Chapter 1

What Is an LLC, Really?

In This Chapter

- Understanding LLC basics
- Deciding how to use your LLC
- Creating your plan of attack

Unless you've been living under a rock, or in Zimbabwe perhaps, you've most likely heard of limited liability companies, LLCs. And you hear about them all the time for good reason! It's almost as if the corporate gods have smiled down on us and decided to improve on the corporation by creating the LLC. As I like to put it: Where the corporation fails, the LLC prevails.

Think of the LLC as a merger of the partnership and the corporation that has the best of both worlds — all the good qualities of each and none of the bad. It offers full limited-liability protection to all the owners (like the corporation), yet has pass-through tax status (like the partnership). In addition, the LLC has a second layer of liability protection that shields the business from any personal lawsuits that may befall you. And it doesn't stop there! The list of benefits goes on and on. In this chapter, I introduce you to those benefits and other LLC fundamentals while steering you toward the other chapters in the book where you can find out more details.

Understanding How LLCs Work

Compared to the corporation, which has been around for hundreds of years, the LLC is the new kid on the block. Therefore, this new type of entity hasn't been so easy for some old-fashioned folks to accept. However, when you understand how LLCs work, you'll probably see many ways that they can help your business.

Even if you're familiar with corporations — or partnerships, for that matter — LLCs present some new concepts and terminology. The best and most basic way to understand an LLC is to think of it as a regular partnership except all the partners have the huge benefit of full *limited liability protection.* This protection means that the partners (the *members*) aren't personally responsible for the actions or debts of the company. Also, LLCs are more official than regular partnerships because you form them with the state and you can raise financing by selling off pieces of the company (the membership interests). But when all is said and done, LLCs are easy to understand and easy to run. Not to mention, if you make a mistake, the consequences aren't as dire as they would be with a corporation.

LLCs, like most entities, are subject to state oversight. The problem is that not all states are on the same page. So in addition to reading this book, you'll need to do a little bit of research so that you can make sure you're complying with the laws of the state(s) where you transact business. Finding that information won't be too difficult, however, because I have provided each state's information on LLCs in Appendix A as well as loading all state LLC laws onto a public wiki at `www.docrun.com/wiki`. This book, along with these added resources, will give you everything you need to get started down the right path.

REMEMBER

Courts still have a lot to decide about LLCs, unlike corporations, which have hundreds of years of case law backing them up. When operating an LLC, know that some practices are based on assumptions rather than actual legal precedents, and this creates gray areas — and potential problems. After all, you don't want to be the unlucky business owner stuck in the courtroom when everything you thought you knew about LLCs is overturned. The best way to avoid that scenario is to have a great registered agent or corporate attorney who stays abreast of LLC laws for you.

Owners: You gotta have 'em

Although LLCs are separate from their owners in a lot of ways, they still need to have them. An LLC without an owner is like a child without parents: It simply doesn't exist. So until you dole out the ownership in your LLC, it doesn't become its own separate entity.

The owners (see Chapter 9) not only own the entire enterprise and all its assets, but they also generally have the last say. Although they may not manage the business, they do elect the managers. They vote on important issues and ultimately control the company's fate.

The owners in the LLC are called *members.* They have units of ownership called *membership interests* that show what percentage of the company they own and how much influence they have when voting on important company matters. Membership interests in an LLC are comparable to stock in a corporation. However, unlike the S corporation (which is often compared to the LLC), LLCs can have unlimited members of any type. Members can be citizens of other countries or even entities such as corporations, partnerships, or trusts.

The actual term for the members of the LLC and their membership interests varies from one state to another. For instance, in some states, the membership interest is called *ownership interest* or *limited liability company interest.* Just keep in mind that no matter what they're called, the concepts are still the same.

LLCs offer a lot of flexibility in how you issue membership. For instance, your LLC can have many different forms of membership, called *classes,* with whatever rules you want for each class. For instance, one class can have priority on the profit distributions while the other class is second in line. Or one class can have a say in managing the company while another class must remain silent. In Chapter 9, I go into detail on how to issue membership interests in your LLC.

