

Chapter 18.

Limited Liability Companies

OVERVIEW

A limited liability company (LLC) is a hybrid entity that combines the corporate benefit of limited liability for its owners with the partnership's advantage of pass-through treatment for income tax purposes. It is created under State law, just like a corporation. As of this writing, 28 States have enacted limited liability company statutes, as follows: Alabama (effective 10-1-93), Arkansas (effective 4-12-93), Arizona (effective 9-30-92), Colorado (effective 4-18-90), Delaware (effective 10-1-92), Florida (enacted 4-92), Georgia (effective 3-1-94), Idaho (effective 7-1-93), Illinois (effective 1-1-94), Indiana (effective 7-1-93), Iowa (effective 7-1-92), Kansas (effective 7-1-90), Louisiana (effective 7-7-92), Maryland (effective 10-1-92), Michigan (effective 6-1-93), Minnesota (effective 10-1-93), Montana (effective 10-1-93), Nebraska (effective 9-9-93), Nevada (effective 10-1-91), North Dakota (effective 7-1-93), Oklahoma (effective 9-1-92), Rhode Island (effective 9-19-92), South Dakota (effective 7-1-93), Texas (effective 9-1-91), Utah (effective 7-1-91), Virginia (effective 7-1-91), West Virginia (effective 3-6-92), and Wyoming (enacted 1977). In addition, authorizing legislation is pending in California, Massachusetts, New Jersey, New York, and Pennsylvania.

ORGANIZATION AND OPERATION

Articles of Organization

Instead of filing articles of incorporation, limited liability companies file articles of organization. These notify potential creditors that, generally, the LLC itself will be the sole recourse for payment. Companies that fail to properly file articles of organization may be fined, barred from doing business in the State, or have difficulty establishing legal status to sue. Furthermore, creditors might try to reach the personal assets of the LLC's members as though they were partners in a partnership.

Members

An LLC is owned by its members, rather than by shareholders or partners. Generally, an LLC must have at least two members. This requirement is consistent with its classification for income tax purposes as a partnership. Although several States apparently permit only one member, it is likely that the Internal Revenue Service (IRS) would treat such an entity as a corporation rather than a sole proprietorship for tax purposes. A corporation, partnership, trust, estate, another LLC, or other legal entity, as well as an individual, may be a member. These coincide with the partnership classification rules of the Internal Revenue Code (IRC), which do not condition partnership status on the legal form of an entity's owners.

Contributions to an LLC in exchange for a membership interest may be made in the form of cash, property, the use of property, services, or any other valuable consideration. In some States, contributions may also be made in the form of promissory notes or other binding obligations.

Operation

Generally, an LLC is not required to have an operating agreement. Some States, however, require the adoption of one and specify certain mandatory provisions. In the absence of an operating agreement, an LLC is governed by its articles and State law. Provisions concerning an LLC's affairs usually may be included in an operating agreement to the extent that they are not inconsistent with State law or the articles of organization.

Management

The typical LLC statute makes extensive use of default rules, which allow an LLC to be customized to suit the needs of its members. The statute generally reserves management rights or the members in proportion to their capital contributions or income interest, unless the articles of organization provide otherwise. An LLC that concentrates management authority in the hands of a few elected or

appointed managers will be considered to have the corporate characteristic of centralized management (see page 115) and could be treated as a corporation if it has other corporate attributes.

Ownership Interests.--Members of an LLC are usually permitted under State law to customize both distribution of cash and property, and allocation of profits and losses, to themselves through the operating agreement or articles. In the absence of such special financial provisions, distributions are generally made, and profits and losses allocated, on a proportional basis in accordance with the members' respective contributions.

Withdrawals.--Members of an LLC are also generally permitted under State law, unless otherwise provided in the articles or operating agreement, to withdraw on 6-months notice and receive the fair market value of their interests. Withdrawals, deaths, bankruptcies, and other events that cause the loss of a member can have serious consequences because the LLC could terminate unless the remaining members agree to continue the business. This requirement is usually imposed by State law so that the LLC will not have the corporate characteristic of continuity of life. An LLC can also be dissolved by written consent of its members or by court order if it is unable to carry on the business.

Assignment of Interest.--Unless the operating agreement or articles provide otherwise, a membership interest is assignable in whole or in part. The assignment entitles the assignee to receive to the extent assigned only the distributions to which the assignor would otherwise have been entitled. In most States, in order for an assignee to participate in an LLC's management and affairs and to exercise other membership rights, the remaining members must unanimously agree to the assignee's admission as a member. Although some State statutes may not prohibit an agreement over and above the operating agreement that allows an assignee to become a member on the consent of fewer than all the remaining members, such a side agreement may cause an LLC to be classified as a corporation for Federal income tax purposes.

Limited Liability.--One of the key advantages of an LLC is that it provides limited liability to all of its members and managers. The typical State statute provides that an individual or entity belonging to an LLC does not have any personal obligation for the LLC's obligations solely because of being a member, manager, or other agent of the LLC. This

ability to insulate an LLC member from personal liability as a member, regardless of management activities, is one of the chief distinctions between an LLC and a limited partnership. Some States permit a member to waive limited liability.

