

FORMING AN LLC

LIMITED LIABILITY COMPANY (LLC)

A Limited Liability Company can be best described as a hybrid between a corporation and a partnership. It provides easy management and "pass-through" taxation (profits and losses are added to the owner(s) personal tax returns) like a Sole Proprietorship/Partnership, with the liability protection of a Corporation. It's a relatively new form of business created about 20 years ago and now recognized in all 50 States and D.C.

LLCs are a creation of law; they are formed by completing and submitting the necessary documentation to the state (Articles of Organization) and paying the required fees. The owners of an LLC are called members, and the LLC can be managed by all of the members, some of the members, or a separate manager. An LLC can be formed in any state. All states, other than Massachusetts allow an LLC with only one member (owner). Massachusetts requires at least two members to form an LLC.

Like a corporation, it is a separate legal entity; unlike a corporation, there is no stock and there are fewer formalities. The owners of an LLC are called "Members", instead of "Shareholders" "Directors" and "Officers". So in essence, it's a like a corporation, with less complicated taxation and stock formalities.

The heart of a Limited Liability Company is known as the "Operating Agreement". This document sets the rules for operating the company and can be modified as the business grows and changes. If forming an LLC with more than one member, it is important to enter into an operating agreement between the members. The operating agreements can set forth the duties and responsibilities of the members, how the LLC is to be managed, how profits are to be divided among the members, and how member interests can be sold. This agreement is just as important in an LLC as a partnership agreement is in a partnership. It prevents disagreements from arising at critical junctures in the performance of business.

Operating an LLC is less formal than a corporation, usually only requiring an Annual Member's Meeting and Member's agreeing to changes of the Operating Agreement.

PROS

- Provides the liability protection of a corporation without the corporate formalities (Board Meetings, Shareholder Meetings, minutes, etc.) and extra levels of management (Shareholders, Directors, Officers).
- Limited liability protections. If the debts of the LLC exceed its assets, or if there is an adverse judgment as a result of a law suit, the creditors cannot go after the member's personal assets. This limited liability protection is a very important consideration when choosing a business entity. An investor in an LLC can only lose his or her initial investment. The member's home, savings, cars, etc. are not at risk.
- Not subject to the double taxation provisions that a corporation is subject to (unless it chooses to be taxed as a corporation). An LLC is considered a pass through type of entity by the IRS. In other words, the profits and losses from the business are not taxed at the LLC level. They are passed through to the owners of the LLC and taxed on the owners' tax return at the owners' level. This is also important for businesses that hold appreciating assets, such as real estate. The sale of real property that has appreciated would create a double taxation issue for a corporation. However, with LLCs, the capital gains are only taxed once at the members' level.
- Taxed the same as a Sole Proprietorship (1 Member LLC) or Partnership (2 or more Members). Can even be taxed as an "S-Corporation" by filing form 8832 with the IRS.
- The detailed requirements of following bylaws and holding shareholder and directors meetings (keeping records of it all) are not required in the LLC. However, it is still important to enter into an operating agreement to detail how the LLC will be managed. This flexibility is also true for deciding how the assets of the business are divided if the LLC is dissolved, as well as how profits are divided between the members. LLCs often do not have the strict regulations dividing profits that corporations often are required to follow. For example, with an LLC you can set forth in the operating agreement that member A receive 50% of the profits, member B receive 30% and member C receive 20%. These distributions can even change with time. For example, distributions to members can revert to equal distributions after 3 years or after the business attains a certain level of income.
- You do not need to be a US citizen to own or invest in an LLC.

CONS

- Usually more expensive to form than a DBA, requires more paperwork and formal behavior.

The Entity of Choice for 1-5 person startups, has recently surpassed Corporations in popularity. Easy management and limited compliance requirements have made the LLC the user-friendly solution for small business.

REAL ESTATE AND LLCs

While LLCs are very popular forms of business entities, they are especially well suited for real estate investors. An LLC is an effective device for buying, owning and selling real estate.

