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Limited Liability Companies in New Mexico

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LIMITED LIABILITY COMPANIES IN NEW MEXICO

I. INTRODUCTION

One of the first and most important decisions an individual or a group of individuals makes when starting a business is the form of entity the business will assume. Choosing the best legal form for doing business is a complex decision involving a host of legal, economic, management, and tax considerations. Perhaps most important among these considerations are the desires to limit the legal and the tax liability of the owners. Until recently, no unincorporated entity provided complete limited legal liability to all owners while still allowing the owners to actively participate in management. Nor did any unincorporated entity provide owners with the opportunity to elect beneficial tax treatment in order to minimize taxes. However, a new form of legal entity, the limited liability company (LLC), possesses all of these attributes.[1]

Limited liability companies have rapidly come of age. A few years ago, LLCs virtually did not exist. To put this in perspective, a decade ago only two states had LLC statutes.[2] Today, in 1997, all fifty states and the District of Columbia have passed statutes recognizing LLCs and tens of thousands of LLCs have been formed throughout the United States.[3] New Mexico is not immune from the LLC phenomenon. Since June 1993, the effective date of the New Mexico Limited Liability Company Act,[4] over 3,000 domestic LLCs have been formed in New Mexico.[5]

The number of LLCs is sure to increase, both in New Mexico and nationally, given the recent promulgation of the "check-the-box" regulations by the federal Treasury Department.[6] The check-the-box regulations do away with the old system of entity classification for tax purposes.[7] Now, under the new regulations, any

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1. A second entity called the limited liability partnership (LLP) also has recently emerged, but an in-depth discussion of that entity is beyond the scope of this Comment. As this Comment went to print, a new LLP statute had been signed into law in New Mexico. *See* N.M. H.R. 105(a) (1997). This may result in an increased use of the LLP in New Mexico.

2. Wyoming and Florida passed statutes in 1977 and 1982, respectively. *See* WYO. STAT. ANN. §§ 17-15-101 to 17-15-136 (Michie 1989 & Supp. 1995); FLA. STAT. ANN. §§ 608.401-608.471 (West 1993 & Supp. 1995).

3. *See* Cheryl A. Cruz & John E. Karayan, *Should Your Firm Operate as a LLC?*, 21 BUS. FORUM 16, 16 (1996). Vermont and Hawaii were the last two states to enact limited liability company (LLC) legislation, enacting their statutes in May and June of 1996, respectively. *See id.* at 16 n.1.

4. N.M. STAT. ANN. §§ 53-19-1 to 53-19-74 (Repl. Pamp. 1993 & Supp. 1996).

5. Telephone Interview with Manual Salinas, Director of Corporations, New Mexico State Corporation Commission (Mar. 24, 1997). During 1993-1994, there were 690 domestic LLCs and 45 foreign LLCs filed in New Mexico. *See id.* In 1995, there were an additional 1,039 domestic LLCs, and 109 foreign LLCs in New Mexico. *See id.* In 1996, the number in New Mexico again increased by another 1,296 domestic LLCs, and 164 foreign LLCs. *See id.* Salinas stated that he has seen a significant increase in the number of LLC filings since the beginning of 1997, the year that the check-the-box regulations went into effect. *See id.*

6. On April 3, 1995, Notice 95-14, relating to classification of business organizations under I.R.C. § 7701 (1995), was published in the Internal Revenue Bulletin. *See* 1995-1 C.B. 297 (1995). A notice of public hearing was published in the Federal Register on May 10, 1995. *See* 60 Fed. Reg. 24,813 (1995). Written comments were received and a public hearing was held on July 20, 1995. On May 13, 1996, the Internal Revenue Service (IRS) and the federal Department of Treasury published the proposed check-the-box regulations in the Federal Register. *See* Prop. Treas. Regs. §§ 301.7701-1 to 301.7701-3, 61 Fed. Reg. 21,989 (1996). Comments responding to the notice were received, and a public hearing was held on August 21, 1996. The proposed regulations were eventually promulgated by the Treasury Department on December 18, 1996. *See* Treas. Regs. §§ 301.7701-1 to 301.7701-3 (as amended by T.D. 8697, 61 Fed. Reg. 66,584 (1996)).

7. *See* T.D. 8697, 61 Fed. Reg. 66,584 (1996). The check-the-box regulations apply to all domestic unincorporated business organizations, unless the organization's classification is determined under another I.R.C.

unincorporated domestic entity will be able to freely elect to be treated as either a partnership or an association taxable as a corporation for federal income tax purposes.[8] In the past, practitioners considered tax classification issues a major drawback to LLCs. With the tax classification impediment eliminated, it is certain that LLCs will become the entity of choice for most small businesses in New Mexico.

This Comment addresses LLCs in New Mexico, and how the recent federal check-the-box regulations will impact the use and development of LLCs in New Mexico. Part II places the check-the-box classifications in context by briefly describing the historical development of LLCs. Part III interprets the check-the-box regulations and examines how they will be implemented. Part IV analyzes other tax issues that should be considered in the weighing of the relative advantages and disadvantages of LLCs. Part V addresses the impact of non-tax issues on LLCs. Part VI analyzes the impact LLCs will have on New Mexico, and what steps should be taken by practitioners now that the check-the-box regulations have been finalized. Finally, this Comment concludes in Part VII with some speculations about the future of LLCs in New Mexico.

II. CHOICE OF ENTITY AND THE HISTORY OF THE LLC

A. *Choice of Entity*

In order to fully understand how the final check-the-box regulations affect the growing popularity of LLCs, the reader needs a general understanding of the types of available business entities, and the history behind the development of LLCs. Before there were LLCs, there were three basic entity forms from which businesses could choose: the sole proprietorship, the partnership, and the corporation. Although a number of factors impact the "choice of entity" decision, the most important factors include: (1) the tax treatment of the particular entity; (2) opportunities for owners to participate in the management of the entity; (3) limited legal liability; (4) simplicity; (5) flexibility; and (6) freedom from special restrictions.[9]

1. Sole Proprietorships

The sole proprietorship is a business owned directly by one individual, called a sole proprietor.[10] Generally, the greatest advantage of a sole proprietorship is that it is the simplest business entity to form and operate.[11] No statutes govern its organization or operation.[12] "The sole proprietorship provides an entrepreneur with

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provision. *See* Treas. Reg. § 301.7701-1(a) (1997). Examples of such organizations include publicly traded partnerships which are taxed as a corporation under I.R.C. § 7704 (1996), taxable mortgage pools classified under I.R.C. § 7701(i) (1996), or a Real Estate Mortgage Investment Conduit (REMIC) taxed under I.R.C. § 860D(b) (1996). *See* Treas. Reg. § 301.7701-1(a) (1997).

8. The classification of entities that do not file an election is: (1) "a partnership if it has two or more members"; or (2) "disregarded as an entity separate from its owner" (taxable as a sole proprietorship), if it has a single owner. *See* Treas. Regs. §§ 301.7701-3(b)(i), (ii) (as amended in 1996); *see also* discussion *infra* Part III.A.

9. *See* Cruz & Karayan, *supra* note 3, at 17.

10. *See* WILLIAM A. KLEIN & JOHN C. COFFEE, JR., BUSINESS ORGANIZATION AND FINANCE 5 (4th ed. 1990).

11. *See* HARRY J. HAYNSWORTH, SELECTING THE FORM OF A SMALL BUSINESS ENTITY § 1.02, at 2 (1985).

12. *See id.*

an opportunity to own his own business without the formalities and expense of incorporation or the necessity of sharing control of the business with others."[13]

Because there are no formalities required to organize a sole proprietorship, "it is usually not thought of as a separate 'business organization' in the legal sense."[14]

> [T]he common law never recognized the 'separateness' of an individual proprietorship as an entity apart from the proprietor himself for purposes of limiting the claims of those who dealt with the business to the assets of the business. The law regarded the unincorporated, one-owner business and its assets as an unseparated part of all the owner's assets, personal and otherwise, and it made the proprietor himself liable for his business debts as he would be for his personal debts.[15]

Thus, the inability of the sole proprietor to separate herself from the proprietorship makes her personally liable for the debts and other liabilities of the proprietorship. This personal liability is the principal disadvantage of the sole proprietorship.

The tax treatment of the sole proprietorship also is affected by the fact that the sole proprietorship is not viewed as an entity separate from its owner. All the taxable income, credits, and deductions of the business are reported on the proprietor's individual income tax return.[16] Thus, the earnings of the business are taxed only once, at the proprietor's individual income tax rate. In addition, for certain fringe benefits, the sole proprietor is not provided the same tax treatment that is available to employees of a corporation.[17]

2. Partnerships

For many joint venturors, prior to the emergence of the LLC, the partnership had been the most tax efficient structure under which to operate a business. A general partnership may be formed with relative ease; indeed, many times people form general partnerships with merely a handshake or a tacit agreement to carry on as co-owners of a business for profit.[18] Partnerships also have the benefit of "pass-through" treatment of income.[19] In other words, the income that the partnership earns is not taxed as income of the partnership entity, but rather the income "passes through" the entity to the individual partners.[20] Thus, the income of the partnership is taxed only once, as income reported on the individual partners' income tax return.[21] Each partner includes his or her proportional share of the partnership's income, gain, loss, or deduction on their individual tax return.[22] However, a traditional drawback to the general partnership is that the partners are all held personally liable for the debts and

13. *See id.*
14. *See* KLEIN & COFFEE, *supra* note 10, at 5.
15. ELVIN R. LATTY & GEORGE T. FRAMPTON, BASIC BUSINESS ASSOCIATIONS xv (6th ed. 1963).
16. *See* HAYNSWORTH, *supra* note 11, § 1.02, at 2.
17. *See* discussion *infra* Part IV.D.
18. *See* KLEIN & COFFEE, *supra* note 10, at 59.
19. *See* JEFFREY L. KWALL, THE FEDERAL INCOME TAXATION OF CORPORATIONS, PARTNERSHIPS, LIMITED LIABILITY COMPANIES, AND THEIR OWNERS 8 (1995).
20. *See id.*
21. *See id.*
22. *See id.*

other liabilities of the partnership.[23] In return for this liability, all general partners have the right to actively participate in the management of the business.[24]

Another variety of the partnership structure is the limited partnership. Limited partnerships allow investors, called limited partners, to invest in the partnership and enjoy limited liability to the extent of their investment.[25] However, in order to form a limited partnership, there has to be one or more general partners.[26] The general partners in the limited partnership have the right to actively participate in the management of the partnership.[27] However, the general partners, as in general partnerships, also are personally liable for the debts of the limited partnership.[28] Limited partners have limited liability, but in return are not allowed to manage or control the partnership.[29] For tax purposes, limited partnerships, like general partnerships, have the benefit of "pass-through" treatment of income.[30] Thus, the income of the limited partnership is taxed only once, as income reported on the individual partners' income tax return.

3. Corporations

Limited liability for all owners is available by forming a corporation.[31] "The owners of a corporation typically are not liable for the corporation's debts . . ., except to the extent the owners can lose their equity investments."[32] Nevertheless, there are several drawbacks associated with incorporating. First, the income earned by a corporation is subject to an entity level income tax, the corporate income tax.[33] After the corporation's income is taxed at the entity level, the income can be distributed to shareholders/owners in the form of dividends.[34] These dividends are reported as income on the shareholder's individual income tax return and taxed again at the individual shareholder's income tax rate.[35] This results in "double taxation."[36] In addition, "corporate shareholders do not receive the tax benefits, available to many partners, of deducting business losses against personal income."[37] Furthermore, the corporation has traditionally not been well-suited to smaller, closely-held firms.[38]

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23. *See* HAYNSWORTH, *supra* note 11, § 1.04 , at 7.
24. *See* KLEIN & COFFEE, *supra* note 10, at 94.
25. *See id.*
26. *See id.*
27. *See id.*
28. *See id.*
29. *See id.*
30. *See supra* notes 19-22 and accompanying text.
31. *See* BORIS I. BITTKER & JAMES S. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS, & 2.02[2], at 2-9 (6th ed. 1994).
32. *Id.*
33. *See* KWALL, *supra* note 19, at 5-8; *see generally id.* at 19-90 (providing a detailed analysis of corporate taxation).
34. *See id.* at 19.
35. *See id.*
36. *See* BITTKER & EUSTICE, *supra* note 31, at § 1.03, at 1-7.
37. Larry E. Ribstein, *The Emergence of the Limited Liability Company*, 51 BUS. LAW. 1, 2 (1995).
38. *See id.* Ribstein notes that while case and statutory law have allowed closely-held firms to adapt the corporate form to their distinct needs, this approach put the burden on closely-held firms to engage in costly and detailed planning. Many times poor planning has resulted in solutions that were unfavorable to most parties and that disregarded the deals the parties had actually made. *See id.*

Subchapter S of the Internal Revenue Code (Code) cured some of the tax defects of the corporate form.[39] It allowed closely-held corporations to elect "pass-through" tax treatment, similar to the tax treatment of a partnership,[40] while still retaining the limited liability provided by the corporate form.[41] The corporations that elect this tax treatment are referred to as S corporations.[42] However, the Code placed many restrictions on the use of S corporations, including limitations on the number of shareholders,[43] restrictions on the type of shareholders,[44] and limitations on the type of stock that could be issued.[45] The Code additionally required shareholders to allocate income, loss, deduction, and credit in direct proportion to the shareholders' interests in the corporation, similar to partners in a partnership.[46] While some of these restrictions were modified in 1996,[47] the S corporation is still not ideal for some businesses.[48]

The problems and limitations associated with both partnerships and corporations were the impetus for a new hybrid business entity, one that combined the best attributes of the partnership and the corporate form. And, thus, the idea for the LLC was born.

