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The West Virginia Limited Liability Company Act: Time for a Change

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**THE WEST VIRGINIA LIMITED LIABILITY
COMPANY ACT:
TIME FOR A CHANGE**

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I. INTRODUCTION

Limited liability companies (LLCs) are statutorily created business entities that combine the corporate characteristic of limited liability with the flow-through income attributes of partnerships.¹ As of the date of this writing, only four states have not adopted LLC acts.² However, the modern LLC³ is a recent development.⁴

The West Virginia Limited Liability Company Act⁵ (the West Virginia Act) became effective March 27, 1992.⁶ West Virginia was one of the first states to enact LLC laws.⁷ Thus, West Virginia established itself as a forerunner in the area of LLC law.

The West Virginia Act is inflexible in that it places restrictions on how an LLC is operated once it is formed.⁸ Specifically, the West Virginia Act is structured to guarantee the organizers of an LLC that the LLC will be classified as a partnership for federal income tax

1. Joseph C. Vitek, *Tax Aspects of Limited Liability Companies*, 27 CREIGHTON L. REV. 191, 192 (1993).

2. Brian L. Schorr & Sylvia Wong, *New York's LLC and Professional LLP Law May Be the Best Yet*, 4 J. OF MULTISTATE TAX'N 148, 148-49 n.1 (1994) (noting that the only states without LLC legislation are California, Hawaii, Massachusetts, Pennsylvania, and Vermont). Subsequent to the Schorr & Wong article, Pennsylvania approved LLC legislation. See Pa. Act 106, S. 1059, 178th Gen. Assembly, Reg. Sess., 1993-94.

3. See, e.g., Scott R. Anderson, *The Illinois Limited Liability Company: A Flexible Alternative for Business*, 25 LOY. U. CHI. L.J. 55, 59-60 (1993) (noting that, although the origin of the limited liability company in the United States dates back to a business entity called a "partnership association" in the late 1800s, Wyoming became the first state in the nation to adopt LLC legislation in 1977).

4. The first statute passed in the modern wave of limited liability legislation was the Wyoming statute, codified at WYO. STAT. §§ 17-15-101 to -136 (1993) (enacted in 1977).

5. W. VA. CODE § 31-1A-1 (1994) (naming Article 1A of Chapter 31 the "West Virginia Limited Liability Company Act").

6. S. 10, 70th Leg., 2d Reg. Sess. (1992) (adding W. VA. CODE §§ 31-1A-1 to -69) (approved March 27, 1992). The annotations to W. VA. CODE §§ 31-1A-1 to -69 indicate that the sections were to take effect March 6, 1992. However, the bill was not approved until March 27, 1992.

7. See Mary Elizabeth Matthews, *The Arkansas Limited Liability Company: A New Business Entity is Born*, 46 ARK. L. REV. 791, 796-98 (1994) (placing West Virginia among the first eighteen states to enact LLC legislation).

8. See, e.g., W. VA. CODE § 31-1A-34 (1994) (limiting the ability of a member to transfer an LLC interest).

purposes.⁹ However, subsequent research and reflection, along with changes in federal tax laws,¹⁰ have changed the opinions of many tax planners¹¹ regarding the best way to draft LLC acts.

The decision to form a business as an LLC is primarily driven by federal income tax ramifications.¹² The primary tax benefit achieved by organizing a business as an LLC is only achieved if the business is classified as a partnership, as opposed to a corporation, for tax purposes.¹³ A partnership is taxed only once at the partner level, whereas a corporation is taxed twice: once at the corporate level when the corporation earns income and once again at the shareholder level when the corporation distributes income.¹⁴ Although inflexible acts, such as West Virginia's,¹⁵ ensure that the LLC will be taxed as a partnership, these acts also prohibit many planning opportunities that would otherwise be available under more flexible acts.

Recently-enacted LLC acts allow greater flexibility in organizing and operating LLCs so that organizers can structure LLCs to maximize tax savings.¹⁶ By affording planners with greater flexibility, those states with flexible LLC acts will benefit by attracting business from states with inflexible LLC acts. Without flexible acts, some taxpayers

9. Rev. Rul. 93-50, 1993-2 C.B. 310 (stating that West Virginia limited liability companies are classified as partnerships under I.R.C. § 7701 (1988) (as amended)).

10. See *infra* notes 44-45 and accompanying text.

11. Telephone Interview with Howard Zaritsky, Esq., Zaritsky & Zaritsky (Aug. 24, 1994) (Mr. Zaritsky stated that he originally favored LLC acts such as the West Virginia Act, but now prefers flexible LLC acts).

12. See, e.g., David C. Culpepper, *Tax Aspects of Limited Liability Companies*, 73 OR. L. REV. 5, 6 (1994) (stating that nearly all the benefits of LLCs depend on LLCs being classified as partnerships for income tax purposes).

13. See Anderson, *supra* note 3, at 62 (declaring the most advantageous aspect of structuring business entities as LLCs, rather than corporations, is to obtain partnership treatment for federal income tax purposes).

14. Briefly, a corporation pays income tax at the corporate level, and its shareholders pay personal income tax on their individual returns when the corporation distributes its income to its shareholders. In contrast, a partnership is only taxed once at the partner level because all of its earnings are passed through to the partners' returns without being taxed at the partnership level.

15. See *supra* notes 8-9 and accompanying text.

16. See, e.g., Schorr & Wong, *supra* note 2, at 149 (stating that one of the organizing principles behind the New York Act, a recently enacted statute, was broad flexibility in structuring LLCs).

will find it impossible to create an entity that satisfies their objectives.¹⁷

This Note will serve five purposes. First, this Note discusses the criteria used to classify LLCs as either partnerships or associations. A basic knowledge of how LLCs are classified is a prerequisite to understanding the differences between the two types of LLC acts. This Note also stresses any changes that have occurred in the classification criteria since West Virginia adopted its LLC act. Second, this Note discusses the two types of LLC acts that exist today. Background information on the two types of LLC acts will serve as a foundation for the subsequent discussion of the West Virginia and New York Acts. Third, this Note compares specific provisions of the West Virginia Act with mirror provisions of the newly-adopted New York Act. This comparison shows how one modern LLC act is structured as compared with the West Virginia Act. Fourth, this Note elaborates on some tax planning strategies available under the New York Act, and other flexible acts, that are not viable under the current West Virginia Act. Finally, this Note urges the West Virginia Legislature to amend the West Virginia Act to allow taxpayers greater freedom in the formation and operation of LLCs. By amending its LLC Act to allow greater freedom in organizing and operating LLCs, West Virginia will prevent organizers from migrating to states with more flexible acts.

