LEARNING MADE EASY

3rd Edition

Limited Liability Companies

for dummies®
A Wiley Brand

Manage the day-to-day operations of an LLC

Become a savvy entrepreneur with your own LLC

Understand the pros and cons of an LLC structure

Jennifer Reuting
Founder, InCorp Services, Inc.

Limited Liability Companies

3rd Edition

by Jennifer Reuting

for dummies
A Wiley Brand

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Introduction

Individuals are now, more than ever, realizing the power of the limited liability company (LLC). If you're like many people, you probably understand that an LLC can benefit you in one way or another; you just don't know the next steps to take. Maybe you've just purchased a piece of real estate and know that it should be protected in some way; you just don't know how to form the LLC and do the transfer. Or, on a whim, you created an LLC for your current business and can't get any answers on what to do now. How do you transfer assets? What do you do at tax time? How can you take on a partner?

You now hold in your hands the key to some of the most powerful strategies of the rich and successful. This book was written to make your life easier and eliminate the guesswork on forming and owning an LLC. After all, your LLC should work for *you*, not the other way around.

After I get into the basics on LLCs in this book, I go into some more-complex strategies. This info sets this book apart from all the others. The rich have used a lot of these strategies for decades to operate their businesses, protect their assets, and pass on their estates. Now, I'm putting the power in your hands. When you find a strategy that may work for you, I encourage you to sit down with your team (your attorney, accountant, and/or corporate consultant) and figure out how to build on it and how to customize it to your specific situation. Use this book as your starting point. Your possibilities are endless, and your asset protection and tax strategies should grow along with you.

Now get going on your journey to success and don't look back!

About This Book

Although this book was written in an easy-to-understand, concise manner, I didn't limit this book to the basics. You'll find that a lot of other books on LLCs just skim over things, filling their pages with forms and legal statutes. They often just cover the basics of filing your articles and creating your operating agreement without delving into the more powerful uses of LLCs or the strategies that LLCs can be integrated with. Instead, I crammed these pages with valuable information that you'd be hard-pressed to find in other books.

Even though this is a *For Dummies* book, you're no idiot. You don't want to be put to sleep while reading a jargon-laden book on complex strategies that even most attorneys can't understand. You want something that dives deep but keeps it simple, and that's what I strive to give you — well-organized, easy-to-read, and fluff-free information.

I know, I know — you're busy! You operate on a need-to-know basis and the rest is just gibberish. Therefore, to speed things up a little, feel free to ignore anything with a Technical Stuff icon next to it. The information in those paragraphs isn't really necessary to understand the topic. Also, the sidebars are fun, but they're sort of a bonus for those who aren't time-impaired. Feel free to skip those too.

I use a few conventions in this book. They're pretty intuitive and easy to understand, but here's a rundown anyway.

- Any industry terminology that may be new to you will appear in *italics*.
- I **boldface** the action parts of numbered steps and keywords or the main points in bulleted items.
- Sidebars, which are the gray boxes of text, contain fun stories, examples, or other pieces of information that are great to know but not necessary to read if you're in a time crunch.
- Nine times out of ten I won't spell out "limited liability company" but will instead use the abbreviation "LLC." I can't help it — it's just too easy!
- When this book was printed, some web addresses may have needed to break across two lines of text. If that happened, rest assured that I haven't put in any extra characters (such as hyphens) to indicate the break. So, when using one of these web addresses, just type in exactly what you see in this book, pretending as though the line break doesn't exist.

Foolish Assumptions

In order for this book to cater to a broad audience, I needed to make some foolish assumptions about you, the reader, and your skill level. After all, it's not *Limited Liability Companies For Attorneys* or *Limited Liability Companies For Real Estate Investors.* It's *Limited Liability Companies For Dummies* — in other words, "everyone". Let's see if any of these shoes fit:

- You're a budding (or experienced) entrepreneur, looking for the next leg up.
- You have a business, and you want to finally get legit and form an entity to protect yourself.
- You're a real estate investor looking to save some dough and keep your butt out of the courtroom.
- You're an inventor who wants to protect his patents from a random lawsuit that may be just around the corner.
- You have intellectual property, and you want to keep it right where it is — in your name.
- You're old, or young, and are planning your estate.
- You want to raise money for a project and want a vehicle that can keep things in order and sweeten the pot for your investors.
- You were born on a day that ends in the letter *y*.

If any of the above assumptions fits your profile, then this book was written especially for you!

Icons Used in This Book

In this book, I use little pictures, called *icons,* to highlight important information. When you see these, make sure to pay close attention — otherwise, you may miss some really good info!

