

# Arizona Limited Liability Company Discussion

If you will be setting up a limited liability company in Arizona, the best time for discussion of questions is before preparing the operating agreement and filing the articles of organization.

This page will assist you in understanding common issues involved with a typical company. Associated topics about written operating agreements, profits and loss distribution, limited liability protection, tax treatment, membership rights and managerial duties are discussed.

What is an LLC?

A Limited Liability Company is a unique business organization permitted by state law. It is very similar to a partnership, but has the limited liability characteristics of a corporation. Tax treatment, management and ownership structure of an LLC differs from the corporate form of business.

Do you create Limited Liability Corporations?

Actually, not. While we do create LLC's, there is really no such animal as a limited liability corporation. If you are referring to creating a limited liability company, then, yes, we do.

How many people are required to start an LLC?

One, at least in most states, Arizona included. One person may be the registered agent, the single member and manager of the entity. In the past, most states required more than one member to start an LLC. The reason for this is that laws authorizing LLCs were patterned after partnerships.

Obviously, a partnership requires a minimum of two people, so the logic follows that LLC's would consist of at least two persons. However, the laws of most states have now evolved to authorize the single-member LLC.

Don't I need an attorney to form a limited liability company?

No. You will need to have an understanding of the procedural law regarding formation of the business to properly carry out the clerical tasks involved with filing the paperwork.

You should also be familiar with at least the general provisions of state law concerning limited liability companies. This is why our Arizona Operating Agreements contain numerous

provisions patterned after Arizona law.

With these operating agreements, you can see what "default" laws apply to operating an LLC. Then, you can make your decision as to whether or not your needs require any deviations or "tweaks".

Why form an LLC in the first place?

The primary purpose of forming a LLC is to take advantage of the "limited liability" properties this form of business provides. While incorporating also provides liability protection, most people choose an LLC because it is just plain simpler to maintain than a corporation is. Also, an LLC is usually easier to form and less expensive than incorporating is.

Another reason for its popularity is its use as an investment holding vehicle. LLCs are generally less complicated to set up when compared to drafting a trust. While the LLC is most commonly used as a form of business, it may also be inexpensively and quickly set up for use to own real estate and other types of property.

Formation requirements are minimal. If an Arizona LLC is utilized to hold property, as a general rule it will expose its owners to less capital gains taxes than that which would result with a corporation. A CPA or tax lawyer should be consulted for topical information on this subject.

What are the benefits of forming a limited liability company?

To be honest, this question is rather vague to answer directly. When most people ask this question, it usually means they have seen some advertising claims about LLC tax advantages. The truth is, these "advantages" depend on how you look at them.

Most companies that emphasize tax advantages as a selling point are overstating the benefits of the pass through taxation treatment of the entity by the IRS. If you think about it for a minute, you will understand this pass through feature is the same as with a partnership, a sole proprietorship (where there is no separate legal entity at all) or a Subchapter S Corporation.

Another term for the pass through tax feature is "disregarded entity". What this means, is for tax purposes, the LLC is disregarded. It doesn't exist as far as the IRS is concerned. The owners are individually responsible for income taxes on the profits and losses of the business. This is the same with an individual operating as a sole proprietor, or a partner to a partnership, or shareholder of a Subchapter S corporation.

Disregarded entity status does mean the LLC will not need to file tax returns. This may be an "advantage", since it simplifies things, but it is hardly a tax savings advantage.

However, there is an important tax advantage that an LLC has over a corporation in some instances. This advantage is with respect to company property which appreciates during the life of the company. Please call us for information on this tax benefit, especially if you plan on holding real estate under the LLC or will be using it as an investment holding vehicle.

What about double taxation of a corporation vs. a limited liability company?

Avoiding double taxation with a limited liability company tends to be another exaggerated benefit of a LLC over a corporation. Yes, it is true that a corporation pays income tax on its earnings, and then the same monies are taxed again when they are passed to directors in the form of salaries and to shareholders in the form of dividends.

With an LLC, this does not happen. But, a corporation has certain advantages over a limited liability company. With a corporation, you can pay yourself a salary and avoid paying FICA and withholding on the entire amount of profits through the year.

Gross profits, less your salary can then be distributed at the end of the year as a dividend. While you will pay taxes on that dividend, you will not have paid withholding, unemployment and FICA taxes on that sum. Also, as an employee of the corporation, your salary can be deducted as a business expense.

For LLC's, this is not possible. An individual is either an owner (member) or an employee of an LLC. A member cannot deduct his salary as a business expense. Salaries paid to non-owner employees, however, are deductible. Instead, a member must take his profits and losses on at least a quarterly basis.

Are you saying that incorporating is better than creating an LLC?

Not at all. In fact, Most people choose the LLC structure instead of incorporating when starting a new business. Especially when there is uncertainty in anticipated revenues, salaries, and business expenses.