If your LLC has only one member, it's called a *single-member LLC.* Single-member LLCs are treated as sole proprietorships by the IRS for tax purposes. Your state laws, if they even allow single-member LLCs (some don't), may also treat them differently. Single-member LLCs are often disadvantageous, because they don't have the benefit of partnership taxation and aren't guaranteed *charging order protection,* which protects the LLC from lawsuits that may be filed against you personally. (I discuss this concept in depth in Chapter 16.)

Contributions: Where the money comes from

When you buy a share of stock on the stock market, the money you pay is what you are contributing (or *investing*) in return for a percentage of the company's ownership. Well, LLCs are no different. In exchange for their membership interest in the company, members must contribute something of value. This *something* can be in the form of cash, services, hard assets such as equipment, real estate, or even promissory notes (which are allowed in some states). See Chapter 9 for more details on contribution types.

When a member makes a contribution, the other members need to determine the value of that contribution in relation to everyone else's. They then distribute the membership interests proportionally, which is really easy to do when cash is involved. For instance, if Joe, Steve, and Mary each contribute $100,000 in cash, then they each are issued one-third of the company. All the contributions made by each of the members and their corresponding membership interests are listed in the operating agreement.

Most LLCs issue membership certificates that, like stock certificates in a corporation, are evidence of the amount of ownership a member has in the company (see Chapter 9). The membership certificate displays the member's name and the number of membership units the person owns. To determine the member's percentage of ownership in the company, you divide the number of units she owns by the total number of units issued in the company. For instance, if 10,000 membership units are issued to members of the company and you own 100 of those units, then you own 1 percent of the company. If the company doesn't issue membership certificates, then the number of units you own should be listed in the operating agreement next to your contribution amount. (In Chapter 10, I show you how to properly list your members, their contributions, and membership interests in your LLC operating agreement.)

Distributions: Getting what you're due

After the company starts turning a profit, the members will no doubt want to benefit. After all, they didn't invest their hard-earned money into the company for nothing — they want to see a return! At certain points in time — usually at the end of the year, but sometimes at the end of each quarter — the company profit is calculated and doled out to each member, usually in proportion to her percentage of ownership. These payments are called *distributions* and are generally in the form of cash (see Chapters 9 and 10 for more on distributions).

TIP

Unlike corporations, LLCs don't have to distribute profits in proportion to the members' percentage of ownership. The members can decide to vary the distributions however they want. The IRS generally allows this variation as long as you pass their tests (mainly to prove that you aren't varying the distributions to avoid taxes). Speak to your accountant if you are interested in doing this.

The birth of the LLC

The LLC didn't come out of nowhere. Business entities with the same characteristics as LLCs have been around for many years. The origin of LLCs can be traced back to 1892, when German law enacted what was called the *Gesellschaft mit beschränkter Haftung* (GmbH) — a modern-day variation of the English private limited company.

Germany's GmbH format was copied throughout Europe and Central and South America. This concept has remained popular in many parts of the world to this day.

In the United States, limited partnership associations actually predated the German concept. These entities were formed in several Midwestern states starting as early as 1874. However, this entity structure fell out of favor soon after. In 1977, the LLC was born in Wyoming and modeled after the German GmbH and the successful Panama variation. LLCs didn't become popular nationally until 1988, when the IRS ruled that LLCs would be taxed as partnerships. And the rest, as they say, is history.

Distributions also occur if your LLC goes out of business, but in this case they're handled differently. The LLC's assets are liquidated, the creditors are paid back (including any members to whom the business owes money), and then the remaining amount is distributed to the members according to their specific ownership percentages. When these final distributions are made, you can't choose how the money is distributed — it must be doled out according to how much of the company each member owns. For instance, if you own 50 percent of the company, you can rest assured that you will receive 50 percent of the remaining cash.

Creating Your Own LLC: It's a Piece of Cake

I'm baffled why so many people go about doing business and owning real estate without the protection of a limited liability company or other entity. They are risking everything! I can only guess that they must be intimidated by the process of forming an LLC and think that it's much more complicated than it really is.

