At a minimum, record the following information for each transaction:

1. The date of the transaction
2. The total amount of the transaction
3. Description of the transaction (item purchased, service rendered, loan source, etc)
4. Account (General Category) for the transaction (Sales, Equipment, Rent, etc)
5. Method of payment (cash, check, credit card, etc)

TAX RETURN PREPARATION

Provide documentation

Come tax season, you will need to provide totals for your revenues and expenses. Your expenses will need to be broken down into some basic categories for easier reporting. If you keep your records using small business software, you can simply print out a categorized Profit and Loss Statement. If you created your own spreadsheet, you will need to tally up totals for the categories found on your tax preparer's organizer sheet for business returns. In addition to completing their tax organizer, the tax preparer will need all other tax documentation including 1099's, W-2's, etc. You do not need to submit your receipts with your taxes, those are only necessary in the event that your company is selected for an audit.

Business Tax Returns

Business tax returns provide the IRS with information regarding the profits of the company. With the exception of C-Corporations, business entities do not pay taxes as an entity. Business returns do not receive "refunds" like personal tax returns either; instead, the profits of the company are reported and taxed as income on the owner's personal tax return. Once your business tax return has been completed, each owner will receive a form called a "K-1" that reports their individual portion of the company's profits (or losses) which is taxable to them. Your business profits will be added to any other income you have received through the year and will be factored into your taxable income (Adjusted Gross Income).

Should your business report a net loss, the loss will flow to your personal return and cancel out any other taxable income up to the amount of the loss. For example, if you and a spouse had $50K worth of taxable income from W-2 wages and had a $30K loss in a new side business, you will only have a taxable income of $20K. Do not be afraid to report a net loss; just be aware that because business losses reduce tax liabilities, they are often abused. The IRS understands that most businesses start in the red and work to black so they have given a general guideline that businesses should report profits 3 out of 5 years to avoid triggering a red flag for audit.

Tax return(s) required

Based on the tax structure of your LLC and the number of owners, you will file your business and personal taxes using the following forms:

Entity Type	Company Tax Return	Filing Deadline	Individual Income Tax Return	Filing Deadline
Single Owner LLC	NA	NA	Form 1040	Apr. 15th
Multiple Owner LLC	Form 1065 (Partnership Return)	Mar. 15th	Form 1040	Apr. 15th
Single Owner LLC (s-elected)	Form 1120S (S-Corp Return)	Mar. 15th	Form 1040	Apr. 15th
Multiple Owner LLC (s-elected)	Form 1120S (S-Corp Return)	Mar. 15th	Form 1040	Apr. 15th

Get professional tax help

Personal income tax jargon is confusing and difficult to understand. Business tax information is equally as confusing. In fact, MainStreet has even been contacted by professional tax preparers to prepare their own business tax returns for them because they themselves were not trained in small business taxes! Do-it-yourself tax software is becoming more and more prevalent. It provides a "quick & easy" approach to filing taxes from the comfort of your home. These programs can be relatively effective for individuals with extremely easy returns; however, after reviewing hundreds of personal and business returns that had been filed online, MainStreet has yet to find a single business owner who did not have errors on their return or additional money left on the table that they could have claimed. Moral of the story: DO NOT PREPARE YOUR OWN TAX RETURNS-ESPECIALLY IF YOU OWN A BUSINESS! While tax software has made tax filing possible from your home office, it does not incorporate any tax strategy into your business. The results you obtain online or at home with software are only as good as your own personal understanding and the algorithms within the software. Professional tax help is well worth the investment when you view the immediate and long term results of applying the tax strategy and planning that only a professional can give. In most cases, paying a few hundred dollars for an experienced small business tax preparer will result in thousands worth of tax reductions that otherwise would have been missed. If you do not already have a tax accountant, we encourage you to find one.

Tax Planning

If you have some ideas to grow your business, purchase capital, make investments or just want to understand how to better minimize your tax liabilities, meet with your accountant and create a tax plan for the next few years. If you are a brand new start up with minimal investment, your meeting may simply get you on track to know what kinds of things you should be recording as you get going. Many deductions, such as mileage, require documentation over a large period of time. Others, like depreciation, take planning to maximize your savings when purchasing new assets. By meeting with your accountant, you can learn the areas where your business can find greater deductions and the actions you should take now to achieve them.

USE OF PERSONAL ASSETS

Home office

Many entrepreneurs begin by working out of their own home. While this is done to reduce the expenses for your business, it can often increase your expenses at home (electricity, water, heating/AC, etc). Prior to creating an LLC, you were able to claim the Home Office Tax Deduction by deducting the expenses of your home based on the percentage of square footage used exclusively for business. Now that you own an LLC, that specific deduction is no longer available to you; however, you can still deduct home expenses associated with your business by personally leasing the office space to your business. Based on the percentage of square footage you use for your home office, create a lease agreement between you and your company. Lease the office to your business for a fair market rate per month. In your agreement, you could figure a flat rate for utilities or a percentage of the monthly bill, just as you would if your neighbor wanted to lease office space in your home. Each month, your company will pay you (your personal account) a lease payment for office space. The amount could also figure in a rental costs for furnishings (i.e. desk, chair, filing cabinet, etc) and small office equipment. Charging your business for the space will allow you to deduct office expenses for the business while still maintaining documented separation between personal and business accounts.

