

"Is an LLC For Me?"

by Joe Hadzima

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Well the Massachusetts legislature finally did it: enacted a "Limited Liability Company" statute. As mentioned in an earlier *Starting Up* column, Massachusetts was one of only a handful of states that did not recognize this legal form of doing business. Now that we have it, a number of clients and entrepreneurs starting new ventures have asked me: "Is an LCC for me?"

First, what is an LLC? To answer this, we need to climb into a time machine and take a journey back in history. In the beginning of time before the LLC statute, there were two main legal forms in which businesses operated: corporations and partnerships.

The corporate form is most familiar and provides limited liability to the stockholders/owners. For federal tax purposes, corporations are categorized into "C corporations" and "S corporations," with the letters referring to the subchapter of the Internal Revenue Code under which they are taxed. "C corporation" is the default category and results in two layers of tax: the corporation is taxed on its net income, and the stockholders are taxed when they receive dividends, etc. This can result in a combined tax rate of 60 percent or more. "S corporations" are so-called "pass thru" tax entities, meaning they have only one layer of tax. The S corporation does not pay tax on its income, which is deemed distributed or "passed thru" to the corporation's stockholders who have to include the income on their individual tax returns whether or not they actually receive any cash. This one layer of tax is generally viewed as a good thing. The problem is that there are strict eligibility rules for Subchapter S status—e.g. no more than 75 stockholders, all of whom must be "human beings" (some trusts qualify) who are "not non-resident aliens," and there can only be one class of stock. These rules limit the situations in which S corporations can be used. For example, a venture capital investment usually destroys S status because a venture capital fund investor is not a "human being" (many entrepreneurs would agree with this statement on many levels). [Note: some of these Subchapter S rules changed in 1997, so look into your situation more closely with proper advisors.]

Partnerships are also "pass thru" tax entities and they don't have as many eligibility requirements as S corporations. In fact, the partnership tax rules can accommodate fairly creative allocations of profits and losses among the participants in the business. However, to achieve limited liability status the limited partners of a limited partnership cannot participate in management of the business, while the general partner has full personal liability for the business.

So for years we had to choose between the corporate form and the partnership form. In the vast majority of cases the corporate form was chosen for operating businesses and, if we could make it work, the corporation elected to be taxed as a Subchapter S corporation. Over many years the gurus in this area kept scratching their heads and said, “There must be a better way.” And after much scratching, the outlines of a new entity began to appear, one in which limited liability could be achieved for all owners regardless of who or how many there were or whether or not they participated in management, and which would receive pass thru tax treatment without undue restrictions. A few state statutes were enacted, a few IRS rulings were obtained, and the whole thing snowballed until, in a “2001” Zarathustra fanfare, the LLC was born.

As the 2001 fanfare diminishes the question remains: Is an LLC for me? Although each situation needs to be looked at on its own facts, here are some general points to consider.

It's New.

Massachusetts lawyers are busy attending seminars and reading up on the LLC form of business. In the short term, this means it probably will cost more in legal fees because we haven't developed our legal boilerplate documents and there are no cases interpreting ambiguities in the statute. Investors and banks may be reluctant to invest or lend to LLCs until they understand the implications of the LLC for them. Tax exempt investors in venture capital funds (e.g. pension funds, educational endowments) have issues (albeit solvable) of UBTI (unrelated business taxable income) to deal with, and foreign investors have to consider the effect of an LLC on their U.S. tax status.

Employee Equity.

Many employees have fuzzy but generally correct understanding about how stock works. LLC interests, with their potentially varying allocations of profits, are a whole other thing. Because LLC interests are not “stock,” you can't grant ISOs (incentive stock options), although there are other mechanisms available.

Potential Complexity.

The LLC statute provides great flexibility but contains a number of “default provisions” which may not apply to your business situation. As a result, the governing document for an LLC (the operating agreement) can be complex if you want to override the statutory defaults. This may translate into higher initial and on-going costs.

Tax Qualifications.

Although designed to be a blend of a partnership and a corporation, the LLC must still meet the IRS tests to qualify as a pass thru tax entity. One of these requirements which, for technical reasons, will often apply, is that the LLC interests must not be freely transferable. This can limit the usefulness of LLCs for larger organizations, and will

most likely require the LLC to convert to a corporation in order to “go public,” which can involve a number of complexities.

Acquisitions.

My tax partners tell me that acquisitions of LLCs will usually be taxable transactions. An acquisition of an LLC by a public company using public company stock will probably result in a taxable event with the recipient of the public company stock possibly not being able to resell the stock immediately in order to raise the cash to pay the tax.

Some Other Issues.

LLC personal property is subject to Massachusetts local tax; manufacturing corporations have an exemption for this. There are a number of operational requirements which must be observed—e.g. an LLC terminates for tax purposes if there is a sale or exchange of a majority of the LLC interests in a 12-month period. Many of these rules also apply to partnerships, but will be new to operating businesses. Also, the 14percent small business capital gains rate only applies to C corporations, not LLCs.

So the answer is: a traditional high-tech growth company may not want to rush out and become an LLC without carefully considering the costs and uncertainties involved, while businesses which have traditionally operated in partnership form (e.g. real estate ventures) may want to look at the new LLC statute.

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