



# Newsletter

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Our office will be closed for the following holidays:

January 19<sup>th</sup> – Martin Luther King Day

February 16<sup>th</sup> – President's Day

Our next newsletter will be mailed out the beginning of April 2004. Remember if you have an article that you would like to contribute to our newsletter just fax it to us for our review. We must receive the article no later than March 15<sup>th</sup> for our April newsletter.?

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## FORMS OF DOING BUSINESS

### PROPRIETORSHIP

The advantage of being a sole proprietor is that it is simply the easiest and simplest form of doing business. You, as an individual, simply start a business. You are then a proprietor.

The main disadvantage is that the individual proprietor is subject to full liability from business activity. If the proprietor gets sued because of a related activity, all of his or her personal, as well as business assets, are on the line. He or she could lose everything in a lawsuit.

As with a partnership, a proprietor is subject to a 15.3% self-employment tax on all income earned from the business. Further, proprietors do not have available to them benefits such as Medical Reimbursement Plans, certain pension plans and full deductibility of certain business related expenses.



### PARTNERSHIPS

A partnership is a relatively simple form of doing business used when two or more people get together to conduct a business enterprise. Partnerships are simple to form. The partners simply get together and enter into a partnership agreement. From that point, the income or loss of the partnership is passed through to the individual partners and is included on their individual tax return. This creates an

ease of doing business and simplicity in figuring taxes.

The main disadvantage of a partnership is that it provides no liability protection to the partners. If, for example, Joe and Don get together and form a business partnership, and the partnership gets sued and loses, then both Joe and Don's assets are on the line. Each of them could lose everything. Usually this disadvantage alone is enough to compel those considering a partnership to consider another form of doing business.

An added disadvantage, is that the partnership doesn't have many of the tax benefits that a corporation does, such as Medical Reimbursement Plans, certain pension plans and full deductibility of certain business-related expenses. Further, in a partnership the active partners are subject to a 15.3% self-employment tax on the income they receive from the partnership. This self-employment tax is not income tax; it is a separate tax that must be paid by certain taxpayers. A corporation is not subject to self-employment tax on its income.

### LIMITED PARTNERSHIPS

A limited partnership is taxed like a partnership and it has many of the liability protection aspects of a corporation.

There are two types of partners in a limited partnership. There are the limited partners who invest in the partnership but have no control. Then there is a general partner or partners who have control. The problem with a limited partnership is that the general partner has personal liability in certain lawsuits by the limited partners against him or against the partnership itself. The liability protection that a limited partnership provides is by no means absolute. The general partner is at risk. His personal assets are on the line.

Another drawback to the limited partnership is that they are quite complex and often expensive to form. As with the general partnerships and proprietorships, the general partner(s) in a limited partnership is subject to the 15.3% self-employment tax on income. Limited partnerships do not allow for Medical Reimbursement Plans, certain pension plans and other benefits a corporation offers.

The primary advantage of a limited partnership is that it affords the limited partners limited liability and a single tax level. The income that comes into a limited partnership flows through to the partners for tax purposes and is included on their personal tax returns. (Limited partnerships used to be useful – from an asset protection standpoint- but that's not necessarily true.

### LIMITED LIABILITY COMPANIES

Until recently, the choices of methods of conducting business were the sole proprietorship, the partnership, the limited partnership and the corporation. Naturally, each of these has its own advocates, depending on the nature of the business to be conducted, the risks and the need to raise additional capital.

The limited liability company provides added flexibility for business and tax planning. A limited liability company is taxed as a partnership under the Internal Revenue Code but provides limited liability to its owners and Manager (owners are referred to as "Members".) Both the revenue and expense of the limited liability company (LLC) flow through to the Members for tax purposes in the same fashion as revenue and expense of a Partnership flow through to partners. Given its true pass-through characteristics and limited liability for all involved, many consider an LLC as a good alternative to either the S corporation or a limited partnership.

