

LIMITED LIABILITY COMPANIES--A NEW WAY TO DO BUSINESS

January 1, 1994, marked both the New Year and the start of a new way to do business in Illinois. With the passage of the Illinois Limited Liability Company Act (the Act), entrepreneurs can now operate under a new form of business--the Limited Liability Company (LLC). LLCs are much heralded, and for good reason. They blend the tax advantages of partnerships with the legal advantages of corporations. This combination offers business owners unmatched flexibility in organizing their enterprises.

Organizing an LLC

An LLC is organized by filing a paper known as Articles of Organization with the Illinois Secretary of State. The Articles, which become a public record, contain general information about the LLC, including the names and addresses of its initial managers or owners (called members under the Act). An LLC officially exists as soon as the Articles are filed, unless the Articles specify a later date. Although an LLC must have at least two members, it has no upper limit.

The Operating Agreement

Before filing the Articles, an LLC's prospective members should agree on how they will conduct the business's internal affairs. This agreement, which should be in writing, is called the operating agreement. The operating agreement should cover such issues as the management of the LLC, withdrawal of members, transferability of membership interests, and dissolution of the LLC. However, the most important part of the operating agreement covers how the LLC will allocate distributions to its members.

LLCs and Special Allocations

Under the Internal Revenue Code (IRC), partners in a partnership are not required to divide the gains and losses from the partnership in proportion to their ownership interests. Instead, they can agree to allocate those gains or losses in almost any manner. Such arrangements are called special allocations, and they are best explained by an example.

Let's say that Susan has invented a new plumbing device, called EZ Flush, that will virtually eliminate stopped drains. Selena, her friend, agrees to invest \$50,000 in the venture. Susan will market the device directly to consumers until the two friends can license their product to a large manufacturer. Susan and Selena do not want to split the gains and losses equally. Instead, they agree that Susan can keep the fees paid by the consumers, and Selena will receive the first \$100,000 of license fees paid by the manufacturer. The allocations of the consumers' fees to Susan and the manufacturer's fees to Selena are examples of special allocations.

Until passage of the Act, special allocations could only be made within partnerships. Now, owners can also make special allocations through LLCs.

Although partnerships offer the flexibility of special allocations, they also have a major disadvantage. Each partner is liable for all the debts of the partnership. Limited partnerships are available to shelter passive investors from liability. However, organizing a limited partnership is expensive and complex. LLCs provide a simpler alternative.

LLCs and Personal Liability

In general, the owners of a corporation are not personally liable for the corporation's debts. Indeed, owners often incorporate their businesses primarily to gain protection from personal liability. The Act makes this key advantage of corporations--protection from personal liability--a feature of LLCs as well. Accordingly, the members of an LLC will ordinarily not be liable for the LLC's debts.

Other LLC Advantages

Business owners who choose to incorporate often elect Subchapter S status for their corporations. Under Subchapter S, which is part of the IRC, a corporation pays no income taxes. Instead, the owners pay all taxes.

S corporations have several disadvantages. The IRC regulations that govern S corporations limit the flexibility by which the owners may be compensated. For example, an agreement under which only one owner receives certain fringe benefits could violate the regulations, causing an immediate and automatic termination of the Subchapter S election. This could have disastrous income tax consequences.

LLCs have much greater freedom to compensate their members than do S corporations. In addition, unlike the Subchapter S regulations, the regulations governing LLCs contain no provisions for the immediate or involuntary termination of LLC status.

Subchapter S also restricts the ownership of S corporations. S corporations cannot have more than 35 owners, and nonresident aliens cannot be owners. For an example, let's return to Susan and Selena. If Susan lived in Illinois but Selena was a citizen and resident of Hong Kong, they could not organize their venture as an S corporation. LLCs have no such limitations. With the increasing globalization of our economy, the S corporation's ban on ownership by nonresident aliens may lead to increased use of LLCs.

Along with nonresident aliens, trusts generally cannot be owners of S corporations. This limitation can adversely affect estate planning. If you

leave your S corporation stock to your heirs in a trust, the trust must distribute the stock within 60 days after the stock is transferred to the trust. In contrast, trusts can own LLCs without any limitations. As more business owners become concerned about estate planning, they may turn to LLCs.

Traps for the Unwary

Under the IRC, the Internal Revenue Service (IRS) will treat an entity as a partnership, and therefore honor its special allocations, only if the entity possesses certain technical characteristics. The LLC must possess those same characteristics to have the IRS honor its special allocations. Extreme care is required to ensure that the required characteristics are in place. If the IRS justifiably refuses to honor those allocations, the LLC's members may face serious tax liabilities.

The Best of Both Worlds

The LLC combines the best features of partnerships and corporations in one package. Two or more business owners can now make special allocations of the gains and losses from their enterprise while avoiding personal liability. They can flexibly compensate each other, and they can leave their LLC interests to their heirs in a trust. Provided that the owners use care in organizing the entity, an LLC may give them an excellent platform from which to launch a successful business.