Limited Liability Companies
An Alternative to Joint Ventures

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A new form of business organization, the Limited Liability Company (LLC), could present new planning opportunities for business owners. Basically, the LLC is treated as a partnership for tax purposes, but affords partners protection against liability for the acts or conduct of other partners. It is a new type of entity, a hybrid between the corporation and the partnership, that is a creature of the state law under which it is organized. Most states now have LLC statutes and, although LLC laws vary from state to state, there are some common threads that characterize the LLC. It is definitely a vehicle to consider as an alternative to the traditional business organization, as well as in the context of a joint venture.

The Economic Advantage: Tax Treatment as a Partnership

Most importantly, if structured properly, an LLC will be classified as a partnership that is not subject to federal income tax at the entity level. Earnings over the life of the enterprise, and gain if the project is sold at a profit, are taxed to the owners (known as "members"), but the venture itself pays no tax. Additionally, no member of an LLC is personally liable for the venture's obligations. An LLC also has the advantage that its members are not required to avoid participation in management in order to be shielded from the liabilities arising out of the venture. This is particularly important in construction companies and construction joint ventures. Members and managers of LLCs will not, however, avoid personal liability for their own negligent acts and omissions.

Corporations pay taxes on their earnings and, generally speaking, stockholders are taxed again when those earnings are distributed to them. There are also two levels of tax if the stockholders want the corporation to sell appreciated assets and distribute the proceeds to the stockholders. Historically, most joint ventures have been structured as partnerships to avoid two levels of tax, but the participants have been forced to face the possibility of being, in practical effect, guarantors of the joint venture's obligations. If properly structured, the LLC limits the liability of the joint venture participants and permits partnership treatment for income tax purposes.

Qualifying Characteristics

The Internal Revenue Service looks at four characteristics to determine whether an association should be treated as a partnership or taxed as a corporation under federal tax law. If corporate characteristics

predominate, the LLC will be taxed as a corporation; a tie results in partnership treatment.

Therefore, in general, to be treated as a partnership for federal income tax purposes, an LLC must lack at least two of the following corporate attributes:

1) continuity of life;
2) free transferability of interests;
3) centralization of management; and
4) limited liability.

Limited Liability

By definition, an LLC automatically has this corporate characteristic. Practically speaking, an LLC can therefore possess just one of the other three characteristics. Joint venture participants will often find that these other restrictions are consistent with the essential business objectives of the venture participants.

Centralization of Management

Under U.S. Treasury Regulations, centralization of management means that a person, entity, or narrow group (either from inside or outside the overall membership) has continuing, exclusive, and unilateral authority to make management decisions. A member-managed LLC generally will not have this characteristic, and a manager-managed LLC generally will. When member-managers behave more like general partners than shareholders of a corporation, management tends to become less centralized. This is a very fact-sensitive issue. Sometimes it can be difficult to distinguish between centralized and non-centralized management, so facts and circumstances most definitely come into play.

Free Transferability of Interests

To transfer a membership interest means to completely confer upon the transferee all attributes of ownership (including rights to vote, act on behalf of the LLC, share in the profits, etc.). Restricted transferability of LLC membership is a corollary to a general feature of partnership interests. Like partners, LLC members cannot transfer their ownership and compel their co-owners to be in business with someone they consider to be undesirable. LLC statutes usually ensure that member interests are not freely transferable by requiring that at least a majority of the non-transferring members consent to the transfer. States vary by the degree to which consent of the co-owners must be obtained. Some require unanimous consent and some require majority consent. Joint ventures typically do not allow for new members or, at the very least, require the consent of all members before a new participant can be admitted. Consequently, restricting transfer of members' interests is a business objective common to

joint ventures, as well as a requirement to avoid treatment as a corporation for tax purposes.

It is important to note that the concept of free transferability contemplates all of the rights and privileges of ownership, so an assignment to a transferee of an economic interest in the profits and distributions of an LLC is not necessarily the same as a transfer of the membership interest itself. Freedom to transfer economic interests does not constitute free transferability of interests.

Continuity of Life

Under federal tax regulations, a business organization lacks continuity of life if it is required to dissolve upon the death, insanity, bankruptcy, retirement, resignation, expulsion, or other event of withdrawal of an equity owner. Similar provisions are generally written into LLC statutes as an organizational requirement. Joint ventures are commonly limited to a specific construction project. If one participant becomes bankrupt or otherwise ceases to exist, the parties in a joint venture would expect to revisit their arrangements. Therefore, as a practical matter, lack of continuity of life is manageable for a joint venture.

