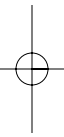
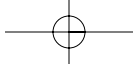


Part One

INTRODUCTION TO LIMITED LIABILITY COMPANIES





1 WHAT IS A LIMITED LIABILITY COMPANY?

The **limited liability company** (LLC) has become the most popular form for organizing business and investment activities. It can provide tremendous benefits. For example:

- For a modest cost and no additional annual tax filing requirements, you can make your home-based business sound more professional; and most importantly, you can protect your personal assets from claims relating to your business by setting it up as an LLC.
- An entrepreneur starting a new business will likely have tax losses for the first year or two until sales grow. An LLC provides an approach to dealing with these losses.
- For doctors, lawyers, and other professionals seeking to protect assets from malpractice and other claims, the LLC is a key tool in their **asset protection** arsenal. Owning nonrisk assets (e.g., a doctor's personal investment portfolio) in an LLC with other family members and **trusts** can make it more difficult for claimants to reach those assets.
- A parent wants to minimize **estate tax** costs while retaining considerable control over family business and investment assets. Transferring assets into an LLC with the parent serving as the **manager** or sole voting **member** of the LLC can accomplish these two important goals.
- A real estate investor owns five rental properties. Each can be owned by a separate LLC to insulate each property from claims on the other properties and to protect personal assets. Thus, if there is a suit by a tenant on one property, only the assets of the LLC owning that property can be reached.
- A business owner wants to start a new retail store but wants to keep the liability of that store independent of other retail stores he owns. A separate LLC can own each store.

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This book tells you how to use LLCs to deal with these situations, and more. This book guides you step by step through understanding, forming, operating, and eventually winding down and dissolving an LLC. This book also describes the many benefits that make the LLC form of business organization a practical way of doing business, managing investments, and handling personal issues.

WHAT IS A LIMITED LIABILITY COMPANY?

An LLC is an entity formed under state law with both tax and legal advantages. It separates business assets from personal assets and thus can generally limit business-related claims on the business assets. It has relatively simple and favorable income tax attributes because it is generally taxed as a **partnership** if there is more than one member. This means income is taxed to the members, not the entity. If there is only one member of the LLC, the income tax situation is even simpler; it is ignored. Most importantly, you can choose the intended income tax result. Tax regulations, called *Check the Box Regulations*, let you check the appropriate box on a federal tax filing to obtain the desired tax status. This law provides certainty and simplification, and assured income tax results.

An LLC is a hybrid between a **corporation** and a partnership. The tax and legal advantages that the LLC form offers may make it the preferred choice for new transactions.

LLCs ARE STILL NEW

Although LLCs have been in use for a number of years, they are still quite new compared with other forms of ownership for businesses and investments. Thus, some caution must be exercised. There are likely to be changes in state laws. Court cases interpreting both the tax and legal rules will take years to develop a thorough and consistent resource. The concepts explored throughout this book are unlikely to change, but the nuances—in particular, the rules applicable in your state or for your specific legal or tax situation—could change. Therefore, it is essential to consult competent legal, tax, and accounting advisers before making any decision about using the LLC structure.

THE NATURE OF YOUR LLC DEPENDS ON STATE LAW

LLCs are formed and exist solely in accordance with the specific state law under which they were formed. Hence, to properly understand any LLC

that is in existence, you must examine the state statute under which that particular LLC was organized. There can be important differences from state to state.

CAUTION: Make certain that the lawyer who assists you in the organization of an LLC has knowledge and experience with your particular state's LLC laws. If the business your LLC will operate extends beyond your state's boundaries, your lawyer must be familiar with the other states' LLC laws, or must hire counsel in those states who have this specialized knowledge.

Most statutes, known as *flexible* statutes, permit members (who are the owners) of an LLC to enter into any agreement they desire to govern internal relationships within the LLC; they are only limited by broad public policy restrictions. Most statutes are written in this manner "unless the **operating agreement** provides to the contrary. . . ." In other words, you can agree in the contract between the members (the operating agreement, which is analogous to a shareholders agreement for corporate shareholders or a partnership agreement in the partnership context) to almost anything you wish. If, however, you don't agree as to a specific matter (your LLC's operating agreement may not address that particular matter) then the rules of the state law where the LLC is formed will apply. These rules are thus called **default rules** (they apply in default of your providing otherwise). Because these rules can differ in important ways from state to state, it is important that you have some familiarity with them. They really are not that complex to read; and you can find them in your public library, or on the Internet. These differences make it imperative that the attorney you hire be familiar with the LLC law in the state where your LLC is formed and operates.