II. CRITERIA FOR PARTNERSHIP CLASSIFICATION

A. *Introduction to Classification Criteria*

Generally, there are two types of LLC acts,¹⁸ bulletproof acts and flexible acts.¹⁹ In order to fully understand the differences between the two types, one must understand the criteria utilized to classify an entity as a partnership or an association. Internal Revenue Service Regulations

17. See Anderson, *supra* note 3, at 57-58.

18. James C. Seiffert & Alan K. MacDonald, *General Overview of Kentucky's LLC's and LLP's*, KENTUCKY BAR ASSOCIATION TAX AND BUSINESS LAW SECTION SEMINAR: INTRODUCTION TO LIMITED LIABILITY COMPANIES AND REGISTERED LIMITED LIABILITY PARTNERSHIPS 3 (June 8, 1994).

19. *Id.*

(Regulations) provide that if an organization that would otherwise be classified as a partnership possesses too many corporate characteristics, it will be deemed an association²⁰ and, therefore, taxed as a corporation.²¹

In Revenue Ruling 88-76,²² the Internal Revenue Service (IRS) classified an LLC as a partnership based on the definition of a partnership under Regulation Section 301.7701-3.²³ Initially, the Ruling noted that Section 7701(a)(2) defines a partnership to include a syndicate, group, pool, venture, any business, financial operation, or venture that is carried on, and which is not a trust, estate, or corporation.²⁴ Thus, by definition, whether an entity is classified as a partnership is determined by whether the entity is not a corporation.

More specifically, the issue of whether an LLC is an association or a partnership depends on how many characteristics the LLC possesses that are usually present in corporations, but not present in partnerships.²⁵ These characteristics are as follows: "(i) Associates [persons conducting business together], (ii) an objective to carry on business and divide the gains therefrom, (iii) continuity of life, (iv) cen-

20. See *infra* note 23 (explaining the difference between a corporation and an association).

21. Treas. Reg. § 301.7701-2(a)(1) (as amended in 1993).

22. Rev. Rul. 88-76, 1988-2 C.B. 360.

23. Treas. Reg. § 301.7701-3(a) (1967) (In Revenue Ruling 88-76, the appropriate regulation was 301.7701-2. However, the Regulations have since been amended and renumbered.).

In classifying an entity under the Regulations, one must look to see if the entity is a partnership or an association. See Treas. Reg. § 301.7701-2(a)(1) (as amended in 1993). An association is an entity that possesses some, but not all, of the characteristics of a corporation, but has not been formally incorporated under state law. See Treas. Reg. § 301.7701-2(3) (as amended in 1993). The Regulations declare that an association will be treated (including taxed) as a corporation. See Treas. Reg. § 301.7701-2(a)(1) (as amended in 1993). Therefore, because LLCs do not formally incorporate under state law, the proper classification of an LLC is either a partnership or an association.

24. See Rev. Rul. 88-76, *supra* note 22; Treas. Reg. § 301.7701-3(a) (1967) (defining a partnership as an organization which is not a corporation).

25. See Rev. Rul. 88-76, *supra* note 22; Treas. Reg. § 301.7701-2(a)(1)-(2) (as amended in 1993).

tralization of management, (v) liability for corporate debts limited to corporate property, and (vi) free transferability of interests."²⁶

If an organization possesses some but not all of the corporate characteristics, it will be classified as either a partnership or an unincorporated association.²⁷ Classification will depend on which entity the organization more closely resembles.²⁸ The Regulations state that an unincorporated organization shall not be classified as an association unless the organization has more corporate than noncorporate characteristics.²⁹ However, because both associates and an objective to carry on a business and divide the gains therefrom are generally common to corporations and partnerships (or LLCs treated as partnerships), only the remaining four characteristics are relevant to this determination.³⁰

The United States Tax Court, in interpreting Regulation Section 301.7701-2, concluded that equal weight must be given to each of the remaining four corporate characteristics in determining whether an organization is to be classified as a partnership or an association.³¹ Therefore, because no one individual characteristic weighs more heavily on the determination, classification as a partnership depends on whether the entity lacks at least two of the remaining four corporate characteristics. If the LLC possesses at least three of these four characteristics,

26. Treas. Reg. § 301.7701-2(a)(1) (as amended in 1993).

27. *Id.* (discussing the criteria that govern whether an organization will be treated for tax purposes as a partnership or as an association). See also *supra* note 23 (explaining the difference between an association and a corporation).

28. *Id.*

29. Treas. Reg. § 301.7701-2(a)(3) (as amended in 1993).

30. Treas. Reg. § 301.7701-2(a)(2) (as amended in 1993) (Declaring these characteristics to be common between partnerships and associations. But note that the entity must possess these two characteristics to be classified as a partnership since the Regulation stipulates that a partnership will have both).

31. Rev. Rul. 88-76, *supra* note 22 (citing *Larson v. Commissioner*, 66 T.C. 159 (1976), *acq.*, 1979-1 C.B. 1. But *c.f.* Treas. Reg. 301.7701-2(a)(3), which stipulates that in determining whether an organization has more corporate characteristics than noncorporate characteristics, all characteristics common to both types of organizations — namely associates and an objective to carry on business and divide gains therefrom — shall not be considered).

it will be classified as an unincorporated association³² and will be taxed as a corporation.³³

B. State of the Law

1. Liability of Members

One characteristic the IRS considers in classifying an organization as a partnership or an association is the liability of its members.³⁴ By definition, most LLCs will possess the corporate characteristic of limited liability.³⁵ The Regulations state that an organization has the corporate characteristic of limited liability “if under local law there is no member who is personally liable for the debts of or claims against the organization.”³⁶ The Regulations further state that “[p]ersonal liability means that a creditor of an organization may seek personal satisfaction from a member of the organization to the extent that the assets of such organization are insufficient to satisfy the creditor’s claim.”³⁷ Because most LLCs, by definition, shield their members from personal liability for entity-level obligations and obligations of other members, they will possess the characteristic of limited liability.

32. Treas. Reg. § 301.7701-2(a)(1) (as amended in 1993) (stating that an organization will be treated as an association if the corporate characteristics are such that the organization more nearly resembles a corporation than a partnership or trust). *See also* *Morrissey v. Commissioner*, 296 U.S. 344 (1935).

33. *Id.*

34. Treas. Reg. § 301.7701-2(d) (as amended in 1993).

35. *See, e.g.*, W. VA. CODE § 31-1A-33 (1992) (defining the liability of a member of a West Virginia LLC to be the same as the liability of a shareholder of a West Virginia corporation).

36. Treas. Reg. § 301.7701-2(d)(1) (as amended in 1993).

37. *Id.* *See also* Rev. Proc. 95-10, 1995-3 I.R.B. 20 (an LLC will not lack the characteristic of limited liability unless a member(s) assumes *all* obligations of the LLC and the assuming member(s)’ aggregate net worth(s) equals at least ten percent of the total contributions to the LLC) (emphasis added).

