

Chapter 1

What Is an LLC, Really?

In This Chapter

- ▶ Understanding LLC basics
 - ▶ Deciding how to use your LLC
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Limited liability companies have been generating a lot of buzz in the news lately — and for good reason. It's almost as if the corporate gods have smiled upon us and decided to improve upon the corporation and give us the LLC (the acronym for limited liability company). Where the corporation fails, the LLC prevails.

Think of the LLC as a merger of the partnership and the corporation, except it has the best of both worlds — all the good qualities of each and none of the bad. It offers full limited-liability protection to all the owners (like the corporation), yet has a pass-through tax status (like the partnership). In addition, the LLC has a second layer of liability protection that shields the business from any personal lawsuits that may befall you. And it doesn't stop there! The list of benefits goes on and on. In this chapter, I introduce you to those benefits and steer you toward the other chapters in the book where you can gain even more details.

Understanding How LLCs Work

LLCs are a relatively new entity — they are a hybrid between a corporation and a partnership. Therefore, they aren't so easy for some folks to understand at first. Even if you're familiar with corporations — or partnerships, for that matter — you still need to understand some new concepts and a few new terms.

The best and most basic way to understand an LLC is to think of it as a regular partnership, but all of the partners have full *limited-liability protection*. This means that the partners (the *members*) aren't personally responsible for the actions or debts of the company. This is huge! LLCs are more official than regular partnerships in that you have to form them with the state, and you can raise financing by selling off pieces of the company (the membership interests). But when all is said and done, LLCs were made to be easy. They are easy to understand and easy to run. Not to mention, if you make a mistake, the consequences aren't as dire as they would be with a corporation.

LLCs, like most entities, are subject to state oversight. The problem with this is that not all states are on the same page. So in addition to reading this book, you'll need to do a little bit of research so that you can make sure you are complying with the laws of the states you are transacting business in. This won't be too difficult, however, because I have provided each state's information on LLCs in Appendix A to point you in the right direction.



Although in most states, more LLCs are being formed now than corporations, they are still a very new entity. Compared to corporations, which have hundreds of years of case law backing them up, courts still have a lot to decide about LLCs. When operating an LLC, know that some things are based upon assumptions rather than actual legal precedents, and this creates gray areas — and potential problems. After all, you don't want to be the unlucky guy who is stuck in the courtroom when everything you thought you knew about LLCs is overturned. The best way to avoid this is to have a great registered agent or accountant who stays abreast of LLC laws for you. Should any monumental shifts occur in how LLCs are treated, your advisor can fill you in so you can plan accordingly.

Owners: You gotta have 'em

Although LLCs are separate from their owners in a lot of ways, they still need to have them. An LLC without an owner is like a child without parents. It just doesn't happen. In other words, there are no immaculate conceptions when it comes to LLCs.

The owners (see Chapter 10) not only own the entire enterprise and all of its assets, but they generally have the last say. Although they may not manage the business, they choose the managers. They vote on important issues and ultimately control the company's fate.

The owners in the LLC are called *members*. They have units of ownership called *membership interests* that show what percentage of the company they own and how much influence they have when voting on important company matters. Membership interests in an LLC are comparable to stock in a

corporation. However, unlike the S corporation (which is often compared to the LLC), LLCs can have unlimited members and any type of members. Members can be citizens of other countries or even entities such as corporations, partnerships, or trusts (see Chapter 10).



The actual term for the members of the LLC and their membership interests varies from one state to another. For instance, in some states, the membership interest is called *ownership interest* or *limited liability company interest*. Just keep in mind that, no matter what they're called, the concepts are still the same.

As you see in Chapter 10, LLCs can have different types of memberships. These are called *classes*, and you can make up whatever rules you want for each class. For instance, one class can have priority on the distributions, while the other class is second in line. Or one class can have a say in managing the company, while the other class must remain silent.



If your LLC has only one member, it's called a *single-member LLC*. Single-member LLCs are treated as sole proprietorships by the IRS for tax purposes. Your state laws, if they even allow single-member LLCs (some don't), may also treat them differently. For the most part, single-member LLCs still offer the liability protection that multiple-member LLCs offer; they just don't have the benefit of partnership taxation and aren't guaranteed the *charging order protections*, which protect the LLC from lawsuits that may be filed against you personally (I discuss this concept in depth in Chapter 11).