B. *Historical Background*

Prior to the 1980s, even though corporations were subject to "double taxation"[49] on corporate income, the double tax did not cause corporate income to bear a significantly greater tax burden than individual income that was taxed only once.[50] This was due in large part to the fact that corporate tax rates were significantly lower than individual tax rates.[51] Thus, prior to 1980, taxpayers preferred to accumulate income in a corporation, rather than distribute the income to the shareholders, in order to take advantage of the lower corporate income tax rates.[52]

In 1935, the Supreme Court decided *Morrissey v. Commissioner*.[53] In *Morrissey*, the Supreme Court held that a trust created to develop real estate was taxable as a

39. *See* I.R.C. §§ 1361-1378 (1996).
40. *See supra* notes 19-22 and accompanying text.
41. *See* KWALL, *supra* note 19, at 8; *see generally id.* at 91-142 (providing a detailed analysis of the taxation of Subchapter S corporations).
42. The name S corporation refers to the particular subchapter of the Internal Revenue Code (Code) that governs the taxation of this particular type of corporation. Taxation of S corporations is governed by Subchapter S of Chapter 1 of Subtitle A of the Code.
43. The number of shareholders was previously limited to thirty-five. *See* I.R.C. § 1361(b)(1)(A) (1995), *amended by* Small Business Job Protection Act, Pub. L. No. 104-188, § 1301, 110 Stat. 1755, 1777 (1996).
44. The type of shareholders was previously limited to individuals. *See id.* § 1361(b)(1)(B). In addition, nonresident aliens are currently not eligible to be shareholders in S corporations. *See id.* § 1361(b)(1)(C). Furthermore, currently, no corporations, partnerships or LLCs can hold stock in an S corporation. *See id.* § 1361(b)(1)(B).
45. *See id.* § 1361(b)(1)(D) (1996).
46. *See id.* §§ 1366, 1367, 1368; *see also supra* notes 19-22 and accompanying text.
47. *See generally* Small Business Job Protection Act of 1996, Pub. L. No. 104-188, 110 Stat. 1755 (1996).
48. See discussion *infra* Part IV.B.
49. *See* discussion *supra* notes 33-36 and accompanying text.
50. *See* KWALL, *supra* note 19, at 6.
51. *See id.* For a table comparing corporate income rates with individual rates over the years, *see id.* at 7.
52. *See id.* at 6.
53. 296 U.S. 344 (1935).

corporation for federal income tax purposes.[54] More importantly, the Court announced for the first time the "corporate resemblance" test to be used to classify unincorporated entities as associations[55] taxable as corporations for tax purposes.[56] The Court found that there were six specific characteristics of a corporation: (1) the existence of associates; (2) the objective to carry on a business and divide the profits therefrom; (3) centralization of management; (4) continuity of life; (5) free transferability of interests; and (6) limited liability of investors.[57] The Court further established that if, on balance, an unincorporated entity had more corporate characteristics than non-corporate characteristics, the entity would be classified as an association, taxable as a corporation for federal income tax purposes.[58]

In 1954, the *Morrissey* six factor corporate resemblance test was refined in *United States v. Kintner.*[59] *Kintner* involved a doctor and several colleagues who dissolved their partnership and organized an unincorporated association for the practice of medicine.[60] The doctors executed Articles of Association providing that their association would be treated as a corporation for federal tax purposes.[61] At issue were contributions made by the association to a pension fund.[62] The Internal Revenue Service (IRS) attempted to classify the entity as a partnership for federal tax purposes.[63] The IRS argued that the relevant state law did not permit a corporation to practice medicine. Therefore, the IRS asserted that the association could not be taxed as a corporation.[64] At that time, the maximum corporate tax rate was almost forty percent lower than the maximum individual tax rate.[65] The Court rejected the government's contention,[66] and the defendants successfully argued that their organization, although unquestion-ably a partnership under state statutory law, was taxable as a corporation for federal tax purposes.[67]

54. *See id.* at 360.

55. An association is defined as an unincorporated organization that is "treated as a corporation for [f]ederal tax purposes even though it may not qualify as such under applicable state law." BLACK'S LAW DICTIONARY 121 (6th ed. 1990). However, an association is not a legal entity separate from the persons who compose it. *See id.* In *Morrissey*, the Supreme Court noted that it is impossible in the nature of things to translate the statutory concept of "association" into a particularity of detail that would fix the status of every sort of enterprise or organization which ingenuity may create. *See Morrissey*, 296 U.S. at 357. The Court additionally opined that "[t]he inclusion of associations with corporations [in the statutory definition] implies resemblance; but it is [only] resemblance and not identity." *Id.* at 357.

56. *See id.* at 358-60.

57. *See id.*

58. *See id.*; *see also* Treas. Reg. § 301.7701-2 (1996) (amended by T.D. 8697, 1997-2 I.R.B. 11 (codified version of corporate resemblance test)).

59. 216 F.2d 418 (9th Cir. 1954).

60. *See id.* at 419-20.

61. *See id.* at 420.

62. *See id.* at 420-21.

63. Partnership income, at that time, was subject to the higher individual tax rate. *See* KWALL, *supra* note 19, at 8.

64. *See Kintner*, 216 F.2d at 421.

65. *See* KWALL, *supra* note 19, at 7. For a discussion of how partnerships "pass-through" income to the individual partners, resulting in the income being taxed at the individual partner's income tax rate, see *supra* notes 19-22 and accompanying text.

66. *See Kitner*, 216 F.2d at 423.

67. *See id.* at 428.

The Treasury Department, unhappy with the result reached by the Court in the *Kintner* decision,[68] promulgated regulations[69] that resulted in unincorporated organizations, like the one involved in *Kintner*, to be classified as partnerships for federal income tax purposes.[70] Under these regulations, which echo the holding in *Morrissey*, an unincorporated organization had to have more corporate characteristics than non-corporate characteristics before it would be classified as a corporation for tax purposes.[71] These regulations are commonly referred to as the *Kintner* regulations.

The *Kintner* regulations established the objective test the IRS would use in determining whether an unincorporated organization would be classified as a partnership or as an association taxable as a corporation for federal income tax purposes.[72] This test isolated the six corporate characteristics outlined in *Morrissey*.[73] Under the *Kintner* regulations, the IRS recognized that partnerships and corporations have two common characteristics: associates and the objective of carrying on a business for profit.[74] Thus, those two characteristics were disregarded for classification purposes.[75] Therefore, when the IRS determined whether a non-corporate entity would be treated as a partnership under the *Kintner* regulations, it looked to factors pertaining to the four remaining *Morrissey* corporate characteristics: continuity of life, centralization of management, free transferability of interests, and limited liability.[76] If an unincorporated entity had three or more of the four corporate characteristics, it was classified as a corporation for income tax purposes.[77] If an unincorporated entity had no more than two of the four corporate characteristics, it was treated as a partnership for federal income tax purposes.[78] In reaction to the *Kintner* regulations, states began revising their statutes to enable partnerships, as well as other unincorporated organizations, to possess traditionally corporate characteristics such as limited liability.[79]

Taxpayers soon began to manipulate the *Kintner* regulations to justify the particular tax classification that they desired for their business entities. For example, in *Larson v. Commissioner*, a taxpayer had formed various limited partnerships to hold interests in real estate ventures.[80] The limited partnerships suffered losses, which the taxpayer deducted on his individual tax return.[81] The IRS challenged the

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68. Scott E. Grimes et al., *Proposed Entity Classification Regs. Greatly Simplify Rules*, 57 TAX'N FOR ACCT. 4-5 (1996).

69. *See* Treas. Regs. §§ 301.7701-1 to 301.7701-3 (1996) (amended by T.D. 8697, 1997-2 I.R.B. 11).

70. In this way the IRS attempted to assure that it would receive the greatest amount of taxes. *See* Grimes, et al., *supra* note 68, at 4-5.

71. *See* Treas. Regs. §§ 301.7701-1 to 301.7701-3 (1996); *see also* discussion *supra* notes 53-58 and accompanying text.

72. *See* Treas. Regs. § 301.7701-1 to 301.7701-3 (1996) (amended 1997).

73. *See* 296 U.S. 344; *see also supra* note 57 and accompanying text.

74. *See* Treas. Reg. § 301.7701-2(a)(2) (1996) (amended 1997).

75. *See id.*

76. *See id.* § 301.7701-2(a)(1).

77. *See id.* §§ 301.7701-2(a)(1) to 301.7701-2(a)(3).

78. *See id.*

79. For example, Wyoming and Florida passed LLC statutes in 1977 and 1982, respectively. *See* WYO. STAT. ANN. §§ 17-15-101 to 17-15-136 (Michie 1989 & Supp. 1995); FLA. STAT. ANN. §§ 608.401-608.471 (West 1993 & Supp. 1995).

80. *See* 66 T.C. 159 (1976).

81. *See id.* at 166.

deductions, arguing that the limited partnerships should be taxed as corporations.[82] The Tax Court found that the limited partnerships lacked the corporate characteristics of continuity of life[83] and limited liability.[84] Therefore, because the limited partnerships had no more than two of the four corporate characteristics, the IRS's classification of the limited partnerships as partnerships was upheld.[85]

During the 1980s, the "double tax" burden on corporate income increased dramatically.[86] This increase was a result of "significant reductions in individual tax rates which, in 1987, fell below corporate tax rates for the first time in history."[87] During 1987 to 1992, the maximum corporate tax rate exceeded the maximum individual tax rate.[88] Thus, the first tax on corporate income alone often exceeded individual tax rates.[89] Despite recent changes in tax rates,[90] corporate income distributed as dividends still bore a significantly greater tax burden than other forms of individual income. Consequently, in the late 1980s, taxpayers began to manipulate the *Kintner* regulations to support classification of business entities as partnerships to take advantage of the lower tax rates.

The demise of the *Kintner* regulations began in 1988 when the IRS issued Revenue Ruling 88-76.[91] That ruling addressed the classification of a Wyoming LLC formed under the Wyoming Limited Liability Company Act.[92] The LLC came about as practitioners attempted to structure an unincorporated business entity that provided limited liability like a corporation, but was taxed as a partnership for federal income tax purposes. The Wyoming LLC lacked two of the four corporate characteristics: free transferability of interests and continuity of life.[93] Following the reasoning in *Larson*,[94] the IRS concluded that because the LLC lacked two of the four corporate characteristics, it would be classified as a partnership for federal income tax purposes.[95] The revenue ruling established an important precedent by allowing an unincorporated organization which had centralized management and limited liability for its members to be classified as a partnership for income tax purposes.[96] And, thus, the LLC was born.

A LLC is defined as "a non-corporate business in which all of the members have limited liability . . . and in which the members can, and frequently do, actively

82. *See id.* at 171.

83. *See id.* at 175. The partnerships lacked continuity of life because California law provided that a partnership is dissolved by the bankruptcy of the general partner. *See id.*

84. *See id.* at 180. The limited partnerships lacked limited liability because each partnership had a general partner, which was a corporation, that was liable for the debts and liabilities of the partnerships. *See id.*

85. *See id.* at 185.

86. *See* KWALL, *supra* note 19, at 7.

87. *Id.*

88. *See id.*

89. *See id.*

90. *See id.*

91. *See* Rev. Rul. 88-76, 1988-2 C.B. 360.

92. *See* WYO. STAT. ANN. §§ 17-15-101 to 17-15-136 (Michie 1989 & Supp. 1995).

93. *See* Rev. Rul. 88-76, 1988-2 C.B. 360.

94. 66 T.C. 159 (1976).

95. *See* Rev. Rul. 88-76, 1988-2 C.B. 360.

96. *See id.*

participate in man are the equivalent to shareholders or partners.[97] LLC members' ownership rights, called membership interests, consist bothagement."[98] Owners of LLCs are called members. LLC members of economic rights and management rights.[99] Generally, the members themselves manage the LLC, but some state statutes allow delegation of management to managers, who may be, but need not be, members.[100] Thus, a LLC may be member-managed or manager-managed under most state statutes.[101]

The most significant development following the IRS's recognition of the LLC in 1988 was the IRS's issuance of Revenue Procedure 95-10.[102] In Revenue Procedure 95-10, the IRS established guidelines for taxpayers to follow to obtain a ruling that a particular LLC would be classified as a partnership for federal income tax purposes.[103] In practice, Revenue Procedure 95-20 was interpreted as setting forth "safe harbors" with respect to continuity of life, centralized management, free transferability of interests, and limited liability.[104] Revenue Procedure 95-10 is

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97. *See* Stuart Levine, *Limited Liability Companies, Limited Liability Partnerships, Limited Liability Limited Partnerships, and Other Novel Entities*, CA86 A.L.I.-A.B.A. 501, 506 (1996).

