The National Agricultural Law Center

Business Organizations Reading Room

Limited Liability Company

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Introduction

One of the more recent business structures to emerge, the limited liability company ("LLC") has now become one of the most popular business structures for farms and other businesses. An LLC is a hybrid structure that offers the limited liability of a corporate business structure but with the flow-through taxation of the partnership structure. It closely resembles the S Corporation; however it lacks many of the corporate formalities that must be followed to maintain status within that business plan.

In an LLC, the owners are referred to as "members," and LLCs can be either member-managed or manager-managed. A member-managed LLC may be governed by a single class of members (similar to a partnership) or multiple classes of members (similar to a LP). The manager-managed version hires or selects one individual to make most of the executive decisions concerning the business. Either management style for the LLC is created by the operating agreement which sets out the management structure to be used in the business as well as other options for running the business.

The operating agreement, whether written or oral (depending on the state statute), is also an important part of the creation and operation of the LLC. The LLC structure is purposefully designed to be flexible and the operating agreement is the means by which important decisions may be made.

One of the primary advantages that the LLC possesses is the flexibility that most LLC statutes provide; which coupled with the favorable tax status, makes the LLC one of the most popular business structures.

Formation

To form an LLC, members must choose a business name that conforms to their state's LLC rules, file formal paperwork (usually called articles of organization) with the state, and pay a filing fee. All states require that the name must end with an LLC designator of some form, such as "Limited Liability Company" or "Limited Company," or an abbreviation of one of these phrases (such as "LLC," "L.L.C.," or "Ltd. Liability Co."). Because the name of the business does not need to include an individual member's name every state requires that the articles of incorporation include the name and contact information of one individual to serve as the agent of the LLC

Just as there are differences between the naming requirements within a state there also are many differences in the agencies in charge of registering and creating new businesses. A list of these agencies and their contact information may be found at the National Agricultural Law Center under Forms and Filing Information: Business Organizations.

There are many differences between states concerning the formation requirements of LLCs. A very close reading of the statutes and regulations of the state where the LLC is being created is necessary. Most states provide the information needed to create the LLC online and offer free access to state statutes and regulations that govern the creation and operation of LLCs.

Liability

The protection from personal liability differs significantly between the various business structures. Limited liability companies provide some of the strongest protection currently available. Unlike the other "limited" entities such as limited partnerships and limited liability partnerships, the liability protection provided by the LLC encompasses all members completely. Limited partnerships require at least one partner to be a "general" partner that is subject to personal liability and limited liability partners are still personally liable for their actions or for the actions of employees that are under their control. Every state recognizes that all members of an LLC are exempt from personal liability unless there is another situation where a member has waived the protection or lost the protection because of fraud or some other form of misconduct.

In many ways the liability protection provided by a LLC is similar to that of the corporation. Because of the similar protections between the two entities there is a possibility that a court could, for reasons such as fraudulent behavior, undercapitalizing the business, or failing to treat the LLC as a separate entity from its members, "pierce the veil" of the LLC so that the plaintiff could reach the members individually.

Example: A farmer wishes to protect himself from personal liability of running an agritourism operation on a portion of his property. He sets aside 10 acres of corn for a maze during the late summer and fall months and worries that if someone is injured on the property than he could lose all of his property. To remedy this problem, the farmer creates an LLC to run the corn maze and rents the 10 acres from himself to the LLC for an extremely small amount of money. All of the proceeds earned by the LLC are funneled directly to the farmer and the only equipment owned by the LLC is some hand tools needed to maintain the maze. In this scenario it is likely that a court would disregard the LLC and hold the farmer personally responsible for any incidents that occurred with the running of the corn maze. The facts indicate that there are virtually no assets in the LLC and that the farmer is just passing the proceeds directly through it to himself. The farmer is likely using his own equipment, seed, and labor to create the maze all of which are factors that could influence a court to “pierce the veil” of protection surrounding the farmer.

The liability protection provided by the LLC is one extremely attractive feature for entrepreneurs who wish to create a new business. It provides all of the protections of a corporate business structure, however there is a limited amount of case law available to help avoid all of the potential issues that may arise, for the simple reason that the LLC structure is relatively new when compared to corporations.

