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What Is an LLC?

By Ronnie F. Hess, Esq.

Choosing the form of entity through which to operate a business is one of the first decisions facing a business owner. Before making this decision owners must review the advantages and disadvantages of the various entities available. Issues relating to taxation, liability and management structure are the factors that should be considered before the start up of any business entity. Increasingly, the limited liability company (LLC) is the choice of many business owners. For most, the pass-through tax benefits of a partnership along with the limited liability of a corporation make the LLC an attractive alternative. This article will provide you with a brief comparison of the LLC and other entities and discuss the advantages and disadvantages of operating a business as an LLC in Pennsylvania.

Comparison to Other Entities

An LLC may permit all of its members to participate in management like a general partnership if the owners so

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LEGAL UPDATE

Insights and Developments in the Law

Winter 2008

Uniform Trust Act

Pennsylvania recently enacted the Uniform Trust Act. This Act codifies certain pre-existing trust law and enacts changes and additional provisions to trust law. While certain provisions of the Act are already in effect, other changes take effect in the coming months.

New Notice Requirements for Trustees

A change of particular importance to trustees of Pennsylvania trusts takes effect in November of 2008. This change in the law requires trustees to provide notice to certain beneficiaries upon the occurrence of certain events, even if the beneficiary has not requested notice.

A person acting as trustee of certain trusts (including an irrevocable trust or a revocable trust which has become irrevocable), must send to the current beneficiaries in writing information about the existence of the trust and how to contact the trustee. In addition, the trustee must inform the current beneficiaries that they have the right to receive a copy of the trust instrument and the right to receive at least annually a written report of the trust's assets, liabilities, receipts and disbursements. Since the beneficiaries have the legal responsibility to make sure the trustee performs his duties properly, the beneficiaries need this information.

Further notice must be given whenever the settlor of an irrevocable inter vivos trust has been adjudicated incapacitated or died, every time there is

a change in trusteeship, or whenever a person becomes a beneficiary of a trust who did not previously receive notice, such as a young person becoming of age. While a beneficiary may waive the right to receive such notices in writing, absent such a waiver, notice is mandatory.

Note that the Act requires notice be given to current beneficiaries, not all beneficiaries. Current beneficiaries are defined as those who are 18 years older for whom income or principal must be distributed currently or those 25 years of age or older to whom income or principal may in the trustee's discretion be distributed currently.

In the case of an inter vivos irrevocable trust, no notice need be given to the beneficiaries of that trust until after the settlor has been adjudicated incapacitated or has died. The notice requirements take effect in November of 2008, except for notices required on account of death or incapacity. The latter notice requirements took effect in 2006. These notice and reporting requirements are mandatory, meaning a settlor cannot excuse the trustee of his duties by a provision in the trust instrument.

Limiting Trustee Liability

A trustee should also consider providing annual reports to beneficiaries on a voluntary basis. Whether it is advisable to voluntarily provide annual reports depends upon the circum-

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Announcements

On November 2, 2007, Shareholder **Barbara L. Hollenbach** was on the faculty for a PBI CLE course entitled “*Workers’ Compensation Appeal Board Practice*” that was presented in Mechanicsburg, PA. In an informal setting, the faculty offered their perspective on practice, as attorneys for injured workers, employers, and insurers, as well as the workers’ compensation judges’ viewpoint. The law clerks and commissioners shared insights about the nature of practice before the Board. Hollenbach will be one of the presenters at the 2008 version of *Workers’ Compensation Practice & Procedure* in April. Additionally, Barb was recently elected to the Board of Historic Bethlehem Inc. (HBI) and the Kemerer Museum of the Decorative Arts.

Shareholder **Frederick J. Stellato** was elected Chairman of the Board of Directors of the Pennsylvania Stoners Sports Academy. Headed by Stellato, a local group has put together a 501(c)3 nonprofit called the Pennsylvania Stoners Sports Academy, which will lead to the creation of a minor league soccer team called the Pennsylvania Stoners in the National Premier Soccer League. The sports academy will start with soccer, but expects to expand to other sports.

Shareholder **Judith A. Harris** recently joined the Board of Pensions of the Presbyterian Church (U.S.A.) and will serve on the Board’s Legal and Finance Committees. The Board of Pensions is the organization responsible for investment and administration of the Benefits Plan and Assistance Programs of the denomination, managing nearly \$8 billion and serving over 57,000 plan members throughout the United States and Puerto Rico. Harris was recently elected board secretary of the Estate Planning Council of the Lehigh Valley. She is currently president of the Fund to Benefit Children & Youth, Inc.; board operations committee chair of the Allentown Symphony, where she has served as a board member since 1993; and a board

member of the Lehigh County Agricultural Society.