98. LARRY E. RIBSTEIN & ROBERT R. KEATINGE, RIBSTEIN AND KEATINGE ON LIMITED LIABILITY COMPANIES § 1.02, at 1 (1996).

99. *See id.*

100. *See id.*

101. *See id.*

102. Rev. Proc. 95-10, 1995-1 C.B. 501.

103. Briefly, Revenue Procedure 95-10, 1995-1 C.B. 501, provided that if the LLC was member-managed and the default provisions of the state statute or the LLC's operating agreement provided that the death, insanity, bankruptcy, retirement, resignation, or expulsion of any member (termed "withdrawal events") caused the automatic dissolution of the LLC, unless the LLC was continued by the consent of not less than a majority in interest of the remaining members, the IRS would find that the LLC lacked continuity of life. *See* Rev. Proc. 95-10, § 5.01(1) 1995-1 C.B. 501. Second, under Revenue Procedure 95-10, members of a LLC could elect to have only one of the various withdrawal events actually trigger a dissolution, provided the possibility of such event occurring is meaningful. *See id.* § 5.01(4). For example, if an operating agreement provided that the LLC would dissolve only upon the death of the member-manager, and the sole member-manager was a corporation, then death would not qualify as a meaningful event, but bankruptcy presumably would. *See id.* Third, Revenue Procedure 95-10 clarified that only a majority in interest of remaining members, as opposed to unanimity, was required to reconstitute an entity that has been dissolved. *See id.* § 5.01(3).

Revenue Procedure 95-10 also provided that the IRS would not rule that the LLC lacked centralized management unless the member-managers in the aggregate owned at least 20% of the total interests in the LLC. *See id.* § 5.02(1). However, even if the 20% aggregate ownership requirement was met, the IRS would consider all relevant factors to determine whether the LLC lacked centralized management. *See id.*

With respect to free transferability, Revenue Procedure 95-10 provided that a LLC would generally lack free transferability of interests if the operating agreement or default provisions of the controlling statute provided that each member, or those members owning more than 20% of all interests in the LLC, could not transfer all attributes of the member's interests in the LLC without the consent of at least a majority of the non-transferring member-managers. *See id.* § 5.02(1). "Majority" was defined as majority in interest of either the capital or profits interests in the LLC, or a majority determined on a per capita basis. *See id.* § 5.02(3).

With regard to limited liability, Revenue Procedure 95-10 provided that the IRS would not find that a LLC lacked limited liability unless at least the assuming member validly assumes personal liability for all (but not less than all) obligations of the LLC, pursuant to express authority granted in the controlling statute. *See id.* § 5.04. Finally, the IRS stated that it would consider a ruling request for LLC partnership classification only if the LLC has at least two members. *See id.* § 4.01.

104. In addition to the "safe harbors" providing for continuity of life, free transferability of interests, and centralization of management, Revenue Procedure 95-10 also listed additional requirements for LLCs. To the extent a LLC wishes to rely on member-managers, under the tests for continuity of life or free transferability of interests, the member-managers, in the aggregate, must own an interest in each material item of the LLC's income, gain, loss, deduction, or credit during the entire existence of the LLC equal to the lesser of one percent or $500,000. *See id.* § 4.02. Also, the member-managers must maintain, throughout the entire existence of the LLC, a minimum capital

significant because it was the first recognition of a generic LLC.

Although Revenue Procedure 95-10 did provide taxpayers with some LLC guidance, and although many other rulings were issued by the IRS to clarify the tax treatment of the LLC,[105] given the harsh results of non-compliance[106] taxpayers as well as the IRS still expended considerable resources on entity classification.[107] The IRS also found that small businesses lacked the necessary resources and expertise to achieve the tax classification they desired under the *Kintner* regulations.[108] Reacting to the need for simplification, the IRS decided that the time had come to replace its rigid, formalistic rules with a simple, elective approach.

In May 1996, the IRS published proposed "check-the-box" regulations,[109] which would replace the *Kintner* regulations and effectively eliminate the need for entities to artificially structure their organizations in order to achieve the desired federal tax classification.[110] On December 18, 1996, the Treasury Department[111] officially promulgated the check-the-box regulations,[112] which became effective on January 1, 1997.[113]

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account balance equal to the lesser of one percent of total positive capital account balances or $500,000. *See id.* § 4.04. In order for the LLC to lack the corporate characteristic of limited liability, the "assuming member" must maintain throughout the entire existence of the LLC a minimum capital account balance equal to the lesser of one percent of total capital account balances, or $500,000. *See id.*

105. *See, e.g.*, Rev. Proc. 89-12, 1989-1 C.B. 798; Rev. Rul. 93-38, 1993-21 I.R.B. 4, 1993-_ C.B. ___; Rev. Proc. 92-33, 1992-1 C.B. 782.

106. If the entity was not in compliance, the IRS would treat the entity as an association taxable as a corporation from the date of non-compliance, which, for many businesses, would be the date of inception. *See generally* Richard M. Lipton & John T. Thomas, *Proposed Check-the-Box Business Classification Regulations Simplify Rules*, 13 J. PARTNERSHIP TAX'N 195 (1996). Therefore, the entity would be liable for the difference between the resulting corporate level tax and the tax that the entity had paid. *See generally id.*

107. For example, since the issuance of Revenue Rule 88-76, 1988-2 C.B. 360, "the [IRS] has issued seventeen revenue rulings analyzing individual state [LLC] statutes, and has issued several revenue procedures and numerous letter rulings relating to classification of various business organizations." Prop. Treas. Reg. §§ 301.7701-1 to 301.7701-3, 61 Fed. Reg. 21,989, 21,990 (1996). Commentators Lipton and Thomas has estimated that the IRS has issued at least 322 private letter rulings based solely on Revenue Procedure 89-12, 1989-1 C.B. 798, and issued 23 revenue rulings, 2 revenue procedures and 11 private letter rulings under Revenue Procedure 95-10, 1995-1 C.B. 501, in order to provide taxpayers with assurances that their "pass-through" entities would not be taxed as associations. *See* Lipton and Thomas, *supra* note 106. In addition, Lipton and Thomas estimate that tax professionals have published in excess of 1,000 articles in legal periodicals, and have devoted more than 40 pages to explaining the application of the *Kintner* regulations. *See id.*

108. *See* Prop. Treas. Reg. §§ 301.7701-1 to 301.7701-3, 61 Fed. Reg. 21,989, 21,990 (1996).

109. *See id.* at 21,991.

110. *See id.*

111. The authority of the Treasury Department to promulgate the check-the-box regulations has been questioned in a report by the Joint Committee on Taxation. *See* Joint Committee on Taxation, *Review of Selected Entity Classification and Partnership Tax Issues*, TAX NOTES TODAY, Apr. 10, 1997, at 68-8, *available in* WESTLAW, TNT database, at *1. The Joint Committee on Taxation's report questions "the legal authority for the regulations under the statutory language [which] defin[es] partnerships and corporations, [but] which does not explicitly describe an elective regime." *Id* at *2. The report suggests that to resolve the issue of the Treasury Department's authority to promulgate the check-the-box regulations, "Congress ought to establish by specific legislation that the regulations are authorized." *Id.* at *46. The report analyzes the relative advantages and disadvantages associated with the issuance of such specific legislation. *See id.* at *46-*47.

112. *See* T.D. 8697, 1997-2 I.R.B. 11.

113. *See id.*

III. "CHECK-THE-BOX" REGULATIONS

The new federal check-the-box classifications replace the fact-intensive *Kintner* regulations as the means to distinguish corporations from unincorporated business entities. The check-the-box regulations allow organizers of an entity to designate the entity as either an association or a partnership for tax purposes by simply checking a box on IRS Form 8832 and filing that election with the IRS.[114] Furthermore, entities organized on or before December 31, 1996, automatically retain the classification claimed prior to January 1, 1997.[115]

Under the check-the-box regulations, an eligible domestic entity with two or more members is automatically treated as a partnership for federal income tax purposes.[116] An affirmative election must be filed for an eligible domestic entity to be treated as a corporation.[117] Thus, as a practical matter, eligible domestic LLCs do not have to do anything to achieve partnership tax status.

The check-the-box regulations provide a number of benefits.[118] They are short, clear, and relatively easy to understand. One author summed up the primary benefits of the check-the-box regulations as follows:

> [The check-the-box regulations] (1) make it much easier and cheaper for sophisticated taxpayers to achieve the tax goals that could otherwise have been achieved, and at the same time eliminate the residual risk that the [IRS] might claim that some partnership factor is not satisfied for some technical reason; (2) they permit less sophisticated taxpayers quickly and easily to achieve the same tax results that have long been available to more sophisticated taxpayers; and (3) for all taxpayers, as well as the [IRS], they vastly simplify the law of entity classification, eliminate a vast body of arbitrary technical rules, and permit large amounts of time to be shifted to more productive pursuits.[119]

The check-the-box regulations are straightforward and simple to follow. First, the regulations clearly set out the types of business entities to which they apply.[120] Second, the regulations address the types of business organizations that will always

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114. *See id.*

115. *See id.*

116. *See id.* § 301.7701-3(b)(1)(i), 61 Fed. Reg. at 21,996.

117. *See id.* § 301.7701-3(a), 61 Fed. Reg. at 21,996.

118. Not everyone agrees that the check-the-box regulations are a good idea. One author has suggested that the check-the-box regulations violate horizontal equity. *See* Aaron W. Brooks, *Chuck the Box: Proposed Entity Classification Regulations Bring Bad Policy*, TAX NOTES, Mar. 18, 1996, at 1674-75. In addition, Brooks suggests that the premises upon which the check-the-box regulations are based are faulty, argues that the regulations will result in disparate tax treatment among similarly situated businesses, and eventually concludes that the changes necessary to make the check-the-box regulations equitable are impractical. *See id.* at 1676; *see also* Glenn L. Rigby, *California Franchise Tax Board Opposes Single-Member Business Entity Election*, TAX NOTES TODAY, Aug. 21, 1996, at 164-23, *available in* WESTLAW, TNT database. Rigby discusses how states like California, which tax non-corporate business entities, do not want to permit a business entity with limited liability to have its separate existence ignored for state tax purposes. *See* Rigby, *supra*, at 164-23. Rigby finds that ignoring, for tax purposes, the separate existence of these entities, if owned by a single member, is inconsistent with the policy that requires entities with the same measure of limited liability to pay for that statutory privilege. *See id.* The article concludes with a recommendation that single-member business entities always be classified as an associations taxable as corporations. *See id.*

119. Michael L. Schler, *Initial Thoughts on the Proposed "Check-the-Box" Regulations*, TAX NOTES TODAY, June 18, 1996, at 118-21, *available in* WESTLAW, TNT database.

120. *See* Treas. Reg. § 301.7701-2(a) (1997).

be classified as corporations for federal income tax purposes.[121] Third, the regulations discuss the treatment of unincorporated entities as partnerships or corporations for federal income tax purposes.[122] Fourth, they provide rules which govern certain types of foreign organizations.[123] Finally, the regulations address the taxation of unincorporated businesses that have only one owner.[124]

A. *Business Entities*

The first step in the check-the-box classification process is to determine whether a separate taxable entity exists.[125] Whether an organization is an entity separate from its owners is a matter of federal tax law.[126] The check-the-box regulations explain that an organization can be recognized as a taxable business entity under federal law, regardless of whether the entity is recognized as such under local or state law.[127] On the other hand, not all entities formed under local law are recognized as separate entities for federal tax purposes.[128]

A business entity is defined by the check-the-box regulations as "any entity recognized for federal tax purposes including an entity with a single owner that may be disregarded as an entity separate from its owner . . . ."[129] Generally, the business entities recognized for federal tax purposes include corporations and partnerships.[130] Every business entity with two or more owners must be classified as either a partnership or a corporation for federal tax purposes.[131] Perhaps most important is the regulations' treatment of single owner entities. A business entity with a single owner[132] is treated as a corporation or as a sole proprietorship, branch, or division of the owner.[133]

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121. *See id.* §§ 301.7701-2(b)(1) to 301.7701-2(b)(8).
122. *See id.* § 301.7701-3.
123. *See id.* § 301.7701-2(b)(8).
124. *See id.* § 301.7701-3(a).
125. *See id.* § 301.7701-1(a)(1).
126. *See id.* For example, organizations wholly-owned by a state are not recognized as separate entities if they are an integral part of the state. *See id.* § 301.7701-19(a)(3). Similarly, Indian tribes incorporated under section 17 of the Indian Reorganization Act (IRA) or under section 3 of the Oklahoma Indian Welfare Act (OIWA) are not recognized as separate entities for federal tax purposes. *See* § 301.7701-19(a)(3).

The language of Proposed Treasury Regulation section 301.7701-1(a)(3) was of concern to some Native American tribal lawyers. *See* Mary Streitz, *Tribal Corporations Should Not Be Classified as Separate Entities, Says Lawyer*, TAX NOTES TODAY, Aug. 22, 1996, at 165-29, *available in* WESTLAW, TNT database. The check-the-box regulations perpetuate what is seen as a lack of clarity in IRS policy toward wholly-owned tribal law corporations. *See id.* The regulations provide that corporations organized under the IRA and the OIWA are not recognized as separate entities for federal tax purposes, and thus their income is exempt from federal income tax. *See id.* However, the check-the-box regulations do not explicitly state that wholly-owned tribal law corporations will be given the same tax treatment. *See id.* Representatives of tribes with wholly-owned corporations argue that the check-the-box regulations should be amended to recognize the tax status of wholly-owned tribal corporations as well. *See id.* The Treasury Department acknowledged these concerns and stated in a treasury decision that the IRS is studying the tax treatment of wholly-owned tribal entities incorporated under tribal law, and that, if necessary, it will issue separate guidance concerning the issue. *See* T.D. 8697, 1997-2 I.R.B. 11.