Contributions: Where the money comes from

When you buy a share of stock on the stock market, the money you pay is what you are contributing (or *investing*) in return for a percentage of the company's ownership. Well, LLCs are no different. In exchange for their membership interest (see the previous section), members must contribute something to the company. This can be in the form of cash or valuable assets, such as equipment, real estate, services, or even promissory notes (which are allowed in some states). See Chapter 10 for more details on contribution types.

When a member makes a contribution, the other members need to determine the value of that contribution in relation to everyone else's. They then distribute the membership interests proportionally. This is really easy to do when cash is involved. For instance, if Joe, Steve, and Mary each contribute \$100,000 in cash, then they each are issued one-third of the company. All of the contributions made by each of the members and their corresponding membership interest are listed in the operating agreement.

Most LLCs issue share certificates that, like stock certificates in a corporation, are evidence of the amount of ownership a member has in the company (see Chapter 10). The share certificate displays the member's name and the number of shares the person owns. To determine the member's percentage of ownership in the company, you divide the number of shares she owns by the total number of shares issued in the company. For instance, if a total of 10,000 shares is issued to all members of the company, and you own 100 shares, then you own 1 percent of the company. If 35,000 shares are issued to all the members, and your share certificate says you have 5,000 shares, then you own around 14 percent of the company. If the company doesn't issue share certificates, then the number of shares you own should be listed in the operating agreement next to your contribution amount. (In Chapter 9, I discuss operating agreements at length and show you how to list your members, their contributions, and membership interests properly.)

Distributions: Getting what you're due

After the company starts turning a profit, the members will no doubt want to benefit. After all, they didn't invest their hard-earned money into the company for nothing — they want to see a return! At certain points in time — usually at the end of the year, but sometimes at the end of each quarter — the company profit is calculated and doled out to each member in proportion to her percentage of ownership. These are called *distributions* and are generally in the form of cash (see Chapters 10 and 13).



LLCs don't have to distribute profits in proportion to the members' percentage of ownership. The members can decide to vary the distributions however they want. The IRS will generally allow this, as long as you pass their tests (mainly to prove that you aren't varying the distributions to avoid taxes). Speak to your accountant if you are interested in doing this.

Distributions also occur if your LLC goes out of business. In this case, the distributions are handled differently. The LLC's assets are liquidated, the creditors are paid back (including any members to whom the business owes money), and then the remaining amount is distributed to the members according to their specific ownership percentages (see Chapter 10). When these final distributions are made, you can't choose how the money is distributed — it must be doled out according to how much of the company each member has. For instance, if you own 50 percent of the company, you can rest assured that you will receive 50 percent of the remaining cash.

The birth of the LLC

The LLC didn't come out of nowhere. Business entities with the same characteristics as LLCs have been around for many years. The origin of LLCs can be traced back to the Germans. In 1892, German law enacted what was called the *Gesellschaft mit beschränkter Haftung* (GmbH) — a modern-day variation of the English private limited company.

After Germany established the GmbH, the concept soon spread throughout Europe and Central and South America. By the 1940s, in France especially, the concept of the limited liability company was becoming more popular than the traditional corporation.

Not that Germany can take all of the credit. In 1874, Pennsylvania authorized the use of a Limited Partnership Association. By 1875, Michigan, New Jersey, Ohio, and Virginia had enacted similar legislation after seeing how the entity type was gaining popularity in Pennsylvania. Unfortunately, the laws of the time required that the company headquarters remain in one of those five states. Because those states weren't huge epicenters of American commerce, the new legislation began to lose popularity.

In 1977, Wyoming decided to spearhead an effort to build upon the antiquated Limited Partnership

Association and enacted the first true LLC act. The legislature modeled the act after the German GmbH and the successful Panama version of the LLC. Because of Wyoming, the modern-day LLC protects all partners from the liability of the business and has a double layer of liability protection that protects the business from your personal creditors.

