LIMITED LIABILITY COMPANIES

Formation, Operation, and Conversion

THIRD EDITION

Robert W. Wood

Wolters Kluwer
Law & Business

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PREFACE TO THIRD EDITION

Few attorneys, accountants, or business advisors have not had clients ask about the advantages and disadvantages of operating through an LLC. Today, no choice-of-entity discussion is complete without full consideration of the LLC. LLCs are used for small businesses, large businesses, in estate planning, real estate development and venture capital financing. LLCs are used by strictly family businesses, by equity buy-out groups, and even by large public companies in both foreign and domestic operations.

They also are perfect for holding investments. Investors usually wish to have a degree of control that is inconsistent with limited partner status in a limited partnership. With an LLC, there are virtually no restrictions on the degree to which a member may participate in decision-making without fear of general partner liability.

As the role of LLCs has expanded, synthesizing their use and mechanics has become more difficult. Yet one thing has remained eminently clear: LLCs are almost infinitely flexible, perhaps the most flexible business entity ever devised. This can put a premium on drafting, making the lawyer's job more difficult.

With LLC statutes in place in every domestic jurisdiction, one must become familiar with the terminology and operation of these entities. They take their place next to corporations and partnerships as standard business vehicles. Precisely because of the flexibility of the LLC, the role of attorneys and other advisors is more difficult than with corporations or partnerships.

One of the more important federal tax developments of the last two decades concerns tax classification. For the LLC to make sense as a business vehicle, it must be taxed as a partnership. Traditionally, this tax classification decision was convoluted.

The Internal Revenue Service revolutionized the field of entity classification with its check-the-box regulations. As their name suggests, the practitioner now merely checks a box to determine whether the entity will be taxed as a partnership or corporation. The impact of these regulations cannot be overstated. They rescue taxpayers from the burdens of the convoluted corporate classification regulations. They also present at least a few traps practitioners need to avoid.

I hope this third edition of *Limited Liability Companies: Formation, Operation, and Conversion* will make the advisor's role a little easier.

San Francisco, California
June 2010

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CHAPTER 1

LIMITED LIABILITY COMPANIES: AN INTRODUCTION

§ 1.01 INTRODUCTION

The limited liability company (LLC) is a relatively new form of doing business that combines the advantages of a partnership's flow-through tax treatment and operating flexibility with a corporation's limitation on liability for shareholders. All states now have enacted LLC statutes.[1] The following discussion is designed to present an overview of the topic and to reference the reader to more detailed discussion of the key issues found elsewhere in the text.

§ 1.02 HISTORY

Even though most attorneys in the United States have only just begun to practice with LLCs over the past two decades, the LLC, nonetheless, is not a new invention. Entities similar to the LLC have existed for many years in Europe and Latin America. For example, in Germany the *Gesellschaft mit beschränkter Haftung* (the *GmbH)*[2] is a company with the same basic characteristics as an LLC. In French-speaking jurisdictions, the *societé à responsibilité limiteé (Sari)* is quite similar to the LLC; in Spanish-speaking jurisdictions, the *sociedad de responsibilidad limitada (limitada)* is quite similar. Under the foreign laws, an

