

Unedited transcript of

## **Taxation, Fee Considerations and Ownership Behind LLCs**

from **Organizing an LLC**

Recorded 06/02/2021

### **Speaker(s)**

Kelly L. Dutremble, Esq.

Joshua E. French, Esq., Nutter McClennen & Fish LLP, Boston

>>: So starting with sort of an overview of the taxation of LLCs, as I mentioned, in most cases, LLCs are taxed either as sole proprietorships or as partnerships, and that depends on whether they are single-member LLCs or multiple-member LLCs. Single-owner LLCs are generally taxed as sole proprietorships, and multimember LLCs are generally taxed as partnerships. In either case, the gains and losses of the LLC are not reported at the company level and paid at the company level. They are reported and paid at the owner - the equity holder level. So each equity holder reports on their own income taxes their allocated portion of the company's gains and losses. The benefit of that is that as opposed to a corporation where you've got the corporate-level tax - so the gains and losses of the corporation are reported at the corporate level and paid at the corporate level, and then when there's either a distribution or a dividend, or if the stock is sold, the equity holders also then have to pay their own taxes on any gains that they've acquired as a result of their ownership of that stock. Here in an LLC, since there's no entity-level taxation, the only level of tax that's paid is at the owner level. The other benefit to it is the equity holders of an LLC can use the losses that the LLC experiences to offset their own, you know, taxable income from other areas. So if you have a early-stage company who is not yet - the company's not yet profitable, and it experiences - experiencing losses because, you know, they're hiring people, and they're, you know, spending money on marketing or whatever they're doing, the owner of that company can use the losses of the LLC to offset income that they've got, you know, from another job or whatever other income they've got. So that's sort of the benefit from a taxation

standpoint. The gains and losses are generally allocated according to ownership percentage. So if you've got a 50-50 owner - ownership structure, then one of the partners, you know, is allocated 50% of the gains and losses of the LLC, and 50% goes to the other partner. The actual provisions of this and how this works are very technical, so Josh and I always advise our clients to work with one of our tax attorneys, and we would advise you as well to always make sure that you're consulting a - you know, a tax specialist when you're drafting the LLC agreements to make sure that all of the provisions, you know, are - accurately reflect what is - what should be happening and what the IRS requires.

>>: Yeah, so - and I agree with everything Kelly just said, especially the tax aspect of it, in particular for LLCs which are multimember. So, you know, as Kelly noted, single-member LLCs are a lot simpler, right? Anything that happens in the LLC from a tax perspective, the IRS pretends that that entity doesn't exist. It just goes right on to your personal tax filing on a Schedule C. That's what gets filed on your own tax report if you have income from an LLC, whereas with multiple members, you have to do this allocation of profits and losses, and those get delivered to the various members of the LLC annually on what's called a Form K-1. Basically, if you've got an LLC with multiple members, you really ought to have a tax accountant assisting you with your filing obligations. As Kelly noted, there's not an entity-level tax, so the LLC doesn't pay tax. But the LLC has to deliver these notifications to their members, and then the members need to report appropriately. So we often see with early-stage companies, especially companies that might be doing a lot of research and development and are going to be operating at a loss for a while, they may choose to start their life as an LLC because they have other income they can offset. And that's fine, and then there may be reasons - especially if they're getting venture funding - to convert to a corporation later. We'll talk about that, but I'll bring this up only because I see the question in the chat box. And by the way, feel free to submit your questions as we go along, and either we'll try to answer them as part of the, you know, general presentation, or we'll catch up at the end based on how appropriate it is. But we have a question from Daniel - we've got two questions. First question - we'll go with actually the second question because it's more applicable to what we just talked about. What if the entity refuses to

