

- » Getting an overview of important LLC topics
- » Creating your plan of attack
- » Knowing the essentials for operating an LLC

Chapter 1

What Is an LLC, Really?

The Limited Liability Company (more commonly known by its acronym, LLC) is by far the most popular business structure. Only two decades ago, the LLC was the new kid on the block — untrusted and unverified. Luckily, that changed pretty rapidly — LLCs gained popularity and, within a short time, became firmly established in the business world. Since then, LLC has become a household term, and for good reason.

The LLC is a complete divergence from the predominant business structure at the time, the corporation. While corporations have a fixed management structure, LLCs offer *flexibility*. While corporations have strict rules regarding owners and profit distributions, LLCs are adjustable. While corporations are stuck with corporate taxation (or its limited variant, S corporation taxation), with an LLC, you can select whichever form of taxation you prefer. The added flexibility of the LLC enables you to build a solid foundation for your business that works for your *exact* circumstances.

Great, right? Well . . . yes and no. With all the hoopla and the incessant commercials from filing companies, we all know how easy it is to file an LLC. However, very few folks can really explain how an LLC works or why an LLC is right for your situation — or, even worse, how to actually *structure* an LLC after receiving that one-page filing back from the state. Aside from hiring a pricey attorney to do all the work (not an option for most people), most of your peers don't know how to do simple things like issue the ownership properly or formally agree on what happens if one of the partners wants to leave.

The LLC is a powerful tool, but if you don't know how to use it — how to build that crucial foundation that will support your greatest potential — then it really amounts to nothing more than the piece of paper on which your formation document is printed . . . and possibly a few lawsuits along the way.

I go into detail on setting up an LLC for your specific circumstances later in the book, but first, I want to give you an overview — or a refresher if you're a seasoned pro — on the meat and bones of this awesome business structure.

Understanding How LLCs Work

Think of an LLC as a partnership on steroids. If you and a buddy were to get together and start a business without registering it as any particular business structure with the state, your business would automatically be considered a general partnership. All business income and losses would be reflected on your personal tax returns. No rigid formalities would be required — you could literally draft your agreements on a napkin.

The problem is, what happens if you want to raise capital? The business is made up of only you and your partner and possibly some assets you've acquired along the way. You can't exactly sell pieces of yourself. Or what if your partner ends up being, well, a jerk? Or even worse, a jerk who runs up a lot of debts that you could be personally responsible for? Eek! As unfair as it sounds, that was the reality for most partnerships. . .until the LLC came along.

The LLC takes all the best features of a partnership (pass-through taxation — defined at the end of this chapter — and no hefty burdens of corporate formalities) and the best features of a corporation (personal liability protection and ownership shares) and for good measure, adds a few extra perks, like the capability to choose your form of taxation and a formal yet flexible management structure. In addition, the LLC can offer a second layer of liability protection that shields the business from any personal lawsuits that may befall you (referred to as *charging order protection*, which I elaborate on in Chapter 16).

If all this sounds like Martian to you, don't worry. In this chapter, I dive into some of those benefits and other LLC fundamentals while steering you toward other chapters in the book where you can read about specific topics in more detail.

Owners: You gotta have 'em

Although LLCs are separate from their owners in many ways, LLCs still require owners. An LLC without an owner is like a child without parents: It simply doesn't exist. So, even though you may have called up a filing company and filed your LLC with the state, it doesn't become its own legitimate entity until you go through the process of doling out ownership in your LLC.

The owners of an LLC are called *members*. They have units of ownership called *membership interests* that show what percentage of the company they own and how much influence they have when voting on important company matters. Membership interests in an LLC are comparable to stock in a corporation. However, unlike the S corporation, which is often compared to the LLC, an LLC can have unlimited members of any type. Members can be citizens of other countries or even entities, such as corporations, partnerships, or trusts.

