

LIMITED LIABILITY COMPANIES 101

James R. McMaster and Michael Dubetz
Sherman & Howard L.L.C.
(303) 299-8005 jmcmaster@sah.com
(303) 299-8164 mdubetz@sah.com

January 2006

What Are Limited Liability Companies?

Limited liability companies, or LLCs, are a relatively new form of business entity that were first recognized as a form of business entity by the State of Wyoming in 1977, although they were not widely adopted until the Internal Revenue Service recognized them as “pass through” entities for federal tax purposes in 1988. In 1990, Colorado became the third state to recognize the LLC, and now all 50 states have LLC statutes. As the name implies, a limited liability company shields its owners from personal liability for the acts of the entity, just like a corporation. However, an LLC has the advantage of being treated as a “pass through” entity for the purpose of federal and most state tax laws, meaning that its profits are only taxed at the owner, or “member” level. A C-corporation’s profits, on the other hand, are taxed at the corporate level while any dividends distributed are also taxed at the individual shareholder level.

Nuts and Bolts

The creation of an LLC is quite simple. In Colorado, it can be done over the Internet and simply requires the filing of a short form entitled “Articles of Organization” with the Colorado Secretary of State and the payment of \$25 online, or \$125 in person. The real working components of an LLC are in its “Operating Agreement,” a document signed by the members which details the economic and governance characteristics of the entity. In fact, the operating agreement is much more important than the LLC statutes, which give surprisingly little guidance on the workings of LLCs. To this point, in Colorado, with a few limited exceptions, the statutes expressly defer to the operating agreement when the two conflict.

Management

The management of an LLC is almost wholly a function of the operating agreement. This is very different than corporations, which are required by statute to have shareholders, regular shareholder meetings, directors, regular director meetings, officers and so forth; while there is some flexibility in what is contained in the articles of incorporation and bylaws, all corporations have the same general corporate governance structure.

LLCs, on the other hand, have unlimited options of how to structure their management. Generally, these fall into one of three categories or a hybrid of the three. The first of these is a member-managed LLC in which the members directly manage the affairs of the entity. The second form of governance commonly used by LLCs is the manager-managed LLC in which the members delegate most decisions to elected managers with only a handful of fundamental decisions being subject to member approval. The third general management structure is the

corporate model whereby the operating agreement parallels the corporate statutes, or if desired, cites directly to them.

In each case, the provisions of the operating agreement should be carefully drafted because there is no meaningful statutory or case law backstop.

Advantages of an LLC

As described above, one advantage that an LLC offers over a corporation is the pass-through tax treatment. A corporation can achieve tax treatment similar to that of an LLC by making an “S election,” but the ability to make such an election is limited by the type and number of shareholders, as well as the requirement that an S-corporation have only one class of stock. An LLC, on the other hand, has no such constraints on owners or classes of stock.

In addition to avoiding two levels of taxation on profits, pass-through treatment also allows members to write off their proportionate share of losses against other income, although this is subject to a number of limitations. In early stages where losses are significant, this can result in important tax savings to members.

Flexibility is another reason why the LLC has become so popular in recent years. The LLC form allows the members to be very creative. Within certain parameters, losses can be allocated to the members most able to use them, passive investors can receive a higher return than founders until their initial investments are paid off, management power can be allocated in a number of ways, and so forth. This flexibility gives thoughtful planners a myriad of ways to build tax and other efficiencies into an LLC that are not available to C- or S-corporations.

Perceived Disadvantages

The flexibility described above is also viewed as a disadvantage by some because it makes an LLC less predictable. Its governance and ownership attributes can vary widely, and because of the scarcity of statutory and case law regarding LLCs, some view LLCs with a wary eye. Nevertheless, acceptance of LLCs has grown with time, and it is now widespread.

In some ways, however, LLCs are more complicated than corporations. For accounting purposes, LLCs are treated like partnerships with capital accounts and all the accounting issues and complexities that arise with them. In sophisticated LLCs, the accounting can be quite arcane. As a result, membership interests may lose the fungibility associated with stock because different members’ ownership interests may have very different attributes.

LLCs also create the potential for phantom income, whereby taxable income of the LLC is attributed to the members even though no funds are actually distributed to pay the resulting taxes. This can also be an issue for S-corporation shareholders. If this is a concern for members, it can be dealt with by adding a provision to the operating agreement requiring the entity to make distributions approximating the members’ tax liability.

One distinct disadvantage of LLCs is the way distributions are treated for purposes of determining FICA and Medicaid withholding obligations. In an S-corporation, the corporation can designate a reasonable amount as a shareholder’s salary. This amount will be subject to

FICA and Medicaid withholding; however, the remaining profits can be distributed as dividends or retained in the corporation and not be subject to those payroll obligations. In an LLC, on the other hand, the IRS has taken the position that all of an employee type member's allocable share of profits, whether it is rationally related to services performed or not, are subject to FICA and Medicaid obligations. In the case of FICA, this is often not an issue because the wages subject to FICA are currently capped at approximately \$90,000. There is no corresponding cap on wages or salaries subject to the Medicare obligation, and while the individual's share of Medicare obligations is considerably smaller than for FICA (2.9% vs. 12.4%), this can still create a substantial marginal liability when it is applied ad infinitum.

Another disadvantage, or at least perceived disadvantage, of the LLC is that it is not an acceptable vehicle for initial public offerings or "IPOs" which many entrepreneurs, realistically or otherwise, view as the ultimate exit strategy. While it is true that there are very few publicly traded LLCs, the conversion of a limited liability company into a corporation may be accomplished prior to going public.

Additionally, an LLC cannot take part in a tax free reorganization in which an owner selling a business receives stock in the acquiring corporation or its parent as consideration for the sale. In a transaction meeting the requirements of Section 368(a) or (b) of the Code, the owner of a corporation does not pay taxes on the stock received until the stock is sold. An LLC owner, however, cannot take advantage of this provision. This is a disadvantage if the exit plan is to take part in an industry roll up and subsequent IPO.

Finally, entrepreneurs worry that it is difficult to offer stock options in an LLC. While strictly speaking this is true, the issuance of a "profits interest" in an LLC can usually achieve the same result.

Conclusion

LLCs often can provide a tax advantaged, flexible alternative to corporations. While there can be disadvantages, especially with respect to payroll taxes, the benefits of using LLCs often outweigh these disadvantages. Any entrepreneur seeking to start a new venture should consult their advisors about using an LLC.

DOCUMENT LOCATOR PAGE

C:\Documents and Settings\wmaccuis\Local Settings\Temporary Internet Files\OLK9A\LLC
ARTICLE 1.DOC

Created on: 6/29/2005 8:39 AM

Last Saved on: 1/24/2006 3:19:00 PM

Printed on: 1/30/2006 9:16 AM

In order to locate this document quickly, please keep this page with the attached document.
Thank you.

WARNING: You may need to delete the tag footer from this document. Please report any
problems with this macro to the User Support Specialist, x8080.