TIP

This icon flags helpful tips, tidbits, and secrets that may give you an upper hand on your road to success.

REMEMBER

If I mention a topic more than once and/or use this icon, then you should make an effort to remember the information. These concepts are often the most important.

WARNING

Whenever I use this icon, you should watch out! Obtain advice that is specific to your situation from a professional. Otherwise, legal or financial snares can ensue.

TECHNICAL STUFF

I use this icon to flag some technical stuff that may be a little advanced and difficult to understand for the LLC novices out there. When you encounter one of these icons, don't worry — just ignore the information or ask a competent professional for advice.

WEB EXTRAS

This icon directs you to the *Limited Liability Companies For Dummies* page at www.dummies.com/extras/limitedliabilitycompanies. This page on Dummies.com has extra articles and goodies to explore.

CHECK IT OUT

When you see this icon, know that I've got you covered. This icon flags the extra information and helpful, time-saving tips that you can find at the online resource center made especially for For Dummies readers at www.docrun.com/dummies. Just enter the password **onesmartdummy** and you're in! See the next section for more info on online content for this book.

Beyond the Book

One of the great things about LLCs is how much you can do with them! Unfortunately, if I were to write everything one could possibly know, this book would rival the length of *War and Peace*. So, in an effort to save some trees, this book you're reading right now comes with digital perks!

First, I have created a password-protected online resource center made specifically for *For Dummies* readers. Every place where I mention state laws throughout the book, I will refer you to this online resource center for more information specific to your state. You can access this information anywhere and you can also be sure that it's up-to-date. The online resource center can be found at www.docrun.com/dummies and the password is **onesmartdummy**.

Want more information on things like estate planning with LLCs and LLC tax distributions? Well, look no further than the *Limited Liability Companies For Dummies* page at www.dummies.com/extras/limitedliabilitycompanies. Here, you can find extra articles and information on topics covered in this book.

And last but not least, make sure to check out the free eCheat Sheet at www.dummies.com/cheatsheet/limitedliabilitycompanies. This will tell you all you need to know about naming your LLC, help you understand the different tax types, and get clear on more of the benefits of LLCs.

Where to Go from Here

One of the many great things about a *For Dummies* book is that you don't have to read it from cover to cover to get to what you need to know. This book was designed to be jumped into, with each chapter standing on its own. Find a topic that interests you and start there! After all, why waste time reading mundane topics that you already know when you can immediately get to the good stuff?

If you're a complete novice and are just dipping your toes into the whole LLC concept, you may want to read Chapters 2 and 3, and then skip to whatever topic interests you most. If you have already formed your LLC and are looking for the next step, you may want to skip to Chapters 9, 10, and 11 to find out how to create or revise your operating agreement. Only interested in the use of LLCs for real estate? Skip to Chapter 18. Ready to dissolve your LLC? Feel free to flip to Chapter 16.

Or, you can read the book cover to cover if you want. You get a lot of juicy info out of every chapter!

1

The ABCs of LLCs

IN THIS PART . . .

Understand what LLCs are and what they're used for.

Discover the many types of LLCs and the pros and cons of choosing each one.

Compare LLCs to other types of business structures so you can determine if an LLC is right for you and your business.

IN THIS CHAPTER

- » Understanding LLC basics
- » Creating your plan of attack
- » Knowing the essentials for operating an LLC

Chapter 1
What Is an LLC, Really?

The Limited Liability Company (more commonly known by its acronym, LLC) is by far the most popular business structure. Only a decade ago, the LLC was the new kid on the block — untrusted and unverified. Luckily, that changed pretty rapidly — LLCs gained popularity and, within a short time, became firmly established in the business world. Since then, LLC has become a household term, and for good reason.

The LLC is a complete divergence from its predecessor, the corporation. While corporations have a fixed management structure, LLCs offer *flexibility.* While corporations have strict rules regarding owners and profit distributions, LLCs are adjustable. While corporations are stuck with corporate taxation (or its limited variant, S corporation taxation), with an LLC you can select whichever form of taxation you prefer. The added flexibility of the LLC enables you to build a solid foundation for your business that works for your *exact* circumstances.

Great, right? Well . . . yes and no. With all the hoopla and the incessant commercials from filing companies, we all know how easy it is to file an LLC. However, very few folks can really explain how an LLC works, or why an LLC is right for your situation, or, even worse, how to actually *structure* it after receiving that one-page filing back from the state. Aside from hiring a pricey attorney (not an option for most people), the majority of your peers don't know how to do simple things like issue the ownership properly or formally agree on what happens if one of the partners wants to leave.

