**8797. What is an LLC and how is an LLC formed?**

A limited liability company (LLC) is a noncorporate business entity. There are no provisions that provide for LLCs in the IRC, as there are with respect to partnerships and corporations. An LLC is created strictly at the state level with the enactment by the state legislature of an LLC Act or Code.

An LLC, by its nature, provides limited liability for its members, absent personal guarantees. Generally, all members may participate in the management of an LLC. Most state statutes provide that an LLC must have at least two members, although a few states allow one-member LLCs. An LLC is formed by drafting a document called the articles of organization and filing it with the appropriate state agency. This initiating document is similar in scope to a C corporation’s articles of incorporation (see Q 8777).

The LLC will also create an operating agreement that generally dictates how the organization will be operated and sets out the rules that govern interaction between its members. The contents of both documents set out the framework for the LLC. The way these documents are drafted becomes especially critical in states that have flexible LLC statutes, since the wording of these documents may determine whether the entity will be classified as a partnership or a corporation for federal tax purposes.

The operating agreement, unlike the articles of organization, generally is not filed with a state agency. The operating agreement is similar in scope to a partnership agreement or limited partnership agreement in that it sets out the rights, duties and responsibilities of the members. It provides the guidelines by which the LLC will operate on a day to day basis.

The contents of the operating agreement have proven crucial in determining whether an LLC lacks a preponderance of corporate characteristics and may be afforded partnership tax treatment. Revenue Procedure 95-10[[1]](#footnote-1) provides valuable guidance in drafting an operating agreement so as to avoid a preponderance of the corporate characteristics. In states with flexible LLC statutes, the IRS will look to the particular LLC’s operating agreement in order to determine the existence or nonexistence of the corporate characteristics.

The operating agreement will typically contain provisions relating to:

name, purpose and term of the LLC;

names and addresses of the members;

rights, powers and duties of the members and their scope of authority;

scope of authority of the managers and how the managers are to be chosen;

capital contributions of members;

approval of transactions;

allocation of income, profits, losses, expenses, equity and distributions;

compensation of members and/or managers;

provisions for holding meetings, voting and other formalities;

how fiscal matters such as books, records, accounting methods, etc., will be handled;

how interests in the LLC may or may not be transferred;

limitation of liability and indemnification;

any other provisions applicable to the operation of the organization.

One of the unique characteristics of an LLC is that it is a business entity that may provide for management by all of its members. Unlike an S corporation, an LLC has no restrictions on the number or types of owners and multiple classes of ownership are generally permitted. Management status may be determined by the particular state’s LLC act, but most likely will be determined by the LLC’s operating agreement.

**Planning Point:** It is also possible to structure the entity to be “manager managed.” Under this approach, certain individuals are designated to manage the entity. This is analogous to having voting and non-voting stock in the corporate context or with a limited partnership (which is managed solely by its general partner).

If the LLC is treated as a partnership, it combines the liability shield of a corporation with the tax advantages of a partnership (see Q 8764).

1. 1995-3 IRB 20. [↑](#footnote-ref-1)