127. *See* Treas. Reg. § 301.7701-1(a)(1) (1997).
128. *See id.* § 301.7701-1(a)(3).
129. *Id.* § 301.7701-2(a).
130. *See id.*
131. *See id.*
132. *See id.* § 301.7701-1(a)(4).
133. *Id.* § 301.7701-2(a); *see infra* Part III.A.3.

1. Corporations Defined

The basic premise of the check-the-box regulations is that every non-single owner entity that is not a corporation is treated as a partnership. An entity will be taxed as a corporation only after it files an election to be classified as a corporation. By default, all other non-single owner entities, including LLCs, will be taxed as partnerships, without having to file any election. To further simplify matters, the check-the-box regulations set out eight specific business entities[134] which will always be treated as corporations for tax purposes. Such domestic entities include the following:

(1) A business entity organized under a federal or state statute, or under a statute of a federally recognized Indian tribe,[135] if the statute describes or refers to the entity as incorporated or as a corporation, body corporate, or body politic;[136]

(2) An association;[137]

(3) A business entity organized under a state statute, if the statute describes or refers to the entity as a joint-stock company or joint-stock association;[138]

(4) Insurance companies;[139]

(5) State chartered banks, if the bank's deposits are FDIC insured;[140]

(6) Any business entity wholly-owned by a state or any political subdivision thereof;[141]

(7) Non-section 7701(a)(3) entities, including any entity that the Code specifically classifies as a corporation for tax purposes outside of I.R.C. § 7701(a)(3);[142] and

(8) Designated foreign entities.[143]

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134. *See* Treas. Reg. §§ 301.7701-2(b)(1)-301.7701-2(b)(8).

135. *See supra* note 126.

136. *See* Treas. Reg. § 301.7701-2(b)(1).

137. *See id.* § 301.7701-2(b)(2). Only those entities treated as an association by default or by election under the check-the-box regulations will be taxed as an association. *See id.*; *see also id.* § 301.7701-3.

138. *See id.* § 301.7701-2(b)(3).

139. *See id.* § 301.7701-2(b)(4).

140. *See id.* § 301.7701-2(b)(5).

141. *See id.* § 301.7701-2(b)(6).

142. *See id.* § 301.7701-2(b)(7). Some examples of non-section 7701(a)(3) entities are publicly traded partnerships subject to I.R.C. § 7704 (1996) and taxable mortgage pools under I.R.C. § 7701(l) (1996). Entities such as real estate mortgage investment conduits, *see* I.R.C. §§ 860(A)-860(G) (1996), regulated investment companies, *see* I.R.C. §§ 851-855, 860 (1996), and real estate investment trusts, *see* I.R.C. §§ 856-860 (1996), are overlooked because they are not corporations or partnerships and are subject to special classification under the Code. *See* Lipton & Thomas, *supra* note 106, at 195 n.20.

143. *See* Treas. Reg. § 301.7701-2(b)(8). The check-the-box regulations include an extensive list, which is beyond the scope of this Comment, that specifically identifies eighty-two different foreign entities by name. *See id.* These specific foreign entities will be classified by the IRS as corporations for federal tax purposes. *See id.* The regulations do include a special grandfathering provision that permits the listed foreign entities to continue to be treated as a partnership if the following requirements are met: (1) the entity was in existence on May 8, 1996; (2) the entity's classification was relevant; (3) no person, including the entity, treats the entity as a corporation for federal income tax return purposes; (4) any change in the entity's claimed classification within the sixty months prior to May 8, 1996, occurred solely as a result of a change in the organizational documents of the entity; (5) the entity had a reasonable basis for claiming partnership classification; and (6) neither the entity nor any member has been notified in writing during the sixty month period that the entity is under examination. *See id.* §§ 301.7701-2(d)(1) to 301.7701-2(d)(4).

2. Domestic Unincorporated Entities

If an organization is a business entity,[144] and is not deemed to be a corporation, then that organization is an "eligible entity."[145] Eligible entities are divided into two categories: domestic and foreign. A domestic entity is an entity formed under the laws of the United States or any state.[146] A foreign entity is negatively defined as any entity that is not a domestic entity.[147]

3. Single Member Entities

A significant aspect of the check-the-box regulations is the treatment of single member unincorporated organizations. A number of LLC statutes[148] currently allow LLCs to be formed with only one member,[149] or allow a LLC to continue to exist if its membership falls to one.[150] Under the former regulations, the tax treatment of a single member LLC was unclear. In Revenue Procedure 95-10, the IRS stated that it would "consider a ruling request that relates to classification of a LLC as a partnership for federal tax purposes *only if the LLC has at least two members*."[151] This indicates that single member entities could only be taxed as a sole proprietorship or as a corporation. In addition, questions arose with regard to the tax classification of a LLC originally formed with two or more members, but where only one member remained. Also in doubt was the tax treatment of entities owned by two or more members that were under common control; for example, a LLC owned by two wholly-owned subsidiaries of a common parent or a LLC owned by a S corporation and its sole shareholder.

The check-the-box regulations answer these questions. The regulations treat single owner[152] unincorporated entities as either corporations or as sole proprietorships, branches, or divisions of the owner.[153] Under the regulations, two or more members are necessary where partnership tax classification is desired by the LLC.[154] The regulations, however, permit a single owner unincorporated entity to elect to be treated as corporation.[155] If no election is made, the entity is taxed by default as either

144. *See* discussion *supra* Part III.A.

145. *See* Treas. Reg. § 301.7701-3(a).

146. *See id.* § 301.7701-1(d).

147. *See id.*; *see also infra* notes 162-166 and accompanying text.

148. For a discussion of amendments to New Mexico's LLC Act to explicitly provide for single member LLCs, see *infra* Part VI.A.

149. *See, e.g.*, ARK. CODE ANN. § 4-32-201 (Michie 1995); COLO. REV. STAT. ANN. § 7-80-203 (West 1996); MO. REV. STAT., § 347.037 (1997); N.M. STAT. ANN. § 53-19-7 (Repl. Pamp. 1993); TEX. REV. CIV. STAT. ANN. art. 1528(n), 4.01 (West 1980 & Supp. 1995).

150. *See, e.g.*, N.C. GEN. STAT. § 57C-6-01(4) (1996).

151. Rev. Proc. 95-10, 1995-3 I.R.B. 20 (emphasis added).

152. Concerns have been raised because the check-the-box regulations do not define what is a single-owner entity. For example, "[a] question arises as to whether both partners in a two-member partnership will be respected as such when both partners are commonly controlled and the only reason for having the second partner is so that the entity can be classified as a partnership under the entity classification rules." *See* Sheryl Stratton, *Commendations and Concerns Cited at Check the Box Hearing*, TAX NOTES TODAY, Aug. 22, 1996, at 165-3, *available in* WESTLAW, TNT database.

153. *See* Treas. Reg. § 301.7701-3(a) (1997). For further information about the taxation of corporations and sole proprietorships, see discussion *supra* Part IV.A.

154. *See* discussion *supra* Part IV.A.

155. *See* Treas. Reg. § 301.7701-3(a).

a sole proprietorship, branch, or division.[156] Where the single member is an individual, the entity is taxed as a sole proprietorship.[157] Where the single member is a corporation or other business entity, the entity is treated as a branch or a division.[158]

4. Foreign Entities

Possibly the most difficult aspects of the check-the-box regulations involve the extension of the rules concerning domestic entities to foreign eligible business organizations. Before the check-the-box regulations were promulgated, the IRS considered all foreign business organizations as unincorporated for federal tax purposes and analyzed these foreign business organizations under the four-factor test of the former *Kintner* regulations.[159] The classification of a foreign organization involved reviewing all the organizational documents of the entity, as well as reviewing the governing foreign law.[160] Because the IRS had to expend considerable resources in classifying these foreign entities, the check-the-box regulations included foreign entities in the regulations' purview to simplify the classification process and reduce the IRS's administrative burden.[161] Under the check-the-box regulations, an entity is defined as a foreign entity if it is not a domestic entity "created or organized in the United States or under the law of the United States or of any State . . . ."[162] In summary, the regulations[163] provide that a foreign entity is: "(A) [a] partnership, if it has two or more members and at least one member does not have limited liability;[164] (B) [a]n association, if all members have limited liability;[165] or (C) [d]isregarded as an entity separate from its owner if it has a single owner that does not have limited liability."[166] A member of a foreign entity has limited liability only if, based

156. *See id.*; *see also* discussion *supra* Part IV.A.

157. *See* Treas. Regs. §§ 301.7701-2(a), 301.7701-3(b)(1)(ii).

158. *See id.* § 301.7701-2(c)(2). A branch or division is defined as an arrangement "by which the shareholders of a single corporation split up their former investment among several corporate entities." BITTKER & EUSTICE, *supra* note 31, § 11.01[1], at 11-3.

159. *See* Treas. Regs. §§ 301.7701-1 to 301.7701-3 (1996) (amended 1997).

160. *See* Notice 95-14, 1995-14 I.R.B. 7.

161. *See id.*

162. Treas. Reg. § 301.7701-1(d). The check-the-box regulations make distinctions between domestic and foreign eligible entities because, if subject to the same partnership default provisions, foreign entities may be subject "to compliance requirements and excise tax liability under section 1491." *See id.* Similarly, an "association default [provision] might not match the expectations of a foreign entity" that is normally treated as a partnership for tax purposes. *See id.*

163. For more in-depth discussions of how the check-the-box regulations will affect foreign entities, see ____ Deloitte & ____ Touche, *Deloitte & Touche Comments on Check-The-Box Regs.*, TAX NOTES TODAY, Aug. 22, 1996, at 165-21, *available in* WESTLAW, TNT database; Richard M. Leder, *New York City Bar Submits Comments on Check-The-Box Rules*, TAX NOTES TODAY, Aug. 22, 1996, at 165-25, *available in* WESTLAW, TNT database; Lipton & Thomas, *supra* note 106, at 195; Thomas E. Rutledge, *Lawyer Praises Check-the-Box Regs.*, TAX NOTES TODAY, Aug. 22, 1996, at 165-19, *available in* WESTLAW, TNT database; Schler, *supra* note 119, at 118-21; Philip R. West, *The Proposed "Check-the-Box" System for Classifying Entities*, *in* 384 TAX LAW AND ESTATE PLANNING COURSE HANDBOOK SERIES 981 (Practicing Law Institute 1996).

164. Treas. Reg. §§ 301.7701-3(b)(2)(i)(A)-301.7701-3(b)(2)(i)(C).

165. *Id.* § 301.7701-3(b)(2)(i)(B).

166. *Id.* § 301.7701-3(b)(2)(i)(C). In addition, the check-the-box approach for foreign entities is not likely to have a substantial adverse revenue impact because the interests of the United States are better protected if foreign entities are classified as partnerships. *See* William S. McKee, *Issues Relating to Choice of Entity, Entity Characteri-*

on the controlling statute or law pursuant to which the entity is organized, the member's personal liability for the debts of or claims against the entity are specifically limited.[167] If protection from personal liability is optional, the entity's organizational documents will be determinative of which option applies.[168]

B. *Effective Dates*

The check-the-box regulations became effective January 1, 1997.[169] An eligible entity in existence before January 1, 1997, retains its classification unless the entity affirmatively elects to change its classification.[170] Thus, all elections are prospective from the date the election is filed or a later date designated in the election.[171] The entity's current classification will not be challenged by the IRS, so long as the entity: (1) had a reasonable basis for its claimed classification; (2) claimed that same classification for all prior periods; and (3) neither the entity nor any of its members had been notified in writing on or before May 8, 1996, that the classification of the entity was under examination by the IRS.[172]

This transition rule is an important provision for any unincorporated entity currently in existence that has not received a private letter ruling regarding its classification, and to which there is some doubt as to whether the entity reasonably meets the requirements for partnership classification under the former regulations. The practical effect of the foregoing transition rule is that, so long as there is a reasonable basis for arguing that the organization satisfied the requirements for partnership tax status under the former regulations, it can continue to be classified as a partnership for federal income tax purposes.

C. *Filing the Election*

The check-the-box regulations provide that an eligible entity may elect to be classified differently from what the default provisions provide. This is done by filing the election on IRS Form 8832, entitled "Entity Classification Election," with the IRS.[173] A copy of Form 8832 must be attached to the federal income tax return of the eligible entity for the tax year in which the election is made.[174] The election becomes effective on the date specified on the election, but not more than seventy-five days

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zation and Partnership Anti-Abuse Rules, in 382 TAX LAW AND ESTATE PLANNING COURSE HANDBOOK SERIES 9, 40 (Practicing Law Institute 1996).

167. *See* Treas. Reg. § 301.7701-3(b)(2)(C)(ii).

168. *See id.*

169. *See id.* § 301.7701-1(a)(4)(f).

170. *See id.* § 301.7701-3(a). For example, assume Entity X is formed by two associates with the objective to carry on business through Entity X and divide the profits therefrom. Assume further that Entity X is classified under the former regulations as an association taxable as a corporation. As of January 2, 1997, Entity X would continue to be classified as an association taxable as a corporation unless it made an election under the check-the-box regulations to be classified as a partnership. If Entity X were to have been formed on January 2, 1997, however, it would be classified as a partnership, even if no such election had been made. Example taken from West, *supra* note 163, at 988.

171. For example, assume that Entity X is formed on February 1, 1997, and that an election to classify Entity X as a corporation is filed on March 1, 1997. Entity X will be classified as a partnership for the one month period beginning on February 1, 1997, and ending on March 1, 1997, and as a corporation thereafter. Example taken from *id.* at 986.

