
INTELLECTUAL PROPERTY AND TRANSACTIONAL LAW CLINIC



LIMITED LIABILITY COMPANIES

INTRODUCTORY OVERVIEW

Limited liability companies (“LLC’s”) are a hybrid form of business entity that draws from a combination of principles from partnership and corporate law. LLC’s may be owned and managed by one or more individuals, corporations, or businesses that are referred to as “members” of the LLC. Unlike a corporation, LLC’s do not have shareholder investors nor do they issue stock.

LLC’s are a popular form of entity for business owners who seek the advantage of limiting their own personal liability for the debts and responsibilities of the company much like in a corporation. Unlike a corporation, however, an LLC’s profits are not taxed at the entity level before being distributed to members. Instead, members of the LLC pay federal and state taxes on their allocated portion of the LLC’s net profits through their individual tax returns. Shielding members from personal liability for the debts and actions of the LLC as well as the avoidance of double taxation on business profits are the two primary benefits of forming an LLC.

HOW A LIMITED LIABILITY COMPANY IS FORMED

Formation of LLC’s is controlled by state law. If one or more individuals, corporations, or businesses choose to become members of a newly created LLC in Virginia, the first steps toward formation are to draft and then execute the LLC’s articles of organization with the State Corporation Commission (“SCC”). Virginia provides Form LLC-1011 for this purpose, but you are not required to use the State’s form.

The articles of organization require the LLC's unique business name including the designation "limited company," "limited liability company," or the abbreviations "L.C.," "LC," "L.L.C.," or "LLC." This designation serves as a marker for prospective creditors and customers so that they are aware that they are dealing with a limited liability company rather than a sole proprietorship, partnership, or some other business entity that does not place limitations on the personal liability of the business owner(s) for the debts and responsibilities of his or her business. The articles must also include the name and in-state address of the LLC's registered agent which is typically either a member or manager of the LLC or an attorney licensed to practice law in Virginia. This registered agent will be designated to receive all official documents from the state as well as service of process if the LLC is ever sued. An LLC cannot be its own registered agent under Virginia law.

Finally, the articles must include the address of the LLC's principal place of business as well as the name and signature of one or more persons who sign the articles as "organizers" of the LLC primarily as an oath that the information contained in the articles is correct. While the organizers are often members of the LLC, an individual may be named as an organizer who is not a member or manager of the business. A non-member organizer does not become a member of the LLC nor does he receive management rights in the LLC before or after it is formed simply by acting as an organizer pursuant to Virginia Code §13.1-1010.

Virginia law also requires all domestic LLC's to obtain a federal Employer Identification Number ("EIN") for use by state agencies when cross-referencing businesses. The application form for a federal EIN can be found at www.irs.gov. Additional forms, such as registering with the Department of Taxation (www.tax.virginia.gov) and determining liability for Virginia's Unemployment Tax (Form VEC-FC-27 available at www.vec.virginia.gov) should also be completed by the LLC. The official existence of the LLC begins when the Virginia SCC issues a certificate of organization establishing that the LLC has properly completed the articles of organization, all required tax forms, the federal EIN application, and has paid all applicable filing fees.

The most crucial step in developing a successful LLC is the drafting of a well-written and comprehensive operating agreement. Although this document is not required to form an LLC nor is it filed with a state office, multi-member LLC's benefit enormously from doing business under some form of operating agreement which defines how the LLC will carry out its business. Through the operating agreement, members of the LLC can establish financial and organizational guidelines for the LLC, provide rules and regulations for management procedures, and most importantly can create a framework by which the LLC members may allocate interest, divide profits and losses, establish member rights and responsibilities, and enforce other miscellaneous provisions such as the voting percentage requirements for bringing new members into the LLC or the circumstances under which a member may properly resign. The operating agreement also establishes ownership rights among the members as well as defining the rights, duties, and responsibilities of non-member employees of the LLC. Without an operating agreement in place, the law of the state in which the LLC

is formed will impose default rules on many aspects of the LLC which could be avoided by drafting an agreement.

By having these operational procedures in writing at the time of formation, the LLC can avoid future conflicts among its members that may arise if each individual's rights and responsibilities were not considered or were only agreed to orally upon the formation of the LLC. An operating agreement is also useful because businesses, buyers and sellers of assets, and banks doing business with the LLC often request the written operating agreement to ensure that the individuals who sign contracts on behalf of the LLC have the authorization to do so.

ADVANTAGES OF LIMITED LIABILITY COMPANIES

As the name "limited liability company" implies, the primary benefit of forming an LLC rather than a partnership or sole proprietorship is that the member or members of an LLC are shielded from personal liability for the debts and actions of the business. If the LLC incurs debt or is sued, the members of the LLC are not bound to satisfy the debt or pay damages out of their own pocket. Therefore the LLC's members receive non-liability benefits similar to the owners of a corporation without having to form a corporation. Additionally, LLC's require fewer filing documents and LLC owners are not forced to hold annual meetings or record meeting minutes as required for corporations.

