

LLC OUTLINE
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LIMITED LIABILITY COMPANY ACT

1. INTRODUCTION

A. Consider The Following Example:

Bob, Ted and Carol decide to manufacture biodegradable baby diapers. Bob and Ted will invest \$50,000 and \$25,000, respectively; Carol will invest \$1,000 and run the business.

All three will have equal ownership. They all have substantial personal assets and want to protect themselves from personal liability. Also, Bob and Ted will be repaid before Carol receives her share of the profits.

1. HOW SHOULD THIS TRIO PROCEED TO ORGANIZE?

a) Form a corporation to limit their personal liability with special repayment provisions (but possibly cause double taxation)?

b) Form a general partnership (a “flow-through” entity in which the partners are directly taxed on their share of the income) -- an arrangement noted for its simplicity and flexibility and which permits the repayment to Bob and Ted, but will not limit their personal liability?

c) Form a limited partnership with Carol acting as the general partner? This will protect Bob and Ted from personal liability, but Carol will remain fully liable for the debts of the venture.

(1) Carol could form a corporation to act as general partner, but then there would be two entities involved in the venture, and the new corporation must be adequately capitalized to function as a general partner.

d) Form a small business corporation (S corporation), which limits their liability, is a flow-through entity for tax purposes, but does not permit repayment to Bob or Ted?

2. A BETTER CHOICE:

a) For years, these have been the main options available to new small businesses or partnerships. But now there’s another, often better choice:

b) Formation of a Limited Liability Company ("LLC") under Corporations Code ¶17000.

B. Limited Liability Company

1. FLEXIBILITY OF PARTNERSHIP WITH CORPORATE LIABILITY PROTECTION

a) As a new legal entity, the LLC allows the flexibility of a general partnership plus the legal protection of a corporation.

2. A SUPERIOR FORM OF DOING BUSINESS

a) Because of its dual benefits of partnership tax treatment and corporation protection (but without the paperwork and expense of a corporation), LLCs could replace general partnerships, limited partnerships and S corporations as California's business entity of choice.

2. THE BASICS

A. Forming The LLC

1. FILING REQUIREMENTS

a) An LLC files with the Secretary of State and, once approved, becomes legally registered in California. CC ¶17050. See the attached form.

b) It must have at least one or more "members" which may be U.S. or foreign individuals or entities, such as partnerships, trusts, corporations, estates or other LLCs.

c) Professionals (lawyers, accountants and architects) are prohibited from registering as an LLC, but may now form a Limited Liability Partnership.

(1) Note: There are a surprising number of licensed professionals in California who are thus ineligible to form an LLC.

2. THE OPERATING AGREEMENT

a) The LLC uses an operating agreement, similar to a partnership agreement, to control business, financial and tax provisions. CC ¶17001(ab).

b) The operating agreement may be oral, although it should be in writing and signed by all the LLC's members.

(1) It is not filed with the Secretary of State, but is a private agreement among the LLC's members.

(2) Changes to the agreement can be drafted in an informal setting, without the formalities associated with corporate meetings.

c) Management of an LLC may be vested either in the members or in certain designated "managers." CC ¶17151.

d) Managers do not have to be members of the LLC, and even corporations may serve as managers.

e) Through its provisions, the operating agreement determines whether the LLC is taxed as a partnership or corporation, although the presumption is that an LLC will be taxed as a partnership.

(1) In general, most LLCs choose to be taxed as a partnership; as a flow-through entity, income and losses will be reported by its members on their tax returns.

(2) This choice has become easier under the IRS check-the-box regulations that now permit an entity to choose its tax status.