The Internal Revenue Service classifies an LLC as a partnership for tax purposes using a "2-out-of-4" test set forth in case called Larson vs. Commissioner. When deciding whether an LLC or other entity can be taxed as a partnership, the IRS weighs four corporate characteristics:

1. Continuity of life;
2. Centralization of Management;
3. Limited Liability; and
4. Free Transfer of Interests.

If the entity meets two or less of these, it is not treated as a corporation but as a partnership for tax purposes. The IRS ruled that an LLC lacked the corporate characteristics of continuity of life and free transferability of interests and would be taxed as a partnership.

1. **CONTINUITY OF LIFE:** A LLC lacks continuity of life. Statutorily, the LLC can exist for no more than 30 years. In addition, an LLC dissolves on the agreement of all the Members or on the death, retirement, resignation, expulsion, bankruptcy or dissolution of a member.
2. **CENTRALIZATION OF MANAGEMENT:** If the articles of organization so provide, have the corporate characteristic of centralized management. The articles may appoint a manager or managers who are elected annually, much like the officers of a corporation. But if management

mentioned in the articles, management is vested in the members in proportion to their capital contributions and the LLC may lack the corporate characteristic of centralized management.

3. **LIMITED LIABILITY:** Members and Managers of the LLC are not liable for debts of the company. This is the most important attribute that sets the LLC apart from a partnership. Limited partnerships give liability protection only to limited partners, and partners in a general partnership are liable jointly and severally for partnership debts.
4. **FREE TRANSFERABILITY OF INTEREST:** An LLC lacks free transferability of ownership interest, the final corporate characteristic under the Larson vs. Commissioner test. The transfer of a member's interest conveys only that member's right to participate in management of the business – nothing more.

**TAX TREATMENT OF LLCs:** Since the Internal Revenue Service classifies properly-form LLCs as a partnership for tax purposes, all provisions of the Internal Revenue Code and related regulation that apply to partnerships should apply to LLCs in the same manner. However, several areas of uncertainty have been identified, and questions regarding these uncertainties should be directed to tax professionals with experience in this developing area of the law.

The IRS has not yet issued a revenue procedure clearly establishing Private Letter Ruling guidelines for LLCs. For the present, Revenue Procedure 89-12, which applies to limited partnerships, provides the general requirements for obtaining a ruling as to the tax treatment that will be applicable to the LLC. And the IRS has issued numerous private letter rulings concerning LLCs following that Revenue Procedure.

**MANAGEMENT BY MANAGERS OR MEMBERS:** The management of the company may be conducted by managers whose names and addresses must be stated in the articles. The managers are elected annually by the members. If the LLC is managed by managers and not members, the managers can contractually bind the company. For instance, if members manage the company, specific provisions must be provided allowing members to execute documents to acquire, mortgage or dispose of property.

**OPERATING AGREEMENT:** An LLC will operate under a written operating agreement. The operating agreement should provide the details of operating the LLC and provisions for the distribution of income, gains, losses and capital during the life of the LLC and upon dissolution. And operating agreement contains many of the provisions

present in a good partnership agreement.

**A MEMBER'S OWNERSHIP INTEREST:** The contributions to capital of an LLC can be in the form of cash, property, services, a promissory note or some "other obligation to contribute cash or property or to perform services." In order to insure the limited transferability of interests required by the IRC for partnership tax treatment, all members must approve any subsequent transfer of a member's interest. If such approval is not obtained, the transferee obtains only the transferring member's share of profits and return of capital contributions but not the transferee's right to participate in the management of the business. This is similar to provisions contained in the Uniform Limited Partnership Act.