172. Treas. Reg. §§ 301.7701-3(e)(2)(i)-301.7701-3(e)(2)(iii).

173. *Id.* § 301.7701-3(c)(1)(i).

174. *Id.* § 301.7701-3(c)(1)(ii).

before the date the election is filed.[175] If no date is given, the election is effective on the date it is filed.[176] The election may be signed by either: (1) all members of the entity; or (2) any authorized officer, manager, or member of the entity who represents under penalties of perjury to having such authorization.[177]

D. *Limits on Changing Classification*

It is important to note that the IRS also has imposed restrictions on changes in check-the-box classification.[178] If an eligible entity makes an election to change its classification, the entity cannot change its classification again for sixty months (or five years) following the effective date of the election.[179] There are three exceptions to this rule. First, the sixty-month rule is not triggered by an existing entity that files an election for classification to be effective on the effective date of the final regulations.[180] Second, the sixty month limitation does not apply to a new entity that elects out of its default classification at its inception.[181] Finally, the limitation does not apply to a transfer of the business to another entity.[182]

E. *Other Issues*

1. Recognition of Gains or Losses

The comments preceding the check-the-box regulations point out that

> a change in classification, no matter how achieved, will have certain tax consequences that must be reported. For example, if an organization classified as an association elects to be classified as a partnership, the organization and its owners must recognize gain, if any, under the rules applicable to liquidations of corporations.[183]

Therefore, if an organization was previously classified as an association, and thus taxed as a corporation, a check-the-box election effectively treats the association as having liquidated and distributed its assets to the owners.[184] A new partnership is then formed by capital contributions from the owners of the former association. A final return must be filed for the corporation, and the entity and its owners must recognize any gain under the rules applicable to corporate liquidations.[185] This requirement prevents many existing corporations from becoming LLCs. In addition, in order to

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175. *Id.* § 301.7701-3(c)(1)(iii).
176. *See id.*
177. *See id.* § 301.7701-3(c)(2). In addition, it is important that the electing entity have documentation of the signer's authority, either under the LLC agreement, or under a separate authorization document.
178. *See* T.D. 8697, 1997-2 I.R.B. 11.
179. *See* Treas. Reg. § 301.7701-3(c)(1)(iv).
180. *See id.*
181. *See* T.D. 8697, 1997-2 I.R.B. 11.
182. *See id.*
183. 61 Fed. Reg. 66,585 (Dec. 18, 1996); *see* I.R.C. § 331 (1996).
184. *See* I.R.C. §§ 331, 336 (1994).
185. *See id.*

be tax free, "a switch from partnership status to that of an association taxable as a corporation must come within I.R.C. § 351."[186]

2. Tax-Exempt Organizations

A special rule applies to tax-exempt organizations.[187] The IRS believes that the majority of tax-exempt organizations will not be eligible entities, either because they are properly classified as trusts for federal tax purposes or because they are not-for-profit corporations.[188] However, the check-the-box regulations provide that a claim or determination of tax-exempt status is treated as an election to be classified as an association, taxable as a corporation.[189]

3. Partnership Terminations

The check-the-box regulations indicate that the classification of a business entity will not be affected by a technical termination[190] of a partnership under I.R.C. § 708(b)(1)(B).[191] A termination is treated as a liquidation of the existing partnership and the formation of a new partnership.[192] The resulting partnership created by such termination, if an eligible entity, will be allowed to elect to change its classification without regard to the sixty-month rule.[193]

4. Publicly Traded Partnerships

Under the check-the-box regulations, the only barrier to partnership tax treatment is whether the LLC resembles a publicly traded partnership under I.R.C. § 7704.[194] As a result, the check-the-box regulations will increase awareness of I.R.C. § 7704, and the uncertainties that arise from that section. Recently, regulations were issued under I.R.C. § 7704 containing a broad definition of public trading.[195] However, numerous issues arise concerning the definitions contained therein, and these issues are likely to become more prominent now that the check-the-box regulations have been adopted and enacted.

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186. Stuart Levine, *Tax Aspects of Limited Liability Companies, Limited Liability Partnerships, and Other Novel Entities*, Q249 A.L.I.-A.B.A. 45, 67 (1996). For example, Entity X is classified as a partnership. It subsequently elects to be classified as an association taxable as a corporation. Entity X could be viewed as liquidating, with its owners contributing their distributed assets to a newly formed corporation in an I.R.C. § 351(1996) exchange. Alternatively, Entity X could be viewed as transferring its assets to a newly formed corporation in an I.R.C. § 351 exchange and then liquidating. Or, the partners could be viewed as having transferred their partnership interests to a newly formed corporation in an I.R.C. § 351 exchange. *See* Rev. Rul. 84-111, 1984-2 C.B. 88. Example taken from West, *supra* note 163, at 987-88.

187. *See* I.R.C. § 501(a) (1994).

188. *See* T.D. 8697, 1997-2 I.R.B. 11.

189. *See* Treas. Reg. § 301.7701-3(c)(1)(v).

190. *See* I.R.C. § 708(b)(1)(B) (1994).

191. *See id.*

192. *See id.*

193. *See* Treas. Reg. § 310.7701-3(e); *see also* discussion *supra* Part III.E.1.

194. *See* I.R.C. § 7704 (1994). Publicly traded partnerships are treated as corporations for tax purposes. *See id.* § 7704(a). Generally, a publicly traded partnership is any partnership where (1) interests in such partnership are traded on an established securities market, or (2) interests in such partnership are readily tradable on a secondary market or its equivalent. *See* §§ 7704(b)(1), 7704(b)(2).

195. *See* Treas. Reg. § 1.7704-1 (1995).

IV. OTHER TAX ISSUES PERTAINING TO LLCS

A. *Single Member LLCs and the Separate Interests Test*

From the taxpayer standpoint, one of the major developments stemming from the adoption of the check-the-box regulations is the recognition by the IRS of the single member LLC. The check-the-box regulations provide that an eligible entity with a single member can be classified as an association[196] (taxable as a corporation), as a branch or division,[197] or as a sole proprietorship.[198] For tax purposes, the earnings of a sole proprietorship pass through directly to the individual owner, and those earnings are taxed at the individual's tax rate. Thus, the recognition of the single member LLC offers individuals[199] the opportunity to isolate the liabilities of a new or existing sole proprietorship, without incurring a federal corporate-level tax.

The recognition of the single member LLC is laudable because the regulations remove the need for sole proprietors to form a S corporation,[200] and comply with all the requisite corporate formalities, in order to obtain limited liability.

> Before the [single member LLC] was blessed in the final check-the-box regulations, use of an S corporation provided the only certain means for a single individual taxpayer to obtain limited liability from business operation without a corporate-level tax .... The [single member LLC] will eliminate the need ... for the S corporation and its accompanying specialized accounting and tax filings.[201]

However, there are some tax consequences that may arise from the formation of a single member LLC. While the contribution of the assets of an existing sole proprietorship to the LLC, or the purchase of an existing business by the LLC,

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196. *See supra* notes 155-158 and accompanying text.

197. For example, a LLC with a single corporate owner can elect to be a "branch" of the corporate owner, to the extent that an entire chain of these entities could be viewed as branches of a single owner. A branch or division is defined as an arrangement by which the shareholders of a single corporation split up their former investment among several corporate entities. *See* BITTKER & EUSTICE, *supra* note 31, § 11.01[1], at 11-3. For a full discussion of what constitutes a division, see *id.*; see also *id.* §§ 11.01[1][a]-11.01[1][f], at 11-3 to 11-7. Divisions allow corporations to move property from the corporate solution to the hands of the shareholders without recognition of gain or loss at either the shareholder or the corporate level under I.R.C. § 355. *See id.* § 11.01[1][f], at 11-6. I.R.C. § 355 is one of the few remaining Code provisions under which the tax free movement of corporate assets can occur. *See id.* § 11.01[1][f], at 11-6 to 11-7. As a result, "structures that involve separate legal entities for state law purposes, yet are branches solely for tax purposes, are likely to proliferate under the new regime." Schler, *supra* note 119, at 1683. Thus, the rules for branches will be given a considerable amount of attention. For a thorough discussion of the check-the-box regulations and the rules on branches, see *id.*

198. The actual language of the regulations provides that a single member LLC "can elect ... to be disregarded as an entity separate from its owner." Treas. Reg. § 301.7701-3(a) (1996). A single member entity that is disregarded for federal income tax purposes and treated as a mere extension of its owner has been referred to as a "tax nothing." *See* David S. Miller, *The Tax Nothing*, TAX NOTES TODAY, Feb. 3, 1997, at 22-69, *available in* WESTLAW, TNT database. Sole proprietorships have traditionally not been seen as separate entities apart from the individual proprietor. *See supra* notes 14-17 and accompanying text. The law has regarded the unincorporated one-owner business and its assets as an unseparated part of all the owner's assets, making the proprietor personally liable for the business debts. *See id.*

199. Corporations also can isolate liabilities of branches or divisions. *See generally supra* notes 152-158 and accompanying text.

200. *See supra* notes 39-48 and accompanying text; *see also infra* notes 217-226 and accompanying text.

201. Miller, *supra* note 198, at 22-69.

ordinarily will not give rise to federal income tax consequences,[202] when an existing wholly-owned corporation is converted into a single member LLC, gains or losses will be recognized. The corporation will be treated as having distributed all of its assets subject to its liabilities in a deemed liquidation.[203] The deemed liquidation will give rise to gain or loss to the individual equal to the difference between the fair market value of the stock and the shareholder's basis in it.[204] This potential for gains has prevented many existing corporations from converting to LLCs. However, indebtedness incurred by a single member LLC can be and should be treated for federal income tax purposes as a nonrecourse debt of its owner.[205]

Problems with classifying single-member entities still may arise due to what is called the "separate interests test,"[206] a rather ill-defined concept that has been used by the IRS to determine that an unincorporated association has only one member.[207] Prior to the adoption of the check-the-box regulations, if a LLC was found to be a wholly-owned corporate division or branch, it would be classified as a corporation for federal income tax purposes.[208] Thus, LLCs with members consisting of two corporate subsidiaries, where the subsidiaries were controlled by a single corporate parent, were subject to the separate interests test to determine whether there were actually one or two members. If under the separate interests test the LLC was found to be a single member entity, the LLC was liable for corporate income tax on its prior and future earnings.[209]

The following example illustrates the problems associated with the continued use of the separate interests test in the new check-the-box environment.[210] Assume a corporate parent and its wholly-owned subsidiary are the owners of a LLC. The LLC

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202. *See id.* However, Miller notes that if the sole proprietor somehow convinces creditors to release her from personal liability for recourse debt that is assumed by the single member LLC, the transfer of that debt may give rise to a taxable event under Treasury Regulation section 1.1001-3(c)(2)(i) and Treasury Regulation section 1.1001-3(e)(5)(iii). *See* Miller, *supra* note 198, at 22-69.

203. *See id.*

204. *See* I.R.C. §§ 331, 336 (1996).

205. *See* Miller, *supra* note 198, at 22-69.

206. The "separate interests" test officially appeared as part of classification analysis in Revenue Ruling 77-214, 1977-1 C.B. 1978, when the IRS determined that a German "GmbH" (a type of German business entity) bore the *Kintner* characteristics of free transferability of interest and continuity of life. Each member of the GmbH was a subsidiary of a single corporate parent. Reasoning that the common corporate parent could control how either member would vote in approving any transfer of interests or in a continuity vote, the characteristics of free transferability and continuity of life were deemed to be present, and in combination with the presence of limited liability and centralized management, the GmbH was classified as a corporation.

Revenue Ruling 77-214 has been criticized for failing to extend its analysis to its logical conclusion: if one accepts that there is a lack of separate interests, the next logical step is that the entity lacks "associates" and, on the same basis, lacks an "objective to carry on a business and divide the gains therefrom." *See supra* notes 68-85 and accompanying text. Without these two characteristics present, the entity cannot be classified as either a corporation or a partnership. *See supra* notes 68-85 and accompanying text.

The IRS relaxed its Revenue Ruling 77-214 position in Revenue Ruling 93-4, 1993 C.B. 225, stating that finding separate interests is not necessary in determining whether there is continuity of life, and that free transferability will not be found even where there are no separate interests (as with wholly-owned subsidiaries), provided that there is either a prohibition against a transfer of an interest or there is a provision for dissolution of the entity upon the transfer of any interest.

207. For a good discussion about the separate interests test and how it may affect the classification of single member entities, see Rutledge, *supra* note 163, at 165-19; Levine, *supra* note 97, at 530-31.

208. *See* discussion *supra* Part III.A.3.

209. *See* Rutledge, *supra* note 163, at 165-19.

210. *See id.*

then elects to be classified as a partnership. The IRS, in response to a request for a ruling, applies the separate interests test, thereby collapsing the parent and the subsidiary into a single member. Because a single member entity cannot be classified as a partnership and an affirmative election is required to elect branch classification, the LLC probably would be taxed as a corporation.[211]

The IRS responded to whether there would be continued use of the separate interests test in the check-the-box regulations. The regulations state:

> Although the determination of whether an organization has more than one owner is based on all the facts and circumstances, the fact that some or all of the owners of an organization are under common control does not require the common parent to be treated as the sole owner . . . . [D]etermining whether the subsidiaries are associates continues to be an issue.[212]

Thus, it would appear that the IRS will not presume that a LLC owned by a corporate parent and its wholly-owned subsidiary is technically a single member LLC. Nevertheless, it also appears that whenever the particular facts and circumstances dictate, the IRS will employ the separate interests test to determine whether or not the wholly-owned subsidiary is truly an associate of the corporate parent.