After Wyoming, Florida followed suit in 1982. However, LLCs weren't popular entities. Because they were hybrid entities — between a corporation and a partnership — the IRS had yet to decide how it was going to tax the LLC. After all, would you really want to form an entity without knowing what sort of tax structure would be imposed on you?

Finally, in 1988, the IRS ruling came: LLCs would be taxed as partnerships. The business's profits and losses would flow through to the owners, and the LLC wouldn't be recognized as a separate entity for tax purposes. After this ruling occurred, states began to form their own versions of LLC law.

After a while, the public became more familiar with LLCs and began to form more of them. As they were more commonly used, case law built up, which gave members a more solid idea of what the LLC's legal limitations are.

Popular Uses for LLCs

What are LLCs used for? I think the better question is “what *aren't* LLCs used for?” They are the most flexible business structure around by far. With an LLC, you can choose

- ✓ How you want to be taxed
- ✓ How you want to distribute your profits

- ✓ How you want to manage your LLC
- ✓ Who you want to manage it

You can even create your own laws, pretty much disregarding those of the state. When you form your LLC, you will create an operating agreement, which I go over in detail in Chapter 9. In this agreement, you dictate exactly how you want to structure your business and how it should be run.

If you are looking to your next business venture, real estate transaction, or are planning your estate, this sort of flexibility probably appeals to you. And when you couple the flexibility with some of the most comprehensive asset protection around, you can see why LLCs are beating out corporations as the entity of choice as the years go on. If you structure your LLC properly, you can also take advantage of the benefits of a corporation, such as corporate taxation and decentralized management.

LLCs are so powerful and are used for so many things that lots of different offshoots are springing up, such as *series LLCs* and *limited liability partnerships* (a version of the professional limited liability company). All have various added benefits that strive to take the LLC even further than it has gone already.

LLCs have many more uses that I don't discuss in this chapter. These range from protecting personal assets to raising capital for a project. As you find out more about LLCs, I hope you begin to understand the power of LLCs and think of the various ways that they can protect you and all that you have worked for.

Running a small business

Tens of millions of Americans operate small businesses. These range from small, home-based businesses on the side to fully operational companies with many employees. For the most part, these individuals are operating without protection. Granted, they may not take what they do too seriously. They may consider themselves independent contractors or consultants, but in today's litigious society, it's a bad move to operate without even a basic level of liability protection.

As *sole proprietors* (the legal term for how these folks are doing business currently — see Chapter 2), they are used to a specific way of being taxed and the informality of not having to keep any records or officially document any of their decisions. Unless they are a full-fledged operation, this is okay. Spending a lot of time and money on this stuff is overkill for the simple, at-home Web page designer, plumber, or dog breeder. I understand.

Professional LLCs protect you from your partner's mistakes

If you are a licensed professional, such as an attorney, accountant, doctor, or engineer, you are probably working with a partner. After all, partnerships can take you much further than you could ever go on your own. Unfortunately, most partnerships are operating with only an agreement and no actual liability protection. If this is the case, you could face some serious trouble.

Partnerships are like chains and are only as strong as their weakest link. An error on your partner's part, whether purposeful or not, could cost you everything. If he does something in the business that causes a lawsuit or results in an

angry creditor, then your personal assets are on the block to settle the lawsuit. Even if you have malpractice insurance, the results can be just as catastrophic.

Most states allow you to form a *professional LLC*. This not only keeps both your and your partner's assets safe from any lawsuits or creditors of the business, but it keeps your malpractice claims separate. For instance, if your partner accidentally slips and cuts someone's ear off during surgery (not too likely if you are a dentist, but you get the picture), then that claim will be isolated to his malpractice insurance, and you won't be liable in any way.

For these people (and maybe you), a corporation probably isn't the best choice. Corporations require a lot of paperwork, and the accounting can be tough to keep up with. However, you have another option. You can form a *single-member LLC* (where there is only one owner — see Chapters 4 and 10), which is very similar to the sole proprietorship you're already running. The IRS even considers single-member LLCs (SLLCs) to be sole proprietorships, so you'll see few differences when filing your taxes. Also, formal record keeping isn't required. It's a good idea for you to have a record of any unorthodox business decisions, but other than that, you can just go about your business as if you weren't organized as an LLC in the first place.