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[1] Ala. Code §§ 10-12-1 to -61 (Michie Supp. 1993); Alaska SCS CSSS H.B. 240; Ariz. Rev. Stat. Ann. §§ 29-601 to -857 (Supp. 1992); Ark. Code Ann. §§ 4-32-10 to -1316 (Michie Supp. 1993); Cal. Corp. Code §§ 17000-655 (West 1999); Colo. Rev. Stat. Ann. §§ 7-80-101 to -80-913 (West Supp. 1992); Conn. Acts 93-267; Del. Code Ann. tit. 6, §§ 18-101 to -1109 (1999); D.C. Code Ann. §§ 29-1301 to -1375 (1999); Fla. Stat. Ann. §§ 608.401 to .471 (West 1993); Ga. H.B. 264, Ga. Code Ann. §§ 14-11-101 to -1109 (Michie Supp. 1993); Idaho Code §§ 53-601 to -672 (Michie Supp. 1993); 111. Ann. Stat. ch. 805, para. 180/1-1 to 180/60-1 (Michie 1993); Ind. Code §§ 23-18-1-1 to -13-1 (Michie Supp. 1993); Iowa Code §§ 490A.100 to -.1601 (1993); Kan. Stat. Ann. §§ 17-7601 to -7651 (Supp. 1992); Ky. Rev. Stat. Ann §§ 275.001 to .455 (1999); La. Rev. Stat. Ann. §§ 12:1301 to :1369 (West Supp. 1993); Me. Rev. Stat. Ann. Tit. XXXI, §§ 601 -762 (West 1999); Mass. Gen Laws ch. 156C, §§ 1 -68 (1999); Md. Corps. & Ass'ns Code Ann. §§ 4A-101 to -1103 (1993); Mich. Comp. Laws Ann. §§ 450.4101 to .5200 [1993 Mich. Legis. Serv. 110 (West)]; Minn. Stat. Ann. §§ 322B.01 to .955 (West Supp. 1993); Miss. Code Ann. §§ 79-29-101 to -1201 (1999); Mo. Rev. Stat. §§ 359.700 to .908 (1994); Mont. Code Ann. §§ 35-8-101 to -1307 (1993); Neb. Rev. Stat. §§ 21-2601 to -2645; Nev. Rev. Stat. Ann. §§ 86.011 to .571 (Michie Supp. 1991); N.H. Rev. Stat. Ann. §§ 304-C:l to :85 (Supp. 1993); N.J. Rev. Stat.§§ 42:2B-1 to -23 (1993 N.J. ALS 210); N.M. Stat. Ann. §§ 53-19-1 to -74 (Michie Supp. 1993); N.Y. Ltd. Liab. Co. Law §§ 101-1403 (McKinney 1999); N.C. Gen. Stat. §§ 57C-1-01 to -10-07 (Supp. 1993); N.D. Cent. Code §§ 10-32-01 to -155 (Supp. 1993); Ohio Act 94-74; Okla. Stat. Ann. tit. 18, §§ 2000 -2060 (West Supp. 1993); Or. Rev. Stat. §§ 63.001 to .990 (Supp. 1994); Pa. Stat. Ann. Tit. 15, §§ 8901 -998 (West 1999); R.I. Gen. Laws §§ 7-16-1 to -75 (1993); S.C. Code Ann. §§ 33-44-101 to -1207 (Law Co-op 1999); S.D. Codified Laws §§ 47-34-1 to -59 (Supp. 1993); Tenn. H.B. 9052; Tex. Rev. Civ. Stat. Ann. art. 1528n (West Supp. 1993); Utah Code Ann. §§ 48-2b-101 to -157 (1992 & Supp. 1993); Vt. Stat. Ann. Tit. 11, §§ 3001 -013 (Michie 1999); Va. Code Ann. §§ 13.1-1000 to -1073 (Michie Supp. 1992); Wash. S.S.H.B. 1253; W.Va. Code §§ 31-1A-1 to -69 (Supp. 1992); Wis. Stat. §§ 183.0102 to .01206; Wyo. Stat. §§ 17-15-101 to -136 (1977).

[2] *Gesetz betreffend die Gesellschaffen mil beschrdnkter Haftung (GmbHG)* (F.R.G. Apr. 20, 1892).

LLC-type company usually offers limited liability to all the members, each of whom has equal status (no general partner), with restrictions on the continuity of existence and the free transferability of interests either required by statute or permitted by an articles provision. This form of doing business is, in foreign practice, usually used by closely held companies.

In the United States, from 1874 to 1881, Pennsylvania, Michigan, New Jersey, and Ohio passed statutes allowing the creation of a "partnership association," an organizational form that is similar to an LLC.[3] Partnership associations provided limited liability, but such partnership associations never proliferated.

In 1977, Wyoming was the first state in the United States to enact a statute enabling the use of LLCs. The Wyoming act was originally proposed as special interest legislation by a mineral concern headquartered in Houston, Texas. The mineral company had attempted to have the legislation passed by the Alaska legislature and had failed. In lobbying for the legislation, the LLC was likened to the "partnership association."[4]

Five years later, Florida became the second state to enact an LLC statute. The Florida act was modeled after the Wyoming act, which in turn contained provisions drawn from the Uniform Limited Partnership Act and the Model Business Corporation Act. Between 1977 and 1988, not many LLCs were formed, however, because of the uncertainty concerning the tax treatment of LLCs.

At the end of 1988, the Internal Revenue Service issued Revenue Ruling 88-76,[5] which favorably classified a Wyoming LLC as a partnership for federal income tax purposes. After this critical issue was resolved, other states began to recognize the value of the LLC and adopt LLC legislation. Since 1988, the remaining states and the District of Columbia have enacted legislation recognizing LLCs,[6] and thousands of LLCs have been formed.

§ 1.03 GENERAL DESCRIPTION

An *LLC* is an unincorporated form of doing business that provides its members with limited liability and allows them to actively participate in management of the business. Most LLCs are organized in such a manner that they are classified as a partnership for federal income tax purposes.

One of the primary benefits of the LLC is that it provides an alternative to the corporation as an entity that provides its owners with limited liability. Members of LLCs are generally liable only to the extent of their capital contribution to

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[3] 1874 Pa. Laws 274 (repealed); Mich. Comp. Laws Ann. §§ 449.301 to .373 (West 1989); N.J. Stat. Ann. §§ 42:3-1 to -30 (West 1940 & Supp. 1992); Ohio Rev. Code Ann. §§ 1783.01 to .12 (Anderson 1992).

[4] *See* T.N. Long, The Wyoming Limited Liability Company (unpublished paper available from the Wyoming Secretary of State).

[5] 1988-2 C.B. 360, made obsolete by Rev. Rul. 98-37, 1998-2 C.B. 133.

[6] *See* § 1.01.