Unlike corporations, LLCs offer a lot of flexibility in how you issue membership. For instance, your LLC can have many different forms of membership called *classes*. You can set whatever rules you like for each class. If you structure them properly, classes are a great way to entice investors or partners to join your business — some folks may want a bigger piece of the profits up front, while others may want more control. For example, one membership class can get first dibs on the profit distributions, while another class only gets paid with what's left over. Or one class can have a say in managing the company, while another class must remain silent. With an LLC, you can mirror the LLC membership classes to match your individual partners' priorities and needs.

The owners of an LLC not only own the entire business and all its assets but also generally have the final say. Although they may not all manage the business's day-to-day operations, they *do* elect the managers. They vote on important issues and ultimately control the company's fate. In Chapter 9, I go into more detail on membership, including how to issue it and structure it in a way that works for your business.



TECHNICAL
STUFF

When it comes to reading state laws, the actual term for LLC members and their membership interests can vary from state to state. For example, in some states, the membership interest is called *ownership interest* or *limited liability company interest*. Just keep in mind that no matter what they're called, the concepts are the same.

If your LLC has only one member, it's called a *single-member LLC*. Unless the single-member LLC elects corporate taxation (which I'll show you how to do in Chapter 7), the IRS treats it as a sole proprietorship — or *disregarded entity* — for tax purposes.

All states now allow single-member LLCs. (It took a while for a few states to jump on the bandwagon – I’m looking at you, Massachusetts). However, in a few states, because of certain court rulings, single-member LLCs can be disadvantageous for certain purposes — they aren’t afforded the benefit of partnership taxation and aren’t guaranteed *charging order protection*, which protects the LLC from lawsuits that may be filed against you personally. I discuss this concept in depth in Chapter 16.

Contributions: Where the money comes from

When you buy a share of stock on the stock market, the money you pay is what you are contributing (or *investing*) in return for a percentage (or *share*) of the company’s ownership. Well, purchasing ownership in an LLC is very similar: In exchange for a membership interest in the company, a person or company must contribute something of value. This contribution can be in cash, services, hard assets such as equipment, real estate, or even promissory notes (which are allowed in some states).

When a new business is formed, all the initial owners, or *founding members*, come together and pool the value of their contributions. Let’s say Jane contributes \$100,000 in cash, Chris contributes \$5,000 in cash and \$25,000 in services, and Joe contributes an office building worth \$150,000. The combined total of their contributions is \$280,000. To determine each person’s percentage of ownership in the LLC, they simply divide their contributions by the total. The result: Jane gets 35.7 percent, Chris 10.7 percent, and Joe 53.6 percent.



TECHNICAL
STUFF

After you figure out each owner’s percentage of ownership, determining their *membership interest* in the company is easy. Given the previous example, if the LLC has 1,000 membership shares, then Jane’s 35.7 percent ownership in the company translates to 357 membership shares, Chris’s 10.7 percent results in 107 membership shares, and Joe’s 53.6 percent results in 536 membership shares. I dive into more details on issuing membership in Chapter 9.

The contributions made by the founding members (those on board when the company was formed) and their corresponding membership interests are listed in the LLC’s operating agreement. That way, it’s documented that all the owners know what everyone else is contributing to the business and agrees on the value of those contributions.

Things get a bit more complicated when a new member joins an existing company. Newly formed companies have no value — assets are added as contributions. However, things can get weird when a business has been in operation for a

while and elects to bring on additional contributions (and often new members). I mean, is Apple still worth the \$10,000 it took to get things going in Steve Jobs's garage? Ha! Not even close. As businesses evolve, they increase in value. In Chapter 10, I go over the intricacies of taking on new capital and issuing membership in existing businesses.

Some LLCs issue membership certificates that, like stock certificates in a corporation, are paper evidence of the amount of ownership a member has in the company (although these are now often in digital form). The membership certificate displays the member's name and the number of membership shares the person owns. However, physical membership certificates are no longer a legal requirement in most states, and their digital form has replaced the paper version, like so many other things in our lives.

Regardless of whether your LLC issues membership certificates, your membership interest should be listed in the operating agreement next to your contribution amount. (In Chapter 9, I show you how to properly list your members, their contributions, and their membership interests in your operating agreement.)