Sure, LLCs don't just think themselves into existence. Someone has to create them, but LLCs aren't complicated at all. Some professionals use them in complicated situations, but when you're dealing with normal, everyday business activities or asset protection strategies, you'll have no trouble forming and operating as an LLC. As you flip through this book, the concepts may seem overwhelming at first, but after getting familiar with a little bit of industry terminology, you'll have enough of a basic understanding of LLCs to get started on your own. And, in the worst-case scenario, if you have a question that isn't answered in this book, feel free to call my office at 888-88MYLLC so that I can make sure you get the correct answer.

To create an LLC, you have to draft a short document and file it with your state. This step is pretty simple to do and, for the most part, won't require an attorney's help. First, though, you need to do some research so you understand some other elements of LLCs and then make some decisions on how you want to structure your company.

Educating yourself

The first thing to do is gain a little bit of an education about LLCs. I know you're busy, so this doesn't have to be too extensive. You just need to know the basics, and the best way to start is by reading this book. Needless to say, you're on the right track!

TIP

You can always use professionals to do the work for you. And that's okay. Hey, I'm all for delegation! Just make sure you have a good basic understanding so you can have productive and educated conversations with the people you hire. Not to mention, you'll want to have an idea of whether they really know their stuff.

After you understand the basics, call your attorney or accountant and ask about details that pertain to your situation. You may also want to do some research online and set up some free consultations with corporate consulting companies. You can also find a lot of in-depth information in my syndicated articles, which I put online at `www.myllc.com`.

Surveying your assets and making a plan

If you have been working hard all your life, you've probably accumulated some valuable assets. Even if you aren't operating a business, creating an estate plan, or investing in real estate, you likely have some things you want to protect from creditors and lawsuits. Some of these assets may include

- Rental real estate
- Vacant land
- Businesses
- Intellectual property
- Expensive equipment (business or personal)
- Vehicles
- Savings accounts, money market funds, and CDs
- Stocks and bonds
- Any appreciating assets

You should consider protecting anything that's of value to you in an LLC. Lawsuits and personal creditors abound in today's society, and by leaving anything in your name, you are virtually handing it over to any attorney who wants it.

TIP

When using LLCs, consider forming more than one. After all, you never want to put all your eggs in one basket. For example, if you have multiple rental properties in one LLC and a tenant has an accident on one of your properties, then all the properties will be up for grabs because they are in the same LLC. However, if you separate those properties into multiple LLCs, then only the one property that was sued can be taken.

WARNING!

If you are a procrastinator, watch out. Wasting too much time to put together your plan and act on it can cost you. Lawsuits come out of nowhere, and Murphy's Law states that you will get sued at the worst possible time. After you are faced with a lawsuit or have a creditor after you, your hands are tied. Any attempt to protect your assets at that point is illegal. Not only will you still lose your assets, but you can also end up with some hefty fines or, even worse, jail time.

Deciding who manages

There are two types of LLCs:

- Member-managed, where the LLC is managed jointly by all its members
- Manager-managed, where the LLC is managed by a separate manager (who can also be a member)

If you are forming a smaller LLC with only a few partners (members), and each partner will have a say in managing the company, then you may want to choose member-managed. However, if you decide to take on a silent partner and that person will *not* be managing the business, then your LLC needs to be *manager*-managed. Unless *all* members will be managing, you have to be manager-managed.

TIP

In most states, you have to list how the LLC is managed in the organizing document that is filed with the state (called the *articles of organization* — see Chapter 6). If your management structure changes, the organizing document may have to be amended. This process involves fees, so be as forward-thinking as possible before you do your initial filings and begin operations.

Choosing your registered agent

Before you can file your articles of organization, you need to choose a *registered agent* (sometimes called a *resident agent, statutory agent,* or *RA*). This person or company is *always* available during business hours, every single day, to accept any formal legal documents for your company in the unfortunate instance that you are sued.

Most registered agents allow you to use their office address for all your mail and other correspondence. A good registered agent should also stay on top of your state filings for you and make sure that you remain in good standing in the state (or states) where you are registered to transact business. If you are registered in many states, this task can be onerous, so you're better off leaving it to the professional service companies or an attorney (a more expensive option). See Chapter 6 for more on using a registered agent.

