

# *Limited Liability Company*

Limited liability companies are rapidly growing in popularity. Now authorized in the fifty states and the District of Columbia, these companies are an attractive organizational alternative well suited to serving the needs of many businesses and their owners.

In this guide, we answer some of the many questions you may have about limited liability companies. By necessity, our answers are framed only in very general terms. For more details as to how any of this information may apply to your specific situation, be sure to consult with us. We can address your questions and concerns in the context of your particular business situation and applicable state law.

## *WHAT IS A LIMITED LIABILITY COMPANY?*

A limited liability company, or LLC, is a form of business organization that combines certain features of a corporation and a partnership. Like a corporation, a properly structured LLC protects its owners (called "members") from personal liability for the debts and obligations of the organization. When all applicable tax law requirements are met, however, an LLC is taxed as a partnership instead of as a corporation for federal income-tax purposes. In the right circumstances, this combination of limited liability and partnership tax treatment can be highly advantageous to the LLC's owners.

## *HOW IS AN LLC FORMED?*

Generally, an LLC is formed pursuant to state law by filing a public document known as the "articles of organization." An operating agreement spelling out the arrangements agreed to by the members usually supplements the articles of organization.

## *WHAT KINDS OF BUSINESSES MIGHT BENEFIT FROM OPERATING AS AN LLC?*

Many tax and nontax factors can affect the choice of the best way to structure a business. Although LLCs are worth considering whenever limited liability and partnership taxation are sought, they may be particularly attractive for family businesses that have substantial exposure to product or other liability, for real estate investment, and for similar ventures. Professional firms also should carefully consider the possibility of forming an LLC or limited liability partnership (LLP) if state law so allows.

## *WHAT ARE THE KEY CONSIDERATIONS IN CONVERTING AN EXISTING BUSINESS TO AN LLC?*

The most significant consideration may be the tax consequences of conversion. These consequences will vary depending on the business's current structure (e.g., sole proprietorship, general partnership, limited partnership, regular corporation, or S corporation) and many other specific factors. Some existing businesses may find they can accomplish a tax-free conversion, while others may find the tax cost of converting prohibitive.

Where a single member LLC is allowed (such as in California), they can provide for many planning opportunities. Note that many states require an LLC to have at least two owners. However, an existing sole proprietorship or corporation owned by one shareholder could convert to an LLC as long as the newly formed LLC was set up to include at least one additional member.

Apart from taxes, a practical matter that may bear on a business's ability to successfully convert to an LLC may be its existing agreements and relationships with creditors. Before a conversion can be

implemented, the business would have to make sure it could make satisfactory arrangements with its existing creditors or secure alternative financing.

### *IS AN LLC'S LIABILITY SHIELD EFFECTIVE IN ALL CIRCUMSTANCES?*

Most experts agree that the liability protection of an LLC appears to be as good as that of a corporation. However, as with a corporation, this protection does have boundaries.

For example, an LLC generally does not shield its organizers or owners from liability arising from the false statements made in the LLC's organizing documents. Similarly, if the business begins operations before the LLC is officially created under state law, the liability shield may be ineffective. For this reason, it is extremely important that those organizing and operating the LLC strictly adhere to all legal formalities right from the start.

Generally, LLC members are not liable on contracts made on behalf of the LLC. However, if a member personally guarantees a loan or other LLC obligation, he or she can be held personally liable for fulfilling the obligation. LLC members also may be liable for their own intentional misconduct or for other personal actions, including professional malpractice, even if these occur while performing services for the LLC.

Finally, although LLCs are still a relatively untested legal entity, the courts presumably will apply the concept of "piercing the corporate veil" (setting aside the liability shield and holding a shareholder personally liable) to limited liability companies and their members in certain abusive situations.

### *WHY IS TAXATION AS A PARTNERSHIP BENEFICIAL?*

From a federal income tax viewpoint, partnerships (and LLCs taxed as partnerships) are very flexible. The business itself pays no federal income taxes. Instead, all income, losses, deductions, and credits "flow through" to the owners, who report their respective shares of these items on their own income-tax returns.

By contrast, the earnings of a regular "C" corporation are potentially subject to double taxation. The corporation itself pays income taxes on the corporate taxable income. Then, when that income is distributed to the corporation's shareholders as dividends, the shareholders pay tax on the income again. Moreover, both the corporation and its shareholders may have to pay income taxes when the corporation liquidates.

Another tax advantage shared by partnerships and LLCs taxed as partnerships is the ability to make special allocations of income, loss, and credits to their partners or members. By making special allocations, an LLC can pass along tax benefits (e.g., depreciation deductions) to the members best able to take advantage of them and also gain considerable other tax-planning flexibility. Special allocations are allowed as long as they have "substantial economic effect" and meet all other tax law requirements.