3. FEES AND TAXES

a) There is a \$70 filing fee with the Secretary of State when the LLC is first formed.

b) In addition to the annual \$800 franchise tax, the LLC in California is subject to a graduated fee determined as follows:

FEE SCHEDULE - 2000	
Total Income of:	Fee Amount:
\$0 – \$249,999	\$0
\$250,000 - \$499,999	\$1,042
\$500,000 - \$999,999	\$3,126
\$1,000,000 - \$4,999,999	\$6,251
\$5,000,000 or more	\$9,377

FEE SCHEDULE - 2001	
Total Income of	Fee Amount:
\$0 – \$249,999	\$0

\$250,000 - \$499,999	\$900
\$500,000 - \$999,999	\$2,500
\$1,000,000 - \$4,999,999	\$6,000
\$5,000,000 or more	\$11,790

Note: For taxable years beginning on or after January 1, 2001, the total income from tiered entities will only be included once in the calculation of the LLC fees. Total income will no longer include any income, gain, or distribution, that is subject to payment of the fee, and received by an LLC that was allocated or attributable to that LLC simply because it is a member of another LLC.

(1) NOTE: The legislature just raised these fees for the year 2000, while reducing some fees for corporations.

c) For purposes of the fee calculation, total income is defined as gross income (under IRC Sec. 61) without deducting the cost of goods sold.

(1) The fee is based on the LLC's income from all sources, including income from sources both within and outside of California. In certain cases, the fee is calculated by taking into account the income of "commonly controlled limited liability companies".

(2) The fee is payable with the LLC's California tax return.

B. Tax Returns.

Both federal and state income tax returns must be filed on or before the fifteenth (15th) day of the third month following the close of the taxable year, unless a timely extension to file is obtained.

C. Personal Property Taxes.

If the LLC owns significant personal property it may be required to file a property statement with the County Assessor and may be subject to a personal property tax. Forms may be obtained from the County Assessor.

D. Sales and Use Taxes.

If the nature of the LLC's business includes the sale at retail of tangible personal property (goods), then the LLC may be subject to sales and use taxes and would need to obtain a sellers' permit from the California State Board of Equalization.

E. The Advantages

1. COMPARISON WITH OTHER ENTITIES

a) Members of an LLC are shielded from personal liability to the same extent as corporate shareholders. CC ¶17101(a).

b) They also enjoy the financial agility of a partnership, and have greater flexibility than either a corporation or partnership when delegating management responsibilities.

(1) In the above example, if Bob, Ted or Carol decide to shift management roles, it simply takes their agreement.

c) In general, the LLC will be treated as a partnership for tax purposes; it will be a flow-through entity in which income and losses are reported directly by its members.

(1) Unlike an S corporation, special allocations of income, expenses, deductions and losses can be made among its members.

(a) An LLC member may deduct losses that exceed his or her direct investment, which can occur when the LLC borrows funds.

(2) Unlike a partnership, management can be vested in nonmembers. Therefore, an LLC could have a professional management company run the venture.

(3) Unlike a limited partnership, members may be actively involved in the LLC's management, without risk of personal liability, as can occur to a limited partner.

(a) An LLC can provide that Bob and Ted will be repaid in full before profits are equally split among the three.

(b) Carol can manage their venture without participation or interference from Ted or Bob.

d) An LLC permits transfer of a membership interest to a corporation or revocable living trust, and -- of paramount importance -- none of the members is personally liable for any debts or claims against the business.

2. USES FOR AN LLC

a) An LLC is an ideal substitute for an S corporation whenever foreign citizens or entities, corporations, partnerships, other LLCs or trusts are members, or when money is loaned to the LLC.

b) The LLC provides estate planning opportunities since trusts, including revocable living trusts, and estates are eligible shareholders.

c) Also, the LLC could eventually eliminate both general and limited partnerships as business entities since it offers the same tax treatment and management opportunities, yet with the added advantage of limited liability to all its members.

3. STATE TAX CONSIDERATIONS

a) LLCs might also pay a substantially lower California income tax than an S corporation, since the LLC's tax obligation is capped at \$2,500 in 1995, but an S corporation enjoys no ceiling on its tax obligation.

b) The chart illustrates taxes paid by an LLC with a given amount of gross receipts, compared to an S corporation whose net profits are a percentage of the gross receipts.