If your state allows you to serve as your own registered agent, I don't recommend it. Unless you plan on being at your office during business hours every single day, with no exceptions, and you also have a good grasp of all the state filings that need to be done, I suggest you leave it to the pros. Another consideration is that in the event that you're sued, would you really want a process server or sheriff serving you a lawsuit in front of your customers? Eek! Not me!

Bringing your LLC into existence

Your LLC needs to be registered and receive approval in any state where it is transacting business. LLCs don't need to reside in the same state as you — they should reside wherever their headquarters is going to be. In the case of companies that don't have headquarters (like Internet-based companies), they should reside wherever the tax laws are most favorable.

You create your LLC by drawing up a short document called the *articles of organization.* Your articles contain such basic information as the name of the company, how long the company will exist, the initial members or managers, and the name and address of the company's registered agent. In Chapter 6, I show you how to put together your articles of organization. After you are satisfied with your articles, you file them with your local secretary of state's office (or comparable state agency).

Operating Your LLC

Now that you've formed your LLC, you're ready to start business operations, right? Well, not exactly. You still have to create your operating agreement and make some very important decisions.

Operating your LLC is meant to be easy. For the most part, if you forget something or fail to document something in writing, the courts will go easy on you. LLCs aren't like corporations where a single misstep can cost you your limited liability protection. Although this paperwork isn't nitpicked by the state statutes like corporation paperwork is, you can save yourself a lot of time, hassle, and potential legal battles by getting it out of the way and making your agreements as tight as a drum.

Creating your operating agreement

Think of your *operating agreement* as a sort of partnership agreement, except with much more power. Your operating agreement is the blueprint for your company. In it, you state your company's policies on important matters, including

- How the company will be managed and by whom
- How important decisions are to be made
- How profits are to be distributed among the owners
- The titles and positions of managers and officers of the company
- The membership information, including who is a member, what that person contributed, and what membership interest they have been assigned

Creating an operating agreement takes some time and planning, but it's vital. With the wealth of information and provisions that I provide for you in Chapter 10, you'll be able to draft an ironclad document. However, you and your partners may take a while to decide what you want to put in it. After all, you are creating an infrastructure that needs to serve you for many, many years to come.

After you create your operating agreement, make sure that all the members and managers of the LLC sign it. Distribute a copy to everyone for their records, and put the original in your company records kit (which brings me to the next point).

Keeping books and records

All companies need to have a records kit. A *company records kit* normally looks like a big, leather binder with the company name emblazoned on the side. The kit can be cheap and low quality — looking like it came from the office-supply aisle of your local supermarket — or it can be made from the finest leather with real gold plating. No matter how simple or extravagant, every kit serves the same purpose: to house your important company records, such as your filed articles of organization and company charter, your operating agreement, resolutions and minutes from any meetings or voting that take place, your membership roll, and your unissued membership certificates. Chapter 11 has more details on how and where to keep your company's records.

When you order your records kit, make sure it comes with a company seal. Think of the company seal as your LLC's signature. You use it to make your company documents and share certificates official.

Paying taxes

One of the most beautiful features of an LLC is that it can elect any form of taxation it wishes (assuming it's not a single-member LLC). This means that your LLC can have partnership taxation, corporation taxation, or S corporation taxation. What flexibility! I dedicate all of Chapter 8 to helping you make this hugely important decision.

The default taxation for LLCs is partnership taxation, so this is what you'll be subject to if you don't elect otherwise. With partnership taxation, the business's profits and losses get passed on to the owners, who report their share on their personal tax returns. These portions of profits and losses that get passed on to the members are called *allocations.* This type of taxation is commonly referred to as *pass-through taxation.*

Because the LLC doesn't actually have to pay taxes itself, the IRS only requires you to file an information statement (IRS Form 1065) that states how the company's profits and losses are allocated among the members. Additionally, the company issues each member an IRS form called a Schedule K-1 that shows the information they need to determine how much tax they must pay on the company's profits.

LLCs aren't required to distribute any cash to the members. However, the members *are* required to pay taxes on the profits, whether or not they received distributions. When the company doesn't distribute the profits to the members, the profit is called *phantom income,* and the members still have to pay taxes on it out of their own pockets.