Not to mention, forming an LLC is inexpensive. My company forms LLCs for as little as \$99, and the state fees are generally pretty low. I wouldn't expect to pay more than \$500 total for your single-member LLC, no matter which state you form it in.

Although LLCs and sole proprietorships operate similarly, they have one major difference: asset protection. If you're ever sued by one of your clients or if your business takes on a creditor, you can rest assured that everything you have worked so hard for in life — your house, your car, your bank account, your investments — is safe. In short, for a small-business owner, an LLC is the cheapest, yet most powerful, insurance policy that you can get.



What if you decide that you want to grow by taking on investors? If you're operating as a sole proprietor, what are you going to give the folks in exchange for their investment? Sole proprietorships aren't entities — they have no legal separation from yourself. You can't necessarily distribute pieces of yourself, now, can you? LLCs, on the other hand, have *membership shares* (units of ownership that you give to investors in exchange for the money and other contributions that they give to the business). These ownership units allow them to own a piece of the action — they get rights to vote on important events, receive a percentage of the profits, and even get a chunk of what's left if the business goes under.

Maximizing real estate investments

With all of the characteristics of LLCs, it's almost as if they were made for real estate. Not only does the double layer of limited liability ensure that your assets are protected, but the pass-through taxation that comes with LLCs keeps your tax bill low. You see, if you were to place a piece of rental property into a corporation, you would not only get killed with taxes when you take out the rental income each year, but you would also have some serious tax consequences when you sell the property. Why? Because corporations have what is called *double taxation*. You first pay corporate taxation on the profits, and then the owners are subject to long- or short-term capital gains taxes on those same profits when the money hits their hands. Ouch! It kills me just thinking about it! Even so, I devote a whole chapter (Chapter 15) to the real estate issue.

Real estate investors previously used S corporations (see Chapter 2) to get around the double-taxation issues. S corporations are just like regular corporations but have a pass-through tax status that is similar to the LLC. The problem with S corporations, though, is that the ownership of the entity is severely limited.

LLCs are much more suitable for obtaining your real estate goals. Not only can you transfer the property into the LLC as an initial investment without creating a taxable event, but you can also distribute the profits of the LLC however you want. If you only own 10 percent of the company but want 90 percent of the profits (and the other members are okay with that), then it's doable. This isn't possible for the LLC's corporate brothers. By the way, if you are lucky enough to find partners that are okay with this arrangement, then please send 'em my way!

Not to mention the asset protection. I know, I know, I keep yapping on and on about asset protection, but trust me — it's important. After you realize how much you need to protect your assets, it's already too late. There is something I am going to say that is so important I am going to give it its own line on the page:

There is nothing worse you can do than hold investment property in your own name.

Please read that again and again until it is like a mantra that keeps repeating in your head. Of course, this statement is not 100 percent factual. There are technically *some* worse things you can do, such as: looking down a mortar tube after lighting a firework to see why it didn't go off, professing to the IRS that income taxes are not legal and you don't have to pay them, pointing a gun at the police. . . . Yes, there are a few worse things you can do than hold your property in your own name — but only a few, so please read the above line again. You see, if your tenant slips on the front porch, not only will your property be dust, but also your savings, your other properties, and even your kid's college fund (and possibly even your dog, if he is valuable enough!). If they know you have assets, attorneys and claimants can be vicious beyond belief.

If you are operating as a corporation — regardless of your hideous tax bill — it's a good start, but your protection only goes so far. If you are sued personally, your stock in the corporation is considered a capital asset and can be seized by your personal creditors. So if you run into someone's car while backing out of your driveway, your property can be taken from you. An LLC, on the other hand, has what is called a *charging order protection*. This is a second layer of liability protection that protects your properties from your own personal creditors. Corporations don't have this.



