

What You Should Know About Limited Liability Companies

This article is directed to two different groups of people: (1) those who have heard about a limited liability company (LLC) and are wondering if it might benefit them, and (2) those who have already created an LLC and need to be sure they are operating it correctly.

Who can benefit most from an LLC?

Generally speaking, everyone who is engaged in business or in a professional practice as a sole proprietor should consider adopting an LLC. The liability protection offered by an LLC could be critically important to a sole proprietor. Next, owners of rental real estate (both commercial and residential) should consider utilization of one or more LLCs. Again, an LLC could provide valuable liability protection against claims arising out of the ownership, management and maintenance of rental property. In addition, it is virtually indisputable that all persons operating as a general partnership should convert to an LLC operation. Finally, an LLC can be effectively used to protect investments and liquid assets and to enable a family to reduce estate and gift taxes through sophisticated LLC planning.

For what purposes may an LLC be formed?

The laws of most states permit an LLC to conduct or promote any lawful business or purpose, including charitable purposes. An LLC can therefore be formed to conduct an active business operation, to hold an investment portfolio and personal property and to own rental property. In short, there are virtually no limits on an LLC's lawful activities.

What is an LLC primarily intended to accomplish?

The primary purpose of an LLC is to protect assets from lawsuits and judgments. LLCs can be used as vehicles for conducting business operations (much like a corporation) and may also be created to hold investment assets.

What liability protection does an LLC offer?

Members and managers of an LLC are not financially responsible for the debts, obligations or liabilities of the LLC. Thus, an LLC provides a shield in that it protects the members and managers from claims against the LLC arising out of the LLC's operations. Conversely, assets inside an LLC will be protected to some degree from claims and judgments against the owners (members) of the LLC.

Who owns an LLC?

Just as a corporation is owned by its shareholders, and a partnership is owned by its partners, an LLC is owned by its members. Thus, the members of an LLC are equivalent to partners in a partnership and shareholders in a corporation.

Can anybody be a member of an LLC?

There are no legal restrictions on who can be a member of an LLC. For example, a natural person, a corporation, a trust, a partnership or another LLC (or any combination of them) can be a member of an LLC.

How many members must an LLC have?

That depends on the law of the state in which the LLC is organized. No state places a maximum number on LLC members, but many states require at least two members (owners) for formation of an LLC. The trend in legislation in the various states today is to permit one-owner LLCs. States which already authorize one-owner LLCs include Arkansas, Colorado, Iowa Missouri, and Virginia.

Is an LLC subject to federal income tax?

It depends. Treasury regulations permit you to decide whether the LLC will be treated as a corporation, a partnership or, in the case of a one-owner LLC, a sole proprietorship. If the LLC has two or more members and does not want to be taxed as a corporation, it will be treated as a partnership for income tax purposes and will have to file a partnership income tax return, though the LLC itself will not pay any income tax. (All items of income, deduction and credit are passed through the LLC to its members who will reflect those items on their own income tax returns.) However, if the members of the LLC elect to have it taxed as a corporation, the rules governing the taxation of corporations will apply to the LLC.

How will a one-owner LLC be taxed?

Treasury regulations provide that, unless it elects to be taxed as a corporation, a one-owner LLC will be taxed as a sole proprietorship. Thus, no new tax returns will be required and a new taxpayer identification number will not be needed if business is already being conducted as a sole proprietorship.

Can an LLC offer income tax savings?

Because it is a business entity, a LLC can have certain fringe benefits for federal income tax purposes. Specifically, an LLC can have a SIMPLE IRA plan and a Medical Savings Account (MSA) plan, both of which may offer significant income tax savings.

How does a SIMPLE IRA work in an LLC?

Unlike any other qualified retirement Plan, a SIMPLE IRA plan can be used to shelter the first \$6,000 of income from taxation. Other qualified retirement plans typically limit the shelter to a percentage of income, generally no more than 15%. There is no percentage limitation for a SIMPLE IRA on the first \$6,000 of income and thus a participant can shelter 100% of his income if it does not exceed that amount. Thus, if

multiple family members are involved in an LLC, the family can shelter \$6,000 per family member with a properly structured LLC and SIMPLE IRA.

