

LIMITED LIABILITY COMPANIES IN FLORIDA

What is a limited liability company?

When considering the selection of a private business entity ownership structure for a business in Florida, there are a variety of potential choices under Florida law, to-wit: corporations (either “S” or “C” tax status), limited partnerships (“LPs”), limited liability partnerships (“LLPs”), limited liability limited partnerships (“LLLPs”), business trusts (also known as common-law declarations of trust under *Chapter 609, Florida Statutes*), general partnerships or limited liability companies (“LLCs”). AN LLC is a hybrid business entity in that it has the limited liability protection for its owners (that are identified as “members” in an LLC) analogous to shareholders/owners of corporations while otherwise being treated as a partnership for income tax purposes.

The LLC entity-style concept has been around for some time. Many countries around the world have long-standing LLC-type statutes and every state in the U.S. has adopted a form of LLC statutes. Wyoming was the first state to adopt an LLC act in the U.S. that was modeled after the German GmbH statute. In 1982, Florida followed by adopting its LLC statutes. However, LLCs were not widely used in Florida until the IRS enacted the “Check-the-Box” Treasury Regulations in 1997 that allowed automatic treatment of LLCs as a partnership for income tax purposes (and which repealed the “Kintner” regulations for business entity tax classification purposes) and the state of Florida repealed the application of Florida’s 5.5% corporate income tax to LLCs after July 1, 1998. cf. §§608.471, 220.11 and 220.13(2)(j), *Florida Statutes*.

In 1993, the Floridan LLC statutes were amended to permit professional LLCs and allow corporate characteristics for LLCs. Other changes have occurred with respect to the Floridan LLC law that have made Floridan LLCs more attractive as an entity of choice, for example:

1. AN LLC can have one or more members. §608.405, *Florida Statutes*.
2. AN LLC member can be any person or entity, foreign or domestic. §§608.402(21) *Florida Statutes*.
3. AN LLC can be formed by filing articles of organization filed by one member or an authorized representative. §608.407(3), *Florida Statutes*.
4. Capital contributions of a member can consist of cash, property, services rendered or to be rendered, a promissory note or other obligation to contribute cash or property. §608.4211(1), *Florida Statutes*.
5. AN LLC can be a member-managed LLC or a manager-managed LLC. §608.422, *Florida Statutes*.
6. A member’s LLC interest is subject to a charging order obtained against the member/judgment debtor by a judgment creditor which limits the judgment creditor to being an assignee of the member’s LLC profit distributions, if any. §608.433(4), *Florida Statutes*.
7. There can be different classes of members with or without various rights as an LLC member, including voting rights. §608.4231, *Florida Statutes*.

As a consequence of the above-noted federal tax law and Florida law changes affecting LLCs, now LLCs have become a prominent business entity choice.

How may an LLC be taxed?

It is typical that LLC members wish to be taxed as a partnership for federal income tax and Florida corporate income tax purposes if such members wish for the LLC to be a “pass-through” entity and be subject to partnership tax rules. Pursuant to the “Check-the-Box” Treasury Regulations that became effective as of January 1, 1997, the default tax classification of an LLC is that an LLC is considered a

partnership for income tax treatment purposes. *Reg. 301.7701-1, et. seq.; Rev. Proc. 95-10.* However, if the entity is a single-member LLC, then the LLC shall be automatically defaulted to having a “sole proprietorship” tax status, i.e. the member reports LLC activities on his or her Schedule C in their respective Form 1040. *Reg. 301.7701-2(c)(1).* Therefore, it is important to distinguish multiple-member LLCs from single-member LLCs for tax classification reasons.

Moreover, LLC members can elect out of the “Check-the-Box” regulations tax default classification. In a multiple-member LLC, i.e. an LLC with two or more members, the members can elect “C” corporation or “S” corporation tax status by filing Form 8832 and Form 2553 (if “S” corporation status is elected). In a single-member LLC, the member may similarly elect “C” corporation or “S” corporation status.

Thus, in light of the available tax elections possible, an LLC can be an extremely flexible tax planning entity choice. However, remember that the LLC operating agreement should conform with the tax status chosen in order to avoid possibly unintended negative tax consequences.

The new “Check-the-Box Regulations” make it easy to now classify an LLC for federal tax purposes. Beware that a single member LLC cannot be classified a “partnership” for federal income tax purposes. *Reg. Sec. 301.7701-2(c)(1).*

Regardless of the number of “corporate characteristics” an LLC may have, ex. perpetual life, centralized management, limited liability for owners or free transferability of interests, the LLC may elect to be taxed as a partnership. These new regulations create certainty in the federal income tax treatment of LLCs and make compliance easier.

