



February 2010

## ***LLC's Are Here to Stay***

### ***They Offer Significant Benefits to Entrepreneurs and Investors if You Navigate Around the Pitfalls***

Limited Liability Companies (LLC's) have been a popular entity choice for private companies for many years. LLC's provide much greater flexibility than S-Corporations with respect to ownership, management and capital structure. Yet, they provide LLC owners (members) with the same level of liability protection as a corporation with all the tax benefits of a flow-through entity. These tax benefits can be quite substantial. There generally are no entity level taxes for LLC's (although a few jurisdictions, such as New York City, do tax LLC's at the entity level); rather, profits and losses flow-through and are taxed only at the owners/investors. This provides two important benefits:

- Profits and gains are taxed only once, not twice as they are with a corporate structure, and the income retains the same character at the owner level that it had at the entity level. This single level of tax is particularly beneficial if dividends are to be paid, or upon the sale or liquidation of the company. The tax savings upon a sale can be 30 percent or more of the pre-tax gain.
- Losses that flow-through to members can be used to offset other sources of income. (This benefit may be either current or deferred, depending on whether you are an active owner or a passive investor.) Again, this is particularly beneficial to member-investors when a venture is unsuccessful and has to be shut down. With a regular corporation, accumulated net operating losses are generally lost when the business is closed or sold in a fire sale. With an LLC, the flow-through losses can be used by members to offset ordinary income, not just capital gains.

Unless an election is made otherwise, LLC's are taxed as partnerships, which is what enables members to take advantage of these flow-through tax benefits. However, partnership tax law is complicated and there can be administrative issues associated with partnerships that some member-investors would rather not deal with. Waiting for K-1's from portfolio companies often unnecessarily delays the completion of member-investor tax returns. If the investor is a fund, all the fund's investors' tax filings are also delayed. Additionally, because a member-investor may be required to file a tax return in every state its LLC portfolio companies do business in, investing in LLC's may impose additional state filing requirements on investor-members. Finally, it may not be desirable for the tax attributes to flow-through to certain tax exempt and foreign investors. As a result, many investors have steered away from investing in LLC's.

Nonetheless, with the prospect of saving 30 percent of the pre-tax gain or more in taxes upon the sale of a portfolio company, more and more investors are willing to accept the relatively minor headaches associated with investing in LLC's. Furthermore, as more and more states allow composite tax filings by flow-through entities, which can eliminate the state filing requirement for non-resident members, the state filing burden will likely continue to lessen over

time. Accordingly, on a going forward basis, we will probably see more investors opting to invest in LLC's.

LLC's also present other operational challenges, particularly with respect to compensation, benefits and ownership changes:

- Owners of LLC's are not employees; they are *members*. Income is reported to members on a Form K-1 (rather than a W-2), and members must make quarterly estimated tax payments rather than being subject to withholding from wages.
- LLC members are not eligible for certain benefits such as flexible spending accounts and health savings accounts. Health and other insurance premiums are taxed differently for members than for employees.
- Equity incentive plans available to LLC's are different than, and not necessarily equivalent to, those that are available to corporations. Furthermore, the rules regarding equity incentive plans for LLC's are currently in a state of flux, which creates some additional tax risks and presents additional challenges in drafting.

With careful planning many of these challenges can be overcome, making it even smarter for business owners, entrepreneurs and investors to take advantage of the significant tax benefits and flexibility LLC's offer. Some ways to structure owner/employee incentive plans that are equivalent those used by regular corporations include:

- ***Unit Appreciation Rights or "UARs"***. UARs are instruments that allow employees or members to participate in future appreciation of the business. They don't represent actual equity; rather, they represent "phantom equity" and are sometimes referred to as "phantom equity plans". Accordingly, employees remain employees and are entitled to all the benefits available to employees. UARs work in a manner similar to *nonqualified stock option plans* in that distributions made upon a realization or liquidation event will be taxed as ordinary income. UARs are probably the simplest and most straight forward way to reward employees with equity participation.
- ***Award profit only interests***. Under the current tax code, awarding a profit only interest does not ordinarily result in a taxable event to the recipient as long as certain requirements are met (whereas awarding restricted stock of a corporation is generally a taxable event). The recipient of the profit interest will, from the time of the award forward, be treated as a member of the LLC. Income will be reported on a Form K-1 (rather than a W-2) and they will have to make estimated tax payments (in lieu of wage withholding). Income or losses of the LLC will flow through to the recipient of the profits interest, which may or may not be desirable. One significant benefit is that much of the gain upon a sale or liquidation of the LLC should qualify as capital gain rather than ordinary income.
- ***Set-up a multiple entity structure***. By placing an operating company into an LLC and having certain employees-owners hold the operating LLC through one or more holding companies (which are also LLC's), the employee-owners may retain their employee status with the operating company while still benefiting from a sale or liquidation as an owner. This structure is typically more complex than UARs, but will generally allow the owner-employees to benefit from capital gain treatment in the event of a profitable sale or liquidation of the operating company.

If your company is already operating as corporation (S or C), converting it to a Limited Liability Company probably does not make sense, as the conversion of a corporation to an LLC is a

taxable event. However, if you are an entrepreneur forming a new company, or an investor considering a new investment, it is well worth considering creating or maintaining LLC status.

Operating as an LLC is often a bit more complex than using a corporate structure; however, the benefits of a single level, flow-through tax structure, particularly upon a sale or liquidation, can be huge. There are situations, however, where operating as an LLC may not be beneficial; for example, where there are tax exempt or foreign investors. Accordingly, careful consideration should be given as to whether or not it makes sense to operate as an LLC, even after a company has received a venture capital or private equity investment. Due to the complex issues involved, we recommend that you consult with your professional advisors, not only in the planning phase, but on an on-going basis throughout the years.

If you would like more information please contact Bruce Blasnik at (203) 323-2600 or [bblasnik@odmd.com](mailto:bblasnik@odmd.com).

Best regards,

*O'Connor Davies Munns & Dobbins, LLP*

O'Connor Davies Munns & Dobbins, LLP

Copyright © 2010 O'Connor Davies Munns & Dobbins LLP

IRS CIRCULAR 230 DISCLOSURE: To comply with IRS regulations, we are required to inform you that unless expressly stated otherwise, any discussion of U.S. federal tax issues in this correspondence (including any attachments) is not intended or written to be used, and cannot be used, (i) to avoid any penalties imposed under the Internal Revenue Code, or (ii) to promote, market, or recommend to another party any transaction or matter addressed herein.

**New York, NY**  
**212.286.2600**

**Harrison, NY**  
**914.381.8900**

**White Plains, NY**  
**914.421.5600**

**Paramus, NJ**  
**201.712.9800**

**Stamford, CT**  
**203.323.2400**

**www.ODMD.com**