

PART 2. OVERVIEW OF LLC BUSINESS ORGANIZATION LAW AND TAX LAW

OVERVIEW

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A. WHAT IS AN “LLC”?—INTRODUCTORY CONSIDERATIONS

If one of your LLC formation clients were to ask you the question “What is an LLC,” how would you answer it? Here’s my answer, starting with three introductory considerations:

- 1) LLCs are a new business organization form. The first LLC act was enacted in Wyoming in 1977, but because of serious federal income tax questions about LLCs, LLC acts did not begin to proliferate until the early 1990’s; the proliferation was triggered by a favorable IRS ruling in late 1988. Utah adopted its original LLC act in 1992—just 21 years ago.
- 2) However, LLCs did not really take off as business entities in Utah or elsewhere until the issuance of the U.S. Treasury’s famous “Check-the-Box Regulations,” which became effective on January 1, 1997.
- 3) LLCs are now by far the most popular business organization forms not only in Utah but also in all other U.S. jurisdictions except California, Illinois and New York (each of whose LLC acts are beset with major flaws).

B. WHAT ARE THE KEY FEATURES OF LLC BUSINESS ORGANIZATION LAW UNDER THE NEW ACT?¹

- 1) LLCs are legal entities, and they provide their owners (called “members”) with statutory liability shields.
 - a) LLC entity status. LLCs, like corporations, are legal entities. This means that:
 - i) They are legal persons separate from their members; and
 - ii) They can do everything in conducting businesses that individuals can do, such as hiring employees, owning property, signing contracts and incurring liabilities.

¹ The term “business organization law” is used frequently in this Outline. For purposes of the Outline, the term means the subset of state business law consisting of the statutory and common law governing the formation, management and other non-tax features and procedures (including, for example, procedures for statutory mergers, conversions and dissolutions) of state-law business entities. Examples of state business organization law statutes include corporate statutes, LLC statutes, and general and limited partnership statutes.

- b) The LLC liability shield—corporations vs. LLCs. In addition, like corporations, LLCs provide their owners with strong statutory liability shields against claims by third parties. The statutory liability shield provided to members of New Act LLCs will be particularly strong, because it expressly eliminates “non-compliance with statutory formalities” as a ground for veil-piercing. New Act, Section 304(2). Because of Section 304(2), the New Act liability shield is better than any corporate liability shield.
- 2) Main legal differences between LLCs and corporations. Corporations vs. LLCs—in general. The main current competitors of LLCs as business entities are, of course, state-law business corporations (which I’ll refer to here simply as “corporations”). However, for several important legal reasons, LLCs are far superior to corporations for most closely held businesses from both a business organization law viewpoint and a tax viewpoint. As to business organization law:
- a) Informality. LLCs are far less formal than corporations. For example, they do not require bylaws, share certificates, annual owner or manager meetings or minute books.
 - b) Simple management structure. LLCs have a far simpler management structure than corporations. Essentially:
 - i) Single-member LLCs generally have a sole proprietorship management structure.
 - ii) Multi-member LLCs have either a general partnership or a limited partnership management structure.
 - c) Flexibility. LLCs are far more flexible than corporations—e.g., in determining their fiduciary structures. For example, the New Act provides LLC members with substantial flexibility in tailoring the fiduciary duties of members and managers. New Act, Section 112(4).
 - d) Pick-your-partner and charging order protections. Most importantly, all LLC acts, including the New Act, provide members with statutory “pick-your-partner” and “charging order” provisions. Corporations don’t. Thus, LLCs offer their owners substantially better protections of their owners’ ownership rights than corporations.
 - i) Pick-your-partner provisions.
 - (1) Pick-your-partner provisions prevent third parties—e.g., creditors, divorced spouses and trustees in bankruptcy—from obtaining judicial orders transferring LLC members’ management rights to these parties.
 - (2) Pick-your-partner provisions are rooted in the fundamental partnership law principle that complete compatibility among partners is essential to partnership success and thus is a legal right of partners.
 - (3) The pick-your-partner provisions of the New Act are in Sections 401(3)(c) and 502(1)(c)(i) and, arguably, in certain other provisions of the Act. As noted, corporate statutes don’t contain pick-your-partner provisions.

ii) Charging order provisions.

- (1) Charging order provisions prevent third parties from obtaining judicial orders transferring LLC members' economic rights to these parties—i.e., their right to allocations and distributions of LLC assets.
- (2) The charging order provisions of the New Act are contained in Section 503 of the New Act.

As noted, corporate statutes don't contain charging order provisions.

- e) Pick-your-partner provisions and charging order provisions in corporate shareholder agreements. It is true that you can draft buy-out provisions in corporate shareholder agreements that have roughly the legal effect of pick-your-partner and charging order provisions. However, these provisions create contingent financial liabilities for shareholders that many shareholders may not want.

C. HOW DOES THE INTERNAL REVENUE CODE TAX LLCs AND THEIR MEMBERS?

For many closely held businesses, LLC federal tax is much better than corporate tax.

- 1) Single-member LLCs. Like single-shareholder corporations, single-member LLCs owned by individuals can be taxable as S corporations or C corporations. However, individuals who are members of LLCs can also be subject to federal income taxation as sole proprietorships.
 - a) Sole proprietorship taxation. Because of its simplicity, its low tax preparation costs and other factors, sole proprietorship taxation is often the best federal tax regimen for LLCs owned by individuals. Corporations cannot qualify for sole proprietorship taxation.
- 2) Multi-member LLCs. Like multi-shareholder corporations, multi-member LLCs can be taxable as S or C corporations. However, LLCs and their members can also be taxable as partnerships.
 - a) Partnership taxation. Because of its flexibility, partnership taxation is often the best possible federal income taxation for multi-owner businesses and their owners. Corporations cannot qualify for partnership taxation.