Because the LLC's losses are passed on to the owners, if you own multiple real estate properties, each within its own LLC, and one of the properties encounters a hefty loss, you can deduct that loss at tax time against the income from your other properties. Typically, this sort of loss is only deductible against *passive income*, such as real estate. However, if you work with your accountant or corporate consultant and structure it correctly, you may be able to deduct the loss against *active income* (such as dividends). You can do this by becoming an active real estate investor who spends a certain amount of time each year handling the day-to-day management of the properties.

Planning your estate

Note: If you are immortal, you may skip this section.

LLCs are becoming more and more popular in estate planning (Chapter 16 has the details). Trusts are still king, but now they are generally used in conjunction with LLCs so that your assets are protected while you're still alive. Trusts usually don't provide any asset protection whatsoever, whereas an LLC provides two layers of asset protection (which I discuss at length in Chapter 14).

Within every family looms the perfect LLC

Dan and Denise Sager have two children, Michael, 17, and Mary, 16. One night at the dinner table, Michael has one of his crazy business ideas, but this time it's actually a good one! He suggests they all go into business together with a company that seeks to improve the sales and service of local and national banks. They would sell their program locally and then branch out from there. Their background: Dan is a retired banker with dozens of industry connections; Denise is a retired accountant; Mary could sell ice to Eskimos; and Michael is a jack-of-all-trades with the passion and excitement to keep the project moving.

For this highly motivated, entrepreneurial family, an LLC most certainly works best — but not just any LLC. They know that LLCs are extremely flexible in their organization and operation, so

the Sager family discusses each partner's role to decide how to structure their new entity.

The company will be divided into four equal parts, with each family member owning an equal percentage (they're all members) and also handling different aspects of the business. Dan will design the service/sales curriculum that improves each bank's production, while Denise will take care of the accounting. Mary will be a sales associate, and Michael will design and manage the Web site. Because of their children's age, Denise and Dan don't want to empower their kids with a lot of management decisions until they turn 18. So Ma and Pa create a manager-managed LLC in which they are the sole managers and the kids are hired as employees. This way, the kids still get their profit distributions, but they can still be fired (should their grades drop).

With estate taxes as they are, if you have a large estate — more than \$1 million — you may want to start gifting your assets to your heirs while you are alive. LLCs are especially useful for this because they allow you to gift small portions of large assets (such as real estate) by gifting the membership shares. They also allow you to maintain control of the assets while you are alive, even if your heir is the majority owner of the LLC. You do this by making yourself a manager of the LLC until your death, at which point your heir will take over.

When you actively plan your estate using trusts and LLCs (and a great estate attorney), you have much more control over what happens to your assets after your passing. An LLC keeps your estate out of probate and avoids the accompanying (astronomical) probate fees. (If you aren't sure what probate is, let me just say that if the Spanish Inquisitors had been just a little bit more vicious, they probably would have just subjected their victims to the bureaucratic nightmare that is probate.) In probate, you leave the major decisions up to a judge, and you never know how things could turn out. With an LLC, you can ensure that your assets go to the right people and don't get dwindled away with legal fees until they turn into dust.

Creating Your Own LLC — How Hard Is It, Really?

It baffles me why so many people go about doing business and owning real estate without the protection of a limited liability company or other entity. They are risking everything! I can only guess that they must be intimidated by the entire process of forming an LLC and think that it's much more complicated than it really is.

It's true that LLCs don't just think themselves into existence. Someone has to create them; but LLCs aren't complicated at all. Some professionals use them in complicated situations, but when it comes to normal, everyday business activities or asset protection strategies, you'll be fine. As you flip through this book, the concepts may seem overwhelming at first, but after getting familiar with a little bit of industry terminology, you should have enough of a basic understanding of LLCs to get started on your own. And, worst-case scenario, if you have a question that isn't answered in this book, feel free to call my office and I will make sure that you get the correct answer.

To create an LLC, you have to draft a short document and file it with your state. This is pretty simple to do and, for the most part, won't require an attorney's help. First, though, you need to do some research so you understand some other elements of LLCs, and then make some decisions on how you want to structure your company.

Educating yourself

First things first, you'll want to gain a little bit of an education about LLCs. I know you're busy, so this doesn't have to be too extensive. You just need to know the basics, and the best way to start is by reading this book. Needless to say, you're on the right track!