B. *Is the End Nearing for S Corporations?*[213]

Now that the check-the-box regulations provide guidance for the tax treatment of single-member LLCs, a major advantage of the S corporation has disappeared. Many individuals use S corporations instead of LLCs, solely because of the former two-member requirement for partnership classification. With that restriction now eliminated, it may be questionable whether any good reasons to use S corporations remain.

S corporations traditionally have been the entity of choice for small businesses. In 1958, Subchapter S was enacted by the IRS to permit small businesses to take advantage of the liability shield of a corporation, without bearing the onus of double taxation.[214] In 1996, the Small Business Job Protection Act of 1996 was passed.[215] This Act revised many of the restrictions imposed on S corporations by the Code, making the S corporation a more flexible business vehicle.[216] While the changes made S corporations more flexible and increased their availability to small businesses, these changes, in reality, benefit very few businesses. Most importantly, even with these new changes, S corporations provide few options which are not

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211. *See id.*

212. T.D. 8697, 61 Fed. Reg. 66585 (Dec. 18, 1996).

213. *See supra* notes 39-48 and accompanying text.

214. *See* Technical Amendments Act of 1958, Pub. L. No. 85-866, 72 Stat. 1606 (1958).

215. *See* Pub. L. No. 104-188, 110 Stat. 1755 (1996).

216. The changes included increasing the number of shareholders allowed from 35 to 75, liberalizing the limitations on persons allowed to be shareholders of a S corporation, permitting a S corporation to hold stock in a subsidiary in which it holds 80 percent or more of the stock, and allowing a S corporation to have a wholly-owned subchapter S subsidiary. *See id.* In addition, the Small Business Job Protection Act contained a number of other provisions that improved the flexibility of S corporations. These included allowances for late elections to be retroactively validated and, in cases of inadvertent terminations or invalid elections, the S election would still be valid so long as certain steps were taken within a reasonable amount of time. *See id.*

currently available in the LLC.

The following is a brief summary of the relative advantages and disadvantages of LLCs in comparison to S corporations.[217] The advantages of a LLC over a S Corporation include:

• LLCs do not have any limitations on the number of equity owners. By contrast, S corporations are limited to 75 shareholders.[218]

• LLCs can have virtually any type of entity as a member, including corporations, partnerships, certain trusts, and nonresident aliens. S corporations are only allowed to have individuals and certain trusts act as shareholders and cannot have a nonresident shareholder.[219]

• S corporations may have only one class of stock.[220] LLC members can be given a preferred allocation as to income, but may not be able to participate in gains recognized from the sale of property.[221]

• Unlike S corporations, all LLC debt is treated as non-recourse debt.[222] Thus, this debt is allocated among all the LLC members for basis purposes.[223]

• Unlike S corporations, I.R.C. § 754 adjustments to basis elections are available in the event of the sale or exchange of an interest in a LLC or upon the death of a member.[224]

• Members of a LLC may receive distributions and make contributions of appreciated property on a tax-free basis, whereas, with a S corporation, these transactions may be taxable events.[225]

• Certain S corporations may be subject to corporate built-in gains tax, passive receipts tax, and similar types of entity-level tax.[226] A LLC is not subject to any federal income tax at the entity level.

The disadvantages of a LLC as compared to a S corporation include:

• LLCs are subject to the more complex partnership tax rules of subchapter K of the Code.[227]

• Going public is easier for a S corporation.[228]

• S corporations have the ability to limit the amount of Medicare taxes they pay.[229]

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217. For a good summary of the advantages and disadvantages of S corporations and LLCs, see *Check-the-Box and Beyond: The Future of Limited Liability Companies*, 52 BUS. LAW. 605-52 (Larry E. Ribstein and Mark A. Sargent eds. 1997) (This article is an edited version of comments made by lawyers and law professors who participated in an Internet symposium entitled "On-Line Symposium on the Future of Limited Liability Entities," conducted Sept. 11-25, 1996) [hereinafter Ribstein & Sargent].

218. *See* I.R.C. § 1361(b)(1)(A) (1996).

219. *See id.* § 1361(b)(1)(B).

220. *See id.* § 1361(b)(1)(D).

221. *See* Walter D. Schwidetzky, *Is It Time to Give the S Corporation a Proper Burial?*, 15 VA. TAX REV. 591, 636 (1996).

222. *See* Levine, *supra* note 97, at 524.

223. *See id.*

224. *See* Schwidetzky, *supra* note 221, at 637.

225. *See id.* at 599-600, 637.

226. *See id.* at 608-11.

227. *See id.* at 636, 639-42; *see also* I.R.C. §§ 701-761 (1996).

228. *See* Schwidetzky, *supra* note 221, at 637.

229. Both Medicare and FICA taxes are assessed on wages under I.R.C. § 3101 (1996). However, only Medicare taxes apply without an income limitation. Because of this disparity, a planning opportunity exists for S

• Drafting a LLC document, even after adoption of the check-the-box regulations, has the potential of being more difficult, and thus more expensive, than drafting similar corporate forms.[230]

• LLCs are not treated similarly by all states.[231]

• Under I.R.C. § 741, "the loss from the sale or exchange" of an interest in a LLC is a capital loss.[232] Under I.R.C. § 1244, S corporation shareholders generally may deduct a loss from stock as ordinary if it qualifies as § 1244 stock.[233]

• The substantive law for S corporations is more developed than the substantive law for LLCs.[234]

• A C corporation may simply elect S corporation treatment and receive pass-through tax treatment.[235] However, if a C corporation wishes to convert to a LLC to receive the same pass-through tax treatment, the conversion will trigger a *de facto* liquidation and may result in the recognition of gain by the shareholders.[236]

With the adoption of the check-the-box regulations, LLCs appear to be as simple to form as S corporations, and generally have the same, if not better, tax advantages.[237] Thus, it seems that the S corporation has little continuing viability. While limited situations remain in which a S corporation may be preferable,[238] many commentators agree that the demise of the S corporation appears inevitable.[239] It is hard to justify the existence of two wholly different types of pass-through entities, each subject to its own set of rules. In light of the check-the-box regulations, commentators agree that true simplification would be achieved by the repeal of Subchapter S.[240]

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corporations. For example, assume a S corporation has as its sole shareholder a successful attorney. The S corporation has $800,000 of income after all expenses except salary. Suppose the S corporation pays the attorney a salary of $300,000 on which Medicare tax is assessed. After the salary deduction, the S corporation has taxable income of $500,000. This amount will flow through and constitute income to the attorney under I.R.C. § 1366(a) (1996). This flow-through amount is general income, and not wages. If this is true, it is not subject to the Medicare tax, saving 2.9 percent of $500,000, or $14,500. Thus, the more modest salary paid, the greater savings potential. However, this example assumes that the IRS does not challenge this result and claim that the entire $800,000 is earned income. *See* Interview with Ben C. Roybal, business and tax lawyer, in Albuquerque, N.M. (Oct. 14, 1996).

230. Default rules are generally discussed and analyzed more in the LLC context, leading to more difficult and complicated documents than a corporation. *See id.*

231. *See infra* Part VI.B and Part VII.

232. I.R.C. § 741 (1996).

233. *See id.* § 1244(a).

234. *See* Ribstein & Sargent, *supra* note 217, at 629-31.

235. *See id.* at 631-32. A C corporation is a regular corporation governed by Subchapter C of the Code (§§ 301-386). *See* BLACK'S LAW DICTIONARY, *supra* note 55, at 341.

236. *See id.*; *see also supra* notes 202-204 and accompanying text.

237. The most significant tax advantage of LLCs is the allocation of LLC debt for basis purposes. *See* Levine, *supra* note 97, at 524. All LLC debt is treated as nonrecourse debt. *See id.* Thus, this debt is allocated among all the LLC members for basis purposes. *See id.* The S corporation is not accorded this same treatment for its debt. *See id.*

238. *See* Ribstein & Sargent, *supra* note 217, at 631-32. The primary advantage of S corporations, as noted by Ribstein and Sargent, is the ability to convert a corporation to a pass-through tax entity without having to go through a *de facto* liquidation and gain recognition. *See id.*; *see also supra* notes 202-204 and accompanying text.

239. *See* Jerome Kurtz, *The Limited Liability Company and the Future of Business Taxation: A Comment on Professor Berger's Plan*, 47 TAX L. REV. 815, 831 (1992); Schler, *supra* note 119, at 118-21; Schwidetzky, *supra* note 221, at 637-38.

240. *See generally* Kurtz, *supra* note 239; Schler, *supra* note 119; Schwidetsky, *supra* note 221.

C. *Self-Employment Tax*

One issue practitioners should consider when advising clients about LLCs is self-employment tax. Under I.R.C. §§ 1401(a)-1401(b), an individual's net earnings from self-employment[241] are subject to self-employment tax at the current rate of 15.3 percent.[242] Until recently, there was uncertainty as to whether the I.R.C. § 1402(a)(13) exclusion from self-employment tax applicable to the distributive shares received by limited partners, would apply to LLC members.[243] The question was whether the IRS would treat LLC members as limited partners, who generally do not pay self-employment tax on distributive shares,[244] or whether LLC members would be characterized as general partners, who must pay self-employment tax on their distributive shares of partnership income.[245]

The IRS has been working toward the resolution of this issue. In 1994, the IRS issued proposed regulations[246] in an attempt to clarify whether LLC members would be subject to self-employment tax. Under the 1994 proposed regulations, an individual owning an interest in a LLC was treated as a limited partner if: (1) the individual lacked the authority to make management decisions necessary to conduct the LLC's business; (2) the LLC could have been formed as a limited partnership rather than a LLC in the same jurisdiction; and (3) the member could have qualified as a limited partner in the limited partnership under applicable law.[247] If a member of a LLC was treated as a limited partner, then the member's distributive share of income or loss from the LLC would not be included in net earnings from self-employment.[248] The intent of the 1994 proposed regulations was to treat the owners of a LLC in the same manner as similarly situated partners in a state law partnership.[249] However, those proposed regulations were met by mixed reviews.[250] After considering the comments received, the IRS decided to withdraw the 1994 proposed regulations.[251]

In early 1997, the IRS issued a new set of proposed regulations.[252] These proposed regulations apply to all entities classified as partnerships for federal tax purposes, regardless of the state law characterization of the entities.[253] Under the check-the-box

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241. *See* I.R.C. § 1402(a) (1996) (defining net earnings from self-employment as "the gross income derived by an individual from any trade or business carried on by such individual, less the deductions allowed . . ., plus [the individual's] distributive share (whether or not distributed) of income or loss described in [I.R.C.] § 702(a)(8) [1996] from any trade or business carried on by a partnership of which [the individual] is a member, unless a specific exception applies." *Id.*

242. *See id.* §§ 1401(a)-1401(b).

243. Section 1402(a)(13) reads "there shall be excluded [from self-employment tax] the distributive share of any item of income or loss of a limited partner . . . ." *Id.* § 1402(a)(13).

244. *See id.*

245. *See id.*

246. *See* Prop. Treas. Reg. § 1.1402, 59 Fed. Reg. 67,253 (1994).

247. *See* Internal Revenue Service, *Proposed Reg. Would Provide Self-Employment Tax Rules for LLC Members*, TAX NOTES TODAY, Dec. 30 1994, at 251-9, *available in* WESTLAW, TNT database.

248. *See id.*

249. *See* Internal Revenue Service, *IRS Issues Proposed Amendments to Limited Partner Regs.*, TAX NOTES TODAY, Jan. 14, 1997, at 9-25 *available in* WESTLAW, TNT database [hereinafter *Proposed Amendments*].

250. *See id.*

251. *See id.*

252. Prop. Treas. Reg. § 1.1402, 62 Fed. Reg. 1702 (1997).

253. *See Proposed Amendments*, *supra* note 249.

regulations, all LLCs, by default, are classified as partnerships for federal tax purposes, unless the LLC members affirmatively elect classification as a corporation.[254] Thus, if adopted, the 1997 regulations will apply to most LLCs.

The 1997 proposed regulations provide that a LLC member will be treated like a limited partner, and thus not be subject to self-employment tax, unless the member: (1) has personal liability for the debts of or claims against the LLC by reason of being a member (the personal liability test); (2) has authority to contract on behalf of the LLC under the statute or law pursuant to which the LLC is organized (the power to bind test); or, (3) participates in the LLC's trade or business for more than 500 hours during the taxable year (the material participation test).[255] If, however, substantially all of the activities of a LLC involve the performance of services in the field of health, law, engineering, architecture, accounting, actuarial science, or consulting, any individual who provides services as a part of that trade or business will not be considered a limited partner, and thus be subject to self-employment tax.[256]

The 1997 proposed regulations appear to add a level of certainty to the application of the self-employment tax rules to LLCs. However, one commentator has already found the proposed regulations to be problematic.[257] It remains to be seen how the self-employment tax question will be resolved with respect to LLCs.

D. *Fringe Benefits*

One disadvantage of using LLCs relates to the deductibility of fringe benefits. In a C corporation, certain fringe benefits that a corporation pays on behalf of its shareholders who are also employees of the corporation, including premiums paid for health and accident insurance, may be received tax free by the shareholder-employees and deducted by the corporation.[258] The treatment of fringe benefits is not the same for a LLC. Health and accident insurance premiums paid by a LLC on behalf of its members, while deductible by the LLC, are income to the members and subject to income tax.[259]

Only employees of an organization may receive fringe benefits tax free.[260] The IRS takes the position that a member of a LLC cannot be an employee of the LLC.[261] The Code's definition of an employee does not include self-employed individuals.[262] Members of a LLC may be subject to self-employment tax,[263] and thus be considered self-employed for federal tax purposes. Therefore, self-employed members are not allowed to fully exclude the benefits of health insurance and other fringe benefits

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254. *See* discussion *supra* Part III.A.

