

**JOHN CUNNINGHAM'S LLC NEWSLETTER
FOR TAX AND LEGAL PROFESSIONALS**

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**WHAT ACCOUNTANTS (AND LAWYERS, TOO) SHOULD
KNOW ABOUT THE MANAGEMENT STRUCTURES OF
SINGLE-MEMBER LLCs OWNED BY INDIVIDUALS**

EXECUTIVE SUMMARY

Both for legal and for tax reasons, the management provisions in an LLC agreement will normally be among the agreement's most important provisions. These provisions should be structured very differently depending on whether an LLC is owned by one individual; by one entity; or by two or more entities or individuals. Accountants should have at least a general understanding of how LLC management provisions should be structured. Lawyers who form LLCs should have a very detailed understanding of these provisions.

This newsletter addresses the legal and tax issues that arise in choosing management structures for single-member LLCs owned by individuals. Subsequent newsletters will address these issues as applicable to:

- Single-member LLCs owned by entities; and
- Multi-member LLCs.

DISCUSSION

**A. LEGAL CONSIDERATIONS IN DESIGNING THE MANAGEMENT
STRUCTURE OF A SINGLE-MEMBER LLC OWNED BY AN
INDIVIDUAL**

The management structure of an LLC means the set of rules in the governing LLC act and in the relevant LLC operating agreement that determines:

- Who may sign contracts on behalf of an LLC;
- Who may decide LLC issues (such as who shall be the managers of the LLC; whether and when the LLC will make distributions; and whether the LLC will be dissolved); and
- Who may conduct the LLC's day-to-day business.

Although accountants who are not lawyers are barred by ethical rules from drafting the management provisions and the other provisions in LLC agreements, they should have at least a general understanding of these provisions, so that if clients ask them to review LLC agreements for them from a financial or tax viewpoint, they can also warn their

clients if, in the course of their review, they see obvious errors in the LLC's management structure. As indicated, lawyers who draft LLC agreements need to have a very detailed understanding of LLC management structures.

Most or all U.S. LLC acts provide for two distinct LLC *statutory* management structures—the “member-managed” structure and the “manager-managed” structure. Under the former structure, any person who is a member of an LLC may perform any and all LLC management functions. Under the latter, these functions may be performed only by persons (whether members or non-members) who are specifically appointed as members in the LLC's LLC agreement. Under most U.S. LLC acts, including the New Hampshire act, whether an LLC is member-managed or manager-managed is determined by its articles of organization (called a certificate of formation under the New Hampshire LLC Act).

However, in the *real* world of LLCs (as opposed to the *statutory* one), there is far more to an LLC's management structure than indicated by any LLC act. In the real world, single-member LLCs owned by individuals can any of three quite different management structures.

- 1) Member-managed single-member LLC. If the certificate of formation of a single-member LLC owned by an individual provides that it is *member*-managed, then, by statute, the individual who is the LLC's member will also automatically be its manager.
- 2) Manager-managed single-member LLC with member as manager and with one or more assistant managers. If the certificate of formation of such an LLC provides that the LLC is *manager*-managed, then, in the LLC's LLC agreement, the member will normally appoint himself or herself as the LLC's manager but may also appoint one or more other persons who are not members to serve as assistant managers. (In LLC jargon, these assistant managers are called “non-member” managers.)
- 3) Manager-managed single-member LLC with non-member managers. If the certificate of formation of such an LLC provides that the LLC is manager-managed, then, in the LLC agreement, the member may also appoint a *non*-member as the LLC's manager (and may also appoint one or more *other* non-members as assistant managers if the business needs more than one manager).

However, there is a strong statutory argument that if the certificate of formation of a single-member LLC owned by an individual provides that the LLC is member-managed, then the *only* person who may lawfully manage the LLC is the member. If this legal argument is valid, then if, because of illness, absence or otherwise, the member of a member-managed single-member LLC owned by an individual is unable to manage the LLC, then the LLC's management will grind to a halt and *no one* will be able to substitute for the member in depositing checks for it, paying bills for it or performing any other management functions for it.

Thus, to provide for continuity of management in the event that something happens to the member, the certificate of formation of a single-member LLC owned by an individual should almost always provide that the LLC is manager-managed, and the LLC's LLC

agreement should almost always appoint the member as the LLC's manager and one or two non-members as assistant managers. In the case of many small single-member LLCs owned by individuals, the best assistant manager will often be the member's spouse.

However, if the individual who owns a single-member LLC wants to avoid the hassles and the potential legal liabilities of a manager, then, in the LLC's LLC agreement, this individual should appoint one or more *third parties* as the LLC's managers.

- In the case of an LLC that operates a convenience store, the manager might be an individual whom the member knows to be a competent and trustworthy store manager.
- In the case of an LLC that owns and operates an apartment building, the manager might be a property management company. However, there should be a well-drafted property management agreement between the LLC and this company, which should provide, among other things, that the manager is fully insured and will have exclusive liability for any claim against the LLC.

B. FEDERAL TAX CONSIDERATIONS IN DESIGNING THE MANAGEMENT STRUCTURE OF A SINGLE-MEMBER LLC OWNED BY AN INDIVIDUAL

The following are the main tax considerations that accountants should be aware of in reviewing the management structure of a single-member LLC owned by an individual:

- 1) Accountants should be aware that whether the LLC is member-managed or manager-managed, the member will owe full-freight Social Security Tax on the LLC's income if the LLC is taxable as a sole proprietorship (which will be the federal income tax structure of a single-member LLC owned by an individual if the LLC doesn't file an S election).
- 2) Whether the LLC is member-managed or manager-managed, the member will owe Social Security Tax only on the net income of the LLC if the LLC does file an S election.
- 3) However, if the LLC is manager-managed and files an S election and if, under its LLC agreement, the member is not appointed as a manager, this will assist the member in arguing that he or she is not active in the LLC's business and thus ought not to be liable for Social Security Tax on its net income.