If the LLC lacks free transferability of membership interests and lacks continuity of life, it should be characterized as a partnership. Since construction joint ventures typically involve specific firms without any intention to continue without any one of the participants and no intent to allow transfer of membership interests, these restrictions work in concert with the business purpose of the construction joint venture. Of course, the exact terms of the arrangement must be tailored to the business deal and reviewed by legal and tax experts to ensure that the desired result can be achieved.

The Structural Advantage:
Flexibility and Versatility

The economics of LLC interests can have all of the variety of partnership interests. In the simplest joint venture structure, the participants will share profits and losses in proportion to their relative contributions to the venture. In more complex transactions, the members may have shifting interests in profits over the life of the LLC or some members may receive a specified rate of return, while other members split all remaining profits. Moreover, different members of an LLC can receive cash or property at different times. This flexibility is hard to achieve using the corporate form.

The identification of one party as "leader" or "manager" that is customary in construction joint ventures is also permitted under the LLC form. If one participant in the venture is responsible for managing the project, he or she could be the managing member and the other participants

could have rights to approve or veto budgets and changes to plans, or whatever other rights were specified in the operating agreement. If the participants have already identified the individual who is to have day-to-day responsibility, that individual can be named in the operating agreement as the manager; the managers of an LLC need not be owners - they can be appointed or elected by the owners.

Decisions for the LLC can be made by one owner or manager or by a board or committee that functions much like a board of directors. An LLC can also be structured with management using a general partnership model, with all owners sharing management. Consequently, the organizational structures necessary in the construction joint venture are attainable within the LLC.

The operating agreement can set forth not only the general management rights and responsibilities of the parties, but also the designation of operational roles of the participants, as well as establishing any joint panels within the venture. This type of organization, often essential in construction joint ventures, does not fit well in the framework of traditional general or limited partnerships.

Under the most flexible state statutes, the management structure can be adapted to the needs of the parties and modeled on whatever format works best for the project they have in mind. In some states, LLCs can have officers and by-laws that will also make it easier to build a management structure on a corporate model. The state laws authorizing LLCs are not uniform. Those responsible for structuring a joint venture must carefully consider the relevant state statutes and must be sure that the applicable statutes permit the structure desired for a particular venture. State level taxation of LLCs is also not uniform. Some states will treat an LLC for state tax purposes the same way it is treated under the Internal Revenue Code. In those states, if an LLC was structured to be treated as a partnership, it should not be taxed as an entity by the state. Other states, notably Texas and Florida, tax LLCs as if they were corporations.

The great variety in potential economic rights and management options also means that unless the basic organizational documents of an LLC are drafted carefully, there may be room for subsequent argument about the rights and responsibilities of the different participants. If it is not clear who has the authority to act on behalf of the LLC, operating problems will likely result. Confusion about the parties' economic rights can affect whether the parties' projected returns will be realized; it can also change their funding obligations or the value of their interests in the venture at the end of the day. Furthermore, unless structured with applicable federal income tax constraints in mind, the flexibility afforded by many state statutes can result in an LLC having too many "corporate" characteristics, causing it to be taxable as a corporation under the Internal Revenue Code.

Conclusion

Before LLCs became available, many joint ventures were structured as general partnerships, with the participants creating special purpose corporations to be the partners. (For practical, as well as legal reasons, this approach is rarely found in contractor entities.) So long as the partners and the business were properly structured, adequately capitalized, and the requisite formalities were observed, the ultimate owners expected to achieve limited liability.

The LLC is a new business form that seems particularly well suited to joint ventures. The use of an LLC can give the members of a construction venture the ability to contain liability at the venture level and to limit the liability of the companies forming the venture.

While the use of a limited partnership would have protected all but one of the partners (the general partner), the limited partnership has never proven to be a widely-accepted entity for construction companies/ventures. The failings of the limited partnership - managerial restrictions, surety opposition, and owner resistance - need not exist when using an LLC. Organizing a limited liability company will probably not change the rights and remedies available to project owners, who can be expected to require the same completion guarantees and other protections as they have before. Bonding and surety companies will also project their rights as a matter of contract with both the LLC and the individual members of the LLC. Nonetheless, the ongoing potential for liability that has historically been the result of doing business as a joint venture partnership can be minimized by a limited liability company structure.