

THE LIMITED LIABILITY COMPANY: THE BUSINESS HYBRID

By Tina M. Maiolo and Laelia U. Banks

Arguably the most important decision a business owner must make is what business structure to use in his/her company formation. The simplistic days of sole-proprietorships, partnerships and corporations are long gone and the advent of the Limited Liability Company (LLC) has brought on a whole new level to business structures in this country.

What is An LLC?

A creature of state law, the LLC is often described as a combination of a partnership and corporation because it gives the benefits of a partnership's tax advantages and management flexibility while affording the liability protection of a corporation. To better understand what an LLC is meant to accomplish, it helps to first get the nuts and bolts of corporate and partnership structures.

Generally, corporations are formed by filing articles of incorporation with a state agency. Governed by by-laws and strictly managed, a corporation's major appeal is the fact that it protects its shareholders (owners) from the corporation's creditors and offers its shareholders limited liability. Unless a shareholder gives a personal guarantee, a creditor will not be able to attach a shareholder's assets that are not invested in the business. With this benefit, however, comes every shareholder's nightmare; double taxation. A regular corporation is taxed as if it is a separate person, thus diminishing the shareholders' returns to the corporation's earnings minus the taxes paid by the corporation.

Of course there are ways to avoid the corporate tax, but these alternatives also have their downside. For example, shareholders can choose to be taxed as an S Corporation, which provides that the shareholders pay all of the tax themselves on the net income earned by the corporation or claim all of the corporation's losses as their own, thus allowing the corporation's income and expenses to be ignored at the corporate level. The problem, however, is that to qualify as an S Corporation, the company cannot have more than 35 shareholders, other business entities cannot be shareholders, and shareholders may not receive preferred returns over other shareholders.

So, historically, if a business owner did not want his/her company to be subject to corporate tax but could not qualify or did not want to do business as an S Corporation, a partnership was almost the only other alternative for forming a business. At a very basic level, a partnership's income and losses flow through directly to the partners and is not subject to double taxation, like its counterpart, the corporation. The partners are, however, jointly and severally liable for all debts and judgments of the partnership. Of course, those wishing to minimize liability can always enter into a limited partnership. This, however, also has its drawbacks as the limited partnership does require at least one general partner, leaving one person completely exposed to liability for the partnership debts and judgments.

In an attempt to benefit from a corporation's limited liability structure and a partnership's pass through taxation, the first LLC legislation was passed in the late 1970s. By the 1990s it was clear the LLC was here to stay, and today, all 50 states and the District of Columbia have enacted LLC legislation.

Revealing its similarities to both corporations and partnerships, the LLC is formed by filing fairly informal articles of organization, which parallel a corporation's articles of incorporation. It is the LLC's Operating Agreement (analogous to a corporation's articles of incorporation but more similar in form to a partnership agreement or a corporation's by-laws and shareholder agreement) that sets forth the rules that govern the company as well as identifies the rights and responsibilities of the LLC's members.

Within the Operating Agreement, it is the members who define how the LLC will be managed. Unlike the legal requirements of corporations or partnerships, there is a lot of flexibility in choosing how to manage an LLC. Sometimes, most or all of the control of the LLC will be vested in a few people, similar to a corporate structure, while other times the members might decide that everyone will have an active role in the day to day operations of the company.

Advantages of Forming an LLC

Given the flexible nature of the LLC, there are many advantages to forming this type of company, some of which were already discussed above.

1. **Limited Liability:** LLC owners have limited liability, similar to a corporation. Unless they have signed a personal guarantee, members of an LLC cannot be held personally liable for any of the company's debts. A member's liability is limited to the amount he/she has invested in the company.
2. **Pass-through taxation:** For tax purposes, generally, LLCs are treated as sole proprietorships or partnerships and no tax is assessed on the company itself. An LLC with a single owner is automatically taxed as a sole-proprietor while an LLC with several owners is automatically taxed as a partnership. It is possible, however, for an LLC to be treated as a corporation as well for tax purposes.
3. **No Citizenship Requirement:** There is no requirement that LLC owners be citizens or residents of the United States
4. **Flexible Management Structure:** An LLC can be managed directly by its owners or members or a manager who is hired to run the business. Also, unlike corporations, the LLC business structure does not require formal minutes or meetings and as a result is much easier to operate.

Disadvantages of Forming an LLC

Although the perks are many, the LLC can have its share of disadvantages.

1. **Transferability:** It is often harder to transfer ownership of an LLC than with a corporation. In addition, corporations live forever, while the LLC is dissolved when a member dies or becomes bankrupt.
2. **Expenses:** Many states require LLCs to pay ongoing fees, such as annual report and/or franchise tax fees. While it is not extremely expensive for small businesses, it is more expensive to form an LLC than it is to form a sole proprietorship or partnership, neither of which requires documents to be filed for formation with a state agency.

3. New Structure: Finally, in relation to the corporation and partnership, the LLC is a fairly new business structure that is for all practical purposes still developing. As such, there is less case law and legal precedent for LLCs than there is for corporations.

Determining whether your business is best suited for an LLC structure and determining how your LLC should operate depends on a number of different factors, which are unique and specific to each business owner's needs and visions for his/her company. Given the relative newness of the LLC along with the fact that each state has different, specific and possibly quite complicated laws governing LLCs, it is best to consult experienced and capable counsel to assist you in making the crucial decisions of whether and how to form your LLC.