



The Importance of Treating Your LLC as a Business

By: Cecil Smith, JD & Carol Gonnella, JD



Now that you have formed an LLC for your client, it is very important for your client to treat the LLC as an independent and separate entity from his other affairs. Among other things, your client's goals are to:

- Protect his assets from future creditors;
- Protect his other assets from any claims made against the LLC;
- Have centralized management for future generations;
- Protect the assets against failed marriages;
- Facilitate transfers among family members;
- Obtain discounts for estate and gift tax purposes, or for purposes of a sale to family members or trusts for their benefit.

The IRS often attacks these discounts in LLC planning. Their attacks are sometimes based upon the fact that the taxpayer has not treated his LLC as a separate and distinct business entity. Often these attacks are based upon the following arguments:

1. The creator of the LLC treated his LLC as a personal cash register and did not respect the business entity.
2. The LLC was created solely for tax avoidance, and did not reflect the reality of the creator's actual relationship to the now gifted or sold interests.

To counter the IRS's attacks based upon these concepts, it is important that care is taken by the attorney in the formation of the LLC, and thereafter the client must treat his business as a business by following the roadmap below.

1. The formal requirements of the state law in forming the LLC must be followed precisely.
2. A federal tax ID number must be obtained.

3. There are no long delays between the date of forming the LLC and funding assets into the LLC.
4. Assets used to fund the LLC should be actually titled in the name of the LLC.
5. There should be no commingling of any LLC funds with personal funds.
6. The LLC must have its own checking account. All income generated by the LLC assets should be deposited into this account, and all salaries, disbursements and other expenses should be paid from it.
7. The LLC must be compensated for any personal use of an LLC asset by any of its members.
8. The member(s) should not transfer all of their assets into the LLC. The LLC is a business and it is not customary or reasonable for a person to have all of his assets in his business.
9. The manager has a fiduciary duty to the members. It is important that the manager respect these duties.
10. The managing member should be paid a management fee. This fee should be "reasonable compensation" based upon services rendered, especially if such a fee is called for in the LLC Operating Agreement.
11. After a member's death, the LLC should continue to operate as the IRS will be able to argue that the LLC was created solely for tax purposes if it were immediately dissolved.
12. Distributions should be made pursuant to the Operating Agreement, which in most cases require that the disbursements are to be made on a prorata basis. All distributions should be made at the same time and in proportion to the ownership interests.

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13. Only the manager should run the day to day affairs of the LLC. If non-managing members are permitted to run the business, the IRS could argue that the LLC entity is not being respected.
14. The LLC books and records should be maintained with care. Often CPAs handle these documents.
15. The manager of the LLC must file annual income tax returns for the LLC and ensure that the members receive K-1s to attach to their income tax returns.
16. Although minutes are not mandated by many state LLC statutes, it is always a good idea to have minutes of LLC meetings ... preferably at least once a year.
17. It is advised that the manager contact the insurance carrier insuring the assets of the LLC to have the titling of the insurance done correctly.

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Following the above rules goes a long way to deflect the IRS argument that there is an implied agreement or understanding between the creator of the LLC and the other members that the creator is retaining too much control, enjoyment and economic benefit from the property transferred to the LLC.

If a client's objective is to obtain substantial creditor protection or if the client wants to receive justified valuation adjustments for the gifting or sale of units to family members, it is important to research which jurisdiction is favorable for these two issues. The contributors have found that the Wyoming Close LLC (W.S. 17.25 et seq) is one of the best in the country for both creditor protection and discounting of business valuation.

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