Due to the applicable “Check-the-Box” regulations, all uncertainty has been removed with respect to how LLCs are to be taxed.

How is an LLC formed and operated?

In order to form an LLC, one must file articles of organization with the Florida Department of State office along with the requisite filing fees (currently \$125.00, including registered agent's fee). There is a required annual report filing for Floridan LLCs (currently a \$50.00 fee). Pursuant to §608.407, Florida Statutes, LLC articles of organization must include:

1. The LLC name that shall be identified as “limited liability company”, “limited company”, “L.L.C.”, “LLC”, “L.C.” or “LC”.
2. The mailing address and street address of the LLC.
3. The name and Florida address of the registered agent of the LLC along with his or her signature of acceptance.
4. A description of LLC as a member-managed company, if that is the case.
5. Articles must be signed by at least one member or authorized representative.
6. If an effective date is listed, the date must be specific and cannot be more than five business days prior to or ninety days after the date of filing.

An LLC's owners are called "members". Unless otherwise stated in articles or operating agreement, LLCs are deemed to be member-managed. §608.422(1), Florida Statutes. AN LLC can be manager-managed. §608.422(3), Florida Statutes. Different classes of members can be created in an LLC, e.g. voting and non-voting classes of members. §608.4231, Florida Statutes. Thus, an LLC could be set up analogous to a limited partnership in that the LLC could be managed by one or more managing members (or non-member manager) that would be the equivalent of a general partner in a limited partnership while other members could be passive, non-voting members who would be the equivalent of limited partners.

A member's ownership interest in an LLC can be physically represented by an LLC certificate that is analogous to stock certificates in a corporation. These certificates can express ownership as number of units or as percentage of ownership in the LLC.

The operating agreement of an LLC that is signed by all members is the internal governing document of the LLC. The operating agreement includes rules and regulations pertaining to scheduling of meetings of members, voting rights of members, fiscal matters, management authority, distribution of profits or losses, maintenance of books and records of LLC, appointment of operating manager or other officers, restriction on sale or transfer of member interests and other operational issues.

A member-managed LLC is managed by vote of its members like a general partnership. A manager-managed LLC is managed by its manager(s) like a limited partnership. Each manager or managing member owes a duty of loyalty and a duty of care to both the LLC and its members. §608.4225, Florida Statutes.

What is the liability exposure of an LLC member?

Members of an LLC are not personally liable for debts, obligations, judgments or other non-personally guaranteed liabilities of the LLC. §608.4227, Florida Statutes. However, members are liable for return of improper distributions of LLC assets. §608.426, Florida Statutes. It is an open question whether "piercing the corporate veil" type of theories of liability will be successful against LLC members. Logically, such theories of liability would be applicable if the LLC incurred debt while insolvent, the members did not adhere to statutory formalities for setting up or operating an LLC, the legal form of the LLC was disregarded by members, members commingled LLC assets, the LLC was used to perpetrate a fraud or the LLC was used merely as an "alter-ego" of the members.

What is the exposure of an LLC member's interest to a third party creditor?

An LLC member's interest can be attacked by his or her judgment creditor only through the use of a "charging order". §608.433(4), Florida Statutes. A charging order is obtained by a judgment creditor of the LLC member upon application to a court of competent jurisdiction. The charging order requires the LLC to make LLC distributions due to the member to the judgment creditor instead until the judgment is satisfied. However, a charging order does not require the LLC to make any such distributions to the LLC member/judgment debtor and therein lies the rub for the judgment creditor. The judgment creditor has the rights of an assignee with respect to the LLC member's interest and, thus, if there are no LLC distributions, the creditor gets nothing. This legal reality would then supposedly motivate the settlement of the creditor's judgment.