Tax Structure

The tax structure of early LLCs was vastly different from today’s more flexible model. Originally they were taxed as a separate entity by the Internal Revenue Service. In the late 1980s, however, the IRS reversed its position on the issue and recognized that a business may be eligible for pass through status even though it is organized as an LLC. Currently the tax status of most LLCs depends on whether there is one member or more. If there is only one member (some states will not recognize a one member LLC) that owns the LLC, than the LLC is disregarded for tax purposes and the member is responsible for all profits and losses associated with the operation of the business in the same way as if they were operating a sole proprietorship. If there are more than one member, however, than the LLC is taxed like a partnership with profits and losses allocated to the members.

The LLC structure is designed to be flexible. While most states provide default rules for the allocation of profits and losses, the members can arrange the situation differently in the operating agreement as long as they have reason to do so. The IRS is likely to closely scrutinize arrangements that significantly change the allocation of profits and losses so members may need to consult a tax professional before modifying the default tax provisions of their state law.

While the federal tax structure is difficult to understand when the LLC modifies the allocation of profits and losses, the state income tax structure (where it exists) can be even more so. There is a wide variation in the tax treatment of LLCs throughout the various states. Limited liability companies that operate solely within one state can adapt to their state’s particular law. LLCs that operate in numerous states may have an extremely difficult time in working under different tax structures. For this reason, individuals wishing to create a national or international business should examine the potential tax implications before selecting the LLC business structure.

Termination

Termination of an LLC can be difficult. The typical LLC has the liability protection of a corporation and the tax structure of the partnership. Therefore, it may have termination rules and acts that come from either or both structures, as well as having separate termination events and contingencies spelled out in the operating agreement. Most states have default rules that will terminate a LLC (such as the withdrawal, death, or incapacitation of a member, financial insolubility, or an unanimous vote by the members to terminate, among others). Like many other default rules for LLCs, the members of the business may modify or completely do away with many of those provisions by adopting other rules to supersede them. This additional flexibility can make a LLC either very difficult or very easy to terminate depending upon the language of the operating agreement. One similarity that the LLC has with the corporate business structure is that in the event that the LLC is unwilling or unable to dissolve by normal means than a court can order a judicial dissolution in certain, limited circumstances.

Conclusion

While the benefits- including flow-through taxation, flexibility, limited liability and relaxed corporate formalities- that come with forming an LLC are significant, there are also some drawbacks to organizing in this way. One problem with the LLC is caused by its relative newness. As a result, the law in this area is not fully developed and can cause some uncertainty if litigation ensues. Another problem that may arise occurs because of flexibility surrounding the creation and operation of LLCs. The statutes and regulations governing LLCs vary throughout the country. This variance coupled with the ability to revise the default rules through the operating agreement leads to the opportunity to create an LLC structure that is unlike any other in existence. This flexibility may give rise to operating agreements that have incomplete, confusing, or contradictory directions on assigning responsibilities and liabilities to the members. This can further lead to confusion and potential problems in determining the individuals with authority to write checks, request credit, or bind the LLC to contracts. Taxation has the potential to be a problem depending on the individual circumstances. Domestic LLCs that operate in a single state are relatively simple to handle, however LLCs that do not fit this classification risk facing many different taxation issues.

Regardless of the potential problems, the LLC is one of the most popular options for organizing an agricultural business. Most farms and agribusinesses will not be in a position requiring close scrutiny of the tax situation because they are domestically owned and are often owned and operated solely within one state. The limited liability is extremely attractive and, unlike the corporate business structures, it does not come with the responsibility to exercise the wide array of corporate formalities. Finally the flexibility allows the owner(s) to create a business that is tailored to fit their needs and has the ability to be adapted in the future when circumstances change.

One of the problems that owners face when using the LLC structure is the lack of case law. The first LLC statute was passed in Wyoming in 1977 with the rest of the states following suit during the 1980s and 1990s. Because the structure is new there is very little case law in existence to interpret the LLC statutes when disputes arise.