(1) For instance, an entity with gross receipts of \$495,000 will pay \$1,665 as an LLC; however, an S corporation with a profit percentage of --

(a) 33.3% will pay \$2,472;

(b) 25% will pay \$1856; and

(c) 20% will pay \$1,485, on the same amount of gross receipts.

F. The Disadvantages

1. LITTLE LEGAL PRECEDENT

a) As a new entity, an LLC offers little legal precedent. Also, the LLC laws in the various states differ so the legal value of those state court decisions is questionable.

2. TAX TREATMENT UNCERTAINTY

a) Congress has not passed any tax legislation establishing the LLC as a partnership for tax purposes. If Congress decided to tax LLC's as corporations, their use would be greatly diminished. This is extremely doubtful, however, since all 50 states have LLC legislation.

b) Thus far, the IRS has ruled that the LLC will qualify as a partnership for tax purposes, but there is nothing in the Internal Revenue Code that permits such treatment.

c) An S corporation should be used when professionals who are disqualified from selecting LLC treatment want to form an entity.

G. Conclusion

1. WHEN TO CONSIDER AN LLC

a) Forming an LLC should be seriously considered whenever one or more people are considering a business or investment venture.

b) The LLC offers distinct advantages over both general partnership and limited partnership structures, since its members are not personally liable for the debts of the entity.

c) It is similar to an S corporation, but without its restrictions and limitations.

d) LLCs, however, cannot be used by professionals — or in situations when a regular "C" corporation would take advantage of the corporate reorganization tax provisions or the ability to have separate classes of stock.

2. PARTICULAR USES FOR LLCs

a) An LLC is particularly well suited for real estate ventures containing corporations, trusts or foreign investors or new business ventures involving existing corporations.

b) The LLC also provides estate planning opportunities since trusts and estates, including revocable living trusts, may own a membership interest.

c) This makes an LLC an excellent investment vehicle for families or friends who invest together, since they decide how to share their income and losses.

(1) Since an LLC can have revocable living trusts as members, probate will be avoided upon an individual's death.

d) Unmarried couples should consider an LLC both for income and estate tax planning purposes.

(1) Since the LLC is taxed as a partnership, the couple can provide for special allocations of income, gains, deductions

and losses, thereby maximizing each member's income tax planning.

(2) Revocable living trusts will avoid probate at death.

3. HYPOTHETICAL – CREATIVE USE OF AN LLC

A. FACTS – Trust owns Real Estate:

A trust owns a large apartment complex. The beneficiary is a 70 year-old woman, who is not a U.S. citizen, but is a resident, and is in good health. Upon her death, her 4 children become the beneficiaries. The trust terminates and distributes the asset in equal shares, to the children. Two children are married. One married couple and one single beneficiary are not U.S. citizens or residents. None of the children wants to become a 25% owner of the apartment. They would prefer the property remain in the trust to be managed by the trustee.

The apartment has a fair market value ("FMV") of \$5M and an adjusted basis of \$1M. Upon distribution of the Trusts' assets, there will be no basis step-up and the beneficiaries will receive their pro-rata share of the \$1M basis. Problems may arise if the real estate is subsequently sold. U.S. persons who are married and who hold the real estate until death will be entitled to a marital deduction, and will receive a basis step-up at death. The foreign beneficiaries will have a taxable transaction if they transfer their interests to a foreign entity or sell the real estate during their lives. In addition, the foreign beneficiaries will have a large estate tax if they die owning U.S. real property.

B. RECOMMENDATION

- The Trust should place the apartment into a Limited Liability Company ("LLC").
- The Trustee should be the "manager" of the LLC.
- When the Trust liquidates and distributes the LLC interests to the beneficiaries, those interests will be comprised of membership interests in an LLC and not undivided individual ownership interests in the real estate assets themselves.
- This will allow the LLC to manage the real estate assets in one entity, in much the same manner as the Trusts are currently managing those assets.