Allocations and distributions: Getting what you're due

After an LLC starts turning a profit, the members will no doubt want to benefit. After all, they didn't invest their hard-earned money in the company for nothing — they want to see a return! At certain times — usually at the end of the year, but sometimes at the end of each quarter — company profits can be calculated and doled out to each member, usually in proportion to their percentage of ownership. These payments are called *distributions* and are generally cash (see Chapters 9 and 13 for more on distributions).

Now, as many of you savvy entrepreneurs know, growing a business is hard enough without draining it of its much-needed cash in the first few years. You'll hold off on sending checks to the investors and instead use that revenue to grow the business. But what happens when your business still shows a profit at the end of the tax year? Maybe you're saving up to purchase property or other assets pertaining to the business. Well, unfortunately, Uncle Sam still wants his share. And with the partnership form of taxation (how most LLCs elect to be taxed), the owners of the LLC are still *allocated* this revenue and must pay tax on it . . . even though they never saw the cash.

I dive into this topic in more detail in Chapter 7, where I discuss the different forms of taxation that an LLC can elect. Until then, just know that if you elect the most common form of LLC taxation — partnership taxation — then you need to

understand the differences between *allocations* and *distributions*. Allocations are the profits on which you and your partners have to pay taxes. Distributions are the money you actually *get*, in your pocket, ready to be spent on that new backcountry snowboard you've been craving.



TIP

Unlike corporations, LLCs don't necessarily have to distribute profits proportionately to the members' percentage of ownership. The members can decide to vary the distributions however they want. The IRS generally allows this practice as long as you pass their tests (mainly to prove that you aren't varying the distributions simply to avoid taxes). This strategy gets complex, and I dive into it a bit more in Chapters 9 and 13; however, if used correctly, it can result in some huge incentives for powerful partners and investors to join your team.

Distributions also occur if your LLC goes out of business, but they're handled differently in this case. The LLC's assets are liquidated, the creditors are paid back (including any members to whom the business owes money), and then the remaining amount is distributed to the members according to their membership interests or, more specifically, their *capital accounts*. Capital accounts can be, well . . . complex. But an easy way to think of them is how your percentage interest evolves over time as more contributions to the company are made. They also tend to keep accountants in business.

The key takeaway here is this: When the final distributions are made, you can't choose how the money is distributed — it must be doled out according to the balance of each member's capital account.

Management: Some folks are just better at it

Just because you own it doesn't mean you need to know what to do with it. LLCs have a *manager* role — a person who handles the company's day-to-day operations. All LLCs are required to have at least one manager. They can be the owners themselves or other outside persons or businesses.

Two types of LLCs exist:

- » A *member-managed* LLC is managed jointly by all of its members.
- » A *manager-managed* LLC is managed by one or more — but not all — members or by separate (non-owner) managers.

THE BIRTH OF THE LLC

The LLC didn't come out of nowhere. Business entities with the same characteristics as LLCs have been around for many years. The origin of LLCs can be traced back to 1892, when German law enacted the *Gesellschaft mit beschränkter Haftung* (GmbH) — a modern-day variation of the English private limited company.

Germany's GmbH format was copied throughout Europe and Central and South America. This concept remains popular in many parts of the world.

In the United States, limited partnership associations actually predated the German concept. These entities were formed in several Midwestern states starting as early as 1874. However, this entity structure soon fell out of favor. The LLC was born in Wyoming in 1977 and modeled after the German GmbH and the successful Panama variation. LLCs didn't become popular nationally until 1988, when the IRS ruled that LLCs could be taxed as partnerships. And the rest, as they say, is history!

If you are forming an LLC with only a few owners (members), and each owner will have a say in managing the company, then you may want to choose member management. However, if you decide to take on a silent partner who is *not* managing the business daily, your LLC needs to be manager-managed. All members, except for the silent partner, are listed as managers.



REMEMBER

Unless *all* members manage the company's day-to-day business, your LLC is considered manager-managed.

Creating Your Own LLC: Your First Step Toward Success

You need to go through a few processes to get your LLC filed, structured, and up and running. You don't have to be a lawyer or an über-savvy entrepreneur to get it right.

