

LIMITED LIABILITY COMPANY (LLC)

(COLORADO)

A LLC is normally utilized by investors and businesses to obtain the tax advantages of a partnership, limited partnership, or sole proprietorship, but enjoy more limited liability. An LLC can elect to be taxed as a Sub-S Corporation, a C-Corporation, a partnership if there are two or more members, or as an individual if there is only one member.

This Monograph describes some of the most prominent advantages and disadvantages of operating a business/investment under an LLC. A specific business or investment may create additional arguments for or against use of the LLC. Each situation will require a separate determination of which business entity is the best. Your attorney and tax advisor should both be consulted before deciding which business entity is best for you.

ADVANTAGES:

1. Limited liability:

- Similar to corporate shareholder liability protection but better than being a limited partner in a limited partnership;
- ALL members of the LLC have limited liability (as contrasted to limited partnerships where the general partner must have unlimited liability). Note: In Colorado a limited partnership can be set up, or converted to, a limited liability limited partnership so that even the general partner has limited liability;
- CAVEAT: For a SINGLE-MEMBER LLC see “Disadvantages” described below with respect to single-member’s individual liability;
- ALL members of the LLC can be much more active than limited partners of a limited partnership (who will lose limited liability if they become active in the business decisions of the limited partnership – unless registered as a limited liability limited partnership);
- An LLC may hold a single asset (such as condominium or second home) to protect the owner(s) from liabilities arising from rentals/guests/etc. If more than one investment real estate is owned, normally separate LLCs are set up to separate the liabilities of each property from the other LLCs holding the other properties;
- Limited Liability is not available if that member is personally negligent in causing the damages or an injury, or has guaranteed an obligation of the LLC.

2. Creditors of a Member:

- If a Member's creditor has obtained a judgment against the Member, that creditor can collect whatever interests are payable to the Member – not just any creditor, but only one who has sued the Member and obtained a judgment. This means that if income of the LLC is to be paid to the Members, then payment would have to be made to the judgment creditor.
- The ADVANTAGE of the LLC is that the Operating Agreement can limit the ability of the creditor to force sale of assets, or to have any control over the LLC. These arrangements must be included in the initial documents setting up the LLC.

3. Profit and Loss distributions and allocation:

- An LLC has much more flexibility in planning distributions and allocation of profits and losses, than in a Sub-S Corporation which is restricted to allocating profits and losses on the same percentages as share ownership. Thus, even if two members each own 50%, they can agree to have income or losses split, for example, 75/25.

4. Management:

- An LLC can have either designated managers (members or non-members), OR the members themselves can manage without having any managers. Normally, one of the members is designated a Manager, similar to a President of a corporation. Successor Managers can be designated;
- Members cannot transfer their ownership interests without approval of members having a majority interest. These transferability restrictions are more similar to partnerships than to corporations. These restrictions are tied to restrictions against control by judgment creditors mentioned above.

5. Membership Classifications:

- An LLC can have different classes of members (unlike Sub-S corporations which can have only one class of stock). Thus, an LLC could have preferred and subordinated members (limiting voting privileges for the subordinated members).

6. Taxation of Single Member LLC:

- To be taxed as a partnership, there needs to be at least 2 members. However, with new IRS Regulations, it is safe to have just one member in an LLC. In this situation, the single member is taxed as a sole proprietorship
- The single-member LLC is “disregarded” for income tax purposes – all income and expenses are reported on the person's 1040 income tax return. A Sub-S corporation can also be formed by as few as one person, but a separate

corporate tax return must be filed for the Sub-S corporation. However, see below “Disadvantages” for a single-member LLC.

- If husband and wife are the only members, and if they file a joint tax return, all income of the LLC can be reported on the joint return, without filing a separate tax return for the LLC. On the other hand, if the CPA advises that is better to file the LLC as a partnership for the husband and wife, this can also be done.

7. Federal Estate Tax Benefits:

- For an LLC with more than one member, if the LLC is structured properly, the value of a member's interest in the LLC can be worth less, discounted, for federal estate tax valuation purposes, than if the person owned the interest through a corporation or individually. For example, owning 49% of an LLC can be worth less than 49% of the assets owned by the LLC. This advantage is similar to use of the Family Limited Partnership to save on estate taxes.

8. Unlimited Duration:

- Can be perpetual duration like a corporation;

9. Conversion from a Partnership:

- If you have a business that is operating as a partnership or sole proprietorship, converting into an LLC will not cause a "sale" on which tax must be paid. A partnership or sole proprietorship may change to an LLC without recognition of any gain or loss on the conversion.

10. Probate Avoidance:

- Out-of-state residents who own Colorado real estate can avoid Colorado probate if the real estate is in an LLC. The deceased member's interests can be transferred as an “in-house” transaction;
- Or, a Colorado resident can own property outside of Colorado using the LLC, assuming that the state where the property is located allows LLC ownership (which virtually all states allow);
- An LLC should NOT be used for a primary residence, just for business property, second homes or other types of investment property. The income tax residential exemption (\$250,000 per person, \$500,000 for husband/wife owners) upon sale of a primary residence, will not be available if the LLC owns and sells the property.

DISADVANTAGES:

1. State set up process

- Because state law controls the "incorporation" process, we must still comply

with state law in setting up, and maintaining on an annual basis, the LLC to be sure that it complies with the state's laws;

- Must file annual reports with Secretary of State to keep entity in good standing. E-filing is permitted;
- Must have a Registered Agent who is located in Colorado.

2. Automatic Dissolution:

- Unlike other types of corporations, the LLC automatically dissolves upon the death, retirement, resignation, expulsion, bankruptcy or dissolution of any member (however, the remaining members can and do elect to continue the LLC, thus not causing any legal complications);
- A single member LLC would also be technically dissolved on death of the one member. However, the estate of the deceased member can continue the business for the purpose of winding it up, transferring, or selling the assets.

3. Limited Recognition:

- Virtually all states allow corporations to operate. However, an LLC formed in Colorado may not be legally recognized in a state that does not have similar laws on its books recognizing LLCs. Laws of states where the LLC may do business must be checked to be sure the LLC can operate there - for example many states require a limited (not perpetual) duration for the LLC. If not authorized by local state law, all members may be personally liable for business debts as in a general partnership.

4. Conversion from Existing Corporation:

- If your business is already operating as a corporation, even a Sub-S Corporation, to convert your business into an LLC will cause the transfer to be reported as a "sale". This is true whether the conversion is through merger of the two businesses, exchange assets for membership interests, or liquidation of the Corporation and transfer of the assets into a new LLC. Thus, it is not usually wise to change an existing business from a Corporation to an LLC.

5. Single-member LLC:

- The limited liability of members of an LLC may not be available for a single-member LLC. Some states and courts (particularly bankruptcy courts) may allow creditors to "look through" the LLC structure in order to impose personal liability on the single-member just as though the LLC did not exist. This will be true particularly if the "personal" activities of the single-member are comingled with the business of the LLC. Thus, if a single-member LLC is chosen, it is extremely important to keep personal expenses separate from the business, and that the LLC is truly a separate business or investment activity. Further, if a member files personal bankruptcy, the bankruptcy court may allow the member's personal creditors to get the assets in the single-member LLC

even if personal matters are not commingled.

MESSAGE: This Information Sheet is intended to provide general information only. It is not intended to cover all of the legal issues that arise in each situation. It is suggested that none of the documents described above should be signed without first talking to an attorney who is knowledgeable about such matters. This material is dated and the enclosed information may change because of new laws, regulations, or other impacts. Dated December 29, 2011.

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