

PROFESSIONAL SERVICES LIMITED LIABILITY COMPANY

(For professionals doing business as an LLC or LLP)

HIGHLIGHTS OF THE PLAN

IN GENERAL

A Limited Liability Company (LLC) is a flexible business and investment entity that permits income shifting and discount gifting among Members, as they are called. It also provides protection from the claims of creditors for assets that are placed in the Limited Liability Company. If structured properly, an LLC provides a single layer of pass-through taxation, just as a partnership. However, an LLC differs from a partnership in that all Members, including managing Members, are at risk for only their investment in the LLC. In a partnership, even a limited partnership, the general partners can incur liability in excess of their contributions to the partnership. Unlike a limited partnership where limited partners are restricted from participating in managing the affairs of the business, any Member in an LLC may be a managing Member.

An LLC differs from an S corporation in that it can have more than 75 Members, have more than one class of company interests, have interests owned by entities other than natural persons or trusts that represent natural persons, give Members disproportionate distributions, enable a Member's adjusted basis in the company to be increased by nonrecourse debt, make special allocations of profits and losses among Members, and be subject to termination upon the withdrawal or removal of any Member.

PROFESSIONAL SERVICES LIMITED LIABILITY COMPANY

A professional services LLC is one in which its Members are made up of licensed practitioners of a single profession, for example, lawyers, doctors, dentists, engineers, accountants, financial planners, etc. Some states do not permit certain professionals to do business as an LLC. Some of these states have created a special variation of the LLC for such professionals known as a registered limited liability partnership, or LLP. An LLP functions like a professional services LLC, requiring that all Members be licensed practitioners of a single profession.

HOW A PROFESSIONAL SERVICES LIMITED LIABILITY COMPANY IS STRUCTURED

Although some states permit a professional services LLC with just one Member, most require at least two. Unless an LLC is managed by all Members, jointly and severally, it must have one or more managing Members. In the case of an LLC established by a group of professionals, one or more Members function as the managing Members.

These managing Members manage and control the LLC. Members who are not managing Members are not involved in the day to day operations of the LLC. In the absence of fraud or other malfeasance, neither Members nor managing Members can have personal liability beyond their investment in the LLC.

ASSET PROTECTION

The LLC affords Members some degree of protection from creditors. Suppose, for example, that a Member is sued by a creditor on a matter unrelated to the LLC. Further suppose that there are assets in the LLC worth \$1,000,000, and the creditor obtains a \$200,000 judgment against Member A, who is a managing Member.

In most states, the most the creditor can do is obtain a charging order against Member A's interests in the LLC. This means that the creditor can assume Member A's right to receive distributions from the LLC. However, if, according to the terms of the LLC agreement, no distributions are made, the creditor must recognize the income that Member A would have otherwise had to have recognized but not receive any distributions from the LLC. Obviously, this is a very unfavorable position for the creditor to be in, having to recognize income without actually receiving any distributions from the LLC. Even if under state law a creditor could eventually reach the underlying assets of the LLC, the extra steps required to do so might make the creditor think twice before making the attempt.

A similar layer of protection is provided to professionals who are Members of an LLC. If, in the absence of fraud, a Member is successfully sued for actions arising out of the conduct of the business, the LLC affords the same protection to the LLC Members that a Professional Corporation would provide to a shareholder. However, the same issues that apply to piercing the corporate veil apply to piercing the veil of protection afforded a professional by an LLC. It is important, therefore, to adhere to any rules and formalities that are required by state law or the LLC's articles of organization and operating agreement. As a general rule, a professional cannot insulate himself/herself from liability for professional malpractice by using a Professional Corporation or LLC as his/her form of business. Liability rules relating to professional malpractice vary from state to state.

ADVANTAGES OF A PROFESSIONAL SERVICES LIMITED LIABILITY COMPANY

It is taxed as a partnership, with all income and deductions passing directly through to the Members.

All Members, including the managing Members, are given limited liability, with some exposure to liability on the part of an offending professional arising out of professional malpractice.

Any Member can be a managing Member.

There is no double taxation as there would be with a corporation.

Special allocations of profit and loss can be made among the Members.

Members may receive disproportionate distributions.

A Member's nonrecourse debt at the entity level can increase the Member's adjusted basis in the company.

There is no recognition of gain on the part of the LLC for distributions of appreciated property.

Since title to property transferred to the LLC vests in the LLC, creditors cannot reach the underlying assets. In the absence of fraud, the burden of proving which is on the creditor, transfers made for legitimate purposes will be beyond the reach of creditors.

The creditor can only obtain a charging order that permits taxable income to flow through without any actual distributions. The creditor cannot become a substitute Member.

Members have a measure of protection against malpractice suits as long as formalities required by law or the articles of organization and operating agreement are observed.

If the LLC elects partnership status for tax purposes and if life insurance on the life of a Member is owned by the LLC, only that portion of the proceeds equal to the insured's pro rata interest in the LLC will be includible in the insured's estate for estate tax purposes.