There has been no case law in Florida adjudicating whether a charging order is the exclusive remedy of a judgment creditor against an LLC member/judgment debtor. However, both federal and state courts in Florida have held that a charging order is the exclusive remedy for a judgment creditor versus a limited

partner/judgment debtor in a limited partnership, thus preventing the execution sale of limited partnership interests in order to satisfy a judgment obtained against the limited partner. *Matter of Dutch Inn of Orlando, Ltd.*, 2 B.R. 268 (Bankr. M.D. Fla. 1980); *Pressner v. Pressner*, 59 So.2d 379 (Fla. 2d DCA 1991); *Givens v. National Loan Investors, L.P.*, 724 So.2d 610 (Fla. 5th DCA 1999). The charging order remedy statute for limited partnerships is pretty much the same in terms of intent as the LLC statute. §20.153, *Florida Statutes*. From the current status of the law in Florida, we can presume that the charging order now appears to be the exclusive remedy for judgment creditors who seek collection of his or her judgment against an LLC member.

Can LLCs be used in professional practices?

Pursuant to *Chapter 621, Florida Statutes*, a professional such as an attorney, CPA, etc., and their respective professional service corporations or other entities, can organize a “professional limited liability company” in order to render professional services. §621.03(3), *Florida Statutes*. Non-licensed persons cannot utilize a professional LLC. §621.06, *Florida Statutes*. Professional liability, i.e. malpractice, accrues to the professional (or by the person under that person’s supervision and control) committing the negligence while performing services on behalf of the LLC. The assets of the LLC are also subject to the claims of a malpractice plaintiff, regardless of who committed the malpractice. §621.07, *Florida Statutes*. Only professionals licensed in the same profession can form a professional LLC. The name of a professional LLC must contain suffix “Chartered” or “P.L.”. §621.12, *Florida Statutes*.

Interestingly enough, a CPA can form a non-professional LLC to engage in the accounting practice if the LLC complies with §473.309(3), *Florida Statutes*.

Is the transfer of appreciated property to capitalize an LLC a taxable event?

Gain is not generally recognized when an LLC member transfers appreciated property in exchange for his or her LLC interest. *Internal Revenue Code* (“Code”) §721(a). This non-recognition rule is subject to the “investment company” exception. *Code* §721(b). If an LLC member transfers appreciated property that results in “diversification” and, after the exchange, more than 80% of the LLC assets constitute “stock and securities”, then the transfer creates a taxable event. *Reg.* §1.351-1(c)(1). “Stock and securities” are defined in *Code* §351(e)(1)(B). Closely held business securities fall within the above definition.

What is the meaning of the above? The investment company problem becomes an issue only when different family members contribute different securities to capitalize the LLC. For reference, review *S.Rep.No. 938, 94th Cong., 2nd Sess. pt. 2, at 43-44(1976)*.

How are LLC interests valued for transfer tax purposes?

LLCs can be used as a planning platform in order to make gifts to junior family members. Gifting of LLC interests require valuation of those interests for IRS reporting purposes. It can be said that business valuation is not a science but an art. This is due to the fact that business valuation is an opinion of fair market value (“FMV”) that is subject to various factors. For estate and gift tax valuation purposes, FMV is the price at which property would change hands between a willing buyer and a willing seller with neither being under any compulsion to buy or to sell and both having reasonable knowledge of all relevant facts. *Reg.* §20.2031-1(b);*Reg.* §25.2512-1.

When an LLC interest is gifted by a senior family member to a junior family member, the valuation of the gifted interest may be subject to three types of discounts:

1. Lack of Marketability Discount. This discount results from the LLC interest not having an established market for sale and purchase.
2. Minority Discount. This discount results from the LLC interest not having control of the LLC business.
3. Fractional Discount. This discount results from the inconvenience of shared ownership and management.

Beware that if the gift of the LLC interest is intended to qualify for the \$11,000.00 per donee annual exclusion as per *Code §2503(b)*, the LLC operating agreement should contain the equivalent of at least a sixty (60) day “Crummey Power” provision that provides the donee member a restricted right to obtain the gifted asset or sell the gifted interest for a limited time period. cf. *Hackl v. Commissioner*, 118 T.C. No. 14 (March 27, 2002); TAM 9751003.

How is an “S” corporation different than an LLC for tax and estate planning purposes?

A “S” corporation is subject to various legal restrictions in terms of use that are not applicable to an LLC, ex. all shareholders of “S” corporation must be either U.S. citizens or U.S. resident aliens (*Code §1361(b)*), shareholders are limited to seventy-five (75) in a “S” corporation (*Code §1361(b)(1)(A)*), “S” corporations cannot retain or acquire “S” status if business activity is prohibited, e.g. bank, insurance company, foreign corporation, etc. (*Code §1361(b)(2)*), a “S” corporation can only have one class of stock (*Code §1361(b)(1)*), “S” corporation distributions of appreciated property to shareholders trigger taxable gain to corporation (*Code §1368*), shareholder’s stock basis in “S” not increased when corporate debt is assumed (*Code §1367*), “S” corporations cannot specially allocate gains or losses among shareholders (*Code §1366(a)*) and shareholders of “S” corporations have no charging order type of asset protection.

