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NORTHERN ILLINOIS UNIVERSITY

Limited Liability Companies

A Thesis Submitted to the

University Honors Program

In Partial Fulfillment of the

Requirements of the Baccalaureate Degree

With University Honors

Department of Accountantcy

by

Cindy Buckley

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Student name: Cindy Buckley

Approved by: Rodger H Bulley

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HONORS THESIS ABSTRACT
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ABSTRACT (100-200 WORDS):

In summary, a new business form combining corporate limited liability and partnership pass-through taxation is well on its way to becoming the preferred form for conducting business. The new limited liability company possesses many advantages, with few disadvantages, over alternative forms of ownership. With this new business form also comes questions concerning ethical behavior and public relations problems. Over time, these issues will be encountered and further approached by upholding professional and ethical standards and by helping third parties understand the benefits of this new business form. While still growing in recognition and adoption, new limited liability companies have the ability to expand the options of business formations, add a new perspective in accounting for this issue, while also providing benefits for all parties involved with this future preferred form of business.

A limited liability company is a hybrid business form where the corporate characteristic of owner's limited liability and the partnership characteristic of pass-through taxation are combined. The number of states permitting this new legal form for conducting business is rapidly expanding. From the beginning of 1993 to the end of 1993, the number of states that have passed legislation permitting the limited liability company legal form has risen from 18 to 36 states.

Simply passing a state law proving limited liability company status does not ensure that partnership taxation will exist. According to section 7701(a)(3) of the Internal Revenue Code and related regulations, a business entity will be considered an association and taxed as a corporation if it possesses a majority of the following four characteristics:

1) Continuity of Life
2) Centralized Management
3) Limited Liability
4) Free Transferability of Interests

A limited liability company always possesses the characteristic of limited liability and must therefore avoid at least two of the remaining three characteristics. In most limited liability company cases it was found that the two characteristics avoided the most were continuity of life and free transferability of interests.

Limited liability company cases are usually determined on an individual basis because of the different tax treatment existing from state to state. Some states have adopted rigid

limited liability company statutes while other states have adopted flexible statutes. States allowing centralized management, but not continuity of life or transferability of interests have adopted rigid limited liability rules. The Internal Revenue Service has ruled that the limited liability companies formed in these states are to be treated as partnerships. In contrast, states allowing the adoption of any or all of the corporate characteristics of centralized management, continuity of life, or transferability of interests have adopted flexible limited liability company rules. The Internal Revenue Service has ruled that the limited liability companies formed in these states are to be treated as corporations or partnerships based on individual cases.

As most new developments and changes in the business world are encountered for the first time, the issue of ethical considerations also become apparent. What are the effects of changes in business forms, either to limited liability companies or from limited liability companies to another business form? What is an accountant's responsibility, professionally and ethically, to obtain information discovered, but not voluntarily given, concerning such a change in business form? The following case, taken from West's Federal Taxation, demonstrates the issue of an accountant's responsibility to inquire of structure changes.

Case I

"A Practitioner's Responsibility to Seek Information"

You are a CPA practicing in a state that permits limited liability companies. Your client, Limco, is a limited liability company. Your state has a flexible statute that allows a limited liability company to have centralized management, continuity of life, and free transferability of interests. The Internal Revenue Service has ruled that any limited liability company in your state that has two or three of these characteristics will be treated as a corporation for Federal income tax purposes, but limited liability companies with only one of these characteristics will be treated as a partnership instead.

Limco is in its second year. Last year you reviewed the charter and operating agreements. You determined that while the company had centralized management, it did not have continuity of life or transferability of interest. Therefore, you prepared a partnership return for the company. This year, you noticed that several members have resigned and have been replaced by new owners. You suspect that the members may have modified the operating agreement so that the organization now has continuity of life, transferability of interest, or both. You are not an attorney and have not been informed of any actions of the organization's members with respect to any structural changes. You know that for tax purposes the organization is best served by being treated as a partnership. If you should learn that the company has adopted either modification in its structure, you

Case I, Continued

must prepare a corporate return. You are also aware that the competing accounting firm, which serves several of Limco's members, has an "ask no questions" philosophy, and would prepare any return that the client wanted. You must decide whether to take any steps to determine if the organizations structure has changed in a way that will cause it to be treated as a corporation if it is audited by the Internal Revenue Service.

One of the distinguishing characteristics of any profession, is the existence and compliance with a code of professional conduct. Certified public accountants must comply with a code of ethics and uphold various principles established in the American Institute of Certified Public Accountants Professional Standards.

