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LLCs: The entity of choice

Even though limited liability companies have only been with us in California since 1994, they have proved to be immensely popular – and for good reason. LLCs offer the benefits of simplicity of operation and limited liability coupled with great flexibility in terms of structuring different economic arrangements. Furthermore, if the recent decision of the San Francisco Superior Court that the LLC gross receipts tax is unconstitutional is upheld on appeal, LLCs are even more likely to become the default entity of choice.

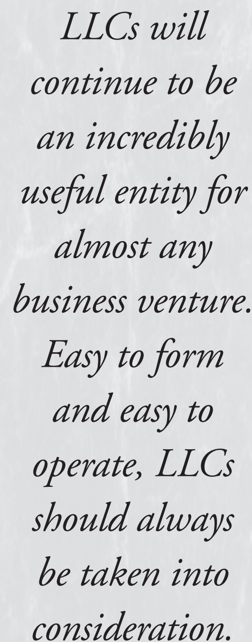
However, an LLC will not always be right for every business.

Technology or other companies funded by venture capital or angel investors will typically opt to use a C corporation rather than an S corporation or an LLC.

The reasons are varied and include the rule that only U.S. resident individuals may be shareholders in S corporations, ruling out institutional or overseas investors. The rule that S corporations can only have one class of share capital means preferred stock, which is often required by investors, is not an option. Also, owners of membership interests in LLCs cannot participate in a stock-for-stock tax-free transaction, which is a common form of liquidity event for this type of business.

Any business that plans to use stock options as part of its compensation package to attract key talent will have to opt for a corporation rather than an LLC.

However, as a result of the new deferred compensation rules published by the IRS last year, the valuation process for stock options in non-public companies has now become administratively much more burdensome. Similar equity participation plans in LLCs have the added complication of potentially turning an employee into a partner in the business for tax purposes.



LLCs will continue to be an incredibly useful entity for almost any business venture. Easy to form and easy to operate, LLCs should always be taken into consideration.

Sometimes there is industry resistance to change when it comes to choosing an entity. For many years, venture capital and real estate investment vehicles have used limited partnership structures. In the early days of LLCs, this may have been motivated as much by uncertainty over the tax treatment of LLCs by the IRS (which has now been settled since 1996) as well as the impact of the gross receipts tax (which is now decidedly unsettled).

Using an LLC as the general partner avoids the impact of unlimited personal liability of the general partner of a limited partnership. Of course, in most cases, an LLC is as flexible as a limited partnership structure and has the added advantage of not needing to create two entities to limit liability. For example, estate planners recommending family limited partnership arrangements are using LLCs as often as limited partnerships to achieve the same objectives.

There are several important tax considerations for foreigners holding interests in LLCs. These include the complex branch profits tax rules, significant withholding tax obligations with regard to distributions and sales of assets or the membership interests themselves, as well as even estate tax implications. To avoid most of these issues, many foreign investors will choose to form a U.S. C corporation to hold the membership interests in an LLC. This should also allow the ultimate owner – but not the corporation itself – to avoid having to file a U.S. tax return.

Real estate transactions are ideally suited to the LLC format, particularly if there are multiple owners. Co-owners who hold property in their individual names run not only personal liability risks but also the possibility of a court mandated sale if there is a subsequent disagreement between the owners and an application is made to the court for partition of their respective

interests.

The LLC insulates owners from these types of risks. However, using an LLC for real estate investment purposes is not a problem-free solution. Particularly in the estate planning context there are potential California property tax reassessment issues if the planned gifting might involve a change of control of the ownership of the property. In addition, particular care has to be taken if you are contemplating a 1031 exchange. In both cases, if there is an LLC involved, careful planning is required to ensure you end up with the end result you want.

For most non-real-estate businesses, the differences between using an LLC rather than an S corporation will be marginal, particularly for "mom and pop" type operations. However, when it comes to sharing part of the profits or equity of an LLC with employees, the position is far from straightforward.

Although an employee in an S or C corporation can also be a shareholder, it is by no means clear that an employee of an LLC can be a member and an employee. If the employee is treated as a member of the LLC, the employee may have to be treated as a "partner" for tax purposes, not as an employee. This means getting used to K-1 reporting, estimated tax payments and self-employment taxes as well as possible exclusion from certain benefit programs such as cafeteria plans.

The position of employee/members is complicated and requires careful analysis since there are many different ways in which the issues may be approached. However, an employee who is treated as a member of an LLC for tax purposes, may still be recognized as an employee for California labor and employment law purposes, including workers' compensation, unless he or she can genuinely be said to have "partner" status within the organization, participating in decision making in a meaningful way as well as sharing in the profits and losses of the business.

Notwithstanding all of the above issues, LLCs will continue to be an incredibly useful entity for almost any business venture. Easy to form and easy to operate, LLCs should always be taken into consideration. However, there are numerous variables involved in the choice of an entity, many of which may not be obvious at first glance. Seasoned professional advisers, skilled at analyzing the relevant issues applicable to your business, can help guide you through the maze of options and ensure that you arrive at the right decision.

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About The Author

Simon Inman is a partner in the law firm of Carle, Mackie, Power & Ross LLP. His practice focuses on general corporate finance, securities and business law matters, including mergers and acquisitions, venture capital, banking and other financing transactions. Prior to joining the firm in 1999, he was a partner with Hammonds, a major UK-based pan-European law firm for 15 years handling numerous national and international corporate finance transactions.

Based in Santa Rosa, CMPR represents a wide variety of individuals, businesses, non-profits and public agencies, locally, statewide, nationally and internationally. CMPR's core practice areas are corporate and commercial, real estate, tax, estate planning, litigation and employment. Within these areas CMPR has developed particular skills with respect to trademarks, intellectual property litigation, land use and environmental law. In addition, CMPR has significant experience and expertise with respect to the Wine industry and all aspects of Affordable Housing transactions. The firm consists of 16 professional staff members, including 6 partners, out of a total compliment of 26.

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