JOHN CUNNINGHAM'S LLC NEWSLETTER FOR TAX AND FINANCIAL PROFESSIONALS

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DO YOUR CLIENTS' LLCs NEED FIXING?

PART II – EIGHT COMMON MISTAKES IN FORMING SINGLE-MEMBER LLCS

INTRODUCTION

There are currently about 23,000 New Hampshire LLCs. Most of these LLCs have been formed by their owners without the assistance of a lawyer, accountant or other professional with LLC expertise. In the June 2004 issue of this newsletter, I listed and briefly described the main mistakes that that these owners often making in forming single-member and multi-member LLCs.

Of the above 23,000 LLCs, about half are single-member LLCs. In this issue of the newsletter, I'll discuss in greater detail

- The eight biggest mistakes that "John Doe" and "Mary Roe," hypothetical LLC owners who lack LLC expertise, are likely to make in forming single-member LLCs; and

- What John and Mary should do to fix these mistakes.

In the next issue, I'll discuss the mistakes that John and Mary are likely to make in forming multi-member LLCs.

EIGHT COMMON MISTAKES IN FORMING SINGLE-MEMBER LLCS

MISTAKE # 1 - FAILURE TO ADDRESS VEIL-PIERCING ISSUES

Whenever business founders form new businesses, they should implement right from the start all of the various anti-veil piercing measures they will need in order to ensure that if they are ever sued, their personal assets will be protected. Extensive guidelines for preventing veil piercing are set forth in the "FAQ" section of my website. Please visit www.llcformations.com to access these guidelines.

> EXAMPLE 1. John Doe sets up "John Doe, Esq. and Associates, P.L.L.C.," a single-member professional LLC, to conduct a solo law practice. However, in conducting his practice, John does not maintain his professional books and records separately from his personal books and records, and his business card says only "John Doe, Esq.," not "John Doe, Esq., P.L.L.C." If John's P.L.L.C. is ever sued for malpractice because of something one of his associates or co-members

does, his P.L.L.C. will face a significant risk of veil piercing.

MISTAKE # 2 - FORMING ONLY ONE LLC FOR A BUSINESS THAT WILL HAVE SIGNIFICANT BUSINESS ASSETS

Whenever business founders are starting new businesses that, at the time of their formation or reasonably soon thereafter, will have valuable business assets, the founders shouldn't just form one LLC to conduct these businesses; they should form two. One of these businesses should conduct the founder's actual business operations. The other should hold most or all of the founder's business assets and should loan, lease or license these assets to the operating LLC. If founders use this two-entity arrangement and if their operation entities are ever sued, this arrangement should protect them from losing their business assets in the suit.

> EXAMPLE 2. Mary Roe is starting a new widget manufacturing company in New Hampshire. The company will own its name ("Cosmic Widgets"); it may eventually own trademarks associated with the name; it will own a website (www.cosmicwidgets.com); and it will own various manufacturing equipment and miscellaneous other assets. In addition, Mary expects that her business will eventually maintain operating capital of about $100,000.
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> When Mary forms her business, she should form a single-member LLC, of which she will be the owner; and she should form a second entity that will hold all of its assets. The second entity will license her business name, her website, her trademarks and all other intellectual property that she owns to her operating entity; it will lease all of her hard assets to her operating entity; and it will loan to the operating entity all of the operating cash that it will need. The loan will be secured by all of the operating entity's assets, and this security interest will be "perfected" by a UCC-1 filed with the New Hampshire Secretary of State.

MISTAKE # 3 - FORMING AN ENTITY AS A SINGLE-MEMBER LLC THAT NEEDS THE SYNERGIES THAT MULTIPLE MEMBERS CAN PROVIDE

Multi-member LLCs are usually much more complicated and expensive to form than single-member LLCs. However, there are also many situations in which businesses that lack the synergies afforded by multiple members will fail. Before business founders form single-member LLCs to conduct their businesses, they should first ask themselves whether they will need these synergies. If the answer is yes, they should consider forming their LLCs as multi-member LLCs, not single-member LLCs.

> EXAMPLE 3. John Doe, an engineer, is starting a manufacturing company, in which he plans to invest his life savings and the proceeds from a second mortgage on his home – total start-up capital of $300,000. However, if he were to do the numbers, he would realize that before his company becomes profitable, he will

need business capital of at least $400,000. But until he has a significant track record, he probably won't be able to borrow the extra $100,000 that he needs. Instead, he will need one or more equity investors as co-members of his LLC – i.e., he will need to form his LLC as a multi-member LLC. Otherwise, he may as well give up before he starts.

MISTAKE # 4 - FORMING A SINGLE-MEMBER LLC THAT SHOULD HAVE TWO MEMBERS IN ORDER TO PROTECT ITS BUSINESS ASSETS

As I've discussed in other issues of this newsletter, both LLC legal theory and a famous LLC case called In re: *Ashley Albright* make clear that if you want to protect your business assets from claims brought against you by third parties in your personal capacity, you need to hold these assets not in a single-member LLC but in an LLC with at least two members.