You can always use professionals to do the work for you. And that's okay. Hey, I'm all for delegation! Just make sure that you have a good basic knowledge so you can have productive and educated conversations with the people whom you hire. Not to mention, you'll want to have an idea of whether they really know their stuff.

After you understand the basics, call your attorney or accountant and ask about things that pertain to your situation. You may also want to do some research online and set up some free consultations with corporate consulting companies. Also, I have put a lot of in-depth information online at www.myllc.com, where you can read my syndicated articles.

I didn't go in-depth on some advanced topics, like taxes, in this book. For business contracts, I highly recommend *Business Contracts Kit For Dummies* by Richard D. Harroch (Wiley). Also, *Estate Planning For Dummies* (Wiley) by N. Brian Caverly and Jordan S. Simon is really good if you are interested in finding out more about estate planning.

Surveying your assets and making a plan

If you have been working hard all your life, you've probably accumulated some valuable assets. Even if you aren't operating a business, creating an estate plan, or investing in real estate, you likely have some things you want to protect from creditors and lawsuits. Some of these things may include

- ✓ Rental real estate
- ✓ Vacant land
- ✓ Businesses
- ✓ Intellectual property
- ✓ Expensive equipment (business or personal)
- ✓ Vehicles
- ✓ Savings accounts, money market funds, and CDs
- ✓ Stocks and bonds
- ✓ Any appreciating assets

Anything that is of value to you, you should consider protecting in an LLC. Lawsuits and personal creditors abound in today's society, and by leaving anything in your name, you are virtually handing it over to any attorney who wants it.



TIP

When using LLCs, consider forming more than one. After all, you never want to put all your eggs in one basket. A good example of this is that if you have multiple rental properties in one LLC and a tenant has an accident on one of your properties, then all the properties will be up for grabs because they are in the same LLC. However, if you were to separate those properties into multiple LLCs (or a series LLC, which I discuss in Chapter 15), then only that one property that was sued can be taken.



WARNING!

If you are a procrastinator, watch out. Wasting too much time to put together your plan and act on it could cost you. Lawsuits come out of nowhere, and Murphy's Law states that you will get sued at the worst possible time. After you are faced with a lawsuit or have a creditor after you, your hands are tied. Any attempt to protect your assets at that point is illegal. Not only will you still lose your assets, but you could also end up with some hefty fines or, even worse, jail time.

Deciding who manages

There are two types of LLCs:

- ✓ Member-managed, where the LLC is managed jointly by all of its members
- ✓ Manager-managed, where the LLC is managed by a separate manager (who can also be a member)

If you are forming a smaller LLC with only a few partners, and each partner will have a say in managing the company, then you may want to choose member-managed. However, if you decide to take on a silent partner and that person will *not* be managing the business, then your LLC will have to be *manager*-managed. The original partners will still be listed as members; however, because not *all* members will be managing, you have to be manager-managed.



In most states, you have to list how the LLC is managed in the organizing document that is filed with the state (called the *articles of organization* — see Chapter 6). If your management structure changes, the organizing document may have to be amended. This will involve fees, so you may want to be as forward-thinking as possible before you do your initial filings and begin operations.

Choosing your registered agent

Before you can file your articles of organization, you need to choose a *registered agent* (sometimes called a “resident agent,” “statutory agent,” or “RA”). A registered agent is a person or company that is *always* available during business hours, every single day, to accept any formal legal documents for your company in the unfortunate instance that you are sued.

Most registered agents allow you to use their office address for all of your mail and other correspondence. A good registered agent should also stay on top of your state filings for you and make sure that you remain in good standing in the state (or states) that you are registered to transact business in. If you are registered in many states, this can be an onerous task and one that is better left to the professional service companies, or a more expensive option is to use an attorney. See Chapter 5 for more on this.



If your state *does* allow you to serve as your own registered agent, I don't recommend it. Unless you plan on being at your office during business hours every single day, with no exceptions, and you also have a good grasp of all of the state filings that need to be done, I would leave it to the pros. Another consideration is that in the event that you are sued, would you really want a sheriff or process server serving you a lawsuit in front of your customers? Eek! Not me!