If you've listened to the radio or watched TV in the past few years, you're probably well aware that filing an LLC is as simple as "one low fee." However, the important stuff comes before and after you call up a formation company or fill out a quick form and send it to the state. That's where the big decisions come into play, and the real structuring of your company takes place. So, let's get started.



TIP

As you flip through this book, the concepts may seem overwhelming at first, but after you get familiar with a little bit of industry terminology, you'll have a basic understanding of LLCs to get started on your own. See the glossary at the back of the book for all the need-to-know terms.

Educating yourself

The first thing to do is gain a little bit of education about LLCs. I know you're busy, so this doesn't have to be too extensive. You just need to know the basics, and the best way to start is by reading this book. Needless to say, you're on the right track!

You can always use professionals to do the work for you. And that's okay. Hey, I'm all for delegation! Just make sure that you have a basic understanding so you can have productive and educated conversations with the people you hire. Not to mention that you want to have an idea of whether they really know their stuff. (You'd be surprised how many don't.)

Only after you understand the basics should you call your attorney or accountant and ask about details that pertain to your situation. You may also want to do some research online and set up some free consultations with corporate consulting companies. If you have specific questions on the formation of your LLC, you can ask my team and me directly at <http://www.corpassure.com/>, and we'll get back to you as soon as possible.



CHECK IT
OUT

LLCs, like most entities, are subject to state oversight. The problem is that not all states are on the same page. As much as I wish I could include information about every state's laws, doing so would result in a page count rivaling *War and Peace*. (My wise editors at Wiley quashed that idea pretty quickly.) So, to make it easier for you to ensure that you're complying with the laws of the state(s) in which you transact business, I provide state-specific information about LLCs and all state LLC laws on a login-only website, especially for Dummies readers. You can access it by going to <http://www.corpassure.com/dummies> and entering the password **onesmartdummy**. Along with these additional resources, this book should give you everything you need to get started on the right path.

Divvying up the ownership

When starting your business, it's usually pretty clear who the owners will be. The real question becomes, how much ownership does an owner actually get? Sometimes, the answer is clear-cut, such as when all the owners contribute cash and nothing else (see the "Contributions: Where the money comes from" section earlier in this chapter). However, with most businesses, deciding who gets what isn't easy.

Often, businesses are started based on just an idea and possibly some savings pooled together. Say three people are in a room and think up an idea, and all three people get excited and decide to pursue it. The first thing that often comes to mind is that all three will be equal partners. After all, it's only fair, right? Each person is valuable and smart and equally excited as the others, so why not share the ownership equally? Right? *Wrong*. In my experience, misjudgments in structuring partnerships are the number-one reason a new business venture fails.

Ideas don't really have much value — at least as far as the law is concerned. It's the *execution* of those ideas that's valuable. So, yes, your crazy cousin Joe might have been in the room when the idea was brought up and thrown in a few asides that got you thinking, but that doesn't mean you need to bring him on as a full partner. In fact, there's a good chance you'll hate life if you do. You need to choose your business partners as carefully as you choose your spouse. Not only is there a very good chance that you'll see this person as much as — if not more than — your spouse, but the success of your business rides on you and your partners making crucial decisions synergistically.

We entrepreneurs are natural risk-takers. You may encounter a situation where you have a good feeling about a partner and want to take a chance on that person. Luckily, LLC membership enables you to do so by using *membership vesting*. A potential partner can earn (or *vest*) their ownership upon completing certain milestones or a fixed amount of time spent with the company. Don't be afraid to have these crucial conversations, and then go to Chapter 9 to find out how to structure the membership in your LLC in a way that promotes accountability.

Deciding who manages

If your LLC is a small business without investors, chances are it is a *member-managed* LLC, with all company members managing the day-to-day business equally. If you have silent partners or want to involve other non-owner managers, your LLC is likely *manager-managed*. This means one of two things:

- » Some, but not all, of the owners are also company managers.
- » An outside party (a person or company that is not an owner) is a company manager.