255. *See* Prop. Treas. Reg. §§ 1.1402(a)-2(h)(2)(i) to 1.1402(a)-2(h)(2)(iii), 62 Fed. Reg. 1702, 1704 (1997). Proposed Treasury Regulation section 1.1402(a)-2(i) provides examples of how these rules are applied.

256. *See id.* §§ 1.1402(a)-2(h)(6)(i) to 1.1402(a)-2(h)(6)(iii).

257. *See* Richard Loengard, Jr., *NYSBA Comments of Self-Employment Regs.*, TAX NOTES TODAY, Mar. 27, 1997, at 59-24, *available in* WESTLAW, TNT database.

258. *See* I.R.C. §§ 79, 106, 162(a) (1996).

259. *See id.* §§ 105(g), 162(a).

260. *See id.* § 106(a).

261. *See id.* § 105(g). *But see* Armstrong v. Phinney, 394 F.2d 661, 663-64 (5th Cir. 1968) (holding that a member of a partnership may be an employee of the partnership for federal income tax purposes).

262. *See* I.R.C. § 105(g) (1996).

263. *See supra* Part IV.C.

from their personal income.[264] As of 1997, the IRS allows self-employed individuals to deduct only forty percent of the amount paid for health insurance.[265] This can result in a considerable tax burden for a small-business owner.[266]

V. NON-TAX ISSUES REGARDING LLCs

A. *Piercing the LLC Veil*[267]

An important non-tax issue regarding LLCs concerns the grounds on which courts will "pierce the veil" of the LLC and impose liability on its members. "Piercing the corporate veil" is a term of art used to describe the equitable doctrine under which courts will disregard the limited liability shield of the corporation, and impose personal liability on the stockholders, officers, and directors for wrongful acts done in the name of the corporation.[268] Veil-piercing is based on equitable and common sense principles including: (1) misrepresentation of capitalization or owner's responsibility; (2) continued deliberate undercapitalization; (3) failure to separate adequately the firm's and the owners' assets; and (4) complete disregard for decision-making and other formalities.[269] Many commentators argue that these principles should apply equally to LLCs.[270]

Some state LLC statutes attempt to clarify veil-piercing with respect to LLCs. These statutes provide that the limited liability shield will be pierced in LLCs to the same extent as in corporations, or that LLC members will have the same liabilities as corporate shareholders.[271] The New Mexico Limited Liability Company Act[272] provides that ". . . the principles of law and equity supplement [the Act], including such principles applicable to corporations and their owners."[273] Thus, it seems that New Mexico LLCs and their members are subject to veil-piercing to the same extent as corporations and their shareholders.

With the advent of single member LLCs, this issue takes on further significance. In fact, commentators have predicted that "courts will compensate for the recent expansion of limited liability to more closely held entities by applying the doctrine

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264. *See* I.R.C. § 162(l) (1996).

265. *See id.* § 162(l)(1)(B). The percentage that may be deducted by a self-employed individual will increase in 1998 to 45%; in the year 2006 up to 80% will be deductible. *See id.*

266. For example, suppose a sole proprietor decides to form a LLC. This member has the cost of the health insurance for his family paid out of the LLC. Suppose the cost of health insurance for a family of four is $5,000. The cost of the health insurance must then be added to the member's income. The member is allowed to deduct $2,250 (45% of $5,000, using 1998 figures) leaving $2,750 of taxable income. If taxed at a 30% individual tax rate, the member would have to pay $825 more in taxes than if the member had formed a corporation and received this income tax free. This amount may be significant to small business owners, and should be given due consideration. *See* Interview with Ben C. Roybal, *supra* note 229.

267. For a discussion about the pros and cons of the expansion of limited liability entities, see Ribstein and Sargent, *supra* note 217, at 641-45.

268. *See generally* WILLIAM L. CARY & MELVIN ARON EISENBERG, CASES AND MATERIALS ON CORPORATIONS 163-200 (7th ed. 1995).

269. *See* Ribstein, *supra* note 37, at 8-9.

270. *See id.* at 9.

271. *See id.*

272. N.M. STAT. ANN. §§ 53-19-1 to 53-19-74 (Repl. Pamp. 1993 & Cum. Supp. 1996).

273. *Id.* § 53-19-65(B) (Repl. Pamp. 1993).

of piercing with increased vigilance."[274] Courts will disregard limited liability shields if they find that an entity is essentially the "alter ego" of the owner; that is, if there is "such unity of interest and ownership that the separate personalities of the corporation and the individual no longer exist."[275] An alter ego may be demonstrated by several factors, most notably, the failure to maintain adequate business records or to comply with formalities, the commingling of funds or assets of the business with the owners funds and assets, and undercapitalization.[276] Thus, it is clear how a single-member LLC could easily be seen as an alter ego of the owner.[277]

Practitioners should make LLC owners aware of the grounds on which New Mexico courts will "pierce the LLC veil." In New Mexico, courts will pierce the corporate veil when at least three requirements are met.[278] These include: (1) a showing of instrumentality or domination; (2) improper purpose; and (3) proximate causation.[279] Instrumentality or domination are the terms New Mexico uses to refer to the alter ego doctrine.[280] Thus, where there is evidence of instrumentality such that the individuality or separateness of the owner and the LLC has ceased, coupled with an improper purpose and causation, the owner of a LLC may be held liable for the contractual obligations of the business under New Mexico law.[281] It is also worthwhile to note that while LLCs provide limited liability, the scope of the limited liability "does not protect members from liability for agreed contributions and excessive distributions, for members' own wrongs, or for debts the members contractually assume or guarantee."[282]

B. *Fiduciary Duties*[283]

State LLC statutes vary in their descriptions of fiduciary and other duties owed by the members and managers to the LLC and its members. As previously stated, New Mexico's Limited Liability Company Act[284] permits a LLC to be managed either by the members themselves or by managers who may be selected by the members.[285] In LLCs, the people who have management authority may also enter into contracts and obligate the LLC.[286] Thus, in a LLC in which management is reserved to the members, members can bind the LLC to contracts.[287] But if the LLC is operated by managers, only managers may bind the LLC, and members do not have that

274. Ribstein & Sargent, *supra* note 217, at 644.

275. Scott v. AZL Resources, Inc., 107 N.M. 118, 121, 753 P.2d 897, 900 (1988); *see* Sea-Land Services, Inc. v. Pepper Source, 941 F.2d 519, 520 (7th. Cir. 1991); Van Dorn Co. v. Future Chemical and Oil Corp., 753 F.2d 565, 569-70 (7th. Cir. 1985).

276. *See Van Dorn*, 753 F.2d at 570.

277. For a discussion of the use of operating agreements and single member LLCs, see *infra* Part VI.A.2.

278. *See AZL Resources*, 107 N.M. at 121, 753 P.2d at 900.

279. *See id.*

280. *See id.*

281. *See id.*

282. Ribstein, *supra* note 37, at 9.

283. For an in-depth discussion of fiduciary duties in LLCs, see RIBSTEIN & KEATINGE, *supra* note 98, §§ 9.01-9.11, at 9-1 to 9-57.

284. N.M. STAT. ANN. §§ 53-19-1 to 53-19-74 (Repl. Pamp. 1993 & Supp. 1996).

285. *See id.* § 53-19-15.

286. *See* N.M. STAT. ANN. §§ 53-19-15 to 53-19-16 (Repl. Pamp. 1993).

287. *See id.*

authority, unless they are acting in some other capacity.[288]

A member in a member-managed or a manager in a manager-managed LLC has duties that can be characterized as fiduciary. Members of a member-managed LLC are comparable to general partners[289] in that they are general agents of the LLC, but they are different in that their actions do not create liabilities that are individually binding on the other owners.[290] The LLC's members also may owe each other a duty to perform under the agreement that created the relationship.[291] Furthermore, members may owe to each other fiduciary duties that arise from the control that a majority member exercises over the business.[292]

Fiduciary duties are normally not fully defined in statutes.[293] In part, this is due to the ambiguous and changing nature of the roles similarly titled actors may have. A member of a LLC may, at times, be the equivalent of an owner, director, officer, or employee.[294] It is difficult for a statute to outline a single, prescriptive standard which would be applicable in all situations.

However, New Mexico's Limited Liability Company Act attempts to provide some guidance as to the fiduciary duties owed by members and managers. In New Mexico, LLC members, when acting in a management capacity, can be held liable only when their acts or omissions constitute *gross negligence or willful misconduct*.[295] New Mexico, however, has no specific provisions setting forth the duties of managers, preferring instead to allow the members themselves to define such duties.[296] The New Mexico Limited Liability Company Act provides that "the articles of organization or an operating agreement may prescribe the qualifications and the number of managers, the method in accordance with which managers shall be selected, and *duties and responsibilities* of such managers."[297] Therefore, the New Mexico Limited Liability Company Act imposes a gross negligence and willful misconduct standard of duty on the members of a LLC, and allows the members themselves to prescribe the standard of duty applicable to the managers of the LLC.

VI. HOW LLCS WILL IMPACT NEW MEXICO

This Part explores the impact that the check-the-box regulations will have on New Mexico law. It then discusses salient issues regarding LLCs about which New Mexico's attorneys and tax advisors should be aware.

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288. *See id.*
289. See notes 18-30 and accompanying text.
290. *See* Robert R. Keatinge, *The Implications of Fiduciary Relationships in Representing Limited Liability Companies and Other Unincorporated Associations and Their Partners or Members*, 25 STETSON L. REV. 389, 390-91 (1995).
291. *See id.* at 403-13.
292. *See id.*
293. *See* RIBSTEIN & KEATINGE, *supra* note 98, § 9.01, at 9-1.
294. *See generally id.* § 9.01, at 9-2 to 9-3.
295. *See* N.M. STAT. ANN. § 53-19-16(B) (Repl. Pamp. 1993).
296. *See id.* § 53-19-15(B).
297. *Id.* (emphasis added).

A. *Possible Amendments to New Mexico's Limited Liability Company Act*

1. Single Member LLCs

Fortunately, New Mexico's Limited Liability Company Act[298] was drafted with foresight and with flexibility in mind. New Mexico's statute is sufficiently flexible to allow new and existing LLCs to take advantage of the benefits provided by the check-the-box regulations. In New Mexico, a LLC's articles of organization[299] and operating agreement[300] can include any provisions the members desire. If the members do not include provisions in the articles of organization or the operating agreement, the default provisions in the New Mexico Limited Liability Company Act will serve as "gap fillers."

It is unclear whether, under the New Mexico Limited Liability Company Act, a single member LLC will be recognized.[301] Currently, the Act provides that "[o]ne or more *persons* may *form* a [LLC] *by filing* articles of organization with the commission."[302] While this language seemingly allows for the formation of single member LLCs, it also could be interpreted to mean that it only takes one person to *file* the necessary documents with the state in order to *form* a LLC.[303] In fact, the sentence following the above language provides that "[t]he persons forming the [LLC] need not be members of the [LLC]."[304] This language seems to indicate that any person can file the necessary documentation to form the LLC, such as the attorney who drafts the articles of incorporation.[305] Furthermore, no section in the New Mexico Limited Liability Company Act states explicitly that a LLC can be formed with only one member.[306]

However, this ambiguity in the New Mexico Limited Liability Company Act could be eliminated with a simple amendment to the section of the statute that defines a LLC. The relevant section currently reads: "[A LLC] . . . means an organization formed pursuant to the provisions of the Limited Liability Company Act[.]"[307] This section could and should be amended to state a LLC means an organization *consisting of one or more members* formed pursuant to the provisions of the New Mexico Limited Liability Company Act.[308] With this amendment, any concerns regarding the recognition of single member LLCs in New Mexico would be effectively eliminated.

2. Single Member Entities and Operating Agreements

One problem with the single member LLC is that current LLC statutes have been

298. *Id.* §§ 53-19-1 to 53-19-74 (Repl. Pamp. 1993 & Cum. Supp. 1996).
299. *See id.* § 53-19-8.
300. *See id.* § 53-19-2(O).
301. Interview with Stan Betzer, member of the New Mexico Limited Liability Company Act drafting committee, in Albuquerque, N.M. (Dec. 9, 1996).
302. N.M. STAT. ANN. § 53-19-7 (Repl. Pamp. 1993 & Cum. Supp. 1996) (emphasis added).
303. *See* Interview with Stan Betzer, *supra* note 301.
304. *See id.*
305. *See id.*
306. *See id.*
307. N.M. STAT. ANN. § 53-19-2(I) (Repl. Pamp. 1993).
308. *See* Interview with Stan Betzer, *supra* note 301.

drafted with multiple members in mind.[309] The default rules contained in most LLC statutes do not really fit single member firms. Initially, it may be awkward for practitioners to adapt LLC standard forms, such as operating agreements that are drafted for two or more members and are based upon the default rules contained in the statute, into a form appropriate for a single member LLC under the check-the-box regulations.[310]

In New Mexico, in order to form a LLC, all that must be filed is the Articles of Organization.[311] Thus, in order to form a single member LLC in New Mexico, one may think that an operating agreement is unnecessary. However, some commentators contend that even in a single member LLC, an operating agreement may need to be drafted.[312] The reasons behind this argument are: (1) third parties that take an interest in the ownership, such as by taking a security interest in the membership interest, may have concerns with the rules governing the operation of the LLC and its relationship with its owner;[313] and (2) courts may be more inclined to respect the limited liability of the owner if the organization is operated as a separate entity, with rules governing distributions and other payment to the owner clearly set forth in an operating agreement.[314] However, there is still debate as to whether there can actually be an enforceable operating agreement with only one member.[315]

3. Dissolution

Practitioners also should be aware of the default provisions in the New Mexico Limited Liability Company Act pertaining to the continuation of the LLC following the occurrence of an event of dissolution.[316] Currently, the New Mexico Limited Liability Company Act requires that if an event of dissolution occurs, the LLC must dissolve unless a majority in interest of the remaining members give their written consent to continue the LLC.[317] Determining a "majority in interest of the remaining members" is difficult, because of the complicated definitional language.[318] The

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309. *See* Ribstein & Sargent, *supra* note 217, at 638.