Bringing your LLC into existence

Your LLC needs to be registered and receive approval from the state that it is to live in (see Chapter 8). LLCs don't need to reside in the same state as you — they should reside wherever their headquarters is going to be. In the case of companies that don't have headquarters (like Internet-based companies), they should reside wherever the tax laws are most favorable.

Because LLCs are not necessarily perpetual entities (they don't live forever), when creating your LLC, you may have to specify what the dissolution date is to be. Don't worry! You don't actually have to dissolve on this date (as I explain in Chapter 12) — it is mainly just one of those many erroneous procedural things that the state makes you do.

You create your LLC by drawing up a short document called the articles of organization. Your articles contain such basic information as the name of the company, how long the company will exist, the initial members or managers, and the name and address of the company's registered agent. In Chapter 6, I show you how to put together your articles of organization. After you are satisfied with your articles, you file them with your local Secretary of State's office (or comparable state agency).

Operating Your LLC

Now that you've formed your LLC, you're ready to start business operations, right? Well, not exactly. You still have to create your operating agreement and make some very important decisions.

Operating your LLC is meant to be easy. For the most part, if you forget something or fail to document something in writing, the courts will be easy on you. LLCs aren't like corporations where a single misstep can cost you your limited-liability protection. Although this paperwork isn't required, you can save yourself a lot of time, hassle, and potential legal battles by getting it out of the way and making your agreements as tight as a drum.

Creating your operating agreement

Think of your *operating agreement* as a sort of partnership agreement, except with much more power. Your operating agreement is the blueprint for your company. In it, you state your company's policies on important matters including

- ✓ How the company will be managed and by whom
- ✓ How important decisions are to be made
- ✓ How profits are to be distributed among the owners
- ✓ The titles and positions of managers and officers of the company
- ✓ The membership information including who is a member, what that person contributed, and what membership interest they have been assigned

Creating an operating agreement is not easy by any means, but it's vital. With the wealth of information and provisions that I provide you in Chapter 9, it shouldn't take you too long to draft the thing. However, it may take you a while to decide what you and your partners want to put in it. After all, you are creating an infrastructure that needs to serve you for many, many years to come.

After you create your operating agreement, make sure that all of the members and managers of the LLC sign it. Distribute a copy to everyone for their records, and put the original in your company records kit (which brings me to the next point).

Keeping books and records

All companies need to have a records kit. A *company records kit* normally looks like a big, leather binder with the company name emblazoned on the side. The kit can be cheap and low quality — looking like it came from the office supply isle of your local supermarket — or it can be made from the finest leather with real gold plating. No matter how simple or extravagant, every kit serves the same purpose: to house your important company records, such as your filed articles of organization and company charter, your operating agreement, resolutions and minutes from any meetings or voting that took place, your membership roll, and your unissued membership certificates. Of course, if you plan on raising financing or selling your company one day, it may be more impressive to turn over a nice, leather binder! Chapter 11 has more details on records kits.

When you order your records kit, make sure it comes with a company seal. Think of the company seal as your LLC's signature. You will use this to make your company documents and share certificates official.

Paying taxes

The IRS doesn't consider LLCs to be separate from their owners like corporations are. Because of this, LLCs are normally subject to partnership taxation (unless they elect another type of taxation), where the business's profits and losses get passed on to the owners who report their share on their personal tax returns. These portions of profits and losses that get passed on to the members are called *allocations*. This type of taxation is commonly referred to as *pass-through taxation*, which I go over in great detail in Chapter 13.

Because the LLC doesn't actually have to pay taxes itself, the IRS only requires you to file an information statement (IRS Form 1065) that states how the company's profits and losses are allocated among the members. Additionally, the company issues each member an IRS form called a Schedule K-1 that shows the information they need to determine how much tax they must pay on the company's profits.



LLCs aren't required to distribute any cash to the members. However, the members *are* required to pay taxes on these profits. When the company doesn't distribute the profits to the members, but the members still have to pay taxes on the profit out of their own pockets, this is called *phantom income*.