The LLC is a powerful tool, but if you don't know how to use it — how to build that crucial foundation that will support your greatest potential — then it really amounts to nothing more than the piece of paper on which your formation document is printed . . . and possibly a few lawsuits along the way.

I go into detail on setting up an LLC for your specific circumstances later in the book, but first I want to give you an overview — or a refresher, if you're a seasoned pro — on the meat and bones of this awesome business structure.

Understanding How LLCs Work

Think of an LLC as a partnership on steroids. If you and a buddy were to get together and start a business without registering it as any particular business structure with the state, your business would automatically be considered a general partnership. All business income and losses would be reflected on your personal tax returns. No rigid formalities would be required — you could literally draft your agreements on a napkin.

The problem is, what happens if you want to raise capital? The business is comprised of only you and your partner, and possibly some assets that you've acquired along the way. You can't exactly sell pieces of yourself. Or what if your partner ends up being, well, a jerk? Or even worse, a jerk who runs up a lot of debts that you could be personally responsible for? Eek! As unfair as it sounds, that's the reality for partnerships. Until the LLC came along, that is.

The LLC takes all the best features of a partnership (pass-through taxation — defined at the end of this chapter — and no hefty burdens of corporate formalities) and the best features of a corporation (personal liability protection and ownership shares) and then adds a few extra perks for good measure, like the capability to choose your own form of taxation and a formal yet flexible management structure. In addition, the LLC can offer a second layer of liability protection that shields the business from any personal lawsuits that may befall you (referred to as *charging order protection*, which I elaborate on in Chapter 17).

If all this sounds like Martian to you, don't worry. In this chapter, I dive into some of those benefits and other LLC fundamentals a bit more, all while steering you toward other chapters in the book where you can read about specific topics in more detail.

Owners: You gotta have 'em

Although LLCs are separate from their owners in a lot of ways, they still need to have them. An LLC without an owner is like a child without parents: It simply doesn't exist. So, even though you may have called up a filing company and filed your LLC with the state, until you go through the process of doling out ownership in your LLC, it doesn't become its own legitimate entity.

The owners in an LLC are called *members.* They have units of ownership called *membership interests* that show what percentage of the company they own and how much influence they have when voting on important company matters. Membership interests in an LLC are comparable to stock in a corporation. However, unlike the S corporation, which is often compared to the LLC, an LLC can have unlimited members of any type. Members can be citizens of other countries or even entities, such as corporations, partnerships, or trusts.

Unlike corporations, LLCs offer a lot of flexibility in how you issue membership. For instance, your LLC can have many different forms of membership, called *classes.* You can set whatever rules you like for each class. If you structure them properly, classes are a great way to entice investors or partners to join your business — some folks may want a bigger piece of the profits up front, while others may want more control. For example, one class can have priority on the profit distributions, while another class is second in line. Or one class can have a say in managing the company, while another class must remain silent. With an LLC, you can structure the membership in a way that makes everyone happy. And happy partners make for a happier you. Trust me on this.

The owners of an LLC not only own the entire business and all its assets, but also generally have the final say. Although they may not all manage the day-to-day operations of the business, they do elect the managers. They vote on important issues and ultimately control the company's fate. In Chapter 10, I go into more detail on membership, including how to issue it and structure it in a way that works for your business.

TECHNICAL STUFF

The actual term for the members of an LLC and their membership interests varies from one state to another. For example, in some states, the membership interest is called *ownership interest* or *limited liability company interest.* Just keep in mind that no matter what they're called, the concepts are the same.

If your LLC has only one member, it's called a *single-member LLC.* Unless the single member LLC elects corporate taxation (which I'll show you how to do in Chapter 8), the IRS treats it as a sole proprietorship — or *disregarded entity* — for tax purposes.

All states now allow single-member LLCs. (It took a while for a few states to jump on the bandwagon.) However, in some states, because of certain court rulings, single-member LLCs are often disadvantageous — they aren't afforded the benefit of partnership taxation and aren't guaranteed *charging order protection,* which protects the LLC from lawsuits that may be filed against you personally. I discuss this concept in depth in Chapter 17.

Contributions: Where the money comes from

When you buy a share of stock on the stock market, the money you pay is what you are contributing (or *investing*) in return for a percentage (or *share*) of the company's ownership. Well, purchasing ownership in an LLC is very similar: In exchange for a membership interest in the company, a person or company must contribute something of value. This contribution can be in the form of cash, services, hard assets such as equipment, real estate, or even promissory notes (which are allowed in some states).

