# For LLC Owners to Know:
## The Differences between Allocations & Distributions

Many business partners choose to organize their business as a limited liability company ("LLC"), as it gives you the limited liability protection that corporations, where the owners are kept from being held personally responsible for the company's debts, but with less formality and more flexibility than a corporation.

One flexible benefit of LLC organization is done through the operating agreement. Specifically, having the members agreeing to how profits are divided among the owners. The dividing up of money is done through separate processes called allocation and distribution. Due to default rules, many owners conflate these two ideas, but they are in reality separate concepts.

## What is Pass-Through Taxation?

LLCs are "pass-through" or "flow-through" entity for income tax purposes. The LLC does not pay any income taxes on its profits, but rather the profits "pass through" the company to the members. The members are the ones who report them as income on their personal tax returns.

The share of the profits that each owner reports as income should be specified in the operating agreement. If not, the default rule is that profits are divided according the size of each owner's membership or ownership interest in the LLC. Usually, many business partners find this the easiest way to divvy up profit, but it does not have to be that way and discussion amongst the partners should be made prior to organizing the LLC and drafting the operating agreement.

## What is Allocation of Profits?

"Allocation" specifically refers to the process of determining each LLC owner's share of the profits. Any allocation gets added to your "capital account", which is the dollar value of your ownership interest in the LLC. Basically, it means what is a member's worth or value of their stake in the LLC.

This is why it is important to determine prior to organizing the LLC and drafting of the operating agreement what everyone business partner will initially contribute for their initial capital contribution prior to becoming a member. Thus, a member's allocated share is what that member reports on their income taxes.

For example:

*Let us imagine we have ABC LLC. ABC LLC has three members, A, B, and C. A owns 46%, B owns 34%, and C owns 20% percent of the LLC, respectively. The LLC reports $100,000.00 in profit in a given year. Under a typical allocation, the member A would be responsible for reporting $46,000.00 of the profit on his or her personal income tax return. The member B would be responsible for reporting $34,000.00, and finally, member C would be responsible for $20,000.00. If the ABC LLC suffered a net loss rather than a profit, that loss is allocated the same way, with each member getting a portion of the loss as a write-off.*

## Taxes on Allocation of Profits

One key point to remember is that LLC members MUST report their share of the profits as income on their tax returns. It does NOT matter whether they actually receive any of those profits as cash or in some other form (as you may receive some other type of property). Many businesses in their initial years have the business owners decide to hold onto their profit. A couple of reasons being reinvestment into the business or creating a rainy day fund. Therefore, in a situation where they are members of a LLC, they might receive less than their allocated share of the profit, or even nothing at all. ***Reiterating the point made earlier, the members will be taxed the same as if they had received their entire allocated profit in cash.***

## What is a Distribution?

"Distributions" occur when the LLC actually distributes cash or property to the members. Again the default rule being that when distributions are proportional to each member's ownership interest the distributions are generally not subject to further tax. The reason for saying "further tax" is that the members should have already reported and paid taxes on ALL of the LLC's profits.

Distributions are treated as a return on capital, as the members have invested in the LLC; recall the discussion on contributions above. However, the default rule need not be followed, and members can decide other ways to distribute. The biggest concern though is when distributions are out of proportion to the membership interest in the LLC, there may be significant tax consequences.
For business owners first starting out, prior to having someone organize your LLC and draft your operating agreement it is advised to work with an attorney, an accountant, and/or a tax professional. As many LLC owners fall into disputes because of lack of communication or understanding on what allocation versus distribution means for them and their individual finances.