- **Limited liability protection.** The owners, or members, of the LLC are not personally liable for debts or liabilities of the company. Thus, an LLC which holds real estate will protect its owners from personal liability for lawsuits.
 - A foreclosure against the property will not create personal liability for the members (unless, of course, the members sign personally for the loan).
 - If an investor has multiple rental properties each property should be set up as a separate LLC. Then if a tenant in one apartment building is injured, the owner will not be personally liable. Additionally, the owner will not risk losing other real estate in a lawsuit provided each property is set up as a separate LLC.
- **Estate planning features.** The LLC can provide a vehicle for passing wealth to younger family members without having to re-title the real estate. Once real estate is transferred into an LLC, the members' interest is converted to personal property that is represented by the membership interest in the LLC. This membership interest can be transferred incrementally to children as tax-free gifts (\$10,000 per year tax-free). The process for transferring membership interest is very simple compared to filing a new deed each year. Parents can still retain control over the property during their lifetime by acting as the manager of the LLC.

LLC FAQ's

What is a Limited Liability Company (LLC)? An LLC can be best described as a hybrid between a corporation and a partnership. It provides easy "pass-through" taxation like a Sole Proprietorship/Partnership, with the liability protection of a Corporation.

How long will it take to form my LLC? We process most orders by the next business day; however, how long the state will take to process the paperwork once they receive it varies widely depending on the state (and the season). Some states take 3 days; others take 6 weeks or longer.

What is an LLC Seal? An LLC Seal is a small handheld device that allows you to imprint an official-looking emblem with your company name and the year it was founded on paper, important documents, certificates, etc.

Can I form an LLC in one state, while having my business based in another state? Absolutely!

How many people are required to form an LLC? Only 1 person, over the age of 18, is required to form an LLC in any of the 50 states and DC.

How do I add or remove a member of the LLC? This is an internal company decision best addressed by an Operating Agreement. If you have not adopted an operating agreement or held an organizational meeting, then your LLC has not been properly organized yet. Once you've held the organizational meeting and adopted an Operating Agreement, then the Operating Agreement should spell out the necessary steps for adding and removing of members. Once you've done that, then you will notify the State of the change by either filing a) an amendment or b) an early annual report - contact your state for details.

What if I decide to close my LLC, what's involved? An LLC can be dissolved almost as easily as it is created. If you form your LLC and then decide to close it for whatever reason in the future, you simply will have to file "Articles of Dissolution" with the state and take the money out of the company and return it to the members. You will then notify the IRS and any other appropriate Government agencies that the LLC is no longer in business. This can obviously be more complex but that's the basic process.

How is an LLC taxed? A single-member LLC is taxed like a sole-proprietorship. This means that they pay a "self-employment" tax and simply add any income onto their 1040 personal tax return. An LLC with 2 or more members is taxed like a partnership where each partner adds their portion of income onto their 1040 personal tax returns. The LLC must also file an informational return showing all the members and their income on form 1065. An interesting aspect of an LLC is that it can file a form with the IRS and elect to be taxed like a corporation by filing IRS Form 8832. However, this is fairly rare for small businesses.

What are the name requirements for an LLC? An LLC primarily identifies itself by its name. These include the following additions to the business name: Limited Liability Company (or LLC, or L.L.C. or Ltd. Co)

How is an LLC organized and managed? An LLC can be managed in one of two ways: Member-Managed or Manager-Managed. In a Member-Managed LLC (which is by far the most common type), the company is managed like a partnership or sole proprietorship with each Member participating in the day-to-day activities of the LLC. Members may be designated as "President" or "Treasurer", but this is not required; many times they simply refer to themselves as "Managing Member" or simply "Member".

In a Manager-Managed LLC, the company designates a Manager or Managers (who may or may not be Members) to run the day-to-day activities of the company. The other Members are passive and may or may not be involved in the daily operation of the company; they simply provide money or assets for the managers to operate the company. This is fairly rare for small businesses.

