

An LLC's failure to follow certain rules can result in personal liability. Do you know the rules?

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How to Form and Operate an LLC

Introduction

The life cycle of a limited liability company (LLC) is comprised of two major phases: 1) formation, and 2) operation. While the formation of an LLC is important, its operation is critical for ensuring the LLC maintains its limited liability protections for its members and managers.

LLC Formation and Operation

A properly formed LLC will provide limited liability to its members for the LLC's liabilities. Although an LLC can begin conducting business as soon as its articles have been filed, it is generally best to wait until the articles of organization have been approved by the Arizona Corporation Commission. Although the approval time for the Arizona Corporation Commission varies, expedited articles of organization are generally reviewed within several business days of their submission. The reason this is important is if the LLC's articles of organization are not approved, subsequent amendments could affect any business contracts the LLC previously entered into on the LLC's behalf. As a result, it is generally wise to hold off on conducting business in the name of the LLC until the LLC's articles have been approved.

Operating Steps After LLC Formation

Upon the receipt of the approved articles of organization the LLC members and or managers, depending on the LLC's managerial structure, should engage in the following steps:

Step 1 – Hold Inaugural LLC Meeting

Unlike corporations, LLC's are not required to file an annual report with the Arizona Corporation Commissions. *However, the conducting of regular meetings as a means to satisfy corporate formalities is one way to reduce a creditor's chances of successfully holding an LLC member personally liable for the LLC's obligations.* Even a single member LLC should make a record of management decisions in a business log.

LLC meetings do not have to be time intensive or costly but should be memorialized with minutes for record keeping purposes. Record keeping and the keeping of corporate formalities are one way to help prevent a creditor from placing personal liability on an LLC's member. Minutes should be kept periodically throughout the year reflecting all business decisions.

For practical purposes, an inaugural meeting is especially important for determining the following issues:

- Responsibility for obtaining the Federal Identification Number (EIN);
- Determining responsibilities within the LLC for purposes of conducting the day to day operations of the business;
- Responsibility for keeping the minutes; and
- Responsibility for opening the business bank accounts.

A record of the assignment of these responsibilities should be reflected in the minutes.

Step 2 – Prepare Operating Agreement

An operating agreement is a document adopted by the members of an LLC setting forth how the business of the LLC is to be conducted. These financial and working relationships can be wide and varied and it is important that these topics are clearly addressed within the LLC's operating agreement.

An operating agreement should set forth how the following issues are to be managed:

- Membership rights;
- Membership interests in the LLC;
- Voting rights for member / managers;
- Diversification of operational duties and obligations;
- Meeting requirements;
- Capital contributions – cash, property or services;
- Percentage of ownership;
- Distributions;
- Profit and losses allocation;
- Liabilities;
- Creditor issues;
- Taxes;
- Termination issues;

- Community property issues;
- Buyout, buy-sell or death provisions; and
- Dissolution requirements.

Without an operating agreement, default laws within your state may be used by the court to address issues that would have been otherwise addressed within the LLC's operating agreement.

Although Arizona law does not mandate the use of an operating agreement for an LLC, it can be a very helpful document to set forth how the LLC is to be run by the members or managers as well as how profits and losses are going to be appropriated.

Step 3 – Obtain Employer Identification Number (aka Tax Id. Number)

An EIN is a number given to a business entity by the IRS. The number can be used to transact most of a business' needs including:

- Opening a bank account;
- Applying for a business license;
- Purchasing an existing business;
- Changing the legal character/ ownership of the organization;
- Filing tax returns;
- Acting as a withholding agent for taxes on non-wage income paid to an alien;
- Compliance with the IRS withholding regulations for foreign citizens;
- Representing an estate that operates a business after the owner's death; and
- Administering an estate formed as a result of an individual's death.

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Generally, an EIN can be used immediately upon its receipt but for some services, the number must first become a part of the IRS' permanent records which can take several weeks.

Immediate EIN use:

- Opening a bank account;
- Applying for a business license; and
- Filing tax returns by mail.

Non-Immediate EIN Use

- File electronic return;
- Make electronic payments;
- Pass an IRS Taxpayer Identification Number Match Program.

An Employee Identification Number (EIN) is generally required for:

- Starting a new business;
- Purchasing an existing business;
- Forming an LLC, PLLC or INC;
- Forming a partnership;
- Changing the legal character / ownership from one form of entity into a different entity; or
- Opening a bank account that requires an EIN for banking purposes.

An Employer Identification Number (EIN) is not required if the following occurs:

- A corporation files papers with the state to convert to an LLC and will elect via Form 8832 to be taxed as a corporation;
- The number of members in the LLC changes from more than one member to a single member;
- A sole proprietor files papers to become a state recognized entity, organizes as an LLC, and will file Form 8832 or Form 2553 to elect to be treated as a disregarded entity or taxed as a corporation or small business corporation.

Opening a Bank Account

In order to open a bank account, the following documents will generally be required:

- A valid government issued photo identification card of a member of the LLC with the authority to open a bank account for the LLC;
- A copy of the filed articles of organization; and
- The LLC's Employer Identification Number (EIN).

Certificates of Good Standing

A Certificate of Good Standing is a document issued by the Arizona Corporation Commission. The document is generally requested by lending institutions to insure the LLC or PLLC is in fact in 'good standing' with the Arizona Corporation Commission.

Additionally, absent any qualifying statements contained in the Certificate of Good Standing, each Certificate of Good Standing issued by the Arizona Corporation Commission can be relied on as conclusive evidence as to the veracity of the statements contained in the Certificate.

A Certificate of Good Standing will contain the following:

- Name of the LLC or PLLC;
- Date of its organization;
- LLC or PLLC is organized under the laws of Arizona; and
- LLC or PLLC is in good standing according to the records of the Arizona Corporation Commission.

If the LLC was formed under the laws of another state (e.g. foreign LLC or PLLC), the Certificate of Good Standing will set forth the following:

- The LLC or PLLC's name;
- The LLC or PLLC is authorized to transact business in Arizona; and
- The LLC or PLLC is in good standing in Arizona according to the records of the Commission.

Transferring and Titling Real Estate Property In or Out of an LLC

Transferring Title into an LLC

If you are the owner of multiple investment/rental properties, it may be advantageous to title each property into a separate LLC. The purpose for this is to help protect the value of each property from a third party in the event of a lawsuit involving only one of the investment/rental properties.

Further, effectively titling properties under different LLC's can prevent a creditor from being able to attach their claims to properties unrelated to the lawsuit in their claim for damages. Also, lenders may prefer lending to "single purpose entities" because it limits their risk. Specifically, a loan to an LLC owning only one investment property is generally not subject to the additional potential liabilities of an LLC that is engaged in numerous activities, including the management of several properties.

Example: Joe has four (4) rental properties which are all owned by his LLC named "Joe's Rentals." If Joe's company "Joe's Rentals" is sued, the third party suing could attach their claims to *all* the properties held by "Joe's Rentals." On the other hand, if Joe had placed each one of his rental properties in a different LLC, then the

third party suing would generally only be entitled to attach their claims to the value of the one LLC which only owns the one rental property in question, effectively saving Joe's other three rental properties from the creditor's claims.

Transferring Title out of an LLC

To transfer real estate out of an LLC, a deed transferring ownership from the LLC to another person or entity needs to be executed and recorded. It is important to speak with an attorney regarding a possible acceleration clause issue that may arise by this transfer.

To conform with LLC requirements, the deed needs to be signed by either:

- One or more of the managers of the LLC (if management is vested in one or more managers); or
- One or more of the members of the LLC (if management has been reserved to the members).

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