

LIMITED LIABILITY COMPANY

Overview

- Business is a separate legal entity from its owners.
- Best suited for single- or multiple-owner company needing liability protection and single-level taxation.

Pros

- Liability is limited to the extent of the owner's investment. His/her personal assets are protected.
- Profits and losses may be allocated differently than owners' contributions upon an agreement between them.
- Capital can be raised through the sale of company interest.
- The entity does not pay taxes. The income, deductions, and credits are applied to the members in portions set forth in an LLC agreement and the members report these on their personal income tax returns. The members, however, are taxed on allocations, not distributions of the profits, meaning they owe taxes even if they decided to reinvest the profits rather than take it for themselves.
- No strict formalities like those of a corporation, though certain procedures should be followed to ensure optimal results for the LLC and its members. (See below for LLC formalities.)

Cons

- Raising capital can be difficult. The sale of membership interests in an LLC can create concerns and challenges for investors because not everyone wants to become an LLC member.

LLC "Formalities"

While a "formal" set of rules is not a requirement outlined by any state for an LLC, the concerned and astute business man or LLC member will understand that there are LLC formalities to be followed and adhered to in order to fully enjoy the benefits afforded by the LLC.

- Having a well written Operating Agreement in place, with well-defined roles for members, well outlined distribution guidelines, and operational and taxation rules.
- Adequate records for all transactions and business engagements, as well as properly written minutes of meetings (at least one state, Tennessee, requires an annual meeting of the members). List of members, past and present, articles of organization, tax returns for the past three years, bank statements, resolutions authorizing activities that, either by law or under the terms of the operating agreement, require a vote of the members, etc. Are all examples of the types of records and written agreements that should be properly maintained by the LLC
- Adequate capitalization for the company and maintaining proper operating capital

These are but a few, though vital, suggestions of formalities that should be observed. Other actions, or lack thereof, that could lead to the piercing of the LLC veil include:

- Actions not covered in the Operating Agreement of an LLC--this is tantamount to disregarding the LLC formalities. Although an LLC is technically not required to observe formalities in the same manner that a corporation is, its actions should be completely guided by the operating agreement, and this agreement is taken into consideration by the courts and tax authorities when a determination is made as to the operation of the LLC.



- Deficient or inadequate capitalization is another important deficiency that a court or tax regulator will examine when determining the intent of the LLC and its member's and will usually factor heavily in their decision to pierce the veil. It is important that an LLC be properly capitalized and funded, and that the members manage the funds properly in order to run business properly. Siphoning too many assets or capital and leaving too little in the coffers to satisfy creditors or company operations may lead to a veil-piercing determination.
- Co-mingling of funds is a bad idea in any form of corporation or LLC. Any sense of co-mingling of funds or accounts will almost certainly lead to an "alter-ego" determination by the courts or a tax regulatory board and will lead once again to veil piercing--thereby risking personal assets and stripping members of the liability and asset protection. It is a best-practices act to make certain that separate accounts are maintained and monitored.
- The amount of discretion shown by the members should be metered to ensure that all actions are deemed to be in the best interest of the LLC or the business. Personal agenda's should come secondary to the LLC as a whole, lest it be determined that it was formed for an express personal agenda and not a business goal.
- The LLC should never be treated as an extended personal account of its owners or members. The courts and tax regulatory boards regularly examine the financial dealings and workings of an LLC to determine whether it is a working business or an independent profit center for its owners or members. If it is deemed an independent profit center, the veil could be pierced and there can be tax penalties and liabilities against the owner or members personally.

An LLC should pay and guarantee its own debts, unless specifically outlined in the operating agreement for specific requirements for such things as the rental or leasing of real property, etc. At times, if an owner or member regularly guarantees or pays debts, he will have been shown to act as an alter ego of the LLC and hence will cause that LLC to lose its separate entity status. Owners should not pay or guarantee the debts of their own LLC unless it is specifically outlined in the operating agreement for specified purposes.

Other uses of LLCs

- ***Holding personal real estate.*** Mixing business and personal assets into a single entity exposes personal assets to the judgment creditors of the business. Ideally, individualized LLCs should be used for holding particular assets. The LLC, therefore, can act as a shield entity with ease of management and restrictive rights of future creditors. Whenever feasible, separate LLCs should be used with each piece of investment property. This usually insulates assets and prevents cross-liability, keeping all of the eggs out of one basket.
 - It is worth noting that, in order for an LLC to hold a piece of real estate, the LLC must be listed as the owner on the deed to the property. Often, this means that the individual must transfer the property to the LLC. The deed of transfer must be recorded at the applicable registry of deeds. This may cause an issue if a bank has issued the individual a mortgage in his/her individual name. Often, the lender will not allow an individual to transfer the property to the LLC without being in default of the mortgage. It is best to consult an attorney before making the transfer. Ideally, the LLC will secure the mortgage and avoid this problem altogether.
- ***Holding business real estate.*** The operations of an active business should be owned separately from the real estate upon which the business operates. If, for example, a restaurant patron



suffers damages resulting from food poisoning and wins damages in a lawsuit not covered by insurance, he becomes a judgment creditor. If separate LLCs are used for the business operations and the real estate, the judgment creditor may only be entitled to a judgment lien against the operational business, not the real estate. To best protect the owner's assets in this scenario, the operating entity should lease the real estate from a separate entity whose sole purpose is to own the real estate. From apartment buildings to office buildings to strip malls, LLCs are often used in major real estate deals.

- ***Financing through an LLC.*** Frequently, real estate investors use a single member single purpose LLC to hold property. Often securitized loans require specialized LLC operating agreements for financing at the best rates to allow the loan to be bundled into a fund that is traded on the stock market.
- ***Holding tangible personal property.*** "Hotter" assets, such as boats and planes, are more prone to accidents and the resulting liability than relatively passive real estate. While this does not shield the individual operator for liability from his own personal acts/omissions, it does provide a level of protection stemming from problems with the vessel. In that case, personal liability will be shielded by the liability of the LLC, the holding entity. For these reasons, it is wise to title a "hot" asset, like a boat or plane, in an individual's name.
- ***Holding intangible assets.*** It is very common to hold intellectual property, such as patents, trademarks, and copyrights with an LLC. These sometimes avoid tangible or intangible property taxes in other states. Additionally, people often hold domain names and online assets in the name of an LLC. The rights are then licensed from these holding entities to the operating entities.