2. Continuity of Life

Another characteristic the IRS considers in classifying an organization as a partnership or an association is continuity of life.³⁸ The Regulations state that an organization has continuity of life if the death, insanity, bankruptcy, retirement, resignation, or expulsion of any member will not cause a dissolution of the organization.³⁹ The Regulations defer to local law to determine whether a dissolution has occurred.⁴⁰ Additionally, continuity of life does not generally exist simply because the members enter into an agreement to continue the entity, thereby avoiding dissolution.⁴¹ This holds true only if *at least a majority in interest* of the remaining members must agree to continue the LLC upon an event of dissolution.⁴²

Several private letter rulings (PLRs) have applied this regulation to LLCs in determining whether certain LLCs possessed the corporate characteristic of continuity of life.⁴³ Thus, as long as local law grants any member the power to dissolve the organization, a provision in an LLC's operating agreement allowing continuance by at least a majority vote will not constitute continuity of life.

At the time the West Virginia Act was enacted, the Regulations required *unanimous consent* of the remaining members to continue an

38. Treas. Reg. § 301.7701-2(b) (as amended in 1993).

39. Treas. Reg. § 301.7701-2(b)(1) (as amended in 1993).

40. Treas. Reg. § 301.7701-2(b)(2) (as amended in 1993) (stating that dissolution of an organization means an alteration of the identity of the organization by reason of a change in the relationship between its members as determined under local law).

41. Treas. Reg. § 301.7701-2(b)(1) (as amended in 1993).

42. *Id.* (emphasis added).

43. *See, e.g.*, Priv. Ltr. Rul. 94-12-030 (Dec. 22, 1993) (holding that continuity of life does not exist where an LLC's operating agreement provides that, upon an event of dissolution, remaining members owning a majority interest in the units of participation owned by the remaining members agree to continue the LLC); Priv. Ltr. Rul. 93-33-032 (May 24, 1993) (an LLC's operating agreement provided that the entity would not dissolve upon an event of dissolution if at least two-thirds in number of all owners agreed to continue, provided that the two-thirds in number was at least a majority in interest of all remaining owners). *See also* Rev. Proc. 95-10, 1995-3 I.R.B. 20 (the IRS will generally rule that an LLC lacks continuity of life unless the LLC is continued by the consent of not less than a majority in interest of the remaining members).

LLC after an event of dissolution in order for the LLC to lack the corporate characteristic of continuity of life.⁴⁴ In 1993, the IRS amended the Regulations so that an LLC that allowed its members to continue the entity by a majority approval upon an event of dissolution would lack the corporate characteristic of continuity of life.⁴⁵ The importance of this change will be discussed when this Note compares certain provisions of the West Virginia Act with mirror provisions of the New York Act.⁴⁶

The final issue to consider in determining whether an organization has the corporate characteristic of continuity of life is whether the organization has a stated duration. The Regulations establish that if an agreement requires the organization to continue for a stated duration and the effect of the agreement is to prevent any member from dissolving the organization until the end of the period, then the organization has continuity of life.⁴⁷ The Regulations also establish that if a member has the power to dissolve the organization notwithstanding the agreement, then the organization does not have continuity of life.⁴⁸ Thus, the presence or absence of a provision in the agreement setting forth a maximum period of duration is not determinative of whether an entity has continuity of life.⁴⁹ A stated duration does create a presumption of continuity, but no continuity exists if any member has the power to dissolve the organization notwithstanding the agreement.⁵⁰ In summary, an LLC will possess the corporate characteristic of continuity of life only if local law does not confer the power to dissolve the entity upon any member.⁵¹

44. 26 C.F.R. § 301.7701-2(b)(1) (1993) (emphasis added).

45. Treas. Reg. § 301.7701-2(b)(1) (as amended in 1993).

46. See discussion *infra* Part IV.

47. Treas. Reg. § 301.7701-2(b)(3) (as amended in 1993).

48. *Id.*

49. See Anderson, *supra* note 3, at 65; Treas. Reg. § 301.7701-2(b)(3) (as amended in 1993).

50. Treas. Reg. § 301.7701-2(b)(3) (as amended in 1993).

51. *Id.*

3. Centralization of Management

A third characteristic the IRS considers in classifying an organization as either a partnership or an association is centralization of management.⁵² The Regulations state that:

An organization has centralized management if any person (or any group of persons which does not include all the members) has continuing exclusive authority to make the management decisions necessary to the conduct of the business for which the organization was formed.⁵³

The persons who have such authority may, but need not, be members of the organization.⁵⁴ The authority granted must be the authority to make independent business decisions on behalf of the organization which do not require ratification by members of the organization.⁵⁵ Furthermore, in order for an entity, managed by managers as opposed to members, to lack the characteristic of centralized management, the managers must derive their management authority from being members.⁵⁶ This holds true no matter how the managers are elected.⁵⁷

The IRS has specified an important minimum ownership level for LLCs. The IRS will not rule that an LLC lacks centralized management unless the managing members' interests, in the aggregate, equal at least twenty percent of the total interests in the LLC.⁵⁸ Even if this minimum ownership level is satisfied, the IRS will consider all the facts and circumstances in determining whether the LLC lacks centralized management.⁵⁹ Alternately, if all of an LLC's members, as opposed to elected members, manage the entity in proportion to their respective interests in profits or capital contributions, the entity will

52. Treas. Reg. § 301.7701-2(c) (as amended in 1993).

53. Treas. Reg. § 301.7701-2(c)(1) (as amended in 1993).

54. Treas. Reg. § 301.7701-2(c)(2) (as amended in 1993).

55. Treas. Reg. § 301.7701-2(c)(3) (as amended in 1993) (the Regulations also state there is no centralized management where the centralized authority is merely to perform ministerial acts).

56. Rev. Rul. 93-6, 1993-1 C.B. 229.

57. *Id.*

58. Rev. Proc. 95-10, 1995-3 I.R.B. 20.

59. *Id.*

lack centralized management.⁶⁰ Allowing all members to have a say in management, however, may present problems in operating the organization if an LLC has many members. Those problems may be further exacerbated if the members are geographically dispersed.

4. Free Transferability of Interests

The last corporate characteristic the IRS considers in classifying an LLC is free transferability of interests.⁶¹ The Regulations state that:

An organization has the corporate characteristic of free transferability of interests if each of its members or those members owning *substantially all* of the interests in the organization have the power, without the consent of other members, to substitute for themselves in the same organization a person who is not a member of the organization.⁶²

In order for this power of substitution to exist, in the corporate sense, the member must be able, without the consent of other members, to confer upon his substitute *all* the attributes of his interest in the organization.⁶³ The ability to assign an interest in profits alone does not constitute free transferability of interests.⁶⁴ The IRS has stated that free transferability of interests exists where, after the assignment, the assignee becomes a member or has a right to participate in management without consent of the other members.⁶⁵ However, if an assignee does not become a member and has no right to participate in management unless all of the remaining members consent, no free transferability will exist.⁶⁶

60. *Id.* (if an LLC is managed by its members, the IRS will generally rule that the LLC lacks centralized management).

61. Treas. Reg. § 301.7701-2(e) (as amended in 1993).

62. Treas. Reg. § 301.7701-2(e)(1) (as amended in 1993) (emphasis added).

63. *Id.* (emphasis added).

