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Formation of a Limited Liability Company (LLC)

The following is a short brief regarding the nature of the LLC (and especially the Delaware LLC), and the advantages this legal entity offers.

What is a Limited Liability Company?

A Limited Liability Company ("LLC") is a separate legal entity that offers an alternative to partnerships and corporations by combining the corporate advantages of limited liability with the partnership advantage of pass-through taxation, which means the LLC profits and losses are passed through the business and taxed solely on the members' individual tax returns. An LLC is created and comes into existence when articles of organization are filed with the proscribed fees, and accepted by the proper state authority. An LLC must have at least one member in most of the states (except Massachusetts).

What is the structure of an LLC?

An LLC is owned by its members. The members of an LLC are like partners in a partnership or shareholders of a corporation. A member will more closely resemble a shareholder if the LLC utilizes a manager or managers, because under that situation the members will not participate in the management of the LLC. However, if the LLC does not utilize managers, then the members will more closely resemble partners because they will have decision making powers in the LLC.

The member's ownership in the LLC is represented by their respective "membership interest", in the same manner as a partner has an "interest" in a partnership or a shareholder has stock in corporation.

An LLC is managed by its members or by selected managers. If the LLC is managed by its members, it operates much like a partnership. Each member shares equally in the decision making process of the LLC. Alternatively, the members may choose to appoint a manager or managers to act in a capacity similar to a corporation's board of directors. The managers are in charge of the business affairs of the LLC.

If managers are not designated in the articles of organization, the members will be deemed to direct the business affairs of the LLC.

What are the advantages of an LLC?

Pass-Through Taxation. A limited liability company may be taxed either as a corporation or a partnership, depending on its structure. LLC's allow for pass-through taxation, allowing earnings of an LLC to be taxed only once. The earnings from an LLC are treated in a similar manner as earnings from a partnership, sole proprietorship and most S corporation. Dividend distribution is nontaxable, unlike an S corporation, where dividends are taxable.

If the LLC has only one member, then for federal tax purposes the LLC is disregarded, and the sole member is taxed as a sole proprietor. Current Treasury Regulations provide that a nonresident alien who is not engaged in a U.S. business and who does not derive any income from any source within the U.S. does not have to file a tax return. Similarly, Delaware law currently provides that a nonresident alien having no income from sources within the State of Delaware does not have to file a Delaware return.

Under the current IRS "check-the-box" rules, a Delaware LLC that does not affirmatively elect to be treated for tax purposes as a corporation will be treated for federal tax purposes as a partnership. It will be treated as a partnership for Delaware tax purposes as well.

Limited Liability: The member's liability is generally limited to the amount of money which the member invested in the LLC. As a result, the members of an LLC receive the same limited liability protection as do shareholders of a corporation.

Flexible Organizational Structure: LLC's are generally free to establish any organizational structure agreed upon by its members. Thus, profit interests may be separated from voting interests.

What are the disadvantages of an LLC?

- The possibility of losing pass-through taxation if the LLC is not properly structured.
- More paperwork and documentation is needed than in an ordinary partnership (but no more than in a Corporation).

If an LLC wants to take advantage of pass-through taxation, it must meet certain requirements which have been established. To have pass-through taxation an LLC may not have more than two of the following characteristics of a corporation:

1. Limited Liability
2. Unlimited Life
3. Free Transferability of Interest
4. Centralized Management

The LLC will have limited liability, and if the LLC is managed by managers, the LLC will have centralized management.

In Delaware, the determination of the state tax status of a Delaware LLC is linked directly to its federal tax classification. Thus, an LLC which is taxed as a partnership at the federal level will also be taxed as a partnership in Delaware. Further, while many states impose significant fees on LLCs, sometimes based on the number of members or its income, Delaware imposes only an annual fee of \$100. From a state tax perspective Delaware is an attractive forum for forming an LLC.

To ensure federal partnership treatment, most persons forming LLCs will structure the LLC so that it lacks the corporate characteristic of continuity of life. Although the Delaware LLC Act specifically allows that an LLC may be formed without a set termination date, unlike a corporation which normally possesses perpetual existence, an LLC generally does not. If no length of time is specified in the LLC agreement, a Delaware LLC will dissolve after thirty (30) years.

Please contact our offices with any questions and comments.