Vehicles

Many individuals put tens of thousands of miles on their personal vehicles for business related travel. You may deduct the use of your personal vehicle using only <u>one</u> of the following ways: 1. The costs associated with the vehicle (price, depreciation, interest, registration, insurance, gas, maintenance, repairs, etc) based on the usage for business use, or 2. Mileage (2011 Avg was $0.53/mile). Both the cost method and mileage should be accurately recorded in order to know which deduction is greater at the end of the year. In some situations, such as when an individual puts lots of miles on an older, paid-off car will probably benefit from their mileage more so than deducting vehicle expenses-unless of course it was always in the shop. On the other hand, individuals with more expensive cars and low mileage will generally deduct costs associated with the vehicle to receive the greatest deduction against their income.

Document all business related mileage in a mileage log. You can keep the log weekly, daily or on an individual trip basis. The more detailed your mileage log is, the better. Ideally, you should keep the log in your car at all times and document either the odometer readings or total miles driven after each business related trip. Those who keep accurate mileage logs tend to keep more of their receipts and do not miss as many Estimated logs recorded monthly or annually can be targeted by the IRS and thrown out, costing you a major deduction on your taxes.

If you use your vehicle for work related purposes more than 50% of the time, then the business can own the vehicle and "allow" you as the owner to take it home and use it for personal activities. If you cannot prove that the vehicle is used primarily for business related activities (with a mileage log), you should not purchase the vehicle with company funds. One option is to personally own the vehicle and lease it to your company, like the home office example previously. The lease payments will serve as a tax-free way to pull money from your business, and the vehicle will have a line of protection from business creditors given that the business does not actually own the asset.

Computers & cell phones

If you use a personal computer or cell phone for your business, you can deduct the costs associated with them based on the percentage used for business. Do not forget to include costs relating to printing/ink, insurance, software, maintenance, storage, and internet accessibility. Your company can purchase the assets from you for a fair market value or lease them for a monthly fee. Either way counts as a valid expense to your company when adequately documented. When your percentage of use is over 50%, it is recommended that you pay for Internet and cell phone plans directly through your business.

GETTING PAID BY YOUR BUSINESS

Every new LLC owner's first question is "How do I get paid by my business?" The way you are paid by your LLC varies with its tax structure. Generally speaking, as a business owner, you don't "pay" yourself as an employee; your income is simply the profit of the company, which can be withdrawn throughout the year at any time. If you own the company with other owners, the profits are split between the owners. Only certain entity structures allow/require you to "pay" yourself a salary in addition to collecting the profits of the company. These situations require additional reporting with appropriate state and federal agencies.

Regular LLC

If you own a regular LLC, you may transfer any profit from the business account to your personal account at any time. This transfer must be labeled as a "draw." You may take draws multiple times a day, a few times per month, once a year, it doesn't matter. Draws are not subject to any payroll taxes. If the LLC is owned by multiple members, the draws over the year must be proportionate to each member's equity in the business. Example: If 3 members have their ownership split 20, 30, 50, and choose to draw $100,000 during the year. They must draw 20K, 30K and 50K respectfully to maintain the same ownership percentages. Before all profits are split between members on the business tax return, the managing member(s) of the LLC must also be paid a "Guaranteed Payment to Manager" for their work in running the operations of the company. This can be done at the end of the year with the help of your accountant/tax preparer. The guaranteed payment to manager does not have to come as a lump sum. It can be a guaranteed amount paid to the individual each week, month, etc in addition to any draws the owners choose to take during that time.

S-elected LLC

In an s-elected LLC, you may also transfer profits from your business account to your personal account at any time. When making these transactions, label the transfer as a "distribution." A distribution is just like a draw in a regular LLC; they are not subject to payroll taxes and can be taken at any time. The difference with an s-elected LLC is that rather than paying self-employment tax on your net profit for the year, you can pay payroll taxes on a fair & reasonable salary. Processing a payroll simply means you report to the state and federal agencies the profit of the business during a given period of time, select a salary based on the profit, and submit FICA and other payroll taxes on the amount. Basically put, payroll is writing a check to the government, not writing a check to yourself.

S-elected entities are required to report and file payroll taxes on a quarterly and annual basis. Based on your level of income, you may be required to submit payroll taxes on a monthly basis. Smaller businesses can wait and pay payroll taxes at the end of the year in one lump sum after they know exactly what their net income for the year has been; however, they should still submit reports with zeros on a quarterly basis. Be aware that if you choose to wait until the end of the year, you will need to come up with adequate funds to make the submission. It is recommended that you meet with your accountant quarterly and submit a payroll of approximately 5-6*% of your profit for that quarter. Doing it in this way will ensure that you have adequate funds and that you will only pay a total of 5-6% of your net profit instead of the 15% of your net profit you would have paid in self-employment tax as a regular LLC.