64. Rev. Rul. 94-51, 1994-32 I.R.B. 11; Treas. Reg. § 301.7701-2(e)(1) (as amended in 1993).

65. *Id.*

66. *Id.*

The Regulations leave the issue of what constitutes “substantially all”⁶⁷ unresolved. However, PLR 92-19-022 seems to resolve this issue.⁶⁸ This ruling concerned an LLC agreement which provided that no transferee, designee, or legal representative of a member could become a substitute member without the consent of *a majority*, by sharing ratios, of the non-transferring members.⁶⁹ The IRS declared that transferability of interests did not exist.⁷⁰ The IRS recently confirmed this position.⁷¹

III. TYPES OF LLC ACTS: BULLETPROOF VERSUS FLEXIBLE

As stated earlier, there are two types of LLC acts: bulletproof and flexible.⁷² Background information on the differences between the two types of acts will provide a foundation for a later comparison of the West Virginia and New York Acts.⁷³

A. *Bulletproof Acts*

The goal of a bulletproof LLC act is to guarantee partnership classification for all LLCs organized under the act.⁷⁴ These acts accomplish this goal by dictating which classification criteria LLCs will lack through provisions which govern how LLCs must be operated after formation. For example, bulletproof acts almost always require that an entity will dissolve upon an event of dissolution unless all remaining members consent to the entity’s continuance.⁷⁵ Requiring

67. See *supra* note 62.

68. Priv. Ltr. Rul. 92-19-022 (Feb. 6, 1992).

69. *Id.* (emphasis added).

70. *Id.*

71. Rev. Proc. 95-10, 1995-3 I.R.B. 20 (in addition to confirming their earlier position, the IRS defined consent of a majority to include either a majority in interest, a majority of either the capital or profits interest in the LLC, or a majority determined on a per capita basis).

72. See *supra* notes 18-19 and accompanying text.

73. See discussion *infra* Part IV.

74. Richard M. Horwood & Jeffrey A. Hechtman, *The Limited Liability Company: The New Kid in Town*, 20 J. CORP. TAX’N 334, 337 (1994) (defining bulletproof acts as those designed to ensure partnership classification by compelling certain actions of LLC members).

75. *Id.*

unanimous consent to continue the LLC will cause the LLC to necessarily lack continuity of life.⁷⁶ Because the four criteria are given equal weight,⁷⁷ bulletproof acts must limit organizers in such a way that they cannot create an entity that will possess more than two of the four corporate characteristics discussed above. Such limitations guarantee that an organization will be treated as a partnership. Thus, bulletproof acts trade flexibility in formation for the guarantee of partnership tax treatment.⁷⁸ The West Virginia Act is a bulletproof act. Specifically, the West Virginia Act dictates that an LLC necessarily will lack continuity of life⁷⁹ and free transferability of interests.⁸⁰

B. *Flexible Acts*

Taxation drives the structure of LLCs.⁸¹ As the tax law relating to classification criteria evolves, drafters have found better ways to structure LLC acts in order to provide maximum benefit to those organizing their businesses as LLCs.⁸² Although bulletproof acts were considered adequate at the time most states adopted them, subsequent developments in the federal tax laws and careful reflection on existing laws led drafters to develop a new type of act. This new type of act was designed to achieve two goals. First, the act was designed to guarantee partnership classification if the default provisions⁸³ were followed. Second, the act was designed to provide flexibility by allowing

76. See *supra* notes 44-45 and accompanying text.

77. See *supra* note 31 and accompanying text.

78. Telephone Interview with Donald H. McIver, Jr., Certified Public Accountant, Director of Tax, Ernst & Young, Charleston, WV (Oct. 6, 1994). See also Alan M. Witt, *The Tax Adviser*, 10-93 T.T.A. 645 (Oct. 1993) (stating that while bulletproof acts prevent an entity from shooting itself in the tax foot, they may interfere with normal operation of a business).

79. W. VA. CODE § 31-1A-35 (1994).

80. W. VA. CODE § 31-1A-34 (1994).

81. See Culpepper, *supra* note 12.

82. See Telephone Interview with Donald H. McIver, Jr., *supra* note 78.

83. See Culpepper, *supra* note 12, at 15 (stating that a default provision is a statutory provision that becomes operative only if contrary provisions are not included in the articles of organization or the operating agreement).

organizers to formulate an entity that best suits their particular needs.⁸⁴ Thus, flexible LLC acts came into being.

Flexible acts, unlike bulletproof acts, allow organizers great freedom in how they structure and operate LLCs.⁸⁵ Flexibility is achieved at the risk of losing partnership classification as a cost of deviating from the default provisions.⁸⁶ Thus, flexible acts provide taxpayers with the best of both worlds: guaranteed partnership classification, if desired, and flexibility to depart from default provisions.

The recently-enacted New York Limited Liability Company Act⁸⁷ (the New York Act) is one example of a flexible act.⁸⁸ One of the basic organizing principles of the New York Act was to allow a high level of flexibility in structuring LLCs.⁸⁹ The New York Act contains default provisions designed to ensure organizers partnership classification if they choose to organize an LLC using those provisions.⁹⁰ Organizers who deviate from the Act's default provisions can determine the tax status of their organization by applying for an IRS determination letter prior to formation.⁹¹

IV. WEST VIRGINIA VERSUS NEW YORK

The New York Act is appropriate to compare with the West Virginia Act because, unlike the West Virginia Act, the New York Act

84. See Telephone Interview with Donald H. McIver, Jr., *supra* note 78.

85. See Horwood & Hechtman, *supra* note 74, at 337 (stating that flexible LLC statutes are designed to enable members to structure the entity as they wish to achieve their desired results).

86. See Rev. Rul. 94-51, 1994-32 I.R.B. 11 (stating that an organization could be classified as a partnership or a corporation depending upon how it is structured under the New Jersey Act); Witt, *supra* note 78.

87. S. 7511, 215th Gen. Assem., 2d Reg. Sess. (1994) (codified as enacted in scattered sections of N.Y. LTD. LIAB. CO. LAW § 34 (Consol. 1994) (enacted July 26, 1994; effective Oct. 24, 1994)).

88. See Schorr & Wong, *supra* note 2, at 149.

89. *Id.*

90. *Id.* at 148 (anticipating an IRS ruling that a New York LLC formed under the Act's "default" provisions will be taxed as a partnership).

91. See Rev. Proc. 95-10, 1995-3 I.R.B. 20.

has broad flexibility as one of its primary goals.⁹² Flexibility is needed so that LLCs can be created to possess or lack the corporate characteristics described above as needed in a particular setting. Also, the New York Act is one of the newest in the country.⁹³ Thus, it reflects some of the most current thinking on the subject of LLCs⁹⁴ and its drafters had all prior LLC acts to consider when deciding how to structure the New York Act.

A. *Statutory Provisions Impacting Classification Criteria*

1. Liability of Members

The West Virginia Act provides that LLC members will have the same rights and liabilities as do corporate shareholders organized under West Virginia law.⁹⁵ Therefore, because shareholders of West Virginia Corporations have no obligation to the corporation or to the corporation's creditors,⁹⁶ members of West Virginia LLCs will not be liable to the LLC or to the LLC's creditors. West Virginia does not allow LLC members to opt out of limited liability.⁹⁷ Thus, West Virginia LLCs possess the corporate characteristic of limited liability.