provide the tax forms to the member? So that's a - that's an obligation of the company, both under tax law and then also typically in an operating agreement. So we'll talk about this a little bit, but LLCs will - and this gets to the second question that Daniel asked. Generally, if you form an LLC, the way that you evidence - the governance, you know, the agreement on who runs the company, how the money is split up, how things are allocated, that's all done through either - you might see it called an operating agreement or a limited liability company agreement. And that's the - that is truly the evidence of how you prove your ownership interest in the LLC. Typically, there's a schedule attached to the back of that, and you will have been admitted as a member of the LLC. We'll talk a little bit more about that as we go along. But typically in that operating agreement, there will be an obligation of the company to the members that they will provide these tax reporting - these tax filing notices to the members - these K-1s - and they'll do so on a timely basis. And also, oftentimes you will see provisions in an operating agreement which mandate that as long as the company has the cash, they will pay to the members an amount equal to their expected tax liability. So if the company is making money, and they'd have to pay taxes - right? - just because you didn't get the cash doesn't mean you don't owe taxes on it. So if my company makes \$1,000 of profit, and Kelly and I own it 50-50, we each have to report \$500 of gain of income in that year even if the \$1,000 sits in the company. So you'll see sometimes operating agreements provide for this. But going back to the original question, if the entity doesn't provide the forms, not only is it violating its obligations under the tax code, but also it's breaching a contractual covenant that it has with the members. So theoretically, the members could sue. Now there's, you know - that gets into sort of a circularity problem, but that's really the answer to that. So sorry, Kelly, to jump in.

>>: No, thank you. So in terms of ownership and how - you know, how ownership is distributed, equity holders in an LLC are - they own what's usually referred to as an interest in the LLC, maybe a membership interest. These can be reflected as units. So you might see in an operating agreement that the members will own so many units, and there might even be - go - it might even go so far as to, like, authorize units. The unitization is sort of a way to make it more reflective of the corporate structure that a

lot of people are used to. So the units, again, are just sort of a - it's a way to represent the percentage in the ownership interest, but it's not the same as stock. But you can have sort of different classes, so while it's less common to have sort of sophisticated investors in an LLC, it definitely happens. And so you will see, you know, series A preferred units and series B preferred units and nonvoting units. You can have all of those structures folded into an LLC. Equity holders are usually referred to as members. They don't have to be, but, you know, they're not stockholders, so they're not referred to as such.

>>: And what's important to note here - and we'll say this here - there can - there - you're almost only limited by your own imagination of how you want to set this up, and the distribution of the economics doesn't necessarily have to flow in the same way that the governance is structured. And you can have, you know, as Kelly noted, various preference type classes, and in that way it becomes more flexible than an S corp, which we will talk about the differences a little bit later. But that's why people talk about the flexibility of this structure because it has both the pass-through features and the ability to structure an economic deal that might have some funky bells and whistles.

>>: All right, in terms of management - excuse me - you can either have the LLC be member-managed or manager-managed, and the distinction there is a member-managed LLC - and it's kind of self-explanatory, but the members themselves sort of run the operations of the company day to day. They're, you know, making the decisions. They're, you know, approving new members. This typically works pretty well and is usually used in sort of a - with a - LLCs with a very small equity base. A lot of family-owned companies - you might have, you know, a father and a son that are the members, and they run the company, and so they don't see a point in appointing managers. You can also have manager-managed in which the members elect the managers. The managers then run the company. Generally, if it's manager-managed, the LLC acts by the affirmative vote of the majority of the managers. They can also appoint officers of the LLC. But unlike a corporation, in most states, officers are not required in an LLC, and we'll talk a little bit later about sort of the specifics of election of managers and all that. But kind of going back to having - you know, the

ability to have preferred units and investors and all that in an LLC, it's not uncommon to have, you know, maybe a founder and an investor each able to appoint a manager and one independent. So again, structures like that are absolutely permissible and common in LLCs, and one other sort of big benefit of an LLC is that the fiduciary duties of managers can be disclaimed by the operating agreement. So, you know, not that we advocate doing anything untoward, but the managers can be - the fiduciary duties of managers and managers can be, you know, limited. The liability can be limited for managers as opposed to a corporation where directors cannot sort of get out of their fiduciary duties. You'll see a lot of times provisions in operating agreements that provide that, you know, managers and members can go so far as to potentially, you know, take a business opportunity that - the LLC might, you know, have a business opportunity, and a manager or member is, you know, permitted to, you know, take away that from the LLC, which is something that is generally not permitted in a corporation.