What is a Medical Savings Account (MSA)?

With a Medical Savings Account plan, a family can provide high-deductible medical insurance for all family members and can cover the deductible with contributions to a Medical Savings Account. Both the insurance cost and MSA contributions are deductible for income tax purposes. Having an MSA is like having another IRA account.

Can a revocable living trust and an LLC fit together?

An LLC is owned by its members, such ownership being reflected in membership interests. Those interests can be given to anyone of your choosing, either by way of lifetime gift or at your death. If you establish a revocable living trust, your LLC interests may be assigned to your trust. That way, if you become disabled during your lifetime, your successor trustee will manage those LLC interests for you and the terms of your trust will dictate how they are administered and distributed after you die. Consequently, there will be no probate administration for the LLC interests during your lifetime (if you are disabled) or after your death.

How do I set up an LLC?

In Virginia, a LLC is formed by filing Articles of Organization with the office of the State Corporation Commission (SCC) in Richmond. A one-time filing fee is paid at that time and the SCC will issue a certificate of organization showing that your LLC is now in existence.

Are there any other start-up requirements?

Some states (such as Virginia) require the members of the LLC to set up an operating agreement. This is true for both one-owner and multiple-owner LLCs. Other states do not require the adoption of an operating agreement, but it is always wise to adopt an operating agreement.

Are there maintenance costs for an LLC?

Yes. Once your LLC is established, there are annual fees paid to the SCC to keep the LLC registered. These fees are currently \$50.00 a year in Virginia.

Should others be notified of the LLC's existence?

To make sure that the protective cloak of your LLC is legally recognized, you must publicize the existence of the LLC as much as possible. If you are engaged in business or in the practice of a profession, you must hold yourself out as doing business in the name of the LLC. If you want to place assets in your LLC, it will be necessary to re-title them so that the LLC will be shown as the registered owner of those assets.

What specific steps should I take to publicize my LLC?

If you are operating a business as an LLC, you should change your stationery, invoices, business cards, contract forms, signs and advertising materials to show that you are operating as an LLC. Change your

checking account registration to list it in the name of the LLC. If your business owns motor vehicles, they should be re-titled in the name of the LLC. (The cost of re-titling vehicles is nominal and the title transfer will not be subject to sales tax.) The insurance carriers providing fire and casualty, liability, motor vehicle and errors and omissions insurance must be notified and your LLC should be listed as an additional insured on all such insurance contracts. Business equipment, tools and inventory should be assigned to your LLC. Suppliers and vendors with whom you have accounts should be notified to change their records to reflect the LLC as their customer. If you have not previously obtained a taxpayer identification number for your business from the Internal Revenue Service, you should obtain one now (but if you already have such a number, it is not necessary to get a new one). Finally, you should reflect the name of your LLC on all future filings with federal and state governmental agencies on income, unemployment and withholding tax forms. In other words, you must be consistent in holding your LLC as the business entity so there is no confusion with your personally responsibilities.

If you are not engaged in business but have rental property or investment assets which you wish to transfer to your LLC, the title to real estate should be transferred with a suitable deed and your insurance carriers should be notified, as explained in the preceding paragraph. Brokerage accounts merely need to be re-registered in the name of the LLC and individual securities must be re-registered in the name of the LLC through your broker or transfer agent. Mortgage companies may also need to be contacted to obtain their permission for the transfer to the LLC to avoid triggering any "due on sale or transfer" clauses in your mortgage or deed of trust.

What if I have other questions which have not been answered here?

Estate and asset protection planning with LLCs can be relatively simple or it can be quite complex, depending on your needs and goals. To help you determine whether an LLC is right for you and to set up your LLC and implement it properly, it is highly advisable to retain the services of qualified legal counsel to guide you through the process and to answer many potential questions which have not been addressed in this article.

This article was prepared by Midgett & Preti PC and is intended to provide general advice only. For answers relating to a specific situation, you should consult a competent estate-planning lawyer.