Chapter 17

Limited Liability Companies

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. All 50 States have enacted LLC statutes; however, legislative and administrative details vary from one State to another.

Organization and Operation

Articles of Organization

Instead of filing articles of incorporation, an LLC files articles of organization with the designated State authority—usually the Secretary of State. The articles 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. Further, creditors may try to reach the personal assets of LLC members as though they were partners in a general partnership.

Members

An LLC is owned by its members, rather than by shareholders or partners as with a corporation or partnership. Most LLCs have at least two members. This is consistent with classification of an LLC as a partnership for income tax purposes. Many States, however, permit one-member LLCs; a one-member LLC can be taxed either as a corporation or a sole proprietorship. The partnership classification rules of the Internal Revenue Code (IRC) do not condition partnership status on the legal form of an entity's owners; thus, an individual, corporation, partnership, trust, estate, another LLC, or other legal entity may be a member of an LLC.

Contributions to an LLC, in exchange for a membership interest, may be made in the form of cash, property, use of property, services, or any other valuable consideration. In some States, contributions also may 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 an agreement and specify certain mandatory provisions. In the absence of an operating agreement, an LLC is governed by its articles and State law. Provisions concerning the business of the LLC 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 State LLC statute makes extensive use of default rules, which are statutory provisions that apply unless the articles of organization or operating agreement specify otherwise. Default rules, however, allow an LLC to go beyond the statute to customize administration and management to suit the needs of its members. The statute generally reserves management rights for the members in proportion to their capital contributions or income interest, unless the articles provide differently.

Ownership interests—State law usually permits members of an LLC 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 generally are made and profits and losses allocated on a proportional basis in accordance with the members' respective contributions.

Withdrawals—State law also generally permits members of an LLC to withdraw on 6-month's notice and receive the fair market value of their interests, unless otherwise provided in the articles or operating agreement. 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. An LLC also can 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 to another in whole or in part. The assignment entitles the assignee to receive, to the extent assigned, the distributions to which the assignor otherwise would have been entitled. In most States, in order for an assignee to participate in management of an LLC or to exercise other membership rights, the remaining members must unanimously agree to the assignee's admission as a member. Some State statutes may permit 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.

Limited liability—One of the key advantages of an LLC is that it provides limited liability to all of its members and managers. This is the primary distinction between an LLC and a limited partnership. In the latter, general (managing) partners usually have unlimited liability with respect to partnership debts. On the other hand, the typical State LLC 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. Thus, all LLC members are shielded from personal liability, regardless of the extent of their management activities. Some States permit a member to waive limited liability.

Tax Considerations

In addition to protecting the members' personal assets from liability for the debts and obligations of the business, as discussed above, a primary reason for using the limited liability company form of organization is tax related. The LLC form of organization avoids the double taxation associated with a corporation but achieves pass-through taxation for the members. Thus, from an income tax perspective, an LLC compares favorably with both S corporations and partnerships, and at the same time has advantages not available with the other two types of entities. For example, an LLC member can materially participate in the business activities of the LLC—so that income and losses that are passed through to him (her) are considered active under the passive loss rules—without risking personal liability. In contrast, a limited partner who materially participates in the partnership business within the meaning of the passive loss rules may risk liability for the partnership's obligations. The key to the favorable tax status of LLCs is that they are unincorporated business entities; the Internal Revenue Service (IRS) will not treat unincorporated entities as corporations unless they elect not to be taxed as partnerships.

Basis and Distribution of Property

The method of determining basis differs for LLCs and S corporations. In an LLC, a member's basis includes a share of all LLC liabilities, while in an S corporation not all of the corporate liabilities qualify as part of shareholder basis. This restriction can limit an S corporation shareholder's ability to use pass-through losses to offset other income and receive tax-free distributions in a refinancing.

Neither an LLC nor a member recognizes any gain or loss if the LLC distributes appreciated property to the member. An S corporation, on the other hand, recognizes gain to the extent that the fair market value of the property distributed exceeds the corporation's basis in the property.

Implications for Timber Properties

The LLC represents the latest advance in forms of business entities. An LLC that is classed as a partnership and assured of limited liability in all jurisdictions in which it operates combines ownership, operational, tax, and liability advantages in a way that neither the Subchapter S corporation nor the limited partnership can do. For a family-owned forest enterprise, the LLC certainly has advantages as a way to organize for current operations.

Estate Planning

The LLC also shows promise as an estate planning tool. Because the LLC format is relatively new, however, its use in estate planning still involves some uncertainties, particularly with respect to valuation adjustments as discussed in chapter 4. The *Hackl* case, below, illustrates potential problems.

Hackl case—In *Hackl, C.M. v. Commissioner*, [118 TC 279, affirmed 335 F.3rd 664 (CA-7), 2003-2 USTC ¶60,465], the transfer of LLC timberland interests to the donor's children was held to be gifts of future interests that failed to qualify for the annual gift tax exclusion (see chapter 8). Under terms of the LLC operating agreement, the donor as "Chief Manager" had the personal right to name a successor as well as absolute discretion to permit or deny withdrawal of capital contributions by a member, make or withhold cash flow distributions, and permit or deny the transfer or encumbrance of membership interests. The LLC had failed to make distributions to members for several years or to adopt a forest management plan to seek long-term appreciation and income. It should be noted that it was not at issue whether the donations would have qualified under the $1 million lifetime Federal gift tax exclusion (see chapter 8) wherein gifts of future interests are allowable.

Planning options—Several planning options exist that arguably may circumvent the Hackl result. These include granting recipients of LLC interests a withdrawal right similar to a "Crummey" power (see chapter 9), permitting sales of the LLC interests subject to rights of first refusal, granting donees a limited period to sell interests to anyone, making gifts of cash which are then used by the donees to purchase the interests, and providing for mandatory distributions at prescribed earnings levels.