NOTE: Prior to the IRS permitting LLCs to simply check off a box on a tax filing indicating whether they should be taxed as a partnership or corporation, the state laws were critical to determining the income tax status of the LLC. Even following these rules, important nuances in state law can still have significant tax impacts. The different default rules under state law can be critical when valuing LLC interests for estate and **gift tax** purposes and determining **discounts**, in particular (see Chapter 12).

The contract between the parties, known as an *operating agreement*, must also be reviewed when analyzing an LLC. Many states provide substantial latitude in the provisions that can be included in such an agreement. Other states mandate certain provisions that cannot be modified by an operating agreement.

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LLC RULES DIFFER BY STATE

Despite the tremendous benefits derived from using limited liability companies, LLC statutes throughout the United States are very diverse. Many businesses engage in multistate activities. States vary in their recognition of out-of-state LLCs. As a result of the lack of uniformity among the states, there are a multitude of basic questions, such as:

- May an LLC be engaged in not-for-profit activities?
- Can a member withdraw from an LLC and mandate the payment of fair **value** for the member's **interest**?
- Are one-member LLCs permissible?
- Who can bind an LLC and are there any limits on this authority?
- What fiduciary obligations to the entity and its members are imposed on LLC owners and managers?
- Do the LLC members have the authority to sue the LLC on their own as well as on behalf of the LLC?
- Can general and **limited partnerships** be converted to LLCs and how is this accomplished?
- Which law governs out-of-state LLCs?
- How is the LLC managed?

The differences in state laws may create some uncertainty when you utilize a limited liability company beyond the state of formation.

UNIFORM LIMITED LIABILITY COMPANY ACT

The National Conference of Commissioners on Uniform State Laws prepared a uniform model LLC Act, known as the **Uniform Limited Liability Company Act** (Model Act). Many states model their laws on this act. Therefore, a brief overview of the Model Act provides a good introduction to the laws likely to affect your LLC. Even with a uniform act, many state legislatures have and will continue to put their own interpretation on the uniform act in their laws.

As presently drafted, the Model Act is a flexible statute containing numerous *default provisions*. These default provisions apply unless you affirmatively take steps to have a different result (i.e., unless you provide otherwise in your LLC's operating agreement or organizational documents).

General Provisions of the Model Act

Some of the general provisions of the Model Act include the following:

- An LLC is a legal entity separate from its members. This is important for many reasons. Its separate nature means that formalities relating to this separate identity (e.g., separate bank accounts) should be maintained. This is also the basis for limiting your exposure to lawsuits by using an LLC.
- An LLC may be for-profit or nonprofit.
- An LLC may have one member. One-member LLCs can offer a simple, flexible, and cost-effective method of owning and operating many types of investment and business transactions.
- No **distributions** to members may be made if the LLC cannot pay its debts, or if the LLC's assets are less than its liabilities plus amounts necessary to satisfy preferential rights on dissolution.
- A member has no transferable interest in an LLC's property, but does have a transferable interest in distributions from the LLC and return of capital. The right to transfer LLC equity (membership) interests is a major focus of most LLC operating agreements, which generally try to restrict such transfers.

Key Rules from the Model Act

The Model Act establishes mandatory provisions that cannot be overridden by your LLC's operating agreement. Under these provisions, which your state's statutes may reflect, you cannot:

- Unreasonably restrict a member's right to access the LLC's books and records. Often operating agreements include express provisions requiring that members be sent certain reports within specified time periods. If not, a state law providing the right to access the records often is available.
- Eliminate a member's or manager's statutory duty of loyalty to the LLC and other members.
- Unreasonably reduce a member's or manager's statutory duty of care. For example, a manager operating the LLC will have to conduct LLC affairs in a manner that reasonably protects the member's economic interests in the LLC.

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- Eliminate a member's or manager's obligation of good faith and fair dealing. For example, a manager or member cannot sell real estate to their LLC at an inflated price, to the detriment of the other members.
- Restrict the rights of third parties (i.e., non-members).
- Vary the statutory requirement to end an LLC in certain limited circumstances.
- Vary the statutory right to expel a member in the case of a judicial determination that the member engaged in wrongful acts adversely affecting the LLC's business, committed a material breach of the operating agreement, or engaged in conduct that makes it impractical for the LLC to carry on any business with the member.