Likewise, the New York Act provides that LLC members shall have limited liability.⁹⁸ The New York Act, however, allows its members to opt out of limited liability protection.⁹⁹ The right to opt out may be exercised by all or specified members of the LLC.¹⁰⁰ A member may opt out, however, only if a statement allowing a member to opt out is contained in the articles of organization.¹⁰¹ Furthermore,

92. See Schorr & Wong, *supra* note 2, at 149.

93. See *supra* note 87.

94. See Schorr & Wong, *supra* note 2, at 153.

95. W. VA. CODE § 31-1A-33 (1994).

96. W. VA. CODE § 31-1-89 (1994).

97. W. VA. CODE § 31-1A-33 (1994).

98. N.Y. LTD. LIAB. CO. LAW § 609(a) (Consol. 1994) (enacted July 26, 1994; effective Oct. 24, 1994).

99. N.Y. LTD. LIAB. CO. LAW § 609(b) (Consol. 1994) (enacted July 26, 1994; effective Oct. 24, 1994).

100. *Id.*

101. N.Y. LTD. LIAB. CO. LAW § 102(a) (Consol. 1994) (enacted July 26, 1994; effective Oct. 24, 1994).

a member may opt out only if such member (1) consents in writing to either the adoption of the provision or to be bound by the provision; or (2) votes specifically for the adoption of the provision.¹⁰² The result of even one member opting out of limited liability protection is that the LLC will necessarily lack the corporate characteristic of limited liability.¹⁰³ The ability to waive limited liability distinguishes the New York Act from many other LLC acts.¹⁰⁴

2. Continuity of Life

West Virginia LLCs lack the corporate characteristic of continuity of life.¹⁰⁵ The West Virginia Act provides that an LLC will be dissolved upon the occurrence of any of the following events:

- (1) When the period fixed for the duration of the limited liability company shall expire;
- (2) By the unanimous written agreement of all members;
- (3) Upon the death, retirement, resignation, expulsion, bankruptcy or dissolution of a member or occurrence of any other event which terminates the continued membership of a member in the limited liability company, unless the business of the limited liability company is continued by the consent of *all the remaining members* under a right to do so stated in the articles of organization of the limited liability company; or
- (4) The entry of a decree of judicial dissolution pursuant to section thirty-six [§ 31-1A-36] of this article.¹⁰⁶

tive Oct. 24, 1994) defines "articles of organization" to mean those filed with the state for purposes of forming an LLC pursuant to other LLC provisions. Articles of organization are to be distinguished from an operating agreement of the members. N.Y. LTD. LIAB. CO. LAW § 102(u) (Consol. 1994) defines the latter as the document which governs the conduct of an LLC's business after formation.

102. See *supra* note 99 and accompanying text.

103. Treas. Reg. § 301.7701-2(d) (as amended in 1993) (stating that an organization possesses the corporate characteristic of limited liability only if there is no member who is personally liable). *But see* Rev. Proc. 95-10, 1995-3 I.R.B. 20 (declaring that the IRS will not rule that an LLC lacks limited liability unless a member(s) assumes personal liability for all of the LLC's obligations and such assuming member(s) has an aggregate net worth equal to at least ten percent of total contributions to the LLC).

104. See Schorr & Wong, *supra* note 2, at 150.

105. Rev. Rul. 93-50, 1993-2 C.B. 310.

106. W. VA. CODE § 31-1A-35 (1994) (emphasis added).

The IRS has ruled that requiring all remaining members to consent to continue an LLC creates uncertainty as to continuity of the LLC's life.¹⁰⁷ A unanimous consent requirement creates enough uncertainty, in fact, that an entity with such a requirement lacks continuity of life.¹⁰⁸ Therefore, because the West Virginia Act does not allow organizers to vary the percentage vote required to dissolve an LLC, any LLC organized in West Virginia will lack the corporate characteristic of continuity of life.

The New York Act's continuity of life provisions are more flexible than the West Virginia Act's provisions. The New York Act provides, in part, that: An LLC is dissolved upon the bankruptcy, death, dissolution, expulsion, incapacity or withdrawal of any member or only the member (or group of members) specified in the operating agreement.¹⁰⁹ The New York Act provides an escape if, within 180 days after an event of dissolution, the LLC is continued by a *majority in interest* vote of all the remaining members or under a right to continue stated in the operating agreement.¹¹⁰ Thus, the New York Act's default provision requires only a majority vote to continue an LLC upon an event of dissolution.¹¹¹ Finally, the New York Act allows organizers to declare that some percentage vote other than a majority in interest can continue a New York LLC upon an event of dissolution.¹¹² An LLC that follows the default provision will necessarily lack the corporate characteristic of continuity of life because this provision is within the requirements of the Regulations.¹¹³ However, if an LLC's organizers allow the LLC to continue by a less than majority

107. Rev. Rul. 93-50, *supra* note 105.

108. *Id.*

109. N.Y. LTD. LIAB. CO. LAW § 701(d) (Consol. 1994) (enacted July 26, 1994; effective Oct. 24, 1994).

110. N.Y. LTD. LIAB. CO. LAW § 701(d)(2) (Consol. 1994) (enacted July 26, 1994; effective Oct. 24, 1994) (emphasis added).

111. This provision, along with the other default provisions in the New York Act, should guarantee that any LLC formed under the Act lacks the corporate characteristic of continuity of life. See discussion *supra* Part II.B.2.

112. N.Y. LTD. LIAB. CO. LAW § 701(d)(1) (Consol. 1994) (enacted July 26, 1994; effective Oct. 24, 1994).

113. See *supra* notes 38-45 and accompanying text.

vote, as opposed to following the default provisions, the IRS will deem the LLC to have continuity of life.¹¹⁴

3. Centralization of Management

A West Virginia LLC may or may not possess the corporate characteristic of centralization of management. The West Virginia Act provides some flexibility in how an LLC will be managed.¹¹⁵ The West Virginia Act provides that, absent a provision in the articles of organization or operating agreement, management of an LLC organized under the Act shall be vested in its members.¹¹⁶ A member-managed West Virginia LLC will lack the corporate characteristic of centralized management.¹¹⁷ West Virginia provides that an LLC may be managed by managers, as opposed to being managed by all of its members, if the organizers of the LLC include provisions in the articles of organization allowing the LLC to be managed by managers.¹¹⁸ However, if a West Virginia LLC is managed by managers, it may possess centralization of management.¹¹⁹

The New York Act also provides that an LLC's management shall vest in its members unless the LLC's articles of organization provide for management by a manager or managers.¹²⁰ Additionally, the New York Act provides for different classes of members and different classes of managers.¹²¹ The New York Act also sets out more detailed guidance in relation to how an LLC is managed than does the West Virginia Act.¹²² For example, the New York Act has detailed provi-