C. DISCUSSION:

1. THE PERILS OF REAL ESTATE OWNERSHIP AS TENANTS IN COMMON.

Absent an LLC (or similar structure), each beneficiary will own an undivided pro-rata share of each asset in his or her individual name as tenants in common.

- a) Tenants in common have the right to partition and sell property by filing a lawsuit.
- b) Creditors of a tenant in common (including tax authorities) may seize and sell (or become the owner of) the property interest held as tenant in common.
- c) A tenant in common may become personally liable for any tort claims occurring with respect to the property (including hazardous waste claims).
- d) If a tenant in common dies, a probate in the county in which the property is located is necessary.
- e) There is no continuity of management or control with respect to property held by tenants in common, absent an express agreement among all tenants in common.

2. THE ADVANTAGES TO USING AN LLC TO MANAGE THE REAL ESTATE

In contrast to a distribution of an interest directly to each beneficiary as a tenant in common, placing the real estate into a Limited Liability Company ("LLC") offers the following advantages:

- a) Continuity of management and professional management. Essentially the same management will continue to occur. Income and expenses will be distributed to the members on a pro-rata basis or special allocations can be made, subject to the applicable rules regarding "substantial economic effect" of special allocations.
- b) Rights of members to sell, encumber or assign their respective interests may be restricted by agreement.
- c) Rights of members to partition and sell the properties or to receive an undivided interest in the properties may be eliminated.
- d) Individuals will not own the properties directly, therefore, they will not have personal liability for any potential hazardous substance or other contract or tort claims with respect to the properties.
- e) There will be a lower value of interest for estate tax purposes since a greater minority discount will apply if property is owned in an LLC rather than as individuals.
- f) Use of agreements to purchase each other's interests, such as a first right of refusal or repurchase agreement at a substantial

(50%) discount, are available to the members, as well as the ability to sell the interest or pass it to the members' heirs.

g) Estate planning opportunities: An LLC, unlike an S corporation, can have foreign members and revocable trusts can be members.

h) Advantageous Proposition 13 rules. If an individual owning an undivided interest in land sells that interest, Proposition 13 will apply. Only if there is a change in ownership, a 51% swing, in an LLC will Proposition 13 apply.

i) No probate on property. Undivided interests in land held individually are subject to probate in the county in which the land is located.

j) For non-resident aliens, there could be advantages to owning land in an LLC, if the LLC interest, in turn is owned by a foreign corporation. Land held individually by a foreign person which is then transferred to a foreign country requires a tax return to be filed and the gain reported on the transaction.

3. THE DISADVANTAGES TO USING AN LLC

a) There is the expense of forming the LLC and maintaining it, and the expense of hiring the Trustee to manage the real estate operations.

b) Owning a membership interest in an LLC, rather than an outright undivided ownership interest in property, will cause a loss of certain individual rights to affect the real property. Individuals have the power to force the sale of property held as tenants in common. The limitations on members imposed by an LLC operating agreement (an operating agreement is similar to a partnership agreement) translate into legally enforceable restrictions that could impact the minority of members, should a disagreement develop among the members.

c) There would also be a loss of the power to affect the management of the properties held in the LLC. Members will vote as if they were limited partners, and not as direct owners of the properties, and unless the majority agrees to a particular action, individual members cannot compel a particular course of action.

4. OTHER ISSUES:

a) Proposition 13 reappraisals. Property taxes are reassessed to fair market value when a change in ownership occurs. Although a change in ownership usually occurs when a property is sold, in

some circumstances, there can be a change in ownership when interests in a corporation, partnership or LLC shift.

b) If the interests in the trust remains exactly the same when the LLC is formed, there will be no Proposition 13 reappraisal at that time. The property will be reassessed when 50% of the interests are transferred from the trust to the members.