TECHNICAL
STUFF

All is not always fair and equal in the world of managers. All forms of LLCs allow for *management groups*. When structuring your LLC, you can create groups of managers, with each group having a different, clear-cut scope of responsibility and/or powers to make certain decisions or take certain actions pertaining to the day-to-day business of the LLC. These powers include taking out leases in the company's name, authorizing the company to take on debt, and hiring and firing employees.

Now, hearing the word *manager* probably brings you back to your first job slinging pizzas after school . . . and that pock-faced 18-year-old “manager” looking over your shoulder the entire time. But when it comes to LLCs, these low-level employees are not technically managers in the sense that we’re talking about here. Managers are the ones *fully* running the company, making the make-or-break decisions. They’re the ones who cosign the business loans and leases, for example.

Regardless of how your LLC is structured, I always recommend that a business have a clear leader when there are multiple managers. If not all the managers are willing to get on board with one leader, then at least make sure that their duties are clearly delineated. Isolating each manager’s realm of authority early on saves you a lot of future headaches over disagreements. You draft this delineation of duties in the LLC’s operating agreement, and it becomes a set part of the LLC’s structure that can be changed only by written agreement of the company’s members. I will show you how to do so in Chapter 9.



Although not super common, an LLC can also adopt the fixed management structure of a corporation — with a president, secretary, treasurer, and board of directors. This structure can be useful if you are in an industry or have an investor that is more comfortable with those common titles. You elect a corporate management structure in your LLC’s operating agreement.

Choosing your registered agent

Before you can file any formation paperwork for your LLC, you need to choose a *registered agent and registered office* (sometimes known as a *resident agent* or *statutory agent* or by its acronym RA). A registered agent (and its corresponding office) is a person — or, more commonly, a company — that serves as your *legal* office in the state where your LLC is registered. This office is *always* available during business hours, every single day, to accept formal legal documents for your company in the unfortunate instance that you are sued. It will have on file the addresses of the appropriate members of the LLC to which to forward this important documentation. Your LLC needs a registered agent in its home state (its *domicile*) and every other state where it transacts business.

Most registered agents allow you to use their office address for all your mail and other correspondence for an additional fee. A good registered agent should also stay on top of your state filings for you and help you make sure that your LLC remains in good standing in each state in which it is registered. This task can be onerous and important, so you’re better off leaving it to a professional service company or an attorney (a more expensive option). See Chapter 4 for more on using a registered agent.



WARNING

Even if your state allows you to serve as your own registered agent, I don't recommend it. Unless you plan on being at your office during business hours every single day, without exceptions, and you have a good grasp of all the state filings that need to be done, I suggest leaving it to the pros. If you are unavailable when a lawsuit is served, you could lose the case by default — without knowing about it until it's too late! Another consideration is that if you were sued, would you really want a process server or sheriff serving you a lawsuit in front of your customers? I wouldn't!

Bringing your LLC into existence

After you decide on a management structure for your LLC (member-managed or manager-managed) and on a registered agent, you are ready to file your LLC. Your LLC needs to be registered and receive approval in any state in which it is transacting business. Your LLC doesn't need to reside in the same state as you — it should reside wherever its headquarters will be. A company that doesn't have a headquarters (like a purely Internet-based company) should reside wherever the tax laws are most favorable.

If you don't go through a filing company to file the initial paperwork for your LLC, you can create your LLC yourself by drawing up a short document called the *articles of organization*. Your articles contain such basic information as the name of the company, how long the company will exist, the initial members or managers, and the name and address of the company's registered agent. In Chapter 5, I show you how to put together your articles of organization. After you're satisfied with your articles, you file them with your local secretary of state's office (or comparable state agency).



TECHNICAL
STUFF

In most states, the document that you use to file your LLC is called the articles of organization. However, some states refer to it as the *articles of formation* or *certificate of formation*.

Operating Your LLC

After you form your LLC, you're ready to start business operations, right? Not even close. Actually, your work has just begun. After you're registered, you still have to complete the *formation* of your LLC by creating your operating agreement and making some very important decisions. Luckily, you can handle most of these things while you're waiting for your filed documents to come back from the state, saving you time.