Can an existing entity be converted into an LLC?

In §608.439, *Florida Statutes*, general partnerships, limited partnerships, business trusts, foreign LLCs, common-law trusts, real estate investment trusts or other unincorporated businesses can convert into a Floridan LLC. When conversion occurs, title to real property (as well as other personalty owned by the entity) transfers to the new LLC without the need for recording a deed or paying state documentary stamp taxes.

How about cross-entity mergers?

Cross-entity mergers are permitted in Florida by filing a Certificate of Merger with the State. §§608.438 - 608.4383, *Florida Statutes*.

However, beware of tax consequences of merger! Merger of a “C” or “S” corporation into an LLC constitutes a corporate liquidation that results in a taxable event. Conversion of a partnership into an LLC should not be a taxable event. *Code §708; Treas. Regs. §1.708-1cc; Rev. Rul. 84-52, 1984-1 C.B. 157.*

Is a transfer of real property to capitalize an LLC subject to state documentary stamp taxes?

The Department of Revenue of the State of Florida takes the position under *F.A.C. §12B-4.013(7)* and *§201.02, Florida Statutes*, that when you transfer real property to an LLC in exchange for an LLC member interest, that is a transfer that is subject to the state documentary stamp tax of \$.70 per \$100.00 of value transferred. A Florida state court held in the case captioned *Kuro v. Florida Dept. of Revenue*, 713 So.2d 1021 (Fla. 2nd DCA 1998) that there is an exception to the above position so dearly maintained by the Department of Revenue. In *Kuro*, the taxpayers equally owned real property that was transferred for liability protection reasons to a new corporation in exchange for equal shares in said corporation. The court held in the *Kuro* case that there was no taxable purchase of real estate because the transferors did not receive anything different in terms of ownership in exchange, thus no documentary stamp taxes were due.

The *Kuro* case holding incited the Department of Revenue to attack that precedent by contesting the assessment of state documentary stamp taxes on a capitalization of a limited partnership by a corporate partner and two individual partners. The corporate partner contributed realty for a 98% interest and the individual partners contributed other dissimilar assets for a 2% interest. This factual scenario was deemed to generate a taxable transfer of real estate, i.e. documentary stamp taxes, due to different partners contributing different assets. *Muben-Lamar, L.P. v. Department of Revenue*, 763 So. 2d 1209 (Fla. 1st DCA 2000). The Florida Supreme Court, in June 2001, decided that there was no conflict between *Kuro* and *Muben-Lamar* and thus declined to hear the appellate case.

It appears that for a transfer of real estate to fall within the *Kuro* case rationale, factually, the LLC must have pre-existed the transfer of realty and the ownership of the realty must have been the same as the ownership of the new LLC entity. LLC certificates should be issued prior to the transfer. The realty should not be mortgaged. The transfer of mortgaged realty to an LLC will result in document stamp tax liability to the extent of the unpaid mortgage encumbering the realty transferred. *Department of Revenue v. Race*, 743 So.2d 169 (Fla. 5th DCA 1999).

What are the general advantages of using a limited liability company business entity?

- A. Creditor protection. LLC members have limited liability to the extent of capital contributed. LLC member interests can only be attacked by individual creditors to the extent of the "charging order". LLC members can manage business without personal liability.
- B. Avoidance of double income tax at the state and federal level. LLC is taxed as partnership, if properly constructed, and therefore acts as "pass through" tax entity.
- C. Family LLC (FLLC) offers flexible planning options. FLLCs can be used to accomplish "estate freezing" of values by creating multiple classes of voting and non-voting stock. FLLC interests can be transferred between family members in order to shift income and wealth.
- D. Management of LLC can be centralized. Members or non-members can be used to fill management roles.
- E. LLC can be used to consolidate wealth in one entity to provide economies of scale and centralized control of assets within the LLC.
- F. LLC can be used to avoid ancillary probate.

