

PART 7. FORMING SINGLE-MEMBER LLCs WHOSE MEMBERS WILL BE INDIVIDUALS

OVERVIEW

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A. INTRODUCTION

- 1) From an LLC formation viewpoint, there are two main types of single-member LLCs:
 - a) Those whose members are individuals; and
 - b) Those whose members are entities.
- 2) The relevant issues in forming each of these two types LLCs differ greatly from those relevant in forming the other.
- 3) My purpose in this part of the seminar is to identify the main issues in forming New Act single-member LLCs whose members will be individuals. I will address the formation of New Act single-member LLCs whose members are entities in Part 8 of this Outline.

B. EIGHT KEY ISSUES TO ADDRESS IN FORMING NEW ACT SINGLE-MEMBER LLCs WHOSE MEMBERS WILL BE INDIVIDUALS

ISSUE 1. Should Your Client Form His or Her Business as a Single-Owner Business or as a Multi-Owner Business?

- 1) The relevant case law strongly suggests that the owners of single-shareholder corporations and single-member LLCs face a significantly greater risk of veil-piercing than the owners of multi-owner business entities.
- 2) In addition, under the New Act, LLC statutory pick-your-partner protections and provisions are readily available to multi-member LLCs but very probably unavailable to single-member LLCs.
- 3) For these reasons, you should always ask clients of yours who tell you they want to form single-member LLCs whether it may not be best for them to form multi-member LLCs. The best co-member for a two-member LLC in such a situation is often one's spouse.

ISSUE 2. Should Your Client Form His or Her Single-Owner Business as a State-Law Sole Proprietorship, a Single-Shareholder Corporation or a Single-Member LLC?

- 1) When should a client conduct a single-owner business as a state-law sole proprietorship? Your clients who, despite their business organization law drawbacks, want to start single-owner businesses should think seriously about forming them as state-law sole proprietorships if:

- a) They will have no employees; and
 - b) They will have no collaborators in their business who, because they work closely with them or for other reasons, could be mistaken to be their partners; and
 - c) They will not be parties to any contracts for which the owners will not be personally liable.
 - i) Example. Mary Roe wants to form a single-owner business. She plans to rent an office near her home. She knows that the landlord will not require her to personally guarantee rentals under the office lease. In this situation, she should consider conducting her business as a single-member LLC rather than as a sole proprietorship.
- 2) Single-shareholder corporations vs. single-member LLCs. If, under the above tests, it is clear that your clients should form single-owner entities:
- a) Both single-shareholder corporations and single-member LLCs will provide your clients with relatively strong liability shields.
 - b) However, single-member LLCs will almost be preferable to single-shareholder corporations for your clients because:
 - i) Corporations have a relatively complex and unintuitive management structure; and
 - ii) Corporations cannot qualify for sole proprietorship taxation—which is often the best federal income tax regimen for single-member LLCs whose members are individuals.

ISSUE 3. Who Should be the Members of Your Clients’ Single-Member LLCs?

- 1) The intuitive answer to the above issue is that they should hold them in their own names. However, I understand that the Utah probate process can be burdensome. LLC memberships that pass by trust are not subject to probate.
- 2) Accordingly, assuming your clients have revocable trusts or can afford the roughly \$3,000 that it will cost to form them, they should hold their single-member LLCs in revocable trusts.
- 3) However, if your clients do not want to hold their memberships in their LLCs through revocable trusts, they should consider including in their operating agreements provisions that will provide for the transfer of these members under the Utah Uniform Transfer on Death Security Registration Act, Utah Code Annotated 75-6-301 *et seq.*¹

ISSUE 4. What is the Best Management Structure for Your Clients’ Single-Member LLCs?

- 1) Single-member LLCs and continuity of management. Intuitively, your clients might think that the best management structure for their single-member LLCs is a state-law

¹ I am indebted to Melissa Platt of the Utah bar for her suggestion as to the possible utility of the above statute in drafting provisions in the operating agreements of single-member LLCs under the New Act to provide for the transfer of members’ memberships upon the members’ death.

sole proprietorship structure in which they, the members, are the only managers. However, under the New Act and most or all other LLC acts, if an individual who is a member of a member-managed single-member LLC dies while a member or is otherwise unable to manage the LLC—e.g., because of illness or absence—this may create a serious continuity-of-management problem.