In the Code of Professional Conduct, the six Principles that are identified consist of the following:

1) Responsibilities
2) The Public Interest
3) Integrity
4) Objectivity and Independence
5) Due Care
6) Scope and Nature of Services

First, in carrying out their responsibilities as professionals, members should exercise sensitive professional and moral judgements in all their activities. In the previous case, the accountant must reflect on what should be his or her overall objective to maintain and enhance the stature of the public accounting profession. The accountant should take additional steps to determine if the organizational structure has changed in any way that will cause it to be treated as a corporation because the accountant has the responsibility to prospective users of the information from the professional services.

Second, members should accept the obligation to act in a way that will serve the public interest, honor the public trust, and demonstrate commitment to professionalism. In the previous

case, the accountant should consider the effects of his or her actions taken to determine if organizational structure has changed to that of a corporation. If no actions are taken, the accountant must reflect upon the negative consequences that would occur concerning public interest, public trust, and the accountant's demonstration of professionalism. The public image of the accounting profession in general would be damaged if the public felt that their best interest was being overlooked and therefore the public would loose trust in the purpose of the accounting profession.

Third, to maintain and broaden confidence, members should perform all professional responsibilities with the highest sense of integrity. The characteristic of integrity is said to be the benchmark by which all members must ultimately judge decisions made in the engagement. In the previous case, if the accountant were not to take additional steps to determine if the organizational structure has changed to that of a corporation, this response will damage the work quality on which public trust is based.

Fourth, a member should maintain objectivity and be free of conflicts of interest in discharging professional responsibilities. A member in public practice should be independent in fact and appearance when providing auditing and other attestation services. In the previous case, the accountant should be impartial and unbiased in all matters concerning an engagement. The fact that another competing firm would take on this engagement with a "no questions asked" attitude should not discourage the accountant from gathering the additional information needed to determine if corporation status

is present. It is an accountant's responsibility to further investigate indirect evidence found that will effect the services provided to the client.

Fifth, a member should observe the profession's technical and ethical standard, strive continually to improve competence and the quality of services, and discharge professional responsibility to the best of a members ability. This characteristic of due care should be reflected in the accountant's competence and diligence. In the previous case, the accountant should rely on his or her education and experience. Consideration should be given to past ethical decisions and the manner in which the accountant wishes to conduct business in the future. Ethical situations are always going to arise, and as an accountant, one must take a stand on these issues and act on what is believed to be correct. The accountant should also rely on his or her effort in performing professional services and do so by being thorough in work performed.

Finally, a member in public practice should observe the Principles of the Code of Professional Conduct in determining the scope and nature of the services provided. In addition to considering all of the preceding principles, the accountant should also consider how his or her decision of not taking steps to determine a change of corporation status would effect a possible conflict of interest with Limco in providing the services. The accountant should also consider how the consistency of these actions compare with the role of a professional.

Overall, an accountant faced with this ethical situation should take the necessary steps warranted to determine if a change to corporation status has occurred. This decision is consistent with all the characteristics and principles present regarding the professional conduct expected. The accountant should not consider compromising his or her situation based on the fact that a competing firm would not uphold such ethical standards and benefit from the engagement regardlessly. Such unethical ways of performing business are not profitable in the long-run as society looks upon these actions with a negative viewpoint. The actions of unethical businesses will catch up with them and cause more harm to the business as compared to any benefits received through these unethical behaviors.

As more states adopt limited liability acts and a body of law for limited liability developments, limited liability companies are becoming increasingly popular as an alternative business form. While the most frequently cited benefit of a limited liability company is the limited liability of its owners, limited liability companies also offer the following additional benefits as compared to alternative forms of ownership.

S Corporations

* Limited liability companies may have more than 35 owners and any taxpayers, including corporations, nonresident aliens, other partnerships, and trusts can be owners of a limited liability company. The possible owners of a S corporation are limited to individuals, estates of individuals, and qualifying trusts.

* Partnership tax provisions, rather than corporate tax provisions, govern property transfers to a limited liability company in exchange for an ownership interest. Under the corporate provisions, transferors need to satisfy the 80 percent control requirements to receive a tax-free treatment. Limited liability companies, governed by partnership provisions, do not need to meet the 80 percent control requirements.

* Limited liability companies do not duplicate the S corporation's taxes on built-in gains and passive income.