- G. LLC has all advantages of “flow through” or “pass through” tax entity, however, beware of loss deduction limitations imposed by *Code Sec. 469* and basis limitation rules.
- H. LLC members can specially allocate income, gains, losses, credits and deductions to accomplish income shifting so long as allocations have substantial economic effect as per *Code Sec. 704*.
- I. LLC members can convert passive losses into active losses or vice versa due to characterization of member.
- J. LLC can generate multiple valuation discounts, i.e., lack of marketability and minority discounts, for estate tax planning purposes.
- K. LLC can have individuals or any other legal entities as members. This facilitates financing businesses. Ideal for joint ventures. Ideal for holding or developing real property.
- L. LLC members tax basis is increased by member’s proportionate share of recourse or non-recourse liabilities for entity.
- M. LLC members can receive distributions of appreciated property from LLC without taxable gain at entity level or at member level if member has enough basis to absorb value of distribution.
- N. LLCs can elect “S” or “C” corporation tax treatment and single-member LLCs can do likewise.

What are the relative disadvantages of a limited liability company?

- A. LLCs lack extensive litigation history across the country.
- B. Transfer of LLC interest subject to consent of other members.
- C. LLC must have a substantial business or investment purpose in order to obtain estate or gift tax valuation discount.
- D. LLC member/employees are not eligible for non-taxable fringe benefits like health insurance, medical reimbursement, group term insurance, etc.
- E. Members of LLC who actively manage business must pay self-employment tax on distributive share of LLC income. *Prop. Reg. Sec. 1.1402(a)-18(a)* and *Priv. Ltr. Rul. 9432018*.
- F. Possibility that IRS might argue that member has retained complete control over LLC assets and therefore LLC assets would be included in member’s estate.
- G. Conversion of “C” or “S” corporation to an LLC where there are appreciated assets may cause taxable gain.

What are the estate planning features of a limited liability company?

- A. LLCs receive a *Code Sec. 1014* step-up in basis (both “inside” and “outside” basis) when member dies. Subchapter “S” owners get only “outside” basis step-up in basis upon death.
- B. LLCs can distribute appreciated property to members without gain (unlike “S” corporation).
- C. LLCs provide flexibility since members can be of different classes and different entities (such as grantor trusts). With an “S” corporation, using a grantor trust can result in phantom income and upon grantor’s death, the eligibility for “S” status is limited.

- D. LLCs allow use of “estate freeze” techniques previously utilized prior to enactment of *Code Sec. 2036(b)* (anti-Byrum provisions). One class of members could be “voting” members of LLC and another class could be “non-voting”.
- E. Complex trusts could be LLC members.
- F. “S” corporation could form LLC.
- G. “C” corporation could form LLC.
- H. Active participation by LLC member creates either active income or loss to member thereby escaping passive loss rules of *Code Sec. 469*.
- I. LLCs create possible discounts in valuation of LLC property for estate tax purposes (lack of marketability, minority discounts).
- J. LLCs could be used as an alternative to an irrevocable life insurance trust.
- K. Transfer of real property to LLC avoid ancillary probate of the realty.
- L. Member’s interest is subject only to creditor’s “charging order” (same as limited partner).
- M. LLC provides a mechanism for control of assets by the older generation while increasing the younger generation’s ownership and participation in a family business.
- N. Asset protection provided to members for business generated liability.
- O. Foreign ownership permitted.

LLC COMPARISON CHART

	LLC	C CORP	S CORP	GENERAL PARTNERSHIP	LTD PARTNERSHIP
How is income taxed?	As partnership (unless "S" or "C" corporation elected and single member LLC is Schedule C)	At corporate level and shareholder level	Typically taxed at shareholder level	Not taxed at entity level; pass through to partners	Not taxed at entity level; pass through to partners
What are tax consequences of distribution?	No gain to members	Gain recognized at corporate level	Gain recognized	No gain to partners	No gain to partners
Income taxed by Florida?	No	Yes	No	No	No
Liability to owners?	Limited	Limited	Limited	Unlimited	General partner, unlimited; Limited partner, limited
May owners freely transfer interests?	No	Yes	Yes	By agreement only	By agreement only
Term of existence?	Term of years or perpetual	Perpetual	Perpetual	Indefinite	Indefinite
How managed?	Members or special managers	Board of Directors	Board of Directors	All partners	General partners
Who can be owners?	Unlimited. Any person or entity.	Unlimited. Any person or entity.	75 max. Only individual, subject to exception	Unlimited	Unlimited
What is the effect on owner's tax basis when entity increases liabilities?	Basis increased by share of liability	None	None	Basis increased by share of liability	Basis increased by share of liability