310. *See id.* at 638-39.

311. *See* N.M. STAT. ANN. § 53-19-9 (Repl. Pamp. 1993).

312. *See* Ribstein & Sargent, *supra* note 217, at 640. Specifically, Robert Keatinge argues that operating agreements are still necessary. *See id.*

313. *See id.*

314. *See id.*

315. *See id.* Ribstein argues that such an operating agreement is not legally enforceable because an agreement has to be between members, and an agreement between the member and the LLC is legally invalid. *See id.* at 641. Keatinge argues that such an operating agreement is legally enforceable because the agreement is made between the member and the LLC, which should be treated as separate entities. *See id.* at 640.

316. *See* N.M. STAT. ANN. §§ 53-19-39(A)(3), 53-19-39(C)(1)-(3) (Repl. Pamp. 1993). A LLC is dissolved after the occurrence of an event of dissociation. *See id.* § 53-19-39(A)(3). An event of dissociation is defined as an event that causes a person to cease to be a member of a LLC. *See id.* § 53-19-2(E). These events include, but are not limited to: (1) making an assignment for the benefit of creditors; (2) filing a voluntary petition in bankruptcy; (3) being adjudicated a bankrupt or insolvent; (4) death of the member; (5) insanity of a member; (6) in the case of a member that is a LLC or partnership, the dissolution and commencement of winding up of the LLC or partnership; and (7) in the case of a member that is a corporation, the filing of a certificate of dissolution. *See id.* §§ 53-19-38(B)(1), 53-19-38(B)(3), 53-19-38(B)(5), 53-19-38(B)(6).

317. *See id.* § 53-19-39(A)(3).

318. A majority in interest consists of the remaining members that: (1) hold a majority share of the voting power of all members; (2) whose aggregate share of the capital of the LLC constitutes more than one-half of the aggregate share of capital of the LLC of all remaining members; and (3) whose aggregate share of the distributions

section defining a "majority in interest of remaining members" should be amended to state that a *majority vote of the members* is sufficient to continue the business of the LLC.[319]

B. *State Income Tax Issues*

The check-the-box regime is applicable only for federal income tax purposes. Although most states will likely elect to follow a similar system, some states have already announced that they will not follow the federal check-the-box rules for classification.[320] The implications of this inconsistent tax treatment are particularly severe for single member entities.[321] Under check-the-box regulations, the single member entity, by default, is treated either as a branch, division, or sole proprietorship.[322] In states which do not adopt the check-the-box classifications, a single member entity possibly could be taxed as a corporation.[323]

Similarly, under the check-the-box regulations, a change in a LLC's corporate characteristics[324] will not affect the classification of the entity for federal income tax purposes. However, in a state that does not adopt the check-the-box classifications, a LLC's classification could change as a result of a change in the number of the entity's corporate characteristics.[325] Thus, there is the possibility that a LLC could be taxed as a corporation under state law and as a partnership under federal law. It is imperative, therefore, for practitioners to check whether the state in which the LLC is organized *and doing business* follows the federal check-the-box classifications.

Fortunately, most states, including New Mexico, have elected to follow the federal rules of classification.[326] Under New Mexico's Corporate Income and Franchise Tax Act[327] (CIFT), New Mexico imposes a corporate income tax upon the net income of every domestic corporation and upon the net income of every foreign corporation transacting business within the state.[328] The CIFT defines a corporation as

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and allocations of the LLC constitutes more than one-half of the aggregate share of the distributions and allocations to all remaining members. *See* N.M. STAT. ANN. § 53-19-39(C) (Cum. Supp. 1996).

319. *See* Interview with Stan Betzer, *supra* note 301.

320. Significantly, the Franchise Tax Board in California announced that the check-the-box regulations will not apply for California tax purposes. *See* Alan Shapiro & Barbara Mantegani, *From Morrissey to Check-the-Box: Can You Get There From Here?*, TAX NOTES TODAY, Feb. 10, 1997, at 27-36, *available in* WESTLAW, TNT database. In addition, the New York City Department of Finance recently ruled that a LLC taxable as a corporation for federal and state income tax purposes was not taxable as a corporation for city tax purposes, and was subject to the unincorporated business tax. *See id.* (citing N.Y. Finance Letter Ruling 95-4646, Feb. 26, 1996). However, New York has stated that it will conform to the new federal rules, but only with respect to single member LLCs. *See id.* (citing N.Y. Finance Letter Ruling 95-4646, Feb. 26, 1996).

321. *See id.*

322. It is important to recall that a single-member entity must affirmatively elect to be classified as an association and be taxable as a corporation. *See* discussion *supra* Part III. Otherwise, the entity is disregarded for tax purposes and the entity is taxed as a sole proprietorship. *See* discussion *supra* Part III.

323. For example, in California, a state which does not recognize the check-the-box classifications, a single member entity will be taxed as a corporation. *See* Shapiro and Mantegani, *supra* note 320 (citing Cal. FTB Notice 96-5, Dec. 6, 1996).

324. *See* discussion *supra* Part III.

325. *See* Shapiro & Mantegani, *supra* note 320.

326. *See* Stephen L. Gordon, et al., *The Best Entity for Doing the Deal: Tax Issues*, *in* 937 CORPORATE LAW AND PRACTICE COURSE HANDBOOK SERIES 397, 426 (Practising Law Institute 1996).

327. N.M. STAT. ANN. §§ 7-2A-1 to 7-2A-15 (Repl. Pamp. 1995).

328. *See id.* § 7-2A-3(A).

"corporations, joint stock companies, real estate trusts . . . , financial corporations and banks, other business associations and, *for corporate income tax purposes, partnerships, and limited liability companies taxed as corporations under the [Code].*"[329] Thus, the statute explicitly provides that, for state income tax purposes, it will tax as a corporation only those LLCs which elect to be taxed as corporation under the check-the-box rules for classification. In addition, single member LLCs which elect under the check-the-box regime to be taxed as an association (which is taxable as a corporation), will be taxed as a corporation under state tax law.[330] Finally, single member LLCs which elect to be taxed as a sole proprietorship, will be taxed as such under New Mexico tax law.[331]

C. Drafting LLC Operating Agreements

As a result of the adoption of the check-the-box regulations, a LLC may be structured in almost any manner that business owners desire, and still qualify for partnership tax treatment. For example, it is now possible to create a LLC that functions identically to a corporation, but without the formalities and inconveniences associated with corporations. Or, one may chose to form a LLC that functions identically to a partnership. Clearly, this planning flexibility provides a significant advantage for business owners both in terms of selecting the most suitable form of entity for their business and in organizing the management, continuity, and transferability of interests in the entity.

In addition, practitioners have the ability to significantly amend operating agreements of existing entities to streamline the operation of client's LLCs. For example, commentators have suggested that LLC managers be given the flexibility to eliminate from the operating agreement provisions included solely to attain partnership tax status under the former regulations.[332] These provisions would include the mandatory dissolution of the LLC on the death, insanity, withdrawal, bankruptcy, or other event (subject to a majority or greater percentage vote of the members),[333] as well as provisions restricting free transferability of interests (subject to consent of other members).[334]

However, consideration should be given to the non-tax reasons for such provisions before one modifies an existing LLC operating agreement. Practitioners must realize that the restrictions that have been incorporated primarily for tax status purposes may be important and even desirable to the members of a LLC. In most closely-held LLCs, it will be important to members that there be restrictions on who may own interests in a LLC, because there are always potential transferees that are undesirable or improper. Providing for free transferability of interests, and eliminating the members' rights to vote on such matters, could potentially cause more problems than

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329. *Id.* § 7-2A-2(D) (emphasis supplied).
330. *See id.*
331. *See* N.M. STAT. ANN. § 7-2-2(R) (Repl. Pamp. 1995)
332. *See* Sheldon Banoff & Richard Lipton, *Drafting LLC, Partnership Agreements Pending "Check-the-Box,"* 84 J. TAX'N 254, (1996).
333. *See* N.M. STAT. ANN. §§ 53-19-38 to 53-19-39 (Repl. Pamp. & Supp. 1996).
334. *See id.* § 53-19-36.

it may solve.[335] Furthermore, with regard to provisions designed to avoid continuity of life, it will often be desirable for the entity to dissolve in the case of a LLC manager or member's inability to serve.[336] Under such circumstances, it may be desirable to have the LLC dissolve on the occurrence of such an event, considering that the remaining members can vote to continue the business of the LLC.

VII. CONCLUSION

It has been my observation that practitioners in New Mexico are divided when it comes to acceptance of the LLC. Academics, for the most part, embrace the LLC and widely support its use. However, practitioners are split. If the LLC is such an ideal entity as this Comment describes, why are practitioners hesitant to use LLCs?

One problem with the LLC is that it is a new form of entity, with new, and thus uncertain, legal consequences. Unlike partnerships and corporations, where the substantive law is comprehensive, LLCs do not have the advantage of well-established caselaw.

Another problem is that LLCs are creatures of state statute, and the various state statutes are not uniform. Lack of uniformity means that with multi-state businesses, practitioners must not only consider the rules of the state in which the LLC will be formed, but also the rules in the states where the business will operate. These rules include not only the applicable LLC statute, but also the state income tax rules to see if the state has adopted the check-the-box classification regime. In addition, some state LLC statutes bar certain ventures from operating as LLCs, most notably those state statutes that do not explicitly allow for single member LLCs.[337]

This problem may be rectified by the adoption by all states of the Uniform Limited Liability Company Act (ULLCA). The ULLCA was approved by American Bar Association (ABA) House of Delegates in 1996.[338] Four states have already adopted acts based on the ULLCA.[339] In July of 1996, in response to the release of the "check-the-box" regulations, the ULLCA was amended to modify the rule that the dissociation of a member causes an automatic dissolution.[340] Additional amendments to the ULLCA are predicted in the wake of the new check-the-box regulations.[341]

Lack of acceptance of LLCs also may be the result of simple ignorance, both on the part of the professional and the general public. Although articles about LLCs have been prolific in professional tax journals in recent years, LLCs are still not well-known or understood by practitioners, much less the public. Professionals, and most clients, hesitate to be the first to try something new, and are thus unwilling to be the "test case."

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335. Not only would free transferability of interests open the door to possible undesirable members, but it may also cause classification problems by resembling a publicly traded partnership. *See supra* note 194.

336. These provisions may be particularly relevant for a single member LLC.

337. *See* discussion *supra* Part III.A.3 and Part IV.A.

338. *See* RIBSTEIN & KEATINGE, *supra* note 98, § 1.08, at 13.

339. *See id.* § 1.08, at 12-13. The four states that have adopted the Uniform Limited Liability Company Act (ULLCA) are Hawaii, South Carolina, Vermont and West Virginia. *See id.*

340. *See id.*

341. *See id.*

In addition, as this Comment has pointed out, the past ten years has seen dramatic changes in the ways that LLCs are formed and maintained for tax law purposes.[342] Prior to the adoption of the check-the-box regulations, LLCs were not easy to organize and draft. Thus, the reluctance to use LLCs also could have been the result of uncertainty over how the IRS would treat LLCs under the pre-check-the-box regime.

Transitional costs also may explain why LLCs have not yet become the entity of choice. There are potential tax costs associated with switching from an existing legal form to a LLC. Converting from a sole proprietorship to a LLC is a simple procedure, incurring no tax costs.[343] Similarly, switching from a partnership to a LLC normally will not trigger taxation of any unrealized gains.[344] Converting a regular corporation to a LLC, however, may result in recognition of gains.[345]

It is my opinion that with the recent adoption of the check-the-box regulations, the acceptance of LLCs among practitioners will increase rapidly. With most of the tax uncertainties eliminated, a major drawback of the LLC has been removed. In addition, since 1988, LLC legislation has been continuously analyzed, and any remaining problematic issues can be resolved by careful drafting, or a private letter ruling by the IRS can be sought to better protect the practitioner and the business owners. As for non-tax issues, Congress as well as state legislatures in the next few years will be busy in an attempt to "catch up" with LLCs by modifying existing statutes to accommodate LLCs. Finally, I have observed that business owners are becoming increasingly more aware of LLCs and are asking for them in practice. This recognition and acceptance by clients will no doubt drive practitioners to use the LLC in order to best serve the needs of their clients.

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342. *See* discussion *supra* Part II.B.
343. *See supra* note 205 and accompanying text.
344. *See generally* discussion *supra* Part III.
345. *See supra* notes 203-206 and accompanying text.