

**JOHN CUNNINGHAM'S LLC NEWSLETTER
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**WHAT ACCOUNTANTS AND LAWYERS SHOULD KNOW
ABOUT THE MANAGEMENT STRUCTURES OF
MULTI-MEMBER LLCs**

EXECUTIVE SUMMARY

Multi-member LLCs (i.e., those with two or more members) can have any of three basic management structures—a general partnership structure, a limited partnership structure or a corporate structure. Choosing the right management structure for a multi-member LLC can be important not only for legal and business reasons but also for purposes of avoiding Social Security Taxes.

DISCUSSION

Accountants don't normally assist their clients in planning and drafting voting provisions, contract authority provisions and other management provisions for multi-member LLCs of which the clients plan to become members. However, all accountants should have at least a general understanding of these structures. This is because, among other considerations, LLC management structures can have important tax consequences (as discussed below). And obviously, lawyers who assist clients in forming LLCs must have a deep understanding of these structures.

Set forth below are the basics of what accountants and lawyers should know about the management structures of multi-member LLCs. My LLC formbook and practice manual, *DRAFTING LIMITED LIABILITY COMPANY OPERATING AGREEMENTS*, published by Aspen Law & Business, contains tailored forms for multi-member LLCs with all of the various types of management structures described below.

- 1) Member-managed vs. manager-managed multi-member LLCs. On the basis of their management structures, LLC lawyers generally divide multi-member LLCs into two basic kinds —namely, *member-managed* LLCs and *manager-managed* LLCs. In multi-member LLCs that are *member-managed*, every member has statutory authority to bind his LLC in oral and written contracts. In a multi-member LLC that is *manager-managed*, only those persons (whether they are members or non-members) who are expressly named as managers in the LLC's operating agreement may bind the LLC in contracts. Under the New Hampshire Limited Liability Company Act, the issue whether an LLC is member-managed or manager-managed is decided by its certificate of formation, which must state whether the management of the LLC is or is not vested in a manager or managers.

- 2) Member-managed multi-member LLCs and Social Security Taxes. Most multi-member LLCs are subject to federal income tax treatment as partnerships (although, in my view, most of them should in fact be taxable as S corporations). A fact of which even some of the most sophisticated accountants are unaware is that if a multi-member LLC that is taxable as a partnership is member-managed under its certificate of formation, then, under an IRS regulation called Prop. Reg. § 1.1402(a)-2 (the “Prop. Reg.”), all of its members who are individuals will automatically be subject to the Self-Employment Tax on their shares of LLC income. And this will be so even if these individuals are completely inactive in the LLC and would never think of signing a contract for it. The reason is that under the Prop. Reg., individuals who have *statutory authority* to sign LLC contracts are subject to the Self-Employment Tax, whether or not they ever *actually* sign them; and all members of member-managed multi-member LLCs automatically have statutory contract-signing authority.
- 3) Use of Subchapter S by multi-member LLCs to avoid Social Security Taxes while still member-managed. What does this mean for an LLC in which all the members want the right to sign contracts and to fully participate in LLC management, but also want to minimize their Social Security Tax burdens? The answer is simple: This LLC must make an S election. If the LLC is taxable as an S corporation, then the Prop. Reg. won’t apply to it and all of the net income of the LLC will automatically be exempt from Social Security Taxes.
- 4) The need to go beyond the “member-managed/manager-managed” distinction. Knowledge of the above distinction between member-managed and manager-managed LLCs is indispensable in order to protect LLC members from Social Security Taxes. However, the distinction is a dangerous oversimplification for LLC organizers, members and others in determining the precise management structure that their LLC should have for legal and other non-tax purposes, including management efficiency and effectiveness. This is because, as indicated above, there are, as a practical matter, three quite different basic management structures available to multi-member LLCs, and there are significant management subsets within each of these three categories.

To explain briefly:

- a) The simple general partnership management structure. In LLCs which have relatively few members but in which all of the members want roughly equal management rights and authority, the management structure should be that of a classic simple general partnership—i.e., a structure in which all members, like partners in a general partnership, can vote on all LLC matters, can sign LLC contracts and can participate directly in the conduct of the LLC’s business.
- b) The complex general partnership management structure. However, if all of the members of an LLC want equal management rights but the LLC has relatively numerous members—say, more than eight—then the LLC should have a “complex” general partnership management structure—i.e., one in which, for the sake of management efficiency, the members agree that many specified management matters, potentially including very significant ones like the

admission of new members, are reserved to a managing director or a management committee.

- c) “Manager-controlled” and “member-controlled” simple limited partnership management structures. If one or more members of an LLC do not want the burdens and potential liabilities of being LLC managers or if one or more members don’t want one or more *other* members to be managers, then the LLC should have a simple limited partnership management structure—i.e., a structure that has few management formalities but in which day-to-day business matters are reserved to one or more managers whose functions generally resemble those of the general partners of limited partnerships. .

However, any multi-member LLC that has a simple limited partnership management structure can be structured under its operating agreement as either a *manager-controlled* or a *member-controlled* LLC. In the former type of LLC, the manager has the right to decide not only day-to-day LLC business matters but also important “extraordinary” matters such as whether the LLC shall be dissolved. In the latter, all important LLC matters and even specified matters relating to the LLC’s day-to-day business are reserved to the members. A number of LLC cases suggest that LLCs with the latter structure will be more effective in protecting LLC business assets than the former.

- d) Complex limited partnership management structures. In addition, member-controlled LLCs in which the members want clearly specified rights to monitor the managers and to participate in LLC decision-making need to have *complex* limited partnership management structures with detailed provisions concerning member and manager meetings, information rights and voting rights.
- e) Corporate management structures. Finally, it sometimes happens that the members of an LLC do not want to directly monitor the LLC’s managers or to participate directly in the decision of significant LLC matters but do want representatives to perform either or both of these functions for them. These LLCs need a *corporate* management structure, in which the managers of the LLC will be the equivalent of corporate officers and the above representatives of the members will be the equivalent of corporate directors.