* Limited liability companies can own 80 percent of another corporations operating stock. An S corporation's ownership of 80 percent of another corporations operating stock is viewed as representing a parent-subsidiary relationship and is not allowed.

* When owners contribute appreciated property to a limited liability company, there are more liberal requirements on recognition of such gains. In the same circumstance, S corporations are unable to recognize any gain according to section 351 of the Internal Revenue Code. Limited liability companies follow partnership rules under section 721, and therefore recognize gain for the following transactions:

- appreciated stocks that are contributed to an investment partnership,
- the transaction is essentially an exchange of properties,
- the transaction is a disguised sale of properties, or
- the partnership interest is received in exchange for services rendered to the partnership by the partner.

* Limited liability company ownership interests are not necessarily considered a security. S corporation ownership interests are considered to be a security for security law purposes.

* The owners' share of almost all limited liability company's liabilities are included in an owners' basis. Only certain liabilities of S corporations are included in the shareholder's basis.

* Per a special election under section 704(b) of the Internal Revenue Code, a limited liability company may elect to have a partner's distributive share of income, gain, loss, deduction or credit be determined in accordance with the partner's interest in the partnership. S corporations do not have an election available and must allocate income on a per share per day basis.

* For the benefit of the limited liability company and its owners, the optional adjustments to basis election can be made in order to have the inside basis of the partnership property adjusted to reflect the purchase price paid by the partner. Such an election is not possible with S corporations.

C Corporation

* Limited liability companies have the advantage of being taxed as a partnership, while C corporations have the disadvantage of double taxation. First, C corporation income is taxed at the corporate level tax rates, and then second at the personal level tax rates of the shareholders when the corporation distributes this income.

* Limited liability companies are also able to pass tax attributes through to the owners due to the advantage of partnership taxation. While C corporations can incur many different characteristics relating to income and gains, such as tax-exempt and capital respectively, the distributions received by the shareholders do not reflect these characteristics. The distributions received are taxed as ordinary income to the shareholders upon distribution regardless of the C corporation's characterization of the distribution at the corporate level.

Limited Partnership

* One of the main advantages of limited liability companies is the characteristic of limited liability of all the owners. Limited partnerships must have at least one general partner and at least one limited partner. Both the general and limited partners have personal liability for the entity's debts. The general partner has unlimited liability while the limited partner's liability is restricted to his or her investment.

* While a limited partner in a limited partnership is only limited to the investment amount, he or she may not be involved with the day-to-day management of the partnership without risking the loss of this limited liability. Losing the characteristic of having limited liability would cause the limited partner to be treated as a general partner with the characteristic of unlimited liability. Owners of limited liability companies are allowed to participate in the day-to-day activities of the partnership without jeopardizing their limited liability status.

* The ownership interest in a limited liability company is not necessarily considered to be a security while the interest of a limited liability partner is normally classified as a security for securities law purposes.

General Partnership

* As previously mentioned, a general partner has an unlimited liability status while the status of owners of limited liability companies have a limited liability status.

* Limited liability companies maintain a greater chance for continuity of life as compared to a general partnership. For example, according to section 708(b)(1) of the Internal Revenue Code, general partnerships terminate if there is a sale or exchange of 50 percent or more of the partnership's capital and profits within a 12 month period. Limited liability companies are not subject to this termination requirement.

* Limited liability companies also possess the characteristic of having greater limitations on the ability of an owner to withdraw from the business.

After discovering the many advantages that limited liability companies possess over alternative forms of business, it is easy to see why this new form of a business entity is rapidly expanding across the United States and becoming a popular choice in today's society. Considering again the many advantages of the limited liability company over S corporations, this significant development could have the effect of changing the preferred entity for conducting business from S corporations

to limited liability companies.

While limited liability companies display various advantages over other business forms, they also have the following disadvantages to encounter.

* One of the main concerns of the federal government is the possible loss of large amounts of tax revenue if too many limited liability companies begin replacing C corporations. James Wetzler, a State Taxation and Finance Commissioner of New York, examined the potential costs of taxing limited liability companies as partnerships. He opposed the idea stating that it would cost the state $70 million a year while also causing a $2 billion a year federal loss. Concerning this potential for revenue loss, the New York task force has concluded that a flat annual tax or annual fee would be the best method of raising revenue from limited liability companies. Another alternative is to restrict limited liability company status to small companies that could not use the S corporation status.

* In states that have not yet enacted limited liability companies, there is uncertainty about the limited liability of owners and Federal tax status until the Internal Revenue Service has issued a ruling on a limited liability company statute in a particular state.

