

Adding a New Member to an LLC (with Form)

Steven C. Alerty

Now that LLCs are popular entities, many are adding new members. Doing this safely requires considerable attention to the operational changes to the LLC and the document that brings the member on board.

Steven C. Alerty practices business organizations and tax law in Eugene, Oregon, and is the author of forms for the creation, operation, and termination of LLCs. These forms are available through Alerty Publishing LLC, at <http://www.alerty.com>.

LIMITED LIABILITY COMPANIES have been widely available in the United States for only about 10 years, and their popularity did not begin to skyrocket until 1997, when their federal income tax treatment was clarified by the check-the-box regulations. But LLCs have now been around long enough that practitioners are now seeing increasing numbers of LLCs that want to admit new members in order to obtain additional capital or human resources. Adding a new member can cause fundamental changes in the LLC, and often requires amendments to its operating agreement and attention to tax issues.

This article reviews the nature of the changes that result from the admission of a new member of an LLC and highlights the document drafting issues to consider. The article also reviews the income tax consequences that may result from adding a new member to an LLC.

ARTICLES OF ORGANIZATION • It is possible, although unlikely, that the articles of organization of an LLC will need to be amended when a new member is admitted. Adding a new member does not affect the existence of an LLC as an entity. An LLC is treated as an entity separate from its members as a matter of state law, and membership changes do not alter this status. Even LLCs with one member, which are disregarded as entities for federal income tax purposes, are recognized as separate entities in the 49 states that permit their creation.

Articles of organization of an LLC, whether for a single member LLC or a multi-member LLC, typically include only limited information designed to let persons dealing with the LLC know that the LLC exists, where to locate the LLC, and how to serve the LLC with process. Accordingly, amendment of the articles of organization of an LLC is not normally required when a new member is added.

Amendment of the articles of organization will, however, be required if the admission of a new member is an occasion to convert the LLC from one managed by its members to one managed by managers, or vice versa. The form of management is typically selected in an LLC's articles of organization, so a change in this regard requires an amendment of the articles.

INCOME TAX STATUS • Adding a new member to an LLC also does not affect the

status of the LLC for federal income tax purposes, so long as the LLC already has at least two members. A multi-member LLC is treated as a partnership for tax purposes, except in the rare case that the LLC has elected to be taxed as a corporation, and this status is not altered if a new member is added.

Single Member LLC + New Member=Partnership

But adding a new member to a single member LLC does result in a change in tax status. A single member LLC is not recognized as an entity separate from its owner for federal income tax purposes, unless the LLC has elected to be taxed as a corporation. When a new member is added, a single member LLC is converted from a disregarded entity to an entity taxed as a partnership. A partnership is a pass-through entity, and its income or loss is passed through to its partners to be reported on their individual income tax returns. As a result, the primary consequences of a single member LLC's becoming a partnership for tax purposes relate to its tax reporting obligations.

Reporting Requirements

A single member LLC that adds a new member will, for example, be required to file a partnership tax return for the tax year beginning on the date of the admission of the new member and for subsequent tax years. As a partnership, the LLC will also be required to obtain an employer identification number. Single member LLCs typically use the Social Security number of their member as their taxpayer identification number, and even if the LLC has employees and withholds taxes from wages, any employer identification number that has been obtained in connection with the business of the LLC will be in the name of the single member, and not the LLC. When a single member LLC adds a member it will also be in a position to make the tax elections that are made at the partnership, rather than the partner, level, such as selecting a tax year, adopting accounting and depreciation methods, and electing to amortize organizational costs.

OPERATING AGREEMENT • Although the articles of organization of an LLC typically do not need to be amended when a new member is admitted, the operating agreement will require amendment, and may even need to be rewritten.

New Member Alters Operation

If a new member is admitted to a single member LLC, a new operating agreement will almost always be required. The internal structure of a single member LLC is fundamentally altered when a second member is added. Operating agreement provisions relating to members' rights and obligations that are suitable for an LLC with one member need to be changed to accommodate the conflicting interests that necessarily arise when there is more than one member, and consideration needs to be given in the operating agreement to issues such as members' voting rights, members' rights to profits and distributions, and restrictions on transfer of members' interests that do not exist with a single member LLC.

Default Rules May Be Unsatisfactory

Under section 103(a) of the Uniform Limited Liability Company Act and the LLC

statutes of most states, an LLC does not necessarily need a written operating agreement. The members of a multi-member LLC created when a new member is added to a single member LLC could rely on the default rules of the applicable state LLC statute to define their rights and obligations. But those default rules may not be consistent with the expectations and desires of the members, and preparing a written operating agreement that the members can review and modify before signing is the best way to insure that the members' rights and obligations will be what they expect and that the LLC will be operated as they wish. Having a written operating agreement is also advisable in order to provide a roadmap for the members to follow in operating their LLC.

Economic Terms

If a new member is added to an LLC that already has two or more members, the LLC's operating agreement may deal adequately with the respective rights and obligations of the members and extensive amendments may not be required. But the provisions of the operating agreement relating to members' economic interests will need to be modified. A new member will acquire an interest in the profits, losses, and distributions of the LLC that will necessarily affect the interests of the existing members, and the nature of these changes will need to be documented.

Rights and Obligations of New Members

In addition, it is not unusual for the rights and obligations of a new member to be different than those of the original members. For example, if a new member is admitted in order to provide additional capital, the new member might be expected to make an initial capital contribution and also loan additional funds to the LLC if more capital is needed in the future. A new member who contributes more capital than has been contributed by the other members may want preferential rights to distributions to insure that his or her excess contributions are returned before capital is distributed to other members. If the new member will have special rights or obligations, they will need to be spelled out in amendments to the operating agreement made at the time the new member is admitted.

Application of Existing Obligations

Whether or not the operating agreement is amended to create special rights or obligations, the new member will need to assume the obligations imposed on all members by the operating agreement. Among other things, the buy-sell provisions of the LLC's operating agreement may restrict the transfer of members' interests and may require members or their successors in interest to sell these interests to the LLC or the other members in certain circumstances. Accordingly, a document providing for the admission of a new member should require the new member to agree to be bound by all of the terms and provisions of the operating agreement. Since section 103(a) of the Uniform Limited Liability Company Act requires that all members be parties to an LLC's operating agreement, the failure to have new member so agree could jeopardize the effectiveness of the operating agreement as to all members, not just the new member.

CAPITAL INTERESTS • An issue that is sometimes overlooked when a new member is admitted to an LLC is the capital interests of the existing members. New members are

typically added to provide needed capital or services, so the existing members and new member have generally agreed in advance on what the new member's contribution will be. If the new member is to contribute property, the existing members and the new member may also have agreed on the value of the property. In addition, the members have usually decided what the new member's percentage interest will be in the profits and distributions of the LLC and how this will affect the interests of the other members. But there is one additional factor that needs to be considered to fully define the economic terms of the new member's admission—the values of the capital interests of the existing members.

Valuation of Interests

The values of the capital interests of the existing members need to be determined because the division of the assets of an LLC in a dissolution and winding up depends upon the members' capital interests. Unless the capital interests of the existing members are updated at the time a new member is admitted, the new member may receive either more or less than he or she deserves when the business of the LLC is wound up, and the existing members' shares of the liquidating distribution will be correspondingly affected.

Example: Fair Result for Existing Members

This can be illustrated with an example in which A and B each contribute \$1,000 to an LLC at the time of its creation, and each is entitled to 50 percent of the LLC's profits. If the LLC subsequently earns profits of \$2,000, makes no distributions, and then dissolves at a time when its net assets have a value of \$5,000, A and B will each receive \$2,500 in the winding up of the business of the LLC.

A and B will each receive \$2,500 in the winding up if the operating agreement of the LLC requires capital accounts to be maintained in accordance with the regulations under Internal Revenue Code ("Code") section 704 and provides for distribution of net assets on winding up in accordance with members' capital accounts as required by those regulations. In this case, A and B will each have a capital account at the time of the LLC's dissolution of \$2,000, consisting of the member's initial capital contribution of \$1,000 and the member's share of accumulated profits in the amount of \$1,000. The unrealized appreciation of \$1,000 in the assets of the LLC will be divided between A and B in accordance with their profit shares and added to their capital accounts for purposes of dividing the assets of the LLC.

Fair Result Without Operating Agreement

The existing members, A and B, will also each receive \$2,500 in the winding up if the LLC in the example has no operating agreement and its net assets are divided in accordance with a statutory default rule like that in the Uniform Limited Liability Company Act. Under ULLCA §806(b), the net assets of a dissolved LLC left after creditors have been paid are to be distributed first to members in return of their capital contributions and then in proportion to their profit shares. Under this rule, A and B would each get back their \$1,000 contribution and would split the remaining \$3,000 in proportion to their profits interests, giving them each \$2,500.

Example: Result Skewed in New Member's Favor