114. Treas. Reg. 301.7701-2(b)(1) (as amended in 1993); Rev. Proc. 95-10, 1995-3 I.R.B. 20.

115. W. VA. CODE § 31-1A-18(a) (1994).

116. *Id.*

117. Treas. Reg. § 301.7701-2(c)(1) (as amended in 1993); Rev. Proc. 95-10, 1995-3 I.R.B. 20.

118. W. VA. CODE § 31-1A-20(a) (1994).

119. See discussion *supra* Part II.B.3.

120. N.Y. LTD. LIAB. CO. LAW § 401 (Consol. 1994) (enacted July 26, 1994; effective Oct. 24, 1994).

121. N.Y. LTD. LIAB. CO. LAW §§ 418 to -419 (Consol. 1994) (enacted July 26, 1994; effective Oct. 24, 1994)

122. Compare N.Y. LTD. LIAB. CO. LAW §§ 401 to -420 (Consol. 1994) (enacted July

sions governing when members will meet,¹²³ what constitutes a quorum,¹²⁴ how notice of meetings is to be given to members,¹²⁵ and what actions members may take without a meeting.¹²⁶ The West Virginia Act does not address any of the above.

4. Free Transferability of Interests

The West Virginia LLC provision governing transferability of interests allows minimal flexibility. Initially, the West Virginia Act provides that an LLC member's interest constitutes personal property.¹²⁷ The West Virginia Act next provides that a membership interest is freely assignable, unless otherwise provided in the operating agreement.¹²⁸ However, an assignment does not entitle the assignee to participate in management of the LLC.¹²⁹ Also, the West Virginia Act does not allow an assignee to become a member¹³⁰ of the LLC without the unanimous consent of the LLC's other members.¹³¹ The IRS has ruled that requiring the approval of *all* remaining members to admit an assignee as a member will result in an LLC that lacks the corporate characteristic of free transferability of interests.¹³² Thus, an LLC organized under the West Virginia Act will necessarily lack the corporate characteristic of free transferability of interests. However, a

26, 1994; effective Oct. 24, 1994) *with* W. VA. CODE §§ 31-1A-18, -20 (1994) (the New York Act provides more predictability as to critical management issues which are not addressed in the West Virginia Act).

123. N.Y. LTD. LIAB. CO. LAW § 403 (Consol. 1994) (enacted July 26, 1994; effective Oct. 24, 1994).

124. N.Y. LTD. LIAB. CO. LAW § 404 (Consol. 1994) (enacted July 26, 1994; effective Oct. 24, 1994).

125. N.Y. LTD. LIAB. CO. LAW § 405 (Consol. 1994) (enacted July 26, 1994; effective Oct. 24, 1994).

126. N.Y. LTD. LIAB. CO. LAW § 407 (Consol. 1994) (enacted July 26, 1994; effective Oct. 24, 1994).

127. W. VA. CODE § 31-1A-34 (1994). *See also* Horwood & Hechtman, *supra* note 74, at 338 (declaring that all LLC acts provide that LLC interests are personal property).

128. W. VA. CODE § 31-1A-34(b) (1994).

129. *Id.*

130. W. VA. CODE § 31-1A-2(10) (1994) (defining a member as a person with an ownership interest in an LLC with the rights and obligations specified under this section).

131. W. VA. CODE § 31-1A-34(c)(1) (1994).

132. Rev. Rul. 93-50, 1993-2 C.B. 310 (emphasis added).

unanimous consent requirement is not necessary for an LLC to lack transferability of interest.¹³³

The New York Act is more permissive. It too classifies an interest in an LLC as personal property.¹³⁴ Furthermore, it provides that assignment of an LLC interest does not entitle the assignee to become a member without a vote by the other members.¹³⁵ However, the New York Act only requires a vote by a majority in interest of the members, other than the member who assigned, to admit an assignee as a member.¹³⁶ The New York Act, unlike the West Virginia Act, is identical to the position taken by the IRS.¹³⁷

The New York Act also allows LLC organizers to alter the percentage vote required to admit an assignee as a member by stating the desired percentage in the operating agreement.¹³⁸ Thus, under the New York Act, it is possible for an assignee to be admitted as a member with less than a majority vote.¹³⁹ However, under the position taken by the IRS, an LLC that allows an assignee to be admitted by less than a majority vote necessarily possesses the corporate characteristic of free transferability of interests.¹⁴⁰

To summarize, the West Virginia Act necessarily possesses the corporate characteristic of limited liability, may or may not possess the characteristic of centralized management, and necessarily lacks the characteristics of continuity of life and free transferability of interests. By dictating that every LLC organized under the West Virginia Act lacks continuity of life and free transferability of interests, the West

133. See *supra* notes 67-71 and accompanying text (noting that approval by a majority in interest is all that is necessary to lack free transferability of interests).

134. N.Y. LTD. LIAB. CO. LAW § 601 (Consol. 1994) (enacted July 26, 1994; effective Oct. 24, 1994).

135. N.Y. LTD. LIAB. CO. LAW § 604 (Consol. 1994) (enacted July 26, 1994; effective Oct. 24, 1994).

136. *Id.*

137. See *supra* notes 67-71.

138. See *supra* note 135.

139. *Id.*

140. See *supra* notes 67-71.

Virginia Act mandates that its LLCs will be classified as partnerships by the IRS.¹⁴¹

By contrast, the New York Act allows LLCs to possess or lack any or all of the corporate characteristics that determine an organization's classification. The type of LLC created depends upon the LLC organizer's needs in a given situation. By allowing organizers to choose the characteristics an LLC will possess, the New York Act provides organizers every possible opportunity to create LLCs that satisfy their particular requirements.

B. LLCs and the Professional

In addition to the flexibility that the New York Act allows in forming and operating LLCs, the New York Act contains another provision that is present in many other recently-enacted LLC acts. This provision relates to professionals operating in an LLC.¹⁴² Provisions governing professionals are necessary because of the attractiveness of the LLC form of organization to professionals.¹⁴³ The West Virginia Act does not address professionals organizing as an LLC,¹⁴⁴ therefore, professionals forming an LLC in West Virginia cannot be certain what law will govern every aspect of the LLC's existence.

The New York Act has detailed provisions that apply only to professional LLCs. These provisions govern formation,¹⁴⁵ name,¹⁴⁶ operation,¹⁴⁷ merger,¹⁴⁸ and other aspects of professional LLCs.¹⁴⁹

141. *See supra* note 9.

142. N.Y. LTD. LIAB. CO. LAW §§ 1201 to -16 (relating to professional service limited liability companies).

143. *See Schorr & Wong, supra* note 2, at 149.

144. *See* W. VA. CODE §§ 31-1A-1 to -69 (1994).