- 2) Using non-member assistant managers. Thus, your clients who are forming single-member LLCs of which they will be the managers should generally provide in written operating agreements that their LLCs are manager-managed LLCs and that one or more named non-member individuals will be assistant managers of their LLCs and may act as managers in the situations specified in these agreements. In addition, to avoid possible third-party reviews of their operating agreements, you may want to advise your clients to file statements of authority with the Division of Corporations under New Act, Section 302.
- 3) Using non-member managers. Also, of course, if your clients will be the owners of single-member LLCs but do not want to manage them, they should appoint non-member managers in written operating agreements.
- 4) Form 1.2. Form 1.2, included in the materials in seminar, is intended for use in drafting operating agreements for Utah single-member LLCs that have individuals as their members, that have the above management structure, and that are taxable as sole proprietorships.

ISSUE 5. Do Single-Member LLCs Whose Members are Individuals Need Written Operating Agreements?

In general, yes. The main benefits of written operating agreements for single-member LLCs whose members are individuals are the following:

- 1) Protection from veil-piercing. As noted, for individuals who own single-member LLCs, veil-piercing is a significant legal risk. See, e.g., *Martin v. Freedman*, 272 P.3d 11802 (Colo. App. 2012). Written operating agreements can help to establish the separateness of members of single-member LLCs and their single-member LLCs and thus can reduce the risk of veil-piercing.
- 2) Altering of unwanted default rules of the New Act. Written operating agreements can be useful in clearly altering default rules of the governing LLC act that are inappropriate for single-member LLCs whose members are individuals—such as the default rule arguably implicitly providing that only the members of member-managed single-member LLCs may legally bind or manage their LLCs.
- 3) Understanding one’s single-member LLC. Written operating agreements can also be useful in helping their members to understand and operate them.

ISSUE 6. What should you charge for drafting an operating agreement for a single-member LLC whose member is an individual?

In my view, lawyers should generally be willing to form these single-member LLCs and draft these agreements for them for, say, \$700. For many clients, this will be an affordable amount.

ISSUE 7. What Are the Principal Non-Tax Issues That Should be Addressed in the Written Operating Agreements of Single-Member LLCs Whose Members Are Individuals?

- 1) Management structure issues. The principal non-tax issue is the management structure issue outlined above.
- 2) Fiduciary issues. However, the written operating agreements of manager-managed single-member LLCs in which the member is also a manager but in which there is also a non-member manager should address the fiduciary issues relevant to the assistant manager—usually by reducing or, if possible, eliminating any fiduciary duties applicable to the assistant manager.
- 3) Transfers of memberships upon original members' deaths. As noted, written operating agreements of single-member LLCs should address the issue of what will happen to the member's membership upon his or her death.

ISSUE 8. Which is the Best Federal Income Tax Regimen for your Client's Single-Member LLC?

This is not a tax seminar. However, a few quick words about the above issue may be useful to you.

- 1) Federal tax regimens available to single-member LLCs whose members are individuals. Under U.S. Treasury rules officially designated as the “Entity Classification Regulations” but generally referred to by tax practitioners as the “Check-the-Box Regulations,” the members of single-member LLCs whose members are individuals may choose to have themselves and their LLCs taxed either as sole proprietorships or as S corporations.
- 2) Sole proprietorship taxation vs. Subchapter S.
 - a) Sole proprietorship taxation is often the easiest federal income tax regimen for the above single-member LLCs and is likely to involve tax preparation fees to tax preparers that are several hundred dollars cheaper than under Subchapter S.
 - b) However, a proper use of Subchapter S by these single-member LLCs can potentially save them thousands of dollars of Social Security Taxes per year if the LLCs have employees or significant capital assets to which they attribute a portion of their net income.