

Limited Liability Entities

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WHAT'S COVERED

In this lesson, you will take a closer look at the functions of a particular type of business entity. Specifically, this lesson will cover:

1. Purpose of Limited Liability Companies

By now you should understand how easy yet dangerous it is to do business as a sole proprietor, and why many business organizations are drawn to the corporation as a form for doing business.

As flexible as the corporation is, however, it is probably best suited for larger businesses. Annual meeting requirements, the need for directors and officers, and the unattractive taxation features make corporations unwieldy and expensive for smaller businesses. A form of business organization that provides the ease and simplicity of sole proprietorships, but the limited liability of corporations, would be much better suited for a wide range of business operations.

A **limited liability company (LLC)** is a good solution to this problem. LLCs are a “hybrid” form of business organization that offers the limited liability feature of corporations but the tax benefits of partnerships. Owners of LLCs are called members. Just like a sole proprietorship, it is possible to create an LLC with only one member. LLC members can be real persons or they can be other LLCs, corporations, or partnerships.

Taxation of LLCs is very flexible. Essentially, every tax year the LLC can choose how it wishes to be taxed. It may want to be taxed as a corporation, for example, and pay corporate income tax on net income. Or it may choose instead to have income “flow through” the corporate form to the members, who then pay personal income tax just as in a partnership. Sophisticated tax planning becomes possible with LLCs because tax treatment can vary by year.



TERM TO KNOW

Limited Liability Company (LLC)

A hybrid between a corporation and a partnership in that it is a separate entity but has fewer formalities than a corporation. It is a simpler form of entity than a corporation but also has limited liability of its owners like a corporation, and unlike a partnership. It can only be formed under state law.

2. Formation of Limited Liability Companies

LLCs are formed by filing the **articles of organization** with the state agency charged with chartering business entities, typically the Secretary of State. Starting an LLC is often easier than starting a corporation.

In fact, you might be startled at how easy it is to start an LLC; typical LLC statutes require only the name of the LLC and the contact information for the LLC's legal agent (in case someone decides to file a lawsuit against the LLC). In most states, forming an LLC can be done by any competent business professional without any legal assistance, for minimal time and cost.

Unlike corporations, there is no requirement for an LLC to issue stock certificates, maintain annual filings, elect a board of directors, hold shareholder meetings, appoint officers, or engage in any regular maintenance of the entity. Most states require LLCs to have the letters "LLC" or words "Limited Liability Company" in the official business name. Of course, LLCs can also file d.b.a. filings to assume another name.

Although the articles of organization are all that is necessary to start an LLC, it is advisable for the LLC members to enter into a written LLC **operating agreement**. The operating agreement typically sets forth how the business will be managed and operated. It may also contain a buy/sell agreement just like a partnership agreement.

The operating agreement allows members to run their LLCs any way they wish to, but it can also be a trap for the unwary. LLC law is relatively new compared to corporation law, so the absence of an operating agreement can make it very difficult to resolve disputes among members.



TERMS TO KNOW

Articles of Organization

The state filing required to start an LLC. For corporations, these are called articles of incorporation.

Operating Agreement

The contract between members of an LLC.

3. Disadvantages of Limited Liability Companies

LLCs are not without disadvantages. Since they are a separate legal entity from their members, members must take care to interact with LLCs at arm's length, because the risk of piercing the veil exists with LLCs as much as it does with corporations.

Fundraising for an LLC can be as difficult as it is for a sole proprietorship, especially in the early stages of an LLC's business operations. Most lenders require LLC members to personally guarantee any loans the LLC may take out.

Finally, LLCs are not the right form for taking a company public and selling stock. Fortunately, it is not difficult to convert an LLC into a corporation, so many start-up businesses begin as LLCs and eventually convert into corporations prior to their initial public offering (IPO).

4. Limited Liability Partnerships

A related entity to the LLC is the **limited liability partnership (LLP)**. Be careful not to confuse limited liability

partnerships with limited partnerships.

LLPs are just like LLCs, but are designed for professionals who do business as partners. They allow the partnership to pass through income for tax purposes, but retain limited liability for all partners. LLPs are especially popular with doctors, architects, accountants, and lawyers. Most of the major accounting firms have now converted their corporate forms into LLPs.

Compared to limited partnerships, LLC members can participate in day-to-day management of the business. Compared to S corporations, LLC members can be other corporations or partnerships, are not restricted in number, and may be residents of other countries.



TERM TO KNOW

Limited Liability Partnership (LLP)

A form of business organization that allows the partnership to pass through income for tax purposes, but retain limited liability for all partners.



SUMMARY

In this lesson, you learned that the **purpose of limited liability companies**(LLCs) is to give owners, called members, limited liability just like corporations. Unlike corporations, however, LLCs can avoid double taxation by choosing to be taxed like a partnership or sole proprietorship. The **formation of an LLC** is also simpler than that of a corporation, as LLCs have fewer legal requirements to meet when starting up. Some **disadvantages of LLCs**, however, are that fundraising can be difficult and company stock cannot be publicly traded. The **limited liability partnership** (LLP) is similar to the LLC, except it is designed for professionals, such as accountants or lawyers, who do business as partners.

Best of luck in your learning!

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