When a new business is formed, all the initial owners, or *founding members,* come together and pool the value of their contributions. Say Jane contributes $100,000 in cash, Chris contributes $5,000 in cash and $25,000 in services, and Joe contributes an office building worth $150,000. The combined total of their contributions is $280,000. To determine each person's percentage of ownership in the LLC, they simply divide their contributions by the total. The result: Jane gets 35.7 percent, Chris gets 10.7 percent, and Joe gets 53.6 percent.

TECHNICAL STUFF

After you figure out each owner's percentage of ownership, determining her *membership interest* in the company is easy. Given the previous example, if the LLC has a total of 1,000 membership shares, then Jane's 35.7 percent ownership in the company translates to 357 membership shares, Chris's 10.7 percent results in 107 membership shares, and Joe's 53.6 percent results in 536 membership shares. I dive into more details on issuing membership in Chapter 10.

The contributions made by the founding members (the ones who were on board when the company was formed) and their corresponding membership interests are listed in the LLC's operating agreement. That way, it's documented that all the owners know what everyone else is contributing to the business and agrees on the value of those contributions.

Things get a bit more complicated when a new member joins an existing company. Newly formed companies have no value — assets are added as contributions. However, when a business has been in operation for a while and elects to bring on additional contributions (and often new members), things can get weird. I mean, is Apple still worth the $10,000 it took to get things going in Steve Jobs's garage? Ha! Not even close. As businesses evolve, they increase in value. In Chapter 11, I go over the intricacies of taking on new capital and issuing membership in existing businesses.

Some LLCs issue membership certificates that, like stock certificates in a corporation, are paper evidence of the amount of ownership a member has in the company. The membership certificate displays the member's name and the number of membership shares the person owns. However, membership certificates are no longer a legal requirement in most states, and this practice is fading from popularity as our lives go digital. Which is a bit sad, really — there's nothing like the feel and smell of a newly printed stock certificate representing your stake in an exciting new endeavor.

Whether or not your LLC issues membership certificates, your membership interest should be listed in the operating agreement next to your contribution amount. (In Chapter 10, I show you how to properly list your members, their contributions, and their membership interests in your operating agreement.)

Allocations and distributions: Getting what you're due

After an LLC starts turning a profit, the members will no doubt want to benefit. After all, they didn't invest their hard-earned money in the company for nothing — they want to see a return! At certain times — usually at the end of the year, but sometimes at the end of each quarter — company profits can be calculated and doled out to each member, usually in proportion to her percentage of ownership. These payments are called *distributions* and are generally in the form of cash (see Chapters 10 and 14 for more on distributions).

Now, as many of you savvy entrepreneurs know, growing a business is hard enough without draining it of its much-needed cash in the first few years. You'll hold off on sending checks to the investors and instead use that revenue to grow the business. But what happens when your business is still showing a profit at the end of the tax year? Maybe you're saving up to purchase property or other assets pertinent to the business. Well, unfortunately, Uncle Sam still wants his share. And with the partnership form of taxation (how most LLCs elect to be taxed), the owners of the LLC are still *allocated* this revenue and must pay tax on it . . . even though they never saw the cash.

I dive into this topic in more detail in Chapter 8, where I discuss the different forms of taxation that an LLC can elect. Until then, just know that if you elect the most common form of LLC taxation — partnership taxation — then you need to understand the differences between *allocations* and *distributions.* Allocations are the profits on which you and your partners have to pay taxes. Distributions are the money you actually *get*, in your pocket, ready to be spent on that new backcountry snowboard you've been craving.

TIP

Unlike corporations, LLCs don't necessarily have to distribute profits in proportion to the members' percentage of ownership. The members can decide to vary the distributions however they want. The IRS generally allows this practice as long as you pass their tests (mainly to prove that you aren't varying the distributions simply to avoid taxes). This strategy gets complex, and I dive into it a bit more in Chapters 10 and 14; however, if used correctly, it can result in some huge incentives for powerful partners and investors to join your team.

Distributions also occur if your LLC goes out of business, but in this case they're handled differently. The LLC's assets are liquidated, the creditors are paid back (including any members to whom the business owes money), and then the remaining amount is distributed to the members according to their membership interests or, more specifically, their *capital accounts.* Capital accounts can be, well . . . complex. But an easy way to think of them is how your percentage interest evolves over time, as more contributions to the company are made. They also tend to keep accountants in business.