145. N.Y. LTD. LIAB. CO. LAW § 1203 (Consol. 1994) (enacted July 26, 1994; effective Oct. 24, 1994).

146. N.Y. LTD. LIAB. CO. LAW § 1212 (Consol. 1994) (enacted July 26, 1994; effective Oct. 24, 1994).

147. N.Y. LTD. LIAB. CO. LAW §§ 1204 to -11 (Consol. 1994) (enacted July 26, 1994; effective Oct. 24, 1994).

148. N.Y. LTD. LIAB. CO. LAW § 1216 (Consol. 1994) (enacted July 26, 1994; effective Oct. 24, 1994).

149. N.Y. LTD. LIAB. CO. LAW §§ 1201 to -16 (Consol. 1994) (enacted July 26, 1994;

By drafting such provisions into its LLC Act, New York provides professionals with foresight into which law will govern operation of their professional LLCs. Additionally, the New York Act defines the term profession¹⁵⁰ and provides that the Act shall not alter the regulation of professions by existing law.¹⁵¹ Thus, acts governing professional LLCs provide professionals with a greater degree of predictability than acts without such provisions. Absent such provisions, West Virginia professionals are at a competitive disadvantage to professionals from states whose LLC acts govern professionals.

V. PLANNING TECHNIQUES UNDER THE TWO TYPES OF ACTS

Some planning techniques are viable in states with flexible acts, but not viable in states with bulletproof acts. Although planning can be done in states with bulletproof acts, many planning opportunities are lost due to the rigidity of bulletproof acts.

A. Succession Planning in Family Businesses

LLCs are of great utility in closely-held family businesses with few members where limited liability is desired.¹⁵² LLCs are well-suited for family businesses because LLCs can protect family assets by offering both limited liability and pass-through partnership taxation.¹⁵³ Also, LLCs possess the corporate characteristic of continuity of life, assuring continuance upon an event of dissolution, which is often desirable.¹⁵⁴ Often, however, a family business will not have a need for the other two corporate characteristics: free transferability of interests and centralized management. The business will often be managed by

effective Oct. 24, 1994).

150. N.Y. LTD. LIAB. CO. LAW § 1201(b) (Consol. 1994) (enacted July 26, 1994; effective Oct. 24, 1994).

151. N.Y. LTD. LIAB. CO. LAW § 1215 (Consol. 1994) (enacted July 26, 1994; effective Oct. 24, 1994).

152. See Schorr & Wong, *supra* note 2, at 148 (stating that LLCs are well-suited for family businesses whenever the family wants to maintain family control because LLCs afford the tax benefits of a limited partnership and can restrict the voting rights from outsiders).

153. See Telephone Interview with Donald H. McIver, Jr., *supra* note 78.

154. *Id.*

family members and the family will want to keep control of the business by not allowing transfers of interests outside the family. Thus, a family business operating as an LLC would generally possess two corporate characteristics that protect family assets while maintaining partnership taxation.

If a family business is to continue operating upon the death of an elder family member, usually a parent, one of the most important issues in estate planning is controlling disposition of the business.¹⁵⁵ Bulletproof acts severely hamper the ability to control a business, however, by requiring a unanimous vote to continue the LLC upon an event of dissolution, which includes death of a member.¹⁵⁶ Unanimous consent provisions present an obvious problem if family relationships are strained. For instance, one family member can cause the organization to dissolve by casting a single vote for dissolution at another family member's death.¹⁵⁷ Often, the only solution is to exclude those family members, who are likely to cause the business to dissolve, from owning any part of the family business.

However, in states with flexible LLC acts, the problem is easily solved. First, in a state with multiple classes of ownership rights, certain family members could be given non-voting interests while others could be given voting interests. This would allow the owners to better control the continuity of the business while allowing them to include all family members as owners of the business.

Next, in some family business settings, there are often one or two family members who are interested in, and capable of, running the family business after a parent dies.¹⁵⁸ States with flexible LLC acts generally require only a majority in interest vote to continue the organization upon an event of dissolution.¹⁵⁹ Even smaller percentage

155. *Id.*

156. *See, e.g.*, W. VA. CODE § 31-1A-35 (1994) (requiring the consent of all remaining members to continue an LLC upon an event of dissolution, which includes death of any member).

157. *Id.*

158. *See* Telephone Interview with Donald H. McIver, Jr., *supra* note 78.

159. *See supra* note 110.

votes may suffice if provided for in the operating agreement.¹⁶⁰ Thus, in a state with a flexible LLC act, current family members can devise the responsible family member(s) enough interest in the family business to constitute a majority. Such a devise avoids the possibility of dissident family member(s) causing dissolution of the organization at the death of an elder family member(s). Alternatively, the LLC can be structured to allow continuation by less than a majority vote. This type of structure would cause the entity to possess the corporate characteristic of continuity of life. However, the organizer could sacrifice other corporate characteristics if continuity of life were more important than free transferability of interests and centralized management.

B. Valuation Discounts

1. Background

Valuation discounts are one of the most fertile areas of estate planning available today for tax savings.¹⁶¹ They allow taxpayers to reduce the value of business interests transferred as a gift or at death because of certain restrictions placed upon the entity. For example, if a particular interest is restricted in its ability to cause liquidation of an entity, this interest is worth less than it would be without such a restriction.¹⁶² The greater the restriction, the less valuable the interest.¹⁶³ The IRS allowed a reduction in the value of property based upon this concept in *Watts v. Commissioner*.¹⁶⁴ Because gift and estate taxes are calculated on the value of the property transferred,¹⁶⁵

160. See *supra* note 112.

161. Donald M. Schindel, *Various Methods Exist for Establishing a Sustainable Value for Assets*, 17 EST. PLAN., 258, 264 (Warren et al. eds., 1990).

162. *Id.*

163. *Id.*

164. 51 T.C.M. (CCH) 60 (1985) (Allowing a discount in excess of \$12 million for a right to dissolve a partnership which did not extend to a successor following the death of a partner. Because the successor to the deceased partner's interest did not succeed to the right to dissolve the entity, the court determined that the organizing parties intended to continue the business and, therefore, valued the business using a lower going concern value as opposed to a higher liquidation value).

165. See I.R.C. § 2001(a) (1988) (imposing a tax on the *taxable estate* of every decedent) (emphasis added); I.R.C. § 2051 (1988) (defining *taxable estate* to be equal to the

any reduction in the value of an asset transferred by gift or at death will result in a reduction in the tax due on such transfer.

Section 2704(b)¹⁶⁶ curtailed the availability of valuation discounts utilized by the taxpayer in *Watts*. The section applies if: 1) there is a transfer of an LLC interest to, or for the benefit of, a member of the transferor's family and 2) the transferor and his family control the entity immediately before the transfer.¹⁶⁷ Section 2704(b) still allows the careful planner to reduce the value of membership interests in an LLC for gift-giving or inheritance purposes in recognition of restrictions which are included in the operating agreement.¹⁶⁸

Congress has stated that certain types of restrictions will not be considered to reduce the value of an LLC interest transferred by gift or at death.¹⁶⁹ Congress has determined that an "applicable restriction" will not reduce the value of an LLC interest for purposes of calculating gift or estate tax.¹⁷⁰ Thus, the goal is to create a restriction which is not an "applicable restriction" as defined by the Code and the Regulations, but which still restricts transferability of a member's interest. Applicable restriction refers to "a limitation on the ability to liquidate the entity (in whole or in part) that is more restrictive than the limitations that would apply under the State law generally applicable to the entity in the absence of the restriction."¹⁷¹ Note that a restriction on

value of the *gross estate* less certain deductions) (emphasis added); I.R.C. § 2031(a) (1988) (defining *gross estate* to be the *value* of all property, wherever situated) (emphasis added); I.R.C. § 2501 (1988) (imposing a tax on transfers of property by gift); I.R.C. § 2502 (1988) (declaring *taxable gifts* to be the amount subject to tax) (emphasis added); I.R.C. § 2503 (1988) (defining taxable gifts to be the total *amount* transferred) (emphasis added).