> EXAMPLE 4. Mary Roe forms an operating LLC to manufacture widgets and a leasing LLC that holds $200,000 worth of manufacturing equipment, which it leases to her operating entity. However, the only member of Mary's leasing LLC is Mary herself. A year after starting her business, Mary, while driving her car on personal business, accidentally but negligently runs over and kills a brain surgeon and incurs a judgment of $2,000,000. Her auto insurance coverage per incident is capped at $1,000,000. Because Mary is the sole owner of her leasing LLC, a judge orders the sale of her business assets in satisfaction of the judgment against her by the surgeon's estate. If Mary had had a co-member of her leasing LLC, she could have protected her equipment from her creditor.

MISTAKE # 5 - FAILURE TO MINIMIZE SOCIAL SECURITY TAXES BY ADMITTING A SECOND MEMBER

The default federal income taxation of single-member LLCs owned by individuals is sole proprietorship taxation. Individuals subject to sole proprietorship taxation pay full-freight Social Security taxes. Individuals who form new businesses and want to minimize Social Security taxes often choose to admit a second member - for example, their spouse - and to structure their LLC in accordance with Social Security tax avoidance guidelines set forth in an Internal Revenue Service regulation called Prop. Reg. §1.1402(a)-2.

> EXAMPLE 5. John Doe forms a single-member LLC to providing trucking services. He contributes to the LLC three trucks with a fair market value of $200,000. Under applicable IRS rules, his LLC is taxable as a sole proprietorship, and John pays Social Security taxes on all of his LLC's earnings. If John had admitted his wife as a 20-percent co-member and adopted a properly

drafted LLC agreement, he could be saving thousands of dollars of Social Security taxes every year.

MISTAKE # 6 - FAILURE TO MINIMIZE SOCIAL SECURITY TAXES BY MAKING AN S ELECTION

For most individuals who own single-member LLCs, the best federal income tax regimen is that of a sole proprietor. However, occasionally, such an individual can save substantial Social Security taxes by electing to have his or her LLC taxable as an S corporation. This can happen, for example, if capital investment or employees other than the business owner will be significant income-generating factors in the owner's business.

> EXAMPLE 6. Mary Roe is forming a single-member LLC to manufacture widgets. Right from the start, her company will have $500,000 worth of manufacturing equipment and five employees in addition to Mary. In this situation, Mary should consider making an S election for her LLC and paying herself a relatively low salary of, say, $35,000. (After all, this is a risky start-up that can't afford high salaries anyway.) Mary's S election could save her thousands of dollars a year in Social Security taxes.

(Note: Whether the founder of a new business should save Social Security taxes by (i) admitting a second member and using Prop. Reg. §1.1402(a)-2 or (ii) keeping the founder's LLC as a single-member LLC and making an S election is a complex matter. I will address it in a subsequent newsletter.)

MISTAKE # 7 - FAILURE TO CONSIDER INTEREST AND DIVIDENDS TAX ISSUES RAISED BY SINGLE-MEMBER LLCs

Under the New Hampshire Interest and Dividends Tax, New Hampshire residents who receive distributions from LLCs that have non-transferable management rights are not subject to that tax. It is clear that the members of a multi-member LLC can avoid the I&D Tax as long as their LLC agreement provides that no member may transfer his or her management rights without the consent of other members. Whether it is possible for the members of single-member LLCs to avoid the I&D Tax is less clear. (Personally, I think that no member of a single-member LLC should ever be liable for the I&D Tax, but there are reasonable grounds on which the New Hampshire Department of Revenue Administration can argue otherwise.)

> EXAMPLE 7. John Doe forms a single-member LLC to conduct his widget manufacturing business. The business thrives and eventually John leaves its operations to hired managers and spends all his time polishing his golf game. The LLC makes annual distributions of profits to John of $200,000. The DRA eventually audits John's LLC and assesses a delinquency of five percent of

$600,000 plus interest and penalties – a total of over $50,000. Maybe John can beat the DRA in this case; but if he had had a minor co-member of his LLC during the tax years in question, the problem could never have arisen.

MISTAKE # 8 - FAILURE TO ADOPT A WRITTEN LLC AGREEMENT

The New Hampshire Limited Liability Company Act was originally drafted and adopted in 1993 on the assumption that all LLCs would have at least two members. In 1997, it was amended to provide for single-member LLCs, and these amendments adapted it in various ways to address the special issues of single-member LLCs.

However, there are still many provisions of the Act that simply don't work for single-member LLCs. For this and other important reasons, anyone who forms a single-member LLC and can afford to pay a lawyer to draft an LLC agreement for it should do so. (From what I hear, the typical fee for this service in New Hampshire is very roughly $700.)

EXAMPLE 8. On January 1, 2000, Mary Roe forms a single-member LLC to conduct her financial planning business. She never adopts an LLC agreement for it. Under the default rules of the New Hampshire Limited Liability Company Act, her LLC is "member-managed;" this means that only Mary has the legal authority to manage it. The business does excellently. Tragically, however, on January 1, 2004, Mary suffers a stroke that will incapacitate her for at least a year. Because Mary's LLC is member-managed, neither her husband nor anyone else can pay Mary's LLC's receivables or deposit its receipts in the bank or handle other critical business functions for it during Mary's illness. This results in severe financial hardships for Mary and her family.

If Mary had formed her LLC as a manager-managed LLC and had adopted an LLC agreement in which she appointed her husband as assistant manager with authority to act as manager in the event of her death or disability, all of these hardships would have been avoided.