

LLC Design and Implementation

Tax Considerations and Consequences

LLCs come in four basic forms based on tax treatment which is usually chosen by the members. The four forms of LLC's based upon tax treatment we shall call:

- (i) LLC-D's (those LLC's taxed as a disregarded entity)
- (ii) LLC-P's (those LLC's taxed as a partnership)
- (iii) LLC-S's (those LLC's tax as an "S" corporation)
- (iv) LLC-C's (those LLC's taxes as a "C" corporation)

These four forms of the LLC are functionally very different from each other and are used for very different purposes. It is interesting to note that there can be larger differences between an LLC-P and an LLC-C than there are between a general partnership and a "C" corporation. It would be unthinkable for a transactions lawyer to fail to distinguish between a general partnership and a "C" corporation. Yet practitioners consistently fail to identify the form of LLC that is being discussed and stuff all types of LLC's into the same category, usually that of an LLC-P. It seems that most practitioners just assume that they are dealing with an LLC-P, often even when that assumption is incorrect. That thinking has to end if we want to understand all of the appropriate uses for LLC's and to take full advantage of the LLC tool.

Economic Interests & Non-Economic Interests

Most California LLC operating agreement forms have the economic interests and non-economic interests keyed to capital accounts. Or, to put this another way, most LLC operating agreement forms are designed for an investment LLC-P. Under this approach, a capital account is established for each member based on the member's initial capital contributions and is thereafter adjusted from time to time for allocations of profits and losses and distributions of cash as well as adjustments to fair market value ("booking up"

or "booking down") upon the distribution of property in exchange for some or all of a partner's interest or upon the contribution of cash or property for a new partnership interest. Tying economic interests and non-economic interests to capital accounts often works well for simple investment LLCs, but it usually does not work at all for regular businesses operating as an LLC or for LLC's used for purposes of asset protection, estate planning and the hundreds of other uses for various forms of LLC's. There are other methods of structuring the elements of ownership of an LLC that are more appropriate for LLC-P's used in asset protection and estate planning situations and for LLC-D's, LLC-S's and LLC-C's used for other purposes.

Elements & Methods of Allocations of LLC Ownership Interests

(a) Elements of Allocation - The elements of a membership interest in an LLC can be broken down into (i) economic interests and (ii) non-economic interests. Economic interests would include capital interests, profit and loss allocations and interim distributions from operations and liquidation distributions. Non-economic interests would include voting and management rights and information and document access rights.

(b) Defaults for Economic Interests - Under the 2013 version of the California LLC Act, unless the operating agreement provides otherwise, profits and losses will be allocated among the members in proportion to their capital contributions. Corp C §17202. Unless the operating agreement provides otherwise, distributions that are a return of capital will be made in accordance with capital accounts, as would be any distributions that are not a return of capital, such as distributions of profits and losses. Corp C §17250.

(c) Defaults for Non-Economic Interests - Under the 2013 California default rules for LLC voting and management interests, each member may vote in proportion to the member's interest in current profits, which by default would be based upon capital accounts. Corp C §17103(a)(1). The default rule for minimum access to information is set forth in Corp C §17106. The minimum rights to information may not be reduced by the articles of organization or operating agreement. Corp C §17005(b)(4). California resident

members of a foreign LLC that has at least 25% of its membership interests in the hands of California residents are entitled to the same information and inspection rights that would apply if the LLC were a California LLC. Corp C §17453. Unless the articles of organization or operating agreement provide otherwise, any amendment to the operating agreement requires unanimous vote of the members. Corp C §17103(a)(2).

(d) Act Flexibility - Although the 2013 version of the California LLC Act sets default rules to govern the relations of the members to each other and to the entity, it gives the members a great amount of flexibility to vary the elements of the default rules by creating alternative provisions in the articles of organization or in the operating agreement. Except for those rules set forth in Corp C §17005 (that lists the rules which may not be altered or that may be modified only in a specific way), members of an LLC have a free hand to modify any rule, even if the rule is contained in an Act section that does not contain the phrase “unless otherwise provided in the articles of organization or operating agreement”. Corp C §17005(e). In some cases, default rules under the Act may be modified only by a written operating agreement. Corp C §17005(d). But, for the most part, a California LLC can be structured to operate in just about any manner the members wish.

(e) Methods of Allocation - The manner in which profits and losses and voting rights may be allocated within an LLC are limited only by the drafter's imagination. An allocation may be as simple as a "per capita" allocation in which each partner shares equally in capital distributions, profit and loss allocations and liquidation distributions. Again, one of the most common forms of allocation is that based on adjusted capital contributions, in which each partners' proportionate interest in adjusted capital (capital accounts) dictates the partners' profits and loss allocations, voting rights and liquidation distributions. Another simple form of allocation is allocation based on annual agreement of the appropriate ratio of sharing profits and losses. This is a form of allocation agreement used by service organizations in which the members agree on a sharing percentage at the end of each year, based on productivity or some other aspect of performance. Another simple form of allocating profits and losses would be using a sharing ratio in which specific percentages of profits and losses are set forth in the

operating agreement on a permanent basis. The most flexible form of allocation of elements of ownership in an LLC are allocations based upon “units”, which is much like the concept of shares of a corporation. This is an appropriate structure for an LLC to be used in estate planning and/or asset protection situations and is a structure that duplicates the ownership structure of a limited partnership, an “S” corporation or a “C” corporation.

(f) Ownership Based On Units - The usual forms of operating agreements found in forms books, such as the CEB book on forming and operating LLC’s are structured for an LLC-P in which all attributes of ownership of the LLC interest are tied to capital accounts. In these forms, a member’s capital interest, the members' profit and loss allocations from operations as well as the members' interim distributions and liquidation distributions are tied to the capital accounts, as are the voting and managing rights. In order to convert this to an LLC-P operating agreement for use as a ‘unit’ based estate planning vehicle and/or asset protection vehicle, the form can be amended so that profit and loss distributions and allocations, and voting and management interests, are tied to units, which are here called "membership interests". In addition, the standard forms can be amended to create two classes of “membership interests”. The “voting interests” are those “interests” with complete economic and non-economic rights. The “non-voting interests” are identical to the “voting interests” except that this second class of “membership interests” has few voting or management rights. These are the "non-voting interests". For an LLC with an operating agreement structured in this manner, during the life of the LLC, the profit and loss allocations and distribution rights and the voting and management rights will be allocated in accordance with the units of “membership interests” held by each member. By creating the two membership classes, “voting interests” and “non-voting interests”, we can set up a structure in which the members holding voting interests are in complete control of the operations of the LLC, but which make it very easy for those in control to transfer equitable ownership of the LLC by way of the non-voting membership interests without losing control of the LLC.