>>: Yeah, and you'll see this more often than not - I see it typically with things like joint ventures. So oftentimes an LLC is the form of entity that might be utilized in a joint venture situation where you might have two companies that otherwise compete, but they come together for a specific purpose that's collaborative. And there'll be some disclaimer of any fiduciary obligations that one member has to another in particular that they acknowledge, hey, we compete against each other in other things, and arguably, you know, our own businesses might compete against the joint venture in some ways. But that's OK. We're disclaiming that. So that's where we see it. If you're just talking about a sort of family-owned operation or something like that, you know, that you might not see this language in. But it's typically when there is some sort of overriding concept where there might be some level of competition among the parties.

>>: So costs, this is Massachusetts, obviously, and the formation and annual fee costs for LLCs and corporations obviously differ. And looking at this chart, it might suggest that corporations are actually cheaper, and in some cases they absolutely might be. But one thing to remember is corporations require the state to authorize shares that are then, you know, sold and issued to stockholders. There's a limit in Massachusetts as to the



cost. So \$275 gets you 275,000 shares, and then there's an additional cost for additional shares. And where that often trips up corporations is they might start - they say great, I'll pay \$275, and I'll get 275,000 shares, and the next thing they know, they're getting an investor, and they need to authorize a million shares, which ends up - and that's just, you know, maybe the first investment. And then maybe they want to do an option plan and all that. So the cost for a corporation can become quite high because not only are you paying for the shares, but every time you do an amendment to increase those shares, you also have to pay the filing fees, as opposed to an LLC where, yes, the cost is slightly higher to form it, but there's no - there are - there's no equity that's authorized by the state. So there's no cost if you want to - let's say, you know, the initial unit - right? - there's, you know, 100 units that are issued, and then they want to issue a million more. There's no amendment that's required there because it's all contractual, and it's all sort of being taken out of that percentage pie. So depending on what the sort of life cycle of the entity is, an LLC can end up being the more cost-effective option, at least as it comes to sort of - as it comes to filings with the state. Another thing just to point out since I know there's some non-Massachusetts people on, these are the Massachusetts costs. Delaware doesn't have this quirk with the number of shares, but there are still sort of thresholds over which more shares cost more money. But it's not quite as difficult to hit that threshold in Delaware.

>>: We've got a couple of additional questions that have popped up that might just take this moment to jump in on. So another follow-up on the tax-related question, what happens if there is no operating agreement, or the operating agreement doesn't provide for what we call tax distributions - right? - the obligation of the company to pay to the members? The short answer is if no such agreement exists, and the company isn't obligated to send the money and doesn't send the money, then those members are obligated to pay the tax. So again, going back to my scenario, if we've got a company that's got \$1,000 in income, and Kelly and I own it 50-50, then regardless of whether I get my \$500 of the income, I have to pay taxes as if I received it. So whatever - you know, it basically gets added to my income for the year from whatever my sources are, and when I do my personal tax filing, then I just have to include it, and that - you know, that's - that is what it is. So, you know, oftentimes in transactions or companies

where there is, you know, a lot of money at stake and a lot of investment, this will be something that an investor will obligate the company to include in their operating agreement. So if you're representing any investors, you want to make sure to look and confirm that there's - there is a provision that obligates a company to pay estimated tax liability. Daniel also asked should member managers be listed as managers in filings with the secretary of state? I'd say, yes. The fact that you are a member and also a manager, I would list them in secretary of state filings as a manager. And then Patrick asked when a manager is also a member, are fiduciary duties still able to be disclaimed? Short answer is, yes. It can be. Again, if it's - you know, if the same people are all members and managers, it may not much matter in the grand scheme of things, but, yes, it is permissible, particularly in Delaware, I will say. Delaware - as I think many of you on this call know - is a state that has prided itself on being sort of the key home field for corporate law issues and - including limited liability company law issues, although those are much more recent. Massachusetts' statute on limited liability companies and the case law in Massachusetts is not nearly as well developed, so we sort of take - you know, as much as we can from the statute, we take as much as we can from decisions made in corporate law matters and try to apply it. But Delaware tends to be far more of a creature of contract than other states, and generally speaking, LLC issues are largely matters of contract. You know, it's an entity, and these are governance documents, but it - the way to think of it is it's a contract about the governance and the economics of the business.