States may require an LLC to pay some tax on their income as opposed to federal income tax laws.

### *IS AN LLC SUPERIOR TO A PARTNERSHIP IN ANY WAY?*

An LLC can allow members to be involved in managing the business without exposure to personal liability for the LLC's debts and obligations. In a partnership, the general partner retains personal

liability. (Every partnership must have at least one general partner.) Any limited partners, although shielded from personal liability, cannot participate in the partnership's management.

To circumvent the liability problem, many partnerships are structured as limited partnerships with a corporate general partner. While this approach can be effective, it requires the creation of two entities – the partnership and the corporation – with the related recordkeeping and reporting requirements. Forming a single LLC may be a more streamlined approach.

## *ADVANTAGES*

### **Typical benefits of operating as an LLC include:**

Owners (called "members") protected from "personal" liability for debts of the business

Members can participate in management and still gain personal liability protection

Partnership taxation – no double taxation, flexible allocations

Few restrictions on ownership

Can operate most kinds of businesses

## *HOW DOES AN LLC COMPARE TO AN S CORPORATION?*

Like an LLC taxed as a partnership, an S corporation (a corporation that elects to be taxed under the provisions of Subchapter S of the Internal Revenue Code) is also a "pass-through entity. Thus, except in certain special situations, an S corporation pays no federal income taxes. The corporation's shareholders report their pro rata share of corporate income, loss, deductions, and credits on their own federal income-tax returns. Unlike an LLC, however, an S corporation does not have the flexibility to make special allocations of these items.

The tax law places a number of restrictions on S corporations that may make electing S status unworkable for some businesses.

## *WILL AN LLC BE TAXED AS A PARTNERSHIP?*

The rules for taxing an LLC as a partnership for federal income tax purposes have been simplified so that most LLCs with two or more members can elect to be taxed as a partnership.

## *HOW DOES AN LLC COMPARE?*

### **Limited Liability:**

LLC - Yes

Corporation - Yes

S Corporation - Yes

Partnership - No

Limited Partnership - Only for limited partners

**Federal Income Tax on Equity:**

LLC - No

Corporation - Yes

S Corporation - No (some exceptions)

Partnership - No

Limited Partnership - No

**Double Taxation:**

LLC - No

Corporation - Yes

S Corporation - No (some exceptions)

Partnership - No

Limited Partnership - No

**Allocations of Income/Expenses:**

LLC - Yes

Corporation - No

S Corporation - Yes (pro rata only)

Partnership - Yes

Limited Partnership - Yes

**Ownership Restrictions:**

LLC - No

Corporation - No

S Corporation - Yes

Partnership - No

Limited Partnership - No

### *A COMPARISON OF COMMONLY USED TERMS*

Although the precise legal definitions of these terms vary, they equate to one another in a very general sense as follows when used in the context of a limited liability company, corporation, or partnership.

#### **Who owns the business?**

LLC: members

Corporation: shareholders

Partnership: partners

#### **What is owned?**

LLC: membership

Corporation: share

Partnership: partnership

#### **Who manages the business?**

LLC: managers or members

Corporation: board of directors and officers

Partnership: general partners

#### **Document creating the entity:**

LLC: articles of organization (in most states)

Corporation: certificate of incorporation

Partnership: partnership agreement or certificate of limited partnership

#### **Agreement detailing specifics about rights, responsibilities, etc.:**

LLC: operating agreement

Corporation: bylaws; shareholders' agreement

Partnership: partnership agreement

### *POTENTIAL DISADVANTAGES*

#### **Some of an LLC's potential drawbacks are:**

Relatively new business form largely untested on legal issues

Differences in state law High tax cost of converting to an LLC for some businesses

Some states assess a tax on the LLC such as an annual fee and/or a tax based on revenue

### *WHAT ARE THE POTENTIAL DISADVANTAGES OF OPERATING AS AN LLC?*

Because the LLC is a relatively new form of business organization in the United States, it is as yet largely untested in the courts. The lack of established case law and uniformity may be viewed as possible disadvantages. Also some tax issues remain unresolved.

### *CONCLUSION*

The limited liability company is a welcome addition to the business organization menu that brings with it new planning challenges and opportunities. As use of the limited liability company becomes more widespread, we expect that most of the unanswered questions about it will be wholly or partly resolved. In turn, new issues may emerge.

As always, our firm is prepared to assist you in evaluating the best alternatives for you and your business.

This is designed to provide accurate and authoritative information in regard to the subject matter covered. It is provided with the understanding that it does not constitute legal, accounting, or other professional service. If expert assistance is required, the services of a competent professional should be sought.

*For more information on any of our services, please contact Stephen A. Colley today.*