When an entrepreneur endeavors into a new venture, they should be most concerned with protecting themselves and their personal assets from liability for claims and business liabilities. In this regard, a limited liability company is usually the least expensive and most practical choice.

As the business continues, and the entrepreneur has a more concrete understanding on expected revenue, costs and expenses, they will often review the tax treatment of different entities with a CPA. Even then, they will often elect a limited liability company over incorporating.

What should be remembered is that if corporate tax treatment presents advantages in the future, any LLC can elect to be taxed as a corporation, instead of having the default disregarded entity status. At the same time, remember that a corporation can be elected to be taxed as a partnership, i.e. the Subchapter S Corporation.

The point is, is to remember the reason for bothering with forming a limited liability company or incorporating in the first place, is to protect your self from personal liability. No matter whichever entity you choose to organize, you can always convert its tax treatment at a later time.

What are some advantages of an LLC?

Well, first, please read the above paragraphs. Other than taxation treatment, there are significant advantages of the LLC vs. a Corporation insofar as management, ongoing preservation of the company's limited liability qualities and with the flexibility of ownership rights.

First of all, preservation of the limited liability features of the company should be considered. When you incorporate, you must follow many formalities after the initial incorporation to ensure you have preserved liability protection to the directors and shareholders.

These formalities include holding and recording by way of corporate minutes scheduled meetings of directors and shareholders. Proper procedure for issuing stockholder shares and adherence to strict regulations governing corporate operations must be followed. If not, then the principals to the entity may be held personally liable for debts or other obligations. This is commonly referred to as piercing the corporate veil.

There are no requirements in Arizona for LLC's to hold meetings. No requirement exists to adopt a written operating agreement. Annual reports are not required to be filed in Arizona. So with a limited liability company, when you file Articles of Organization, the members and their personal assets are protected from liability for the companies obligations. This limited liability quality is extended to company members and managers without following the formalities incident to operating a corporation. This, in and of itself is a key advantage of the LLC business creation.

Regarding ownership rights, there may be instances where an LLC is advantageous to a corporation. For example, with an LLC, you may have a situation where ownership is contingent on the prospective members performance of a certain service. In Arizona, a promise to perform future services is not legal consideration for issuance of shares to a corporation.

What is a statutory agent?

A statutory agent is the same as a registered agent. In most states, the person designated to receive legal notice on behalf of a company is called a registered agent. Arizona laws call this

person a statutory agent. Arizona always tries to be different. That's why we don't observe daylight savings time, and stop you at the border in your car to steal your oranges. Hope you don't mind a little humor.

What does a registered agent do?

The registered agent can be any person located within the state where the company will be located. This person does not need to be involved with the corporation in any other manner. Being a statutory agent does not in itself give that person any management or ownership rights to the company.

Most people choose to serve as their own statutory agent to save expenses and to be certain they will directly receive any notices which the state forwards to the company. Registered agents are not required to have any qualifications such as licensing or bonding.

The agent should be at least 18 years of age. You may need to hire a registered agent, if you are forming a company in a state where you do not have a physical address.

What paperwork is necessary to form an LLC?

The only document absolutely required by law to establish an LLC are Articles of Organization, also referred to as Articles of Formation in some jurisdictions. Articles of Organization is a fancy word for a notice filed with secretary of state, corporation commission or state incorporation department. The criteria of information contained in the notice varies by jurisdiction. Arizona requires that the Articles be published in a legally endorsed newspaper.

Although it is not legally required to have an Operating Agreement in Arizona, your circumstance will require it, if you intend to operate the business in any manner different from the default rules of the Limited Liability Company Act. For example, if you would like your successor member to possess management and voting rights in the event of your incapacitation, then an Operating Agreement for your Arizona Limited Liability Company would be necessary.

Similarly, if you want a non-compete provision, a right of first refusal on transfers of members ownership interests, or to set certain rules for allocation of profits and losses, then an Operating Agreement is necessary.

Bear in mind that our operating agreements include terms patterned after default Arizona regulations. By knowing what default operating rules apply, you can decide on modifications in an informed manner.

What is the difference between a member managed and manager managed LLC?

Actually, less than what you would think. LLC's in Arizona can be member managed or manager managed. Member managed means that the owners will be responsible for management of the company. By law, each member has equal managing and voting rights, unless their operating agreements states otherwise.

When you think of a manager based LLC, you will usually envision a company where passive investors are the members and where non owners will handle company operations and management. But a manager managed limited liability company may exist where there are two or more owners and only one of those owners will be charged with management capacity. A manager is not necessarily an owner, but can be.

Or, you may have a situation where two or more owners will have equal management rights as in a member managed company, except for specially designated issues, where only one member will have sole discretion to make binding decisions. In that instance, somewhat of a hybrid limited liability company exists in that it is member managed, except for certain circumstances where a particular member has been designated to have management authority.

The point being is that you should not get too wound up in worrying about terminology with member managed or manager managed limited liability companies. The operating agreement is the binding authority, not the Articles of Organization. Contrary to what I have seen on numerous non-lawyer internet sites, member-managed LLC's are the most common designation on Arizona Articles of Organization.

