



Limited Liability Companies

The LLC is the newest of the forms of business entity, and as a result there are some unanswered questions concerning its use. All states now have enacted LLC statutes which provide that members of an entity incorporating under that state statute will not be personally liable for the debts of the entity. The entity will be treated as a partnership for federal, and generally state, tax purposes unless the entity elects taxation as a corporation.

The biggest advantage of an LLC is its flexibility. LLCs are hybrid entities which combine the flow-through attributes of partnerships with the corporate characteristic of limited liability. Therefore, like a corporation, the LLC offers limited liability to its members. Members of an LLC are only at risk to the extent of their investment and cannot be sued for actions of the LLC (other than their own personal actions). The maximum amount a member can lose is the value of his investment in the LLC. His personal assets are protected.

Like general partners in a partnership, LLC members may participate in the management of the LLC. However, unlike limited partners, participation in management will not cause the member to lose his limited liability protection.

Unlike a corporation, however, an LLC is not subject to two levels of tax. Income or loss from the LLC flows from the LLC to the members and is recorded on the members' individual returns. The LLC operating agreement can provide for an allocation of most items of income and deduction in any manner in which the members see fit (subject to the allocation having "substantial economic effect" - which is a requirement of the Internal Revenue Code). The LLC is, however, required to file a partnership return. LLCs are similar to S corporations in that they provide limited liability but are not subject to tax at the corporate level. However, unlike S corporations, an LLC is not subject to any limitation on the number and type of members it may have. (For example, another corporation or a partnership may not generally be a stockholder in an S corporation but these entities may be members in an LLC.) In addition, the one class of stock restrictions and the complex regulations governing S corporation status do not apply to LLCs, thereby allowing flexibility in planning distributions and special allocations. The LLC operating agreement can provide for special allocation of most items of income and deduction, again, subject to the allocations having "substantial economic effect".

An LLC is created by filing articles of organization with the state in which it is formed. Thus, certain filing fees will be incurred. Although an operating agreement is not required, it is an important document for setting forth the members' understanding of the procedures and formula for distributing profits and losses, as well as various other operational concerns.

Generally, a domestic entity with more than one member that is formed as an LLC, will, unless a contrary election is made, default to partnership entity classification. Nothing is required on the taxpayer's part to ensure such classification.

A drawback to forming an LLC is the limited guidance available concerning their use. Because they are relatively new, there is limited case law and few IRS rulings and procedures to guide taxpayers as to the consequences of certain transactions. Most of the uncertainty stems from the fact that members of an LLC are not designated as limited or general partners as they are in a partnership. Therefore, it is unclear how various statutes which govern the consequences of limited partners versus general partners apply to LLC members.