**WITHDRAWAL OF CAPITAL CONTRIBUTIONS:** Once a member has made a contribution to capital, the members cannot withdraw the capital from the LLC until: 1) all liabilities of the company (except the liability for the member's withdrawal of capital) have been paid; 2) the members consent to such capital withdrawal; or 3) the articles are cancelled or amended to allow the withdrawal. A member can demand the return of his or her capital contribution or dissolution of the LLC after six months prior notice to the other members. A member can petition the district court to order the LLC dissolved when: 1) the member has rightfully but unsuccessfully demanded the return of the capital contribution; 2) the other liabilities of the LLC have not been paid; or 3) the company's property is insufficient for their payment and the member is entitled to the return of the capital contribution.

**INDEMNITY:** A LLC can indemnify its members and manages in statutory language that is quite close to that contained in corporation statutes.

**CAUTION:** A potential problem with LLC's is that they are still not recognized in all states. This situation is changing rapidly and this may not be a problem soon. However, if you intend to do business through the LLC, check to be sure the state recognizes them. Then you can be sure your limited liability company will hold up in court. If the state doesn't recognize LLC's, your status there could be up on the air. Some states might treat an LLC as a corporation and impose a tax on the entity. Others may treat it as a partnership for tax purposes, but may also not recognize the liability protection you seek.

The prudent entrepreneur should investigate the laws of the state where his LLC will operate to determine how the company may be taxed and treated in non-tax matters. The future of LLC's is bright, and it may be helped by the spreading desire in many states to enact a uniform law regulating them.

Absolutely uniformity will likely never be achieved, but the growing acceptance and use of LLC's promise that states will pay more attention to them,

hopefully moving toward similar treatment.

**SUMMARY:** The LLC allows its members, who are owners of the company, to receive the benefits of partnership tax treatment while limited liability to themselves, similar to shareholders of a corporation. The LLC avoids the limiting restrictions of an S corporation and protects its members from debts of the company better than the limited partnership protects its limited partners. The LLC allows its members to participate actively in management without losing their limited liability. It is untested in most courts because of the fact that as an entity it is a newcomer and therefore should be used very carefully.

**SOME POSSIBLE ADVANTAGES OF AN LLC OVER A S-CORPORATION**

With an S-corporation, revenue and expenses flow through to the shareholders in nearly the same fashion as revenue and expense of a partnership flow through to partners. However, LLC's, although taxed similarly have several important advantages over S-corporations:

- ?? S-corporations are limited to no more than 35 shareholders. There is no limit on the number of members in LLCs.
- ?? Shareholders of S-corporations can only be U.S. citizens, resident aliens, estates or certain trusts. There is no such limitation with LLCs.
- ?? S-corporations can have only one class of stock. LLCs may not be so limited. (Note: Warrants, options or certain debt instruments might be deemed a class of stock and cause loss of S treatment.)
- ?? Members of an affiliated group are ineligible to become S-corporations. There is no such restriction for LLCs. (LLCs can

Control corporations and have corporations as members – S-corporations can do neither.

- ? S-corporations must make and file an election with the IRS to be an S-corporation. There is no such requirement for LLCs.
- ? An S-corporation's election is terminated whenever the corporation has excessive passive income from prior C-corporation status or earnings for three consecutive years. There is no such restriction for LLCs.
- ? Shareholders of S-corporations cannot contribute stock for services without recognizing immediate gain. Only certain restrictions apply to LLC's.

**POSSIBLE ADVANTAGES OF THE LLC OVER THE LIMITED PARTNERSHIP**

A LLC has a couple of advantages over a limited partnership: 1) none of the members need be exposed to liability; and 2) all members may participate in management of the company and still retain limited liability.

Many with limited partnerships often try to secure limited liability through a corporate general partner. However, to receive partnership tax treatment, the corporate general partner must receive at least 1% of every partnership item and must contribute certain amounts of cash, property or substantial services to the partnership. If the corporate general partner fails to satisfy certain parts of the Revenue Procedure 89-12, then the limited partnership tax status can be lost. In contrast to limited partnerships which must meet stringent standards to obtain and retain limited liability for the limited partners, all members of an LLC receive limited liability by statute.

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ADDRESS CORRECTION REQUESTED