Have your payroll processed professionally. Given the low cost of payroll services and the complexity of the payroll process, it is more profitable, time efficient and healthier on stress

levels to outsource your payroll to a professional. In fact, 1 of 3 entrepreneurs who prepares their own payrolls ends up paying a penalty of $700/year.
*5-6% is equal to FICA taxes on a fair market salary between 32-46% of net income

How much is a " fair & reasonable salary"?

"Fair & reasonable" are very subjective words. There are no predetermined amounts required by the IRS for owner salaries; however, there are zones that can draw red flags. A fair & reasonable salary can be based on industry comparisons, geographic factors or occasionally on a percentage of net income. Each situation is unique and should be discussed with your accountant. It has been our experience that for a business earning a net income (not gross revenue) of less than $100,000 each year, a fair & reasonable salary should not be less than 25-30% of net income. The higher your profits, the higher percentage salary you should take to avoid penalties. Business owners whose business had a net profit of over $100,000, for example, would probably have a hard time justifying that a fair salary should be less than 40-50% of net income without solid documentation. The better documentation you can show to support the salary being "fair and reasonable" for your position in your location, the better. If your business did not earn a profit, it is not "reasonable" to earn a taxable salary at all. Here are two examples to help understand these principles:

1. Example #1: Brandon made $30,000 doing independent sales over a summer. He took distributions of $20,000 throughout the summer and fall and left the remaining $10,000 in his LLC account until December. Brandon submitted a quarterly report to the government with zeros for the summer quarter. Brandon selected a fair & reasonable salary of $9,000 (30% of net income and the average amount earned by a first year sales rep in his company) and submitted his payroll taxes in December based on that amount along with his fall quarterly report and his annual report. Following the submission, he transferred the remaining balance in his LLC account to his personal account as a distribution.

2. Example #2: Jill is a real estate agent that had averaged $150,000 in net income each year over the past 3 years. Unknowing of what her total income would be for the next year, she took varying distributions each month, totaling $100,000 by the end of the year. Each month, Jill submitted payroll taxes selecting 35% of her monthly distributions as her fair salary. In December, she could see that she had earned a net income for the year of $160,000. Wanting to select a salary of 35% of her annual net income, Jill submitted a final payroll on a salary of $21,000, totaling an annual "fair & reasonable salary" of $56,000. After submitting her final payroll and year-end report, Jill then took a distribution of all remaining funds to her personal account.

Negative net income (net loss)

You can have negative net income; it is called a net loss. A net loss means that your business spent more than it made. If you are just starting a new venture, you probably pour more personal money into the business than you get back in business revenues. When a net loss occurs, it is not necessary to pay payroll taxes on an owner's salary since no salary is "fair & reasonable" when the business did not make a profit.

Say for example Steve opens a small trucking company. He spends $100K of his own personal money to purchase a few trucks, equipment and to cover all other business expenses. By the end of the year he makes $60K. If he fails to report his personal loan to the business for $100K, Steve will be required to pay payroll taxes based on a net income of $60K. If the loan for $100K is recorded properly, Steve's company can accurately report a net loss of $40,000. He is not required to pay payroll taxes. The loss will also cancel out any other income he receives from other sources up to $40,000. Remember that net losses reported continuously over 3-5 consecutive years can trigger a red flag from the IRS since some dishonest business owners twist their books to evade payroll taxes each year. If your business is actually experiencing continual net losses over a long period of time, you should reevaluate your business plan.

STATUS/RENEWAL

Checking the status of your LLC

Each state provides a website that files all registered business entities along with expiration dates, registered agents and entity status. These listing sites are also used to check the availability of business names. Links to these sites can be found at www.msftaxes.com/tools.

Renewing your LLC

LLC's remain current for one year following their creation. It is up to the owner to renew the LLC through the state(s) in which it is registered every year. Renewing an LLC in Utah, for example, costs $15 and can be done online. To check the expiration date of your LLC, make changes to your personal information such as change of address or to renew the LLC in one year, follow the link at www.msftaxes.com/tools. MainStreet recommends that new LLC owners make a note in their personal calendars to renew their LLC rather than waiting for a reminder from the State. Failing to renew your LLC can lead to the loss of legal protection and tax benefits and can be very costly. Allowing your LLC to expire will also make your company name available to anyone seeking to register the name themselves, including competitors. Keep your LLC current, and when you are ready to close the entity, have MainStreet properly report its closure to avoid costly penalties and consequences down the road.

CONCLUSION

We hope this guide is a valuable resource for you as you continue to build your business. Be sure and give your small business finances the attention they need; however, do not allow them to steal all of your time away from building your business. If you have additional questions as you proceed with your small business, please let us know as we will continue to add to this guide for future entrepreneurs like yourself. Good luck!