

Limited Liability Company: Advantages And Disadvantages For The Start-Up

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Role of the LLC

LLCs are hybrid entities created by statute. They are legally recognized as a cross between a corporation and a partnership. Generally speaking, they are intended to provide limited liability to the equity holders (like a corporation) while simultaneously offering tax benefits (like a partnership) but without the restrictions placed on "S" corporations.

An LLC can be formed by filing a certificate of formation (in states like Delaware) or articles of organization (in states like California). In California, the secretary of state has a prescribed form to be used when filing for the formation of an LLC.

The internal operation of the LLC is governed by its *Operating Agreement*. However, if the Operating Agreement does not address certain items such as governance of rights, obligations and economic arrangements between the owners, then a default statute applicable to the LLC will apply. Simply, if the parties do not address certain issues in their *Operating Agreement* the statute will address it for them.

Operating Agreements for LLCs look much like limited partnership agreements, except that the equity owners in the LLC are referred to as "members" and in lieu of a general partner (which would apply in a limited partnership) an LLC has "managers." Further, whereas a general partner in a limited partnership must own an equity interest in the limited partnership, a manager in an LLC need not be an equity owner. Also, an LLC may be "member-managed" where *all of the members* are involved in management decisions or "manager-managed" where management responsibilities are delegated to one or more members.

LLC versus C Corp

An LLC has several advantages over a C corporation. These advantages include:

- There is no corporate-level tax.
- The LLC may specially allocate money and losses.
- There is no double-tax on liquidation.
- Property with "debt and excess of basis" may be contributed and the contribution structured to avoid gain recognition.
- A person who contributes appreciated assets to the LLC in exchange for a membership interest is not required to recognize gain on the exchange.
- Receipt of an interest in an LLC for a profit interest is generally not taxable (although services for stock would be).
- Liquidating and non-liquidating distributions of appreciated property from an LLC are generally received without gain. In short, the LLC offers significant tax benefits to its members, which are not available to a stockholder in a C corporation.

LLC versus S Corp

When compared to an S corporation, an LLC also has significant benefits:

- Distribution of appreciated property from the LLC to a member is generally not subject to income tax, whereas an S corporation shareholder would be subject to tax.

- An LLC may have more than seventy-five members whereas an S corporation may not have more than seventy-five shareholders.
- Corporations, partnerships, certain trusts and non-resident aliens may not be shareholders in an S corporation, but they may be members of an LLC.
- S corporations mainly have one class of stock, but an LLC may have non-pro rata distributions and special allocations of profit and losses (provided the same has substantial economic effect).
- An S corporation may lose its eligibility if certain events occur, whereas an LLC does not have that problem.
- The tax basis of an LLC asset may be "stepped-up" at the death of a member, whereas the inside basis of an S corporation's assets may not be stepped-up.
- A member's adjusted basis of membership interest is increased by the member's share of debt in the LLC, whereas an S corporation's debt does not increase a shareholder's stock basis.

LLC versus Partnerships

When compared to a limited partnership, the main difference is that a member of an LLC may be actively engaged in the management of the business and yet retain limited liability. In contrast, a limited partner in a limited partnership who is actively engaged in management may jeopardize his or her limited liability status by participating in control of the business. Further, under the LLC statutes, no member is required to have the general liability required of a general partner to a limited partnership. And, when compared to general partnerships, the benefit is even more extreme, meaning an LLC member is not jointly and severally liable for partnership liabilities. (In other words, a general partner would have 100 percent responsibility for a partnership liability whereas a member of an LLC would have no responsibility.)

Disadvantages of an LLC

One of the disadvantages of an LLC when compared to an S or C corporation is that it does not permit reorganization within the meaning of Internal Revenue Code Section 368(a) to be recognized as tax-free. Generally speaking, a tax-free conversion can occur, but it is difficult to do so in most instances, particularly in situations where Internet or high technology companies are involved which require fast transition. Also, if a capital loss is suffered for an LLC it is treated as a capital loss, whereas shareholders in an S corporation or C corporation may deduct their losses as "ordinary" if the stock qualified as Section 1244 stock.

Lastly, neither a C corporation nor an S corporation are deemed to be constructively terminated (meaning treated as insolvent) on the sale or exchange of shares of stock, whereas an LLC may be deemed constructively terminated for federal income tax purposes if 50% or more of the total interest in the LLC's capital and profits are sold or exchanged within a twelve-month period. Further, there are some additional provisions, which apply to a constructive termination for federal tax purposes.

To summarize, an LLC makes sense for a start-up entity if the initial intent is to obtain benefits from both the corporate and partnership perspective - meaning limited liability with pass-through of losses. Moreover, an LLC may have more than seventy-five members (equity holders), which an S corporation does not allow. Ultimately, however, the issue will remain as to whether or not equity can be raised in this structure and whether a reorganization into a C corporation can occur. That would ultimately be the preferred structure for any investment exit strategy.

The last article in this series will provide some examples of when and in what circumstances it would be appropriate to use any one of the entities prescribed in the preceding articles of this series. Check in next week!