The key takeaway here is this: When the final distributions are made, you can't choose how the money is distributed — it must be doled out according to the balance of each member's capital account.

Management: Some folks are just better at it

Just because you own it doesn't mean that you need to know what to do with it. LLCs have a *manager* role — a person who handles the day-to-day operations of the company. All LLCs are required to have at least one manager. They can be the owners themselves or other outside persons or businesses.

Two types of LLCs exist:

- A *member-managed* LLC is managed jointly by all of its members.
- A *manager-managed* LLC is managed by one or more — but not all — of the members or by separate (non-owner) managers altogether.

If you are forming an LLC with only a few owners (members), and each owner is going to have a say in managing the company, then you may want to choose member-management. However, if you decide to take on a silent partner and that person is *not* managing the business day-to-day, then your LLC needs to be manager-managed. All members, except for the silent partner, are listed as manager.

THE BIRTH OF THE LLC

The LLC didn't come out of nowhere. Business entities with the same characteristics as LLCs have been around for many years. The origin of LLCs can be traced back to 1892, when German law enacted what was called the *Gesellschaft mit beschränkter Haftung* (GmbH) — a modern-day variation of the English private limited company.

Germany's GmbH format was copied throughout Europe and Central and South America. This concept remains popular in many parts of the world.

In the United States, limited partnership associations actually predated the German concept. These entities were formed in several Midwestern states starting as early as 1874. However, this entity structure soon fell out of favor. In 1977, the LLC was born in Wyoming and modeled after the German GmbH and the successful Panama variation. LLCs didn't become popular nationally until 1988, when the IRS ruled that LLCs could be taxed as partnerships. And the rest, as they say, is history!

REMEMBER

Unless *all* the members are managing the company's day-to-day business, your LLC is considered manager-managed.

Creating Your Own LLC: Your First Step Toward Success

You need to go through a few processes to get your LLC filed, structured, and up and running. You don't have to be a lawyer or an über-savvy entrepreneur to get it right.

If you've listened to the radio or watched TV in the past few years, you're probably well aware that filing an LLC is as simple as "one low fee." However, the important stuff is what comes before and after you call up a formation company or fill out a quick form and send it to the state. That's where the big decisions come into play and the real structuring of your company takes place. So let's get started.

TIP

As you flip through this book, the concepts may seem overwhelming at first, but after you get familiar with a little bit of industry terminology, you'll have a basic understanding of LLCs to get started on your own. See the glossary in the back of the book for all the need-to-know terms.

Educating yourself

The first thing to do is gain a little bit of an education about LLCs. I know you're busy, so this doesn't have to be too extensive. You just need to know the basics, and the best way to start is by reading this book. Needless to say, you're on the right track!

You can always use professionals to do the work for you. And that's okay. Hey, I'm all for delegation! Just make sure that you have a basic understanding so that you can have productive and educated conversations with the people you hire. Not to mention that you want to have an idea of whether they really know their stuff. (You'd be surprised how many don't.)

Only after you understand the basics should you call your attorney or accountant and ask about details that pertain to your situation. You may also want to do some research online and set up some free consultations with corporate consulting companies. If you have specific questions, you can ask me directly at `www.myllc.com`, and I'll get back to you as soon as I can.

CHECK IT OUT

LLCs, like most entities, are subject to state oversight. The problem is that not all states are on the same page. As much as I wish that I could include information about every state's laws, doing so would result in a page count rivaling *War and Peace.* (My wise editors at Wiley quashed that idea pretty quickly.) So, in an effort to make it easier for you to ensure that you're complying with the laws of the state(s) in which you transact business, I provide state-specific information about LLCs, as well as all state LLC laws on a login-only website especially for Dummies readers. You can access it by going to `www.docrun.com/dummies` and entering the password **onesmartdummy**. This book, in conjunction with these additional resources, should give you everything you need to get started down the right path.

Divvying up the ownership

When you're first starting your business, usually it's pretty clear who the owners are going to be. The real question becomes, how much ownership does an owner actually get? Sometimes, the answer is clear-cut, such as when all the owners are contributing cash and nothing else (see the "Contributions: Where the money comes from" section earlier in this chapter). However, I find that with most businesses, the decision over who gets what isn't so easy.

Often, businesses are started based on just an idea and possibly some savings pooled together. Say three people are in a room and think up an idea, and all three people get excited and decide to pursue it. The first thing that often comes to mind is that all three will be equal partners. After all, it's only fair, right? Each person is valuable and smart and equally excited as the others, so why not share the