Limited Liability Companies: A Brief Explanation

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A BRIEF EXPLANATION OF LIMITED LIABILITY COMPANIES

1. What is A Limited Liability Company?

A limited liability company or "LLC" is a business entity that is authorized by specific legislation in most states of the United States and in many foreign countries. In almost every instance, the state or country in question issues a charter to the LLC upon its formation. The most significant characteristic possessed by LLCs is part of its name, that is, it provides limited liability. In this regard, it is very similar to a corporation.

2. How Do You Form An LLC?

An LLC is formed by filing the Articles of Organization with the relevant secretary of state in the U.S. or other licensing agency in a foreign country. The Articles of Organization are normally very brief and simple and provide only basic information with respect to the name of the company, the agent for service of process, the company's address and its manager or members.

3. How Is An LLC Structured?

An LLC is structured much like a partnership except that it has members instead of partners. The LLC can be member managed in a manner similar to a general partnership or it can be manager managed like a general partner does in a limited partnership. If the LLC is member managed, normally, all of the members have an equal vote and decide between themselves on not only the major business and financial policies, but, also the every day operations. If the LLC is manager managed, the members only decide on major financial and business decisions and the manager handles all of the day-to-day business operations.

4. How Is The Structure Of The LLC Determined?

The founding members or promoters of the LLC determine the structure of the LLC by means of an Operating Agreement which is similar to a Partnership Agreement. Normally, when the Articles of Organization are filed, the state requires that the organizers determine in the Articles whether or not the LLC is member managed or manager managed. The members have an experienced attorney draft the Operating Agreement which sets forth the different rights and responsibilities of the members and covers matters such as capital contributions, division of profits, management, member meetings, transfers of member interests, dissolution and indemnification.

5. What Are The On-Going State Fees For An LLC?

California imposes an $800 Annual Franchise Tax on LLCs. This amount is due on the 15th day of the fourth month after the beginning of the fiscal year. For the first year, the due date is the 15th day of the fourth month from the date the LLC was organized. In addition, California, in its arrogance, also imposes a gross receipts tax on LLCs. For LLCs whose annual revenue is between $250,000 and $499,999, the additional fee is $900. The fee increases to $2,500 for annual revenues between $500,000 and $999,999 to $6,000 for annual revenues between $1 million and $499,999, and to $11,790 for annual revenues of $5 million or more.

6. Tax And Accounting Treatment?

The LLC can elect to be taxed as either a partnership or a corporation. Almost always it is better to be taxed as a partnership. What this means is that the LLC files an Information Return and issues K-1s to its members showing the member's share of the income or loss that the LLC incurs. The members then report this amount on their own individual Returns. The LLC, if it is taxed like a partnership, does not pay any income tax. If the LLC is a single member LLC, the owner may treat it as a disregarded entity for tax purposes and report the tax and related accounting on the individual tax return of the member. This eliminates the necessity of a tax return for the LLC.

7. Charging Order Protection

A charging order is a court order available to a judgment creditor directed to a limited liability company or limited partnership of which the judgment debtor is a member or partner which grants the judgment creditor the right to whatever distributions would otherwise be due to the debtor member/partner whose interest is being charged. The purpose of the charging order is to prevent the judgment creditor of an individual partner/member from access to the partnership/LLC assets while at the same time, giving the creditor some relief relative to distributions from the entity to the partner/member. The charging order denies the creditor direct access to the LLC assets and limits the creditor exclusively to collection of the income or distributions which the LLC assets might engender, but which can be withheld from distribution at the discretion of the LLC manager. What this means is that a creditor who has obtained a charging order only has the right to receive distributions from the entity when and if such distributions are ever made even though the entity itself may have substantial income. The charging order remedy is often times the exclusive remedy available to the creditor and provides substantial asset protection for the LLC owner.

8. Putting Real Estate in the LLC.

If the primary purpose of the LLC is to hold title to a real estate investment, the members will need to deed or convey the real property involved to the LLC by means of a formal deed that needs to be recorded. All of the rents with respect to the real property should be deposited in the LLC bank account and all expenses with respect to the property should be paid for out of the LLC bank account. All contracts with respect to the real property and service arrangements should be exclusively in the name of the LLC.

9. Examples.

The following are some examples of when and why an LLC might be wisely selected:

a. Jean Simon is a widow, who in addition to her residence, owns a four-plex in Santa Ana, California. She is concerned about potential liability above and beyond what insurance would cover and has elected to place the four-plex into an LLC of which she is the single member. She treats it as a disregarded entity for tax purposes and all of the tax and accounting are reported on her individual Return.

b. Dave Carson, his brother Bill and their friend, Richard, each own a one-third interest in a small shopping center in Long Beach, California. They have created an LLC in which to hold title to the shopping center so as to protect their respective personal assets from any claims with respect to the shopping center. All three of them participate equally in the LLC which is member managed by the three of them and treat it as a partnership for tax purposes. The LLC files a partnership Return and Dave, Bill and Richard each receive a K-1, the information of which they report on their own individual Tax Returns.

c. Ron Tolberg, owns a 25% interest in a 76 unit apartment building which he manages in Anaheim, California. The other 75% is owned by various members of Ron's family and by some friends. Ron has placed the apartment complex into an LLC which is a manager managed LLC since Ron is the one who does all of the management duties and responsibilities. The LLC reports its taxes as a partnership and Ron and all the other members receive K-1s for their shares of profits and Ron also receives a salary or guaranteed payment as manager which is paid to him as an expense before there is a division of profits.

d. The LLC can also be used to operate a retail or other business in a situation where limited liability is desirable, but the flexibility of the LLC is required.