Flexibility Provided by Modifiable Provisions

The Model Act is a lengthy document containing over 80 pages of default provisions. These provisions, however, may be modified in a particular LLC's operating agreement or articles of organization to meet the requirements of a particular business. Some examples of the default provisions that you might modify are:

- *Limited Liability:* Debts of an LLC are solely those of the LLC unless the **articles of organization** provide otherwise. A limited liability company is legally distinct from its members, who are not normally liable for the debts, obligations, and liabilities of the LLC. Accordingly, members are not proper parties to suits against the LLC.
- *Agency of Members and Managers:* Members of a member-managed and managers of a manager-managed company serve as agents of the company and can therefore bind the company to third parties. Members in a manager-ruled LLC are not such agents and do not have the power to bind the LLC. Acts beyond the scope of the Model Act can only bind the LLC if they are ratified after the act. A member or manager, as agent of the LLC, is not liable for the debts, liabilities, and obligations of the LLC simply because of the agency.
- *Existence:* LLCs may have a specific term or be *at will*. Members of an LLC must agree to remain as members until the expiration of the term. A term company will generally dissolve at the expiration of its specified term unless the articles of organization are amended before the term expires providing for an additional specified term, or the members or managers simply continue the LLC as an at-will entity. Preexisting operating agreement provisions will govern the relationship of the members except to the extent inconsistent with rights and

duties of members of an at-will company with an operating agreement containing the same provisions.

- *Transferees and Creditors of a Member:* Generally, members have no property interest in property owned by an LLC. This interest may be evidenced by a certificate of the interest issued by the LLC and may also provide for the transfer of any interest that the certificate represents. The only interest a member may freely transfer is the member's rights to distributions from the LLC. A transferee may only acquire the remaining rights by being admitted as a member of the LLC by all of the remaining members. A transferee who is not admitted as a member is not entitled to participate in management, require acts to obtain information, or inspect a copy of the LLC records. The only rights of a transferee are to receive the distribution to which the transferor would otherwise be entitled, receive a limited statement of accounting, and seek a judicial dissolution under the Model Act. A judgment creditor may only receive the member's right to receive distributions from the LLC and seek judicial **liquidation** of the LLC. This is accomplished by obtaining a charging order.
- *Dissolution:* An LLC is dissolved on: (1) the occurrence of a specific event described in the operating agreement, (2) the consent of the number of members specified in the operating agreement, or (3) the dissociation of a member-manager, or if none, a member of an at-will LLC, for any reason. The term *dissociation* relates to the change in relationships among the dissociated member, the remaining members, and the LLC. If the member files a bankruptcy or the equivalent thereof, dies, or is deemed mentally incompetent, the LLC will dissolve unless continued by a vote of a majority of the remaining members.

HOW CAN AN LLC BENEFIT YOU?

An LLC is a flexible and relatively easy-to-use form of owning a business or investment. It can provide you with favorable income tax results (flow through—see Chapter 3), liability protection (see Chapter 3), avoidance of ancillary probate (see Chapter 12), control (see Chapter 16), estate tax benefits (see Chapter 12), and other benefits as well.

LLCs Combine the Best of Corporate and Partnership Attributes

An LLC can be viewed as a hybrid entity combining the characteristics and, importantly, the benefits of a corporation and a partnership. If an LLC is properly structured, it will be taxed as a partnership (unless there

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are specific reasons why corporate taxation is preferred). This means that only one level of taxation will occur, not two layers as with a corporation (C or regular corporation). (**Note:** Proposals have been made to eliminate this double taxation by making shareholder receipts of dividends tax free. As of the date this book went to press, these proposals had not been acted upon.) This benefit can be obtained without the complexity required for an **S corporation**, which also has one level of tax. Prior to LLCs, the S corporation had been the most popular way to organize businesses because it afforded owners **limited liability** (like a corporation) and flow-through tax treatment (like a partnership). However, qualifying as an S corporation involves complex requirements and limitations as to type of stock, shareholders, deductibility of losses, and so on, which an LLC does not.

With limited liability for its members, an LLC resembles a corporation. The members of an LLC, like shareholders of a corporation, are generally not responsible for the debts and obligations of the LLC beyond their **contributions** to it. This is a tremendous benefit for anyone owning real estate or a business that could trigger a suit or claim. An LLC, if properly structured, is not taxed at the entity level like a regular corporation. Instead, LLC profits are taxed on its owners' individual tax returns, like partners in a partnership.

