

# Limited Liability Companies (LLC):

## A Major New Form of Business Organization

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Michael Schneider, partner at Schneider, Luce, Quillinan and Morgan of Mountain View, rolled out a detailed explanation of Limited Liability Companies (LLCS) to the members of PASCCO's Corporate Real Estate Section. According to Schneider, the Limited Liability Company is a major new form of business organization. The following article is based on Schneider's talk and his materials.

### WHAT IS AN LLC?

An LLC is an important alternative to the three traditional forms of multi-owner business organization: general partnership, limited partnership and corporation.

In short, an LLC is a highly flexible business structure combining advantages of corporations such as limited liability and continuity of life, with advantages of partnerships such as taxation and informality.

An LLC must consist of two or more "members" (owners), and can be either "member-managed" like a partnership managed by its partners or "manager-managed" by third parties. Members can be individuals or entities such as partnerships, trusts, and corporations.

### WHY AN LLC?

On September 30, 1994, the California Legislature passed the California LLC Act joining 46 other states and the District of Columbia. The primary public purpose of the LLC Act was to promote commerce by giving owners of companies greater flexibility in conducting business.

*Advantages of LLC for organizing a company include:*

- Limited personal liability for owners and managers.
- Pass through taxation plus flexibility in allocating profit and loss.
- Modest formation costs.
- More flexible governance and structure than limited partnerships or corporations.

### WHEN AN LLC?

LLCs must have at least two owners ("members"). LLCs can be capitalized from scratch OR existing general or limited partnership or corporations can be converted into LLCs and their assets transferred.

According to Schneider, businesses well suited for LLCs include real estate, joint ventures, venture capital companies, high technology companies, and situations where partnerships or S corporations might normally be formed. However, LLCs are prohibited from professional practice (law, accounting, and other) and some financial businesses (banking, insurance, and trust companies).

### DISADVANTAGES OF LLC:

*Schneider cautioned that LLCs have some disadvantages in addition to their many advantages, as follows*

- The LLC is still a new and unfamiliar form of California business organization.
- LLC members could lose their partnership tax status with the IRS if

the LLC possesses two or more corporation characteristics (see below under Taxation).

- If an LLC engages in business in any of the few remaining states without LLC laws a court might not recognize LLC limited liability for activities in these states.
- Companies providing professional services such as law or accounting are not allowed to form an LLC, and LLC cannot engage in banking, insurance or trust business.
- Some fringe benefits for LLC members such as medical and group term life are not given as favorable tax treatment as for corporate shareholders.
- Although stock does not have to be issued, LLC members' interests may be defined as securities like limited partners' interests, and therefore the marketing of LLCs may then be regulated by securities law.

#### **TAXATION:**

*Schneider noted that a 1998 IRS ruling and subsequent IRS rulings have held that a properly structured LLC will be taxed as a partnership (pass through profits) not a corporation under the same standards as a limited partnership - it must lack at least TWO of the following FOUR corporate characteristics:*

- Continuity of life
- Free transferability of interest
- Centralized management
- Limited liability

Since LLCs have limited liability by their very name, they cannot have one of the other three. Therefore, LLCs have to be carefully structured so they do not fit the IRS definition of continuity of life or free transferability of interest or centralized management. Schneider pointed out LLCs are relatively new and there is little case law on the subject.

#### **LIABILITY:**

As in the case of corporations, members and managers of LLCs are not liable to third parties for contracts, torts, judgments or other obligations solely due to their status as members and managers but only liable for their own torts or misconduct even if conducted in the name of the LLC.

Schneider pointed out that, as in a corporation, it is possible for LLCs to lose liability protection if their "veil is pierced," but unlike a corporation, an LLC would probably not lose its LLC status by failing to observe organizational formalities.

Participate to the fullest extent allowed in the Operating Agreement which they themselves formulate.

#### **LLC VERSUS OTHER FORMS OF BUSINESS ORGANIZATION:**

*Unlike a C corporation, LLCs and S corporations (and partnerships) have single tier (pass through) taxation, but LLCs have several advantages over S corporations, according to Schneider.*

- No restrictions on number or type/identities of members.
- Few restrictions on ways to allocate profit and loss.

- Favorable “step up,” debt allocation, property contribution, and property distribution treatment.

*LLCs also have two significant advantages over limited and general partnerships.*

- Only limited partners in limited partnerships have limited liability. The general partners in both types of partnerships have unlimited personal liability. There are no general partners in LLCs so all members have limited liability.
- Limited partners cannot participate actively in limited partnerships without risking loss of the liability protection. In contrast, all LLC members can actively participate to the fullest extent allowed in the Operating Agreement which they themselves formulate.

## **LLC FORMATION:**

*The LLC formation process is as follows:*

**Step One:** Select a name which meets the naming requirements of the California LLC Act. If the LLC uses this name in its operations, there is no need for a Fictitious Business Name.

**Step Two:** Formulate the Operating Agreement of the LLC. Analogous to the partnership agreement this agreement governs the way the LLC will conduct business, consistent with the LLC Act and the LLC-1 (Articles of Organization). The Operating Agreement can be formulated before or after filing of Articles of Organization, but the Operating Agreement is a private agreement, not public, and is not filed with any public agency.

**Step Three:** File Articles of Organization (LLC-1) with California Secretary of State, with filing fee.

**Step Four.** Fictitious Business Name Statement (if applicable).

**Step Five:** Capitalization, either starting capitalization or transferred from existing business entity.

**Step Six:** File Initial Statement of Information (LLC-12) with California Secretary of State within 90 days of LLC filing, including filing fee and naming of managers, if any.

*Other and ongoing actions*

- Annual Federal tax return.
- Annual California Franchise Tax Board tax (minimum LLC tax is \$800) with FTB Form Packet 568.
- Other forms prescribed by Secretary of State, including LLC-2, LLC-11 and possibly others.
- Compliance with LLC Act and securities laws, including Notice of Issuance and Exemption, if applicable.

## **TERMINATION**

The California LLC Act has no maximum or default duration but the LLC must state a date or event in its Operating Agreement which will result in its termination.

By the LLC statute, termination of an LLC can occur by majority vote of LLC members, or by the death, resignation, expulsion, bankruptcy or dissolution of a member unless the remaining members vote to continue the LLC within 90 days.

Like other business organizations, LLCs can also be terminated by court order.

**CONCLUSION:**

The LLC is a significant new form of business organization which can be very advantageous to new or existing companies IF it is appropriate and IF it is properly structured. Like partnerships, corporations, and trusts, LLCs lose their advantages and can harm their members and others if not properly structured and maintained. Careful analysis, planning, member selection and consultation with an attorney knowledgeable about business organization and LLCs is essential to protect the interests of the owners and other parties involved with an LLC.