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LIMITED LIABILITY COMPANIES—THE BEST OF ALL WORLDS?

A limited liability company (LLC) is a business structure that combines some of the best features of sole proprietorships, partnerships, and corporations. LLC owners, like their counterparts for partnerships or sole proprietorships, report profits or losses on their personal income tax returns. Like a corporation, however, the owners of an LLC have “limited liability,” that is, they are shielded from personal liability for debts and claims arising from the business.

Limited Liability

The limited liability for LLC owners is not absolute. Owners still can be held liable if they (1) personally and directly injure someone; (2) personally guarantee a loan or business debt on which the LLC defaults; (3) fail to deposit taxes withheld from employees’ wages; (4) intentionally commit a fraudulent or illegal act that harms the company or someone else; or (5) treat the LLC as an extension of their personal affairs rather than as a separate legal entity.

The last exception to limited liability is the most significant. It carries the potential for complete removal of the protections for individual owners. If the line between LLC business and personal business becomes too blurred, a court could find that a true LLC does not exist, leaving the owners personally liable for their actions.

Ownership

Most states allow a single individual to be the sole owner of an LLC. An LLC makes the most sense in circumstances where there is a concern about personal exposure to lawsuits stemming from operation of the business. Most laws prohibit establishment of an LLC in the banking, trust, and insurance fields.

Unlike corporations, LLCs can carry on their business without holding regular ownership or management meetings. Of course, formal meetings backed up by written minutes still may be advisable to document important decisions, such as a change in membership or a major expenditure.

Formation

Setting up an LLC is relatively simple. Articles of organization must be filed with the appropriate state office, usually the Secretary of State. The articles of organization include the name and principal office for the LLC, the names and addresses of its owners, and the name and address of the person or company that agrees to accept legal papers on behalf of the LLC.

Even if it is not legally required, the owners should prepare an operating agreement that spells out the owners’ rights and responsibilities. The absence of an operating agreement will mean that state statutes will govern the operation of the LLC by default. An operating agreement acts as a

guide for resolving common issues that an LLC will face, and thereby helps to avert misunderstandings between the owners. It also underscores the authenticity of the LLC itself, which can be helpful when a judge is deciding whether the owners are protected from personal liability.

A standard operating agreement includes the members' percentage interests in the business; the members' rights and responsibilities; the members' voting power; allocation of profits and losses; how the LLC will be managed; rules for holding meetings and taking votes; and "buy-sell" provisions that control what happens when a member wants to sell his interest, becomes disabled, or dies. Although it is frequently overlooked when an LLC is created, a buy-sell agreement is important as a sort of "premarital agreement" among the owners. The buy-sell provisions can clarify and ease the transition when the inevitable changes come to the members of the LLC.

Taxes

Since an LLC is not considered separate from its owners for tax purposes, the LLC pays no income taxes itself. Like a partnership or sole proprietorship, an LLC is a "pass-through entity." Each owner pays taxes on a share of profits, or deducts a share of losses, on a personal tax return. The IRS regards each member as a self-employed business owner, not an employee of the LLC. There is no tax withholding, and owners must estimate taxes owed for the year, then make quarterly payments to the IRS.

Conversion

By converting to the LLC business structure, sole proprietors and partnerships can gain the protection afforded to LLC owners without changing the way their business income is taxed. Conversion usually can be accomplished either by filling out a simple form or filing regular articles of organization. Federal and state employer identification numbers will have to be transferred to the name of the new LLC, as will

such items as sales tax permits, business licenses, and professional licenses or permits.

The process for creating an LLC is streamlined and free of highly technical considerations. However, there is an important place for professional advice concerning such matters as choosing an LLC over other business structures, preparing or reviewing the operating agreement, and setting up accounting systems.

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We appreciate your referrals!

Happy Thanksgiving!