Forming a multi-member LLC as opposed to a general corporation¹ has certain tax benefits as well. In a general corporation, the business must pay taxes on all profits through the entity itself before those profits are distributed to owners. Multi-member LLC's are not taxed as an entity either by the IRS or for purposes of Virginia state taxes. Instead, the LLC is treated as a pass-through entity, meaning that the business's income passes to the members of the LLC according to their allocated profits and losses and taxes are paid only through their individual returns. This means that, unlike traditional corporations, there is no "double tax" situation where the LLC's profits are taxed at the corporate/business level and then taxed again once those profits pass on to the owners of the business.

Typically, LLC's are not recognized as separate entities by the IRS for tax purposes. The default rule for multi-member LLC's is that they are taxed as if they were partnerships. The members then would file Schedule K-1, Return of Partnership Income, to represent his or her allocation of profits and losses. By default, a single-member LLC is treated as a

¹ If a qualified corporation makes a special tax election to become an S corporation, then that entity is taxed as a pass-through entity much like an LLC. Owners who seek to limit personal liability and avoid taxation on the business itself may choose to incorporate as an S corporation. LLC's offer similar tax and personal liability benefits for those owners who do not wish to have shareholder investors, issue stock, or hold annual meetings as required of all corporations.

“disregarded entity” by the IRS and the member is taxed on the LLC’s income as if it were a sole proprietorship. LLC’s may also elect to be taxed as a corporation.

DISADVANTAGES OF LIMITED LIABILITY COMPANIES

It is important to note that LLC’s are a relatively new business entity, and because they are not able to issue stock, a business seeking to attract considerable outside investment must consider carefully whether an LLC properly serves its best interests. In an LLC, most if not all of the capital needed to do business usually comes from the owners of the LLC themselves.

One tax disadvantage of forming a multi-member LLC is that each member who is involved in running the LLC is considered to be self-employed and therefore must pay the self-employment tax contributions towards Medicare and social security on his or her entire portion of the net income of the LLC, while the owner of a single-member LLC pays self-employment tax on the entire net income of the LLC.

Another disadvantage of LLC’s is the potential for a somewhat limited life. While they can operate perpetually upon agreement by the members, LLC’s are often formed for a single project or purpose, and the operating agreement can limit the life of an LLC to the duration of a particular project or to a particular date. The resignation of one or more members can also cause the LLC to be dissolved if the business is no longer able to carry out its stated business purpose. This further illustrates the importance of a well-crafted operating agreement fully setting out the purpose and life span of the LLC.

COSTS OF FORMATION AND MAINTENANCE

Each state has a filing fee that must accompany an LLC’s articles of organization when submitted to the state office. This fee usually ranges between \$50 and \$500. LLC’s must also pay an annual fee ranging from \$20 to \$500 to maintain the LLC which is usually comparable or somewhat less expensive than the annual renewal fee required of traditional corporations depending on the state of filing.

In Virginia, the original filing fee that accompanies the articles of organization is \$100, and the annual fee is \$50.

LIFE AND DEMISE OF A LIMITED LIABILITY COMPANY

The operating agreement of an LLC dictates whether the entity will operate perpetually or whether the LLC will dissolve upon the completion of a project or on a particular date. According to Virginia Code §13.1-1046, an LLC is dissolved and its affairs are wound up at the time or on the happening of any event in the operating agreement or articles

of organization, upon unanimous consent of all of the LLC's members, upon judicial dissolution, or upon repeated failure to timely pay annual registration fees pursuant to Virginia Code §13.1-1064.

In some states, when one member of an LLC leaves the business, the LLC can be dissolved and forced to wind up its business. This means that even a minority of members or a single member can be responsible for causing the dissolution of the LLC. Virginia does not have such a default rule. However, under §13.1-1047 of the Virginia Code regarding judicial dissolution of an LLC, a member may apply to the local circuit court to determine whether or not it is "reasonably practicable to carry on the business in conformity with the articles of organization and any operating agreement." Judicial dissolution is an unlikely outcome where the LLC has a well-crafted operating agreement in place fully and specifically setting forth the circumstances under which a member of the LLC may dissociate and what will occur in the event of each member's resignation.

In situations where all of the members of an LLC unanimously decide to end the business due to the completion of a project, sale of all assets, or unprofitability; the members are typically required to file notice of dissolution with their state office. All of the company's assets and debts are liquidated, creditors are paid off, and the business is terminated. If the LLC is abandoned but the members do not notify their state office via filing a notice of dissolution of the business, the LLC may remain as an existing business on record with the state and unwarranted annual fees could continue to accrue. Virginia Code §13.1-1050 requires the filing of articles of cancellation of the LLC after its business has been wound up. The articles must include the name of the LLC, the date of filing of the articles of organization, the reason for filing the cancellation, and a statement that the business has concluded winding up its affairs. If the SCC determines the articles of cancellation to be adequate, it will issue a certificate of cancellation which cancels the LLC's certificate of organization and the entity ceases to exist.

