

Understanding the Limited Liability Company

Ted S. Hutchins, Partner
Walter R. Luttrull, Associate
Denton & Keuler
Paducah, Kentucky



In recent years there has been an explosion in the popularity of Limited Liability Companies, or "LLC's", as a business entity form. The Limited Liability Company offers flexibility, asset protection, as well as certain tax advantages. This article will help to explain the Limited Liability Company and how it operates.

History and Background

For much of the twentieth century there were only two main types of business organizations from which to choose, the corporation and the partnership. Both of these organizational forms had inherent strengths and weaknesses based on its structure.

A standard publicly traded corporation, or "C corporation" as it is known in the tax code today, is owned by investors who hold stock in the corporation. Though the stockholders own the corporation and can vote their shares in shareholders' meetings, they are not necessarily part of the corporation's governing board or its management. They are also normally not personally responsible for the actions or obligations of the corporation. Therefore, if the corporation fails and falls into bankruptcy, the stockholder's only loss is the drop in the value of his stock. The corporation's creditors are generally unable to reach to the stockholders to pay for the obligations of the corporation. Thus, the stockholder has "limited liability" for the obligations of the corporation. These characteristics made corporations the primary vehicle for large scale investment in the United States for decades and helped fuel the development of the modern economy.

However, this seemingly ideal business form came with a price, higher taxes. In the last century it was decided that corporations should not be able to act independently of their owners without being taxed independently as well.

Congress enacted a corporate version of the income tax that coincided with the income tax on individuals. This meant that the income of a corporation that was eventually passed to its stockholders would be taxed as income of the corporation, and then would be reported on the stockholder's tax return. This phenomenon became known as "double taxation."

The alternative business form to the C corporation was the partnership. A partnership is a business venture of "members" or "partners" who share in the management of the business as well as its obligations. The business is a "pass-through" entity in that the income of the partnership is only taxed at the level of the individual members and not at the level of the partnership. The income is treated as if it flows directly to the members with the partnership itself ignored for tax purposes. The downside of such an arrangement is that there is no limited liability. Instead each member is personally liable for the debts and obligations of the partnership, regardless of his level of actual involvement in its affairs. This structure worried would-be investors and led them to seek out an alternative.

Eventually the federal government created a new classification of corporation, the "S corporation" which attempted to combine the tax advantages of the partnership with the structural advantages of the C corporation. This form of business proved popular but had a great number of restrictions, including rules governing who can be a stockholder and how many investors can be involved. The search continued for an ideal form for a business entity.

The LLC

The limited liability company first emerged in the 1970's under state law in Wyoming, which sought to combine

the limited liability of a corporation with the tax advantages and flexibility of a partnership. Other states soon followed with their own statutory versions. Each state developed its own laws on the subject without adopting any uniform national acts. Therefore, each state's laws for the LLC must be evaluated independently, since each individual state may have somewhat different requirements. However, most state rules have attempted to keep the most important characteristic of the LLC, flexibility and limited liability. An LLC's flexibility comes directly from its unique structure. An LLC is a non-incorporated entity that is taxed as a partnership (unless its owners specially elect otherwise), but has the limited liability characteristics of a corporation. It can essentially do everything that a corporation can do, but without the extra tax burden. This makes it an ideal organization for small business operations and asset protection from creditors.

The heart of an LLC is its "Operating Agreement," which is a contract that defines how the LLC will function. Though LLC's are governed by statutes, the statutory rules tend to be very flexible and deferential. Normally a particular state's LLC statute will consist mostly of minimum guarantees and default rules that take effect only when the operating agreement is silent on a particular subject. For example, these statutory rules will usually provide that members of an LLC are each given a percentage of ownership in the LLC and that profits and losses of the LLC will be given to each member according to his membership interest. However, if the operating agreement provides otherwise, profits and losses can be distributed unevenly in any number of combinations in order to structure the LLC to reflect the relationship between the parties. For instance, one member may only agree to be a part of an LLC if he is permitted to take a disproportionately large amount of losses incurred by the business. With an LLC, the other members can negotiate this point in order to bring that particular investor along.

This flexibility also extends to governance. An LLC can be managed either by the members themselves (like a partnership) or by managers (like a corporation). (A group of LLC investors decide this point early on when they file their "Articles of Organization" with the Secretary of State for the state they are in. The Articles establish the bare bones of the existence of the LLC and provides notice to the state government that a new LLC is being formed). When an LLC has managers, it can establish the type of insulation between ownership and control of the business that characterizes many large C corporations. This can be attractive to investors who plan to be passive in the everyday affairs of the LLC. It also allows

for an interesting type of estate planning device, the "Family LLC."

The Family LLC allows family members, parents for instance, to place family property such as a business into an LLC, and then gift out membership interests to other family members, usually children. This type of LLC's operating agreement will usually restrict management of the organization to the parents, even when their percentage of membership becomes a minority interest. The operating agreement will also place restrictions on the transfer or sale of membership interests. This will reduce the value of the membership interests for estate and gift tax purposes. This is often called a "minority interest discount."

Conclusion

The LLC is a relatively recent development in American business law, but has made an enormous impact. The LLC's flexibility and special tax status will probably ensure its future success as a top business form.

About Ted Hutchins

Ted's experience at Denton & Keuler spans a broad spectrum of business law and taxation, including purchases, mergers, acquisitions, and business planning. His skill has been invaluable to clients arranging multi-million dollar mergers as well as to those planning for closely held businesses. Ted also concentrates his practice in estate planning for clients with needs ranging from basic wills to more complex estate and gift tax planning. Ted's email address is thutchins@dklaw.com

About Walter Luttrull

After earning a Master of Laws (LL.M.) in Taxation from the University of Denver, Walter practiced business and taxation law with a firm in Lexington, Kentucky. Walter joined Denton & Keuler in 2003 to participate in the healthcare and corporate areas. Walter's email address is wluttrull@dklaw.com

*This article is designed to provide general information prepared by the professionals at **Denton & Keuler** in regard to the subject matter covered. It is provided with the understanding that the author is not engaged in rendering legal, accounting, or other professional service. Although prepared by professionals, these materials should not be utilized as a substitute for professional service in specific situations. If legal advice or other expert assistance is required, the service of a professional should be sought.*