

## WHAT IS A LIMITED LIABILITY COMPANY?

Many business transactions lawyers spend much of their professional lives creating, structuring and manipulating the “unnatural persons” of the legal world, those entities identified as “persons” under the law that are not “natural persons”. These “unnatural persons” are the building blocks of modern civilization. They are the conceptual entities or “legal entities” that we natural persons use to organize our lives and to bring continuity, stability and structure to our lives and societies in our effort to cope with the endless changes of the natural world. We might think of these legal entities as bridges we natural persons build over the endless flow of the river of time. These entities help us bring order to the natural world, what we normally think of as “reality”, and enable us natural persons to organize ourselves in productive ways.

Some “unnatural persons” recognized in our laws today have arisen organically out of human experience. Such prehistoric unnatural persons familiar to western and other cultures might include such entities as marriages, families, partnerships, tribes, villages, kingdoms, and other ancient political and social groupings. Other familiar “unnatural persons” are largely products of modern human conceptual creativity, and are “conceptual tools” created by societies and their governments through written laws, constitutions, case law and legal codes to help solve social problems, promote social organization or provide some social advantage to a group of people. Nations, states, counties, cities, school districts, corporations, trusts, and limited liability companies are just a few examples of such modern conceptual legal entities or “unnatural persons” that natural persons have intentionally created to provide some beneficial organizational structure for our societies.

For business transactions attorneys, the modern limited liability company is an interesting unnatural person with unique characteristics. The most significant characteristic of the limited liability company, sometimes identified as an “LLC”, is that the LLC has evolved into the “stem cell” of modern business entities. Under current California and federal law, the LLC can be structured to substitute for nearly all of the traditional business entities that we business transactional lawyers create in our daily practice. In many fact situations, some form of the LLC is the best choice of entity to promote a client’s goals. But many lawyers are not aware of the full range of flexibility of the LLC, and if we are aware of the many uses for this tool, we often seem to struggle when describing to each other the type of LLC that we are discussing.

Perhaps the lack of appreciation of the many LLC forms available to us and the confusion and difficulty in discussing these LLC forms is, in part, caused by a lack of a standardized, conceptual nomenclature for describing the different LLC forms available. It may be productive to develop such a standardized conceptual framework for classifying and describing the LLC variations.

The LLC is an unnatural person with a partnership heritage that is created by statute, structured by contract, and taxed by choice. This definition might not seem confusing on its face, but let’s explore it in a little more detail. The reasons for the LLC conceptual confusion will soon become apparent.

LLC's are taxed by choice. The conceptual framework for describing what form of LLC we are discussing became more complex with the decision to initiate the "Check the Box" rules for assigning the tax status to various entities. The "Check the Box" regulations allow the owners ("members") of an LLC to choose a tax status they desire for the LLC by "checking a box" on an IRS form. In some fact situations the owners of an LLC may have the option to have their LLC taxed as: 1) a non-entity, 2) a partnership, 3) an "S" corporation, or 4) a "C" corporation. This tax classification does not change the identity of the LLC under state law; it just allows the owners to choose the LLC's federal tax status. Most states, including California, require the LLC to use the federal tax status for state taxation. The LLC owners can also just as easily change the tax status of the LLC by submitting simple prescribed forms to the IRS. Though the change in tax status might have serious tax and other implications for a specific LLC, the procedure itself to change the tax status of an LLC is quite simple.

The possibility of LLC conceptual confusion now starts to become apparent because we now have 1) LLC's that are disregarded for tax purposes, 2) LLC's that are taxed as partnerships, 3) LLC's that are taxed as "S" corporations, and 4) LLC's that are taxed as "C" corporations. These are major variations for LLC's, and, in fact, are four different kinds of entities for tax purposes, entities that would have very different applications and uses. The significance of these LLC taxation alternatives is really equivalent to the use of a different entity, such as a sole proprietorship, a partnership, an "S" corporation or a "C" corporation. The failure of practitioners to specify the tax status of an LLC as an integral part of the description of a specific LLC sometimes causes confusion, and such confusion may become more important as practitioners increasingly choose to use a tax status for LLC's other than partnership tax status, the historical default status.

One of the goals of this tongue-in-cheek essay is to urge lawyers to be sensitive to the LLC tax status issue and to clarify when necessary the tax status of an LLC under discussion. Is the lawyer talking about a "disregarded" LLC (perhaps we could call it a "DLLC"), a partnership LLC (a "PLLC"), an "S" corporation LLC (an "SLLC") or a "C" corporation LLC (a "CLLC")? Or perhaps there is a different nomenclature that Practitioners can agree upon to identify the tax status of an LLC?

LLC's are structured by contract. The ownership structure and the manner of how a California LLC is operated and managed, what we call the "non-economic" interests, and the capital structure of an LLC, what we call the "economic interests" (that includes both capital and profits interests) are governed by a contract (the "operating agreement") between the members of the LLC. Under California law the parties can structure the LLC to operate as they wish with very few statutory provisions that cannot be changed in a written operating agreement. This statutory flexibility allows the creator of the LLC to draft an operating agreement that will create an LLC with a capital structure and an operational structure that looks just like that of a sole proprietorship, a limited partnership, a general partnership, an "S" corporation, a "C" corporation or some combination of any of the above. The creator can mix and match capital structures and operating structures in umpteen different ways. For example, an LLC can have a capital structure that is identical to that of a limited partnership, but have the operational structure of a "C" corporation, or vice versa.

With this structural flexibility, the opportunity for LLC conceptual confusion just became exponential. Now we have the possibility of an LLC that looks and functions like a sole proprietorship, a general partnership, a limited partnership, an “S” corporation, a “C” corporation, or any combination of these entities, but which in fact might be taxed as any other of these entities. What the practitioner means when he says “LLC” becomes somewhat unclear.

Perhaps lawyers can agree on a uniform nomenclature that more accurately identifies the form of an LLC. For example, building off of the suggested nomenclature for tax status offered above, perhaps creators can agree to add a descriptive phrase after the tax status identification described above to identify the capital and operating structure of the specific LLC under discussion. For example, an LLC structured to function as an estate planning entity for asset freeze, discounted asset transfers and asset protection purposes might be described as “a PLLC with an LP (limited partnership) capital structure and a P (general partnership) operating structure”. Now isn’t that crystal clear?

Additional LLC conceptual confusion is created by the fact that the LLC is a statutory creation and many state statutes are in conflict with one another. All of the states, including California, offer a statutory framework providing for the creation of an entity called the limited liability company. One complication here is caused by the differences between some of the state versions of the LLC. As yet, there is no uniform limited liability company act followed by the majority of states, and there are really significant differences between the structures and operations of various state versions of the LLC. A good example is the Delaware series LLC that many other states, such as California, do not yet offer and have not yet fully integrated with their own statutory version of the LLC. However, the conceptual clarification on this issue is simple; the practitioner just needs to indicate the state under which the LLC is formed. For example, if we were using a California LLC for our estate planning entity described above, we would identify it as “a CA PLLC with an LP capital structure and a P operating structure” Now if we could all just agree on the nomenclature, working with LLC’s would be simple.