166. I.R.C. § 2704(b) (Supp. II 1990).

167. I.R.C. § 2704(b)(1)(A)-(B) (Supp. II 1990).

168. JEFFREY A. ZALUDA, *LLCS PROVIDE OPPORTUNITIES FOR ESTATE PLANNERS* 16 (Aug. 1994) (on file at the law offices of Horwood, Marcus & Braun Chartered); I.R.C. § 2704(b)(3) (Supp. II 1990) (noting types of restrictions that will be considered in valuing an interest transferred by gift or at death).

169. I.R.C. § 2704(b)(1) (Supp. II 1990).

170. I.R.C. § 2704(b)(2) (Supp. II 1990).

171. *See* Treas. Reg. § 25.2704-2(b) (1992) (interpreting I.R.C. § 2704(b)(3)(B) (Supp. II 1990)). The Code and the Regulations appear to be in conflict regarding the definition of an "applicable restriction." However, the Regulations' position is followed for purposes of this Note because that is the position the IRS will likely follow today. ZALUDA, *supra* note 168, at 19 (pointing out the apparent conflict).

liquidation of an LLC is the direct opposite of the right to continue an LLC.¹⁷² A brief analysis will demonstrate how the Code and Regulations work against bulletproof acts and in favor of flexible ones.

2. Impact of Bulletproof versus Flexible Acts

In states with bulletproof acts, like West Virginia, obtaining a valuation discount for restrictions placed upon the ability of an LLC to liquidate is impossible. West Virginia requires unanimous consent to continue an LLC upon an event of dissolution.¹⁷³ Thus, Section 2704(b)(1) does not apply because there could not be an “applicable restriction” as defined in Section 2704(b)(2).¹⁷⁴ An “applicable restriction” cannot apply because the governing instrument cannot have a requirement for liquidation more restrictive than state law.¹⁷⁵ Although Section 2704(b)(1) is inapplicable and any valuation discount resulting from restrictions on liquidation are allowable, no valuation discount is possible because no individual interest is more or less valuable than any other interest.¹⁷⁶ No interest is more or less valuable than any other interest because all members have an equal right to cause liquidation of the LLC.¹⁷⁷

Conversely, most flexible LLC acts permit planners to take advantage of the exception contained in Section 2704(b)(3).¹⁷⁸ This section deals with restrictions placed on liquidations which are less restrictive

172. This concept is vital to understanding how Section 2704 applies to LLCs. Most LLC acts speak in terms of the percentage vote required to continue an LLC upon an event of dissolution as opposed to the percentage vote required to liquidate an LLC. However, Section 2704 speaks of restrictions that limit the ability of an LLC to liquidate, not the right to continue. Thus, in order for a limitation on liquidation to be more restrictive than state law, the percentage vote required to continue an LLC must be lower than that required by state law. The lower the percentage vote required to continue an LLC, the higher the percentage vote required to liquidate an LLC.

173. W. VA. CODE § 31-1A-35 (1994).

174. See *supra* note 170; Zaluda, *supra* note 168, at 20.

175. Zaluda, *supra* note 168, at 20.

176. *Id.*

177. *Id.*

178. I.R.C. § 2704(b)(3) (Supp. II 1990).

than those imposed by state law. The exception is likely to operate in the following manner.

As discussed above, an “applicable restriction” is disregarded in valuing a business for transfer tax purposes.¹⁷⁹ However, an “applicable restriction” does not include restrictions on liquidation in the operating agreement that are the same or less restrictive than restrictions under state law that apply if the operating agreement has no restrictions¹⁸⁰ (i.e. default provisions). Thus, under a flexible LLC act with default provisions requiring only a majority vote to continue the LLC upon an event of dissolution, any provision in the operating agreement which requires at least a majority vote to continue the LLC will not be more restrictive than the state’s default provision. Therefore, Section 2704(b)(1) will not apply and a valuation discount will be allowed.

This result is easily understood, considering how a change in the percentage vote required to continue the LLC affects the percentage vote required to liquidate the LLC. If an act’s default provision requires a majority vote to continue an LLC, then a slightly less than majority vote is required to liquidate the LLC. The higher the percentage vote required to continue the LLC, the lower the percentage vote required to liquidate the LLC. Thus, so long as the percentage vote required to continue the LLC is at least equivalent to the state’s default provision, the LLC will not be said to have an “applicable restriction.” In the absence of an “applicable restriction,” Section 2704(b)(1) will not apply, and the parties can utilize a valuation discount in valuing the LLC for gift or estate tax purposes.

As the previous discussion demonstrates, states with bulletproof acts, such as West Virginia, are at a competitive disadvantage with regard to Section 2704(b)(3)¹⁸¹ valuation discounts resulting from restrictions on the right of a member to transfer his or her interest. Therefore, any judicious planner wishing to take advantage of such a discount will search for an LLC act that provides the necessary flexibility.

179. See *supra* note 170.

180. See *supra* note 171.

181. I.R.C. § 2704(b)(3) (Supp. II 1990).

As of the date of this writing, the IRS had issued proposed regulations providing an anti-abuse rule under Subchapter K of the Internal Revenue Code of 1986.¹⁸² These proposed regulations allow the IRS to recast a transaction involving an LLC in order to prevent the use of an LLC to circumvent the intended purpose of the Code.¹⁸³ One should fully consider the impact of these proposed regulations before attempting to achieve the tax result achieved by the taxpayer in *Watts*.¹⁸⁴

VI. CONCLUSION

In 1992, West Virginia placed itself strategically among the leading states in the nation with regard to limited liability company legislation when it enacted the West Virginia Limited Liability Company Act.¹⁸⁵ Without this legislation, West Virginia would have been at a severe disadvantage in the LLC marketplace.

Since that time, however, much has changed in this developing area of the law.¹⁸⁶ Changes in federal tax laws coupled with time for careful thinking by drafters of LLC legislation have led to a second generation of LLC acts.¹⁸⁷ These acts provide organizers flexibility in forming LLCs and the security of partnership tax treatment if the acts' default provisions are followed. Prudent planners will undoubtedly begin to search out states with flexible acts in an effort to maximize statutory advantages.¹⁸⁸

This Note encourages the West Virginia Legislature to amend the West Virginia Act to allow organizers more flexibility in organizing

182. 59 Fed. Reg. