LIMITED LIABILITY COMPANIES: AN INTRODUCTION

A limited liability company is a business structure that can be used as an alternative to a corporation or partnership. It offers limited liability for business owners and a single level of tax on its income. Thus, it can provide limited liability like a corporation and can be taxed like a partnership. Unlike a limited partnership, no owner of the LLC must bear unlimited liability for the obligations of the entity.

The authority to form a limited liability company (or "LLC") is given by state law, like the authority to form a corporation, general partnership or limited partnership. Since 1977 all states have enacted LLC statutes. The California Limited Liability Act became effective in 1994.

- An LLC is created by filing with the designated state authority (such as the Secretary of State) *"articles of organization"* (which resemble articles of incorporation or a certificate of limited partnership).
- The rights and duties of the owners and managers are set out in an *"operating agreement"* (like a partnership agreement) among the owners.
- The ownership interests in an LLC are called *"LLC interests"* (like "partnership interests" and in contrast to "stock" in a corporation). Voting interests are called "*membership interests*."
- The owners of the LLC interests are called *"members"* (in contrast to "partners" or "shareholders"). An LLC must have one or more members.
- An LLC may have one or more *managers*, who may or may not be members. It may also have a board of directors and/or officers like a corporation (president, vice presidents, secretary, chief financial officer, etc.).

Limited Liability. If the LLC is properly funded and operated, the liability limitation is not in doubt. However, it will be possible to "pierce the veil" of an LLC and to hold the members liable for the LLC's liabilities if the members do not respect the separateness of the LLC, under-fund and under-insure it, and/or let others believe that they are doing business with the owners or with a partnership, and not with the LLC. These are the circumstances that would allow a judge to "pierce the corporate veil" in all states.

Taxed Like a Partnership. An LLC with more than one member is treated as a partnership under federal tax law and under the tax laws of most states. Consequently, the members pay tax on their shares of the LLC's income and benefit from its losses (subject to various loss limitations).

Some states, including Texas and Pennsylvania, tax the LLC's income. California imposes on LLCs an annual $800 minimum tax (like the $800 annual minimum tax applicable to limited partnerships and corporations) and a "total receipts" tax (which would apply even if the LLC has losses for tax purposes) of up to $11,790 annually. For LLCs with less than $5 million in total receipts, the tax is less.

Because an LLC with more than one member is taxed like a partnership, it has several advantages over an S corporation:

- There are no limitations on the type or number of LLC members and there are few limitations on the LLC's structure. In contrast, only U.S. citizens, resident aliens, estates, certain trusts and other S corporations can hold S corporation shares; there can be no more than 75 shareholders of an S corporation and it can have only one class of stock. Violating any of these rules will cause the S corporation to become a C corporation for at least five years, and to be subject to a corporate-level tax on earnings and a shareholder-level tax on distributions. The absence of these S corporation limitations makes it much easier to bring in new members and to tailor their interests to their financial expectations.

- When an LLC borrows, it increases the amount of losses that its members can use to offset income from other sources. In contrast, an S corporation's debt, even if guaranteed by the shareholders, does not increase the amount of losses the shareholders can use to offset other income. (The at risk and passive activity loss limitations apply to losses that flow through to the owners of

S corporations, partnerships and LLCs.)

- When an LLC interest is transferred (including a transfer at death) and the transferee has a greater tax basis in the LLC interest than the transferor, the LLC can elect to adjust the "inside basis" attributable to the transferee's interest, thereby accelerating tax benefits (for example, by increasing depreciation deductions or reducing gain on the disposition of the LLC's assets). This election is not available to S corporations.

- Appreciated property generally can be distributed from an LLC without triggering tax on the appreciation. This is not possible with an S corporation.

Tax Classification. An LLC with more than one member can be classified for tax purposes as either a partnership (the default status) or a corporation. An LLC with a single member can be disregarded (the default) or taxed as a corporation. The taxpayer elects the tax classification.

Using the LLC. The LLC can be used instead of a limited partnership, especially a limited partnership with a corporate general partner created for that purpose. Unlike limited partners, the LLC members can participate in the management of the business without risking liability as general partners. This might allow LLC members to characterize their income and loss from the LLC as active and thus not subject to the passive loss limitations.

Most limited partnerships can convert to LLCs with little tax cost. However, there might be income, property or sales tax costs for others, so each situation must be separately evaluated.

Closely-held holding companies that maintain subsidiaries to isolate their liabilities can replace the subsidiaries with LLCs, perhaps converting the holding company to an S corporation and thus avoiding (prospectively) the penalty taxes on personal holding companies and on excess accumulated earnings.

Most S corporations with substantial appreciated property or goodwill will not convert to LLCs. To do so, they must liquidate for tax purposes, which will generate tax on all of the appreciation in the corporate assets, including goodwill.

LLCs can be used for joint ventures that otherwise would be organized as general partnerships, limited partnerships or jointly-owned corporations. The LLC would shield the existing business assets from claims arising in the operation of the joint venture, while minimizing the tax costs of taking cash out of the venture.

For a "family limited partnership" that holds real property, the LLC is a better entity than the limited partnership, because none of the member of the LLC have unlimited liability like the general partners of a limited partnership. Often this is not a concern for the parents who create the entity, but it is a big issue for the child who succeeds them as manager and wants to avoid personal liability for environmental problems lurking under the surface of the real property.

We would be pleased to answer your questions about limited liability companies.

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