What is a limited liability company Operating Agreement?

An Operating Agreement for a limited liability company can be oral or written. It is an agreement that can be entered by the members or, in the case of a manager managed company, an operating agreement would be entered between the managers and members.

A written operating agreement is not mandatory in Arizona. But if any departures from Arizona's default limited liability company laws are desired, then the instrument is necessary.

Standard issues which are covered in an operating agreement are startup capital, distribution of profits, allocation of losses and management rights. Other matters which may be included are buy-out provisions, withdrawal of members, restrictions on transfers of ownership interests, non-compete clauses, and right of first refusal for existing members to acquire a selling member's share.

With every Arizona Operating Agreement which we prepare, the first three pages consist of standard, default Arizona law containing operating rules for an LLC. We can change these provisions if desired, but by reviewing what laws apply in Arizona our clients are able to make

educated decisions regarding modifications, while anticipating their specific needs.

In addition to the clauses patterned after the law, terms and provisions addressing such matters as non-compete clauses, special voting provisions, withdrawal of members, dissolution and management rights of successor members are included. The terms and provisions of the Operating Agreement can then be modified for the client pursuant to their wishes.

Is an LLC better than an S Corporation?

This depends greatly on income and your business plan. Several factors should be considered. With respect to liability protection, there is no distinct advantage to either entity. As long as correct procedure is followed when forming and operating each entity, they will each protect the business principals from personal liability.

If you are asking the question with respect to ongoing taxation issues, then an S Corporation may be the more attractive vehicle, depending on the salaries paid to directors and officers, whether or not a medical care reimbursement plan will be offered, and what benefits are offered to employees. It is advisable to consult a CPA with specific figures when considering this topic.

However, many professionals, including CPA's, tax attorneys and business lawyers fail to look beyond the life of the business entity. The costs and tax liability incurred by the owners of a company when it is time to dissolve and wind down must be a part of any comprehensive tax strategy. Capital gains tax liability can be limited when dissolving the LLC when compared to winding down a corporation.

Is an LLC more affordable than a corporation?

When starting a new company, an LLC is usually less expensive to create than it is to incorporate. If the limited liability company will own assets, then an LLC is still probably the better choice from a tax standpoint. Further, being that a limited liability company can be operated without the formalities of a corporation, there is usually less need to involve a professional with matters such as directors and shareholders meeting, preparing records and minutes.

How is a limited liability company managed?

With an LLC in Arizona the members (owners) of the company vote and manage the company. The Articles of Organization, may however designate that the company is manager managed. In that case, the company would be managed by the managers designated in the Articles, and the management duties would be restricted to the terms of the Limited Liability Company Operating Agreement.

Frequently, the members of the company will each have equal rights to management, equal rights to profit sharing, and equal responsibility for contributing start up capital and funding necessary for continuance of the entity. However, it is quite possible to structure an Operating Agreement where the members have different proportional rights to management, allocation of profits and capital contribution responsibilities.

For example, theoretically, you could have an LLC where one member will have 90 percent management rights, with an obligation for only 5 percent of start up capital contributions. Similarly, you could have a situation where 3 or more members will each have equal voting rights, with one of the 3 members having a 90 percent interest in profit allocations. With a corporation, such an arrangement would be much more difficult to structure.

Does a kit come with your packages?

No, and the reason why is that limited liability companies in Arizona are not required to hold an organizational meeting of members or managers. Nor is a Arizona LLC required to hold annual meetings of its managers and members. Remember, the LLC is a completely different form of business than a corporation.

Some incorporation businesses, especially those on the internet, sell LLC kits. Included in most of those kits are forms, which upon review, are merely corporate kit forms interchanged with LLC language. For the most part, they simply replace the words "directors" with "managers" and replace "shareholders" with "members".

Use of that sort of package should be avoided when you are setting up an LLC. Be careful what sort of forms you execute when you start your limited liability company. By utilizing such forms, you may execute a document which binds you to run your LLC in the same manner as a corporation.

For example, if you execute an operating agreement, or sign minutes of an organizational meeting which states your company shall hold meetings of members on a quarterly basis, and then if you fail to do so, you may be leaving yourself vulnerable to piercing the corporate veil.

Again, one of the benefits of having a LLC as opposed to a corporation, is the ease of operational formalities which must be observed to maintain the companies limited liability features. Why would one immediately forego these benefits by executing any document which would require the LLC to adhere to corporate formalities?

What is the biggest disadvantage to starting an Arizona llc?

For additional topical information, you can read the overview of the [llc](#) business entity, how to

[form an llc in Arizona](#) and our page on [California formation](#) procedure.

This page speaks to topics inherent to limited liability companies with comparisons to Limited Liability Partnerships, Subchapter S Corporations and the sole proprietorship business form. Please see this page if you would like to hire us to [form an LLC in Arizona](#).