Shareholder **Steven E. Hoffman** will be a featured speaker at the Pennsylvania Bar Institute’s February 12, 2008 seminar on Civil Practice in Eastern Pennsylvania. The seminar features attorneys and judges discussing the intricacies of local rules and practice in Berks, Carbon, Lehigh, Monroe, Northampton and Pike Counties. Mr. Hoffman will be speaking about the Lehigh County Rules of Civil Procedure.

On January 8, 2008, Shareholder **Theodore J. Zeller, III** was elected President-elect of the Bar Association of Lehigh County at their annual dinner meeting.

Shareholder **George C. Hlavac** will be a featured speaker at the 2008 Employment Law Legal Update sponsored by the Lehigh Valley Chapter of the Society for Human Resource Management. The Legal Update seminar will be held on February 12, 2008, at 8:00 am, at the Four Points by Sheraton Hotel and Suites Lehigh Valley Airport.

New Attorney

The Firm is pleased to announce the addition of one new attorney.

Rebecca J. Price — Ms. Price received a B.A. in Political Science and International Studies from The Ohio State University, *summa cum laude*, in 2004, and her J.D. from The College of William and Mary School of Law in 2007. While at law school, Ms. Price was the recipient of a Graduate Research Fellowship and a member of the Moot Court team. Prior to joining Tallman, Hudders & Sorrentino, Ms. Price completed an internship at the Lehigh County Department of Law, which she received as part of a Post Graduate Fellowship. Ms. Price is engaged in general civil practice with an emphasis on real estate transactions.

Attorneys **George C. Hlavac, Jeffrey S. Stewart, Steven E. Hoffman,** and **Edward J. Easterly** will be conducting an all-day seminar entitled “*Employment Law from A to Z*” on April 15, 2008, at 8:00 am, at the Four Points by Sheraton Hotel and Suites Lehigh Valley Airport. The seminar is being sponsored by Lorman Education Services.

Uniform Trust Act

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stances. The primary advantage to providing annual reports to beneficiaries is that the trustee effectively limits the period of his or her exposure to future liability. The giving of notice affects the ability of the beneficiaries to sue the trustee for action or inaction in administering the trust.

If the trustee provides a statutorily sufficient annual report disclosing a transaction in year one, and for each of the four subsequent years, and if the beneficiary does not object in writing within six months after receiving the fifth annual report, then the trustee may be relieved of liability for actions taken in administration of the trust. A trustee may therefore want to consider sending annual reports on a voluntary basis as a protective measure against future liability.

Revocable Trusts as Will Substitutes

The Act imposes several restrictions on revocable trusts as will substitutes. At the outset, it defines that the capacity to create a revocable trust is the same as that required to make a will. And, to the extent a revocable trust is created by fraud, duress, or undue influence, the trust is voidable. Revocable trusts are likewise similar to wills in that the

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Uniform Trust Act

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grounds for contesting the validity of a trust under the Act are similar to the grounds for contesting the validity of a will. However, a person contesting a revocable trust must file a petition with the appropriate court no later than one year after the date on which the trustee gave notice to the beneficiaries putting the beneficiary on notice of the transaction at issue.

Potential Federal Estate Tax Concerns for Irrevocable Trusts

The Uniform Trust Act provides the settlor of a trust the right to change the trust with the consent of others under certain circumstances, even where the trust is irrevocable. While it is uncertain at this point, it is possible the Internal Revenue Service may use this new, state-created right to subject trusts to estate tax, where prior to the enactment of the Act the irrevocable trust would not have been subject to the estate tax upon the settlor's death. It is advisable that you seek assistance regarding the applicability of the Act to any trust in which you have an interest.

Repeal of the Rule Against Perpetuities

In addition to passage of the Uniform Trust Act, Pennsylvania also passed an Act repealing the Rule against Perpetuities. This means that a person may now create a perpetual trust in Pennsylvania. This change in the law places Pennsylvania trust law on similar footing as other states, including Delaware, which have repealed the Rule against Perpetuities. Whether it is advisable to establish a perpetual trust depends upon familial and financial circumstances, as well as gift, estate, and generation skipping transfer tax considerations.

Summary

The Uniform Trust Act imposes changes to existing trust law, while also providing planning opportunities. It imposes on trustees new, mandatory notice requirements. However, it also provides trustees with the opportunity to limit the period within which they are liable to beneficiaries for certain actions. Further, it establishes greater

certainty as to creation and enforceability measures for revocable trusts. A person with questions regarding the Act, particularly those who are acting as trustee, who have formed a trust, who wish to form a trust, or who are beneficiaries, should inquire with counsel as to how the law will apply to their circumstances.

LLC

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choose while they enjoy the protection of limited liability which is not available to partners in a general partnership. The members of the LLC also receive the benefit of pass-through taxation afforded to partners in a general partnership. In addition, use of the LLC avoids the need to categorize partners, as is necessary for a limited partnership, while allowing the operating agreement to provide varied participation in management and sharing of profits and losses in a manner similar to a limited partnership. In addition, the LLC provides limited liability for all of its members and managers, as compared to a limited partnership which provides limited liability only for the limited partners.

An LLC is not subject to the limitations on ownership of an S corporation, nor is it subject to the stringent requirements of an S corporation to maintain its favorable tax treatment. An LLC has no limitations on the number of members or type of member and the LLC may issue more than a single type of interest. Like a C corporation, an LLC can provide for special allocations to certain members as well as the opportunity to change such allocations at any time in the future. The LLC, however, is not

subject to the double taxation recognized by a C corporation.

Advantages and Disadvantages

Generally, the benefits of an LLC include (1) limited liability and flexibility in management; (2) the choice of federal tax treatment; (3) flexibility in allocations; and (4) the ability to issue different classes of ownership. In Pennsylvania, the single disadvantage is that the LLC is taxed as an S corporation, therefore subjecting it to capital stock/franchise tax.

Management and Limited Liability

There are typically two types of LLC management — member-managed and manager-managed LLCs. An LLC may be operated as a single member LLC, and the single member will manage the business either as a member manager or an elected manager. This permits the LLC to mirror the management structure of a sole proprietorship. Multiple member, member-managed LLCs permit each member to act as an agent of the company and each member has a vote in the business decisions of the LLC. This structure mirrors the management of a

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Actual resolution of legal issues depend upon many factors, including variations of facts and state laws. This newsletter is not intended to provide legal advice on specific subjects, but rather to provide insight into legal developments and issues. The reader should always consult with legal counsel before taking action on matters covered by this newsletter.

LLC

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general partnership. A decision made by a member related to the operation of the business usually will require approval of a majority of the members. Although each member has the agency to bind the LLC, the remaining members of the LLC will not be personally liable for a decision made by another member unlike a creditor of a general partnership which may seek recovery from any partner jointly and severally.

If the members choose to operate as a manager-managed LLC, the manager serves as the agent for the purpose of the company business and the members cannot act in that capacity unless the operating agreement provides otherwise. Members of a manager-managed LLC may elect either a single manager or a management team, which can serve in a capacity similar to a board of directors or committee of managers. Managers may be members, but can be non-members as well. Furthermore, the manager may be an entity similar to entity general partners of limited partnerships. Manager-managed LLCs are appropriate for LLCs with investors who do not want to participate in the day-to-day activities of the business and prefer to hire a management company to handle operations. A manager's position may be indefinite or term specific, as set out in the operating agreement, and usually can be terminated for cause by the members.

Regardless of the management form selected, the owners are generally shielded from the liabilities of the company. Only in limited circumstances in which a member (acting as an agent) or a member-manager engages in an activity that is actionable might an individual be subject to liability; however, even then the other members would not be liable for that person's actions.

Federal Tax Treatment

The default classification for federal tax purposes is partnership taxation if the LLC has at least two members or disregarded as an entity separate from

its owner if it has a single owner. If an LLC wishes to be taxed other than as a partnership or sole proprietor, it must make an affirmative election pursuant to the "check the box" rules.

Allocations

Similar to a limited partnership, an LLC may allocate profits and losses in any manner it selects, provided that such distributions have a "substantial economic effect" as required by the federal partnership tax rules. For example, if there are two classes of ownership, one made up of the actual operators and founders of the business and another made up of a passive investor group, it would be permissible to provide the investor group with a fixed rate priority return similar to that provided to preferred shareholders of a corporation.

Different Classes of Interests

One of the most significant limitations of an S corporation that is overcome by an LLC is the availability of different classes of interests (beyond the voting — nonvoting distinction) that permit distributions other than pro-rata to ownership. As noted above, variability and flexibility in allocations of profits and losses is a significant advantage for LLCs made possible by the ability to employ partnership taxation. In addition, the ability to make distributions that vary based on different classes of interests, so long as the partnership tax rules are satisfied, makes the LLC extremely attractive.

Pennsylvania Tax Treatment

Pennsylvania taxes LLCs as S corporations, unless it elects to be taxed other than as a partnership pursuant to federal rules. As such, an LLC will not be subject to the corporate net income tax and will benefit from pass-through taxation on its net income, but will be subject to the Pennsylvania capital stock franchise tax. However, for some LLCs the Pennsylvania capital stock tax is not a significant burden. LLCs with low net income and low net worth will not face a significant tax. Furthermore, the capital stock tax is currently being phased

out, with rates of tax reducing until 2010, resulting in the elimination of the tax as of January 1, 2011. There is no assurance, however, that the current law would not be amended to reinstate the tax or that no substitute legislation would be enacted.

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