Operating your LLC is meant to be easy. Historically, the courts have become much easier on LLC owners who forget or fail to document something in writing. LLCs aren't like corporations, where a single misstep in following formalities can cost you your limited liability protection. Although this paperwork isn't nitpicked by the state statutes like corporation paperwork is, you still need it to maintain separation. Also, you can save yourself a lot of time, hassle, and potential legal battles by getting it out of the way and making your agreements as tight as a drum.

Creating your operating agreement

Think of your *operating agreement* as a sort of partnership agreement, except with much more power. Your operating agreement is the blueprint for your company. In it, you state your company's policies on important matters, including

- » How will the company be managed, and by whom?
- » How will important decisions be made?
- » How will profits be distributed among the owners?
- » What are the responsibilities and authority of the company managers?
- » What is the membership information? For example,
 - Who are the members?
 - What did that person contribute?
 - What membership interest have they been assigned?

Operating agreements are the best thing to have happened to the business world since the Internet. They make the LLC great because you can virtually put anything you want in your operating agreement. Except for some state requirements here and there, you can structure your LLC in any way you can imagine. *You* make the rules, not the government or the IRS. *You* say how you want your business to run, and then you structure it accordingly in the operating agreement.

Creating an operating agreement takes some time and planning, but it's vital to forming your LLC. With the wealth of information and provisions I provide throughout this book, you can draft an ironclad document. However, deciding what you want to put in it may take you and your partners a while. After all, you're creating an infrastructure that needs to serve you for many years.

After you create your operating agreement, ensure all the LLC members and managers sign it. Distribute a copy to everyone, and put the original in your company records kit, which brings me to the next point.

Keeping books and records

Every company needs to have a records kit. In this kit, all the crucial company documents and information are stored and remain accessible to all interested parties. In the old days, a company records kit was a big leather binder with the company name emblazoned on the side. Nowadays, the corporate kit is usually housed online, always accessible to all the owners, wherever they are.

Whether your corporate records kit lives in the physical world or the virtual world, it serves the same purpose: to house your important company records, such as your filed articles of organization and company charter, your operating agreement, resolutions, and minutes from any meetings or votes that take place, your membership roll, and your unissued membership certificates. In Chapter 12, I detail how to create and store your company's records.



REMEMBER

Although strict formalities aren't required for LLCs, documenting decisions in at least a semi-formal way maintains that your LLC is a business separate from you as an individual. Otherwise, the courts could claim that your LLC is an *alter ego*, and you could still lose your liability protection. In Chapter 12, I go over how to incorporate quick, easy documentation into your business processes to make your liability protection ironclad.

Paying taxes

One of the most beautiful features of an LLC is that it can elect any form of taxation it wants (assuming that it's not a single-member LLC). This means that your LLC can choose partnership taxation (the most powerful), corporation taxation, or S corporation taxation. What flexibility! I dedicate Chapter 7 to helping you understand these different forms of taxation. You should read it thoroughly before making this hugely important decision.

The default taxation for LLCs with more than one member is partnership taxation, so this form is what you'll be subject to if you don't elect otherwise. With partnership taxation, the business's profits and losses get passed on to the owners, who report their share on their personal tax returns. These portions of profits and losses passed to the members are called *allocations*. This type of taxation is commonly referred to as *pass-through taxation*.

Because the LLC doesn't have to pay taxes, the IRS only requires you to file an information statement (IRS **Form 1065**) stating how the company's profits and losses are allocated among the members. Additionally, the company issues each member an IRS form called a **Schedule K-1** that includes the information they need to determine how much tax they must pay on their share of the company's profits.



WARNING

An LLC isn't required to distribute cash to its members. However, the members *must* pay taxes on the profits (allocations) whether or not they receive distributions. When the company doesn't distribute profits to the members, the members still have to pay taxes on them out of their own pockets. This sort of "profit" is often referred to as *phantom income*. In other words, the members' profits are about as tangible as a ghost.

Hopefully, after reading this chapter, you will have a good overview of the important topics for forming your new LLC. So, feel free to skip to any section that currently applies to you!