ABILITY TO CONTROL BENEFITS

A third and equally important benefit of an LLC is the ability of all of its members to manage and control the business without causing the LLC to be taxed as a corporation. For businesses, but especially for family investment companies, this is an important attribute. Many parents would not make **gifts** of equity in a family business if they could not continue to control operations. For family or other **closely held businesses**, it can be desirable to give management participation to a child or other key person. An LLC can permit this. Members of an LLC can directly participate in the company's management or can elect business managers. The members' ability to participate in the LLC's management distinguishes LLCs from limited partnerships in which only the **general partner** can be involved in management. If **limited partners** engage in management, they risk losing their limited liability. Many benefits of an LLC are available without the restrictions faced by corporations and partnerships.

NOTE: The ability of all members to manage is something that should be addressed very carefully in the operating agreement. What decisions can various members make? What percentage of members should approve a major decision, for example, selling the business?

An LLC is governed by a contract between its owners (members) called an *operating agreement*. This is analogous to a shareholders' agreement for the owners (shareholders) of a corporation, or a partnership agreement among partners. The operating agreement can address an almost endless array of control and management provisions. This flexibility is a major benefit of the LLC format.

An LLC Provides Limited Liability

For any business or real estate owner, protecting the nonbusiness or non-real estate assets from lawsuits emanating from the business or real estate is a key planning goal. If an LLC owns your widget factory or rental house, a lawsuit should not be able to reach your personal assets.

Although the LLC can solve many of the problems associated with the previously mentioned business entities, it does not eliminate all problems of business owners. For most closely held small businesses, the principal owners likely will be required to personally sign leases, bank loans, and other legal documents, and provide personal guarantees, whether the business is a corporation, partnership, or LLC. Thus, an important practical limitation on achieving limited personal liability of a business' owners will remain despite using the LLC format. In addition, the members could still be liable for certain liabilities such as the nonpayment of payroll taxes that have been withheld from employees and not turned over to the IRS or the state taxing authorities. The same holds true for sales taxes and for infractions of certain environmental regulations.

This practical limitation, however, does not negate the importance of achieving limited liability to a business' owners. This is because an LLC, like a **C corporation**, S corporation and limited partnership with a corporate general partner, provides limitations on nonmonetary liabilities (e.g., a customer slipping and injuring himself on the business premises). While a principal owner in any of these entities may have to personally guarantee a bank loan, the proper use of an entity to own and operate the business will provide limitations on an owner's liability from lawsuits and other claims (e.g., environmental and tort liabilities). To the extent that an LLC can provide a simpler method of achieving limited liability it will be more effective and practical. The simplicity of an LLC is attractive to business owners and investors and is increasingly used by them.

Estate Planning Benefits

With or without an estate tax, LLCs can be useful in avoiding ancillary probate (i.e., the process of proving and admitting your will in a state

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other than the state in which you live) and taxes. If you have real estate in another state, having an LLC own it can avoid the costs, taxes, and difficulties of ancillary probate. For parents or others looking to transfer assets or business interests to children in a controlled manner, using an LLC is an excellent technique. If you have an expensive asset that you want to give to your children using the annual gift tax exclusion (currently \$11,000, but inflation indexed), you can give it to an LLC and then give ownership (membership) interests in the LLC to your children or a trust for their benefit. Thus, an LLC provides a way to divide ownership into small pieces to facilitate gift giving.

USAGE AND TERMINOLOGY

Since almost every LLC with more than one member will be treated as a partnership for income tax purposes, the terms *partnership* and *LLC* are interchangeable in the tax aspects of the discussions. Since partnerships have been around for decades longer than LLCs, most of the tax laws, cases, and regulations and rulings issued by the IRS refer to partnerships. For most of these, however (except to the extent that the decision is based on underlying state laws that can differ in important ways for partnerships and LLCs), the analysis is interchangeable. Thus, although this book is about LLCs, many of the income tax comments may mention, or be based on, partnership terminology.

Explaining complex LLC tax, legal, securities, and other concepts to those without legal training is quite a challenge. Because our focus is on these matters, we have opted not to complicate sentence structure or examples to make them gender neutral or equal. Throughout, the discussions pertain to both male and female readers.

SUMMARY

The LLC is a relatively new form of business entity that has come into existence in the United States largely in the past 10 years. The LLC combines the best tax and legal features of a partnership and a corporation. The LLC can provide its owners with the tax benefits traditionally associated with the partnership business entity and the limited liability protection traditionally associated with the corporate form of doing business. The result is that LLCs have become the favored form for new business and investment undertakings.