TAX CONSIDERATIONS

A primary reason for using the limited liability company form of organization is to avoid the double taxation associated with a corporation but yet achieve pass-through taxation for the members and, at the same time, protect the members' personal assets from liability for the debts and obligations of the business.

Corporate Attributes

The key to the favorable tax status of LLC's is that they are unincorporated business entities, and the IRS will not treat unincorporated entities as corporations unless they have more corporate than noncorporate characteristics. Internal Revenue Service Regulation 301.7701-2 lists four characteristics common to corporations but not to partnerships. The IRS will not impose corporate tax treatment unless the business entity has more than two of these. The four are: limited liability, continuity of life, free transferability of interests, and centralized management. Because limited liability is almost always present in an LLC, the test hinges on whether the LLC has more than one of the three remaining corporate attributes.

Continuity of Life

An LLC lacks continuity of life if the death, retirement, mental incapacity, bankruptcy, or expulsion of any member causes the LLC to dissolve. In Revenue Ruling 88-76, the IRS determined that a Wyoming LLC lacked continuity of life because the State statutory provision requiring the LLC to be dissolved upon the occurrence of a withdrawal event, unless its business was continued by the unanimous consent of the remaining members, only established a mere contingent continuity of life. However, an outside agreement obligating a member to approve the continuation of the LLC's business upon either all or certain specified withdrawal events, or on the direction of another member or a certain percentage of the other members, may change this conclusion.

Example 18.1. Four related persons, each with an undivided interest in 1,500 acres of timber-land in Virginia, organized a limited liability company to manage the property. In Virginia, LLC's must dissolve upon the death, resignation, expulsion, bankruptcy, or other departure of a member, or upon the occurrence of any other event that terminates continued membership (other than assignment of the member's interest), unless all remaining members agree to continue the business. Therefore, this LLC lacks the corporate characteristic of continuity of life.

When a dissolution event occurs, LLC's no longer need the consent of all the remaining members to continue the business. The IRS has amended Regulation 301.7701-1(b)(1) so that continuity of life will be lacking as long as at least a majority of the LLC's members must consent to continuation of the business to prevent its dissolution. Although this change applies to tax years beginning on or after June 14, 1993, taxpayers also have the option of applying it to earlier years.

Example 18.2. A tree farm organized as an LLC has four members. One member holds 80 percent of the interests. The LLC has a provision in its articles of organization allowing dissolution, upon the loss of a member, to be prevented by a majority vote of the remaining members. This LLC has the corporate characteristic of continuity of life. It could allow members holding only a 20-percent interest to continue the LLC despite the inaction or objections of the 80-percent interest holder.

Centralization of Management

A business entity has centralized management if one or more of its members, but fewer than all members, has (have) exclusive authority to make business decisions for the entity. Most State LLC statutes vest management authority in the hands of all members, unless the members choose to concentrate such authority with just a few of their number or hire nonmembers to manage the business. When all members--as a membership right--can exercise management authority to bind the LLC, the corporate characteristic of centralized management is lacking. Centralized management, however, is always present if State law requires the LLC members to elect managers to run the business and vests the managers with the managerial authority that most States reserve for the members (Revenue Ruling 93-6).

Example 18.3. The Silver Pines family tree farm LLC states that it is reserving management authority for its members in the articles of organization filed with the State agency that regulates LLC's. However, the seven LLC members agree among themselves that only three of their number will actually manage the woodland. Nevertheless, State law binds the LLC for business or management actions taken by any of its members with third parties that do not have notice of the informal agreement. Because any of the LLC members could easily exercise binding management authority despite the informal agreement, the three designated managers lack the sole authority required for the corporate characteristic of centralized management.

Free Transferability of Interests

An organization has the corporate characteristic of free transferability of interests if members owning substantially all of the interests in the organization can transfer all attributes of their interest to others without the consent of the rest of the members. However, interests are not deemed to be freely transferable if only the right to share in profits can be assigned without consent, but not the right to participate in management. An LLC does not have the corporate characteristic of free transferability of interests if membership and related management rights cannot be transferred without the consent of the other members.

Example 18.4. The Lonesome Oak Tree Farm was organized with only two members, John and Peter. State law allows LLC members to freely transfer their income and capital interests, but their membership interest expires unless all the other members consent to the transfer to the third party. The Lonesome Oak Tree Farm lacks free transferability of interests, even though the consent of only one remaining LLC member (Peter) is needed in order for John to transfer half of his membership interest to his son.

IMPLICATIONS FOR TIMBER PROPERTIES

The LLC represents the latest advance in the forms of business entities. An LLC that is classed as a partnership and which is assured of limited liability in all jurisdictions in which it will operate will combine ownership, operational, tax, and liability advantages

in a way that neither the Subchapter S corporation nor the limited partnership can do. For family-owned tree farms, the LLC certainly shows promise as an advantageous way to organize for current operations.

With respect to estate planning, the advantages are less clear. The restriction on transferability of interests could pose a problem in some situations. However, with a closely knit, family-owned tree

farm, there may be no problem. The unanimous consent of the members to give membership rights to an heir of a deceased member or donee of a living member may be easily obtainable. In considering whether to become an LLC, however, a family timber ownership should proceed with caution and with good professional advice. Because the LLC format is relatively new, its use still involves many uncertainties.