* Because limited liability companies are a recent development in the United States, there is an absence of a developed body of case law which can be relied upon. When legal questions arise in other forms of business entities, reference can be made to similar situations with the outcomes of past case

law decisions. While this disadvantage can be phased out over time when more states pass the limited liability company status, this issue may be frustrating to an initial company beginning operations as a limited liability company.

* Most states require limited liability companies to have at least two owners in the formation, otherwise the entity would be taxed as a proprietorship. If the entity lacks the corporate standards of centralized management and continuity, the Internal Revenue Service may consider such companies as pass-through entities. Some alternatives to being taxed as a proprietorship were to tax these companies as regular corporations, S corporations, or partnerships.

* Limited liability companies are unable to qualify for code section 1244 ordinary loss that is available to small business corporations. Section 1244 of the Internal Revenue Code would result in an ordinary loss treatment for losses on the sale or worthlessness of stock, thus encouraging the investment of capital in small corporations.

* The last disadvantage discussed concerns the issue of changing to a limited liability company and the relating effects in the area of public relations. The following case, taken from West's Federal Taxation, helps to demonstrate this topic in accounting firms.

Case II

"A Big 6 Firm Changes its Form of Conducting Business"

Ted is the managing partner of a Big 6 firm. Like all Big 6 firms, Ted's firm has expended considerable resources, both financial and personnel, in defending itself against various liability claims, many of which are spurious.

Ted is meeting with the firm's management committee this afternoon. On the Agenda is a continuing discussion of ways to deal with liability issues. Ted has held private discussions with several members of the committee about changing the ownership from a partnership to a Delaware limited liability company. All of the partners except Albert regard a limited liability company as a positive option. Albert, who is approaching retirement, has vehemently argued that a professional accounting firm serves the public interest and that operation as a limited liability company is in conflict with that objective and the related public perception.

Limited liability companies offer the advantage of limited liability to accounting firms. Since accounting firms are usually structured as proprietorships, partnerships, or professional corporations, accountants face the high risk of individual liability. This conversion to limited liability companies may provide a public relations challenge for the business involved. Clients, suppliers and creditors would probably feel more comfortable working with a business individuals that are personally liable. Hearing such news of a change to the limited liability company status may make these clients, suppliers, and creditors curious as to the reasons for the change. Is the business form they are associated with in so much liability trouble that they feel it is necessary to change a form where they are not held personally liable for their own mistakes?

A main concern for these businesses wishing to convert to the status of a limited liability company is to find a way to balance the disclosure of such an entity with providing reassurance to the individuals associated with their business. These converting business entities may not merely assert that nothing has changed because this statement may be given legal effect that defeats the limited liability. New limited liability companies should contact their clients, suppliers, and creditors and notify them of their change in business form. They should also take the time to discuss the reasons for changing to a limited liability company and the effects this change will have on the dealings with these individuals. An issue that could be brought to attention would be that any individuals dealing with this new limited liability company

would not have to worry about collecting any possible future claims against the entity. The only issue that would change would be that such claims would not be taken against personal assets outside the limited liability company. Sufficient or additional insurance coverage taken would be ample to cover any possible claims against the business. In explaining this issue, the limited liability company could compare its new status with that of a corporation and explain the similarities concerning the limited liability status of the owners. In explaining this issue, the limited liability company should also compare its new status to that of other business forms, such as a limited partner in a limited partnership, and explain any other advantages that are present. Finally, the limited liability company should discuss the fact that such entities have been in existence in other countries for many years and have proven to be a successful business form.

The individuals involved with this change of status should soon realize the reasons for change and any effects that would occur without perceiving the company in a negative manner. Limited liability companies could possibly become the preferred form of business for many years to come. Clients, suppliers, and creditors should also realize that the benefits received by changing status will eventually be passed through to individuals dealing with the business to benefit the interests of all parties involved.

In conclusion, a new business form combining corporate limited liability and partnership pass-through taxation is well on its way to becoming the preferred form for conducting business. The new limited liability company possesses many advantages, with few disadvantages, over alternative forms of ownership. With this new business form also comes questions concerning ethical behavior and public relations problems. Over time, these issues will be encountered and further approached by upholding professional and ethical standards and by helping third parties understand the benefits of this new business form. While still growing in recognition and adoption, new limited liability companies have the ability to expand the options of business formations, add a new perspective in accounting for this issue, while also providing benefits for all parties involved with this future preferred form of business.

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