I would like to buy real estate with my LLC, does this affect which state I should choose? If you are buying real estate in a state other than where the LLC is formed, then that state may require you to be authorized to transact business before purchasing real estate. However, in many states, the ownership and purchase of real estate does not constitute the transaction of business. It's best to check with the Secretary of state in the state where you are going to purchase the real estate to find out for sure.

What is an LLC kit and do I need one? LLC's are required to maintain a "minute book" that holds things like the formation paperwork, licenses, resolutions and meeting minutes. It is one of the first things requested when your company is audited or being sold. A company may make their own but most simply buy one when the company is formed.

IF YOU ARE CONSIDERING FORMING AN L.L.C., YOU SHOULD BE AWARE OF THE FOLLOWING FACTS:

Tax Treatment of the LLC

All income of the LLC is passed directly through to the personal returns of the members. When property is transferred to the LLC or distributed from it, there are no separate tax consequences. Except in unusual circumstances, the general rule will apply and no gain or loss will be recognized on a contribution to or distribution from the company. There is no tax when funds are withdrawn from the company. The only tax paid is on the income earned, which is reported on the owner's personal tax return. This system avoids the complications and potential double taxation that plagues the corporate format.

- **IRS Treatment of the Two-Member LLC.** If your LLC has two or more owners, The IRS will tax the LLC owners as if the owners were members of a partnership. A partnership files Form 1065 (U.S. Partnership Return of Income).
- **IRS Treatment of the One-Member LLC.** An LLC with only one member / owner is taxed by the IRS as a sole proprietorship is taxed. Thus, the sole member of an LLC will file (Form 1040), (U.S. Individual Income Tax Return) and will include (Form 1040, SCHEDULE C) (Profit or Loss from Business) with his/her tax returns.
- **"Tax My LLC as a Corporation!"** Regardless of how many members the LLC has, the LLC may file an Election to be treated as a Corporation for Purposes of Taxation (IRS Form 8832). If an election is made to be treated as a corporation, the LLC must file Form 1120 (U.S. Corporation Income Tax Return). IRS Form 1120, Form 1120 Instructions
- **Limited Liability for Members (owners).** In most cases, only the LLC is responsible for the company's debts thus shielding its members from personal liability. However, there are some exceptions where individual members may be held liable:
 - Guarantor Liability. Where an LLC member has personally guaranteed the obligations of the LLC, he or she will be liable. For example, where an LLC is relatively new and has no credit history, a prospective landlord about to lease office space to the LLC will most likely require a personal guarantee from the LLC members before executing such a lease.
 - Alter Ego Liability. Where an LLC member has personally guaranteed the obligations of the LLC, he or she will be liable. For example, where an LLC is relatively new and has no credit history, a prospective landlord about to lease office space to the LLC will most likely require a personal guarantee from the LLC members before executing such a lease.

Voting Interest According to Ownership. Ordinarily, voting interest directly corresponds to interest in profits which directly corresponds to share of ownership unless the articles of organization or operating agreement provide otherwise.

Transfer Requires Majority Consent. No one can become a member of an LLC (either by transfer of an existing membership or the issuance of a new one) without the consent of members having a majority in interest (excluding the person acquiring the membership interest) unless the articles of organization provide otherwise.

Perpetual Duration. Traditionally, most states did not allow an LLC to have a perpetual existence; LLCs were traditionally required to specify the date on which the LLC's existence would terminate. Today, however, most states allow a perpetual duration for an LLC if stated in its articles of organization.

Dissolution upon Certain Events. Unless otherwise provided in the articles of organization or a written operating agreement, an LLC is dissolved at the death, withdrawal, resignation, expulsion, or bankruptcy of a member (unless within 90 days a majority in both the profits and capital interests vote to continue the LLC).

Different Laws in Different States. While laws governing corporations have grown to be quite uniform amongst the different states over time, LLC statutes can vary quite drastically from state to state. This is most likely due to the fact that the LLC is a VERY new form of business structure only recently recognized by most governments (e.g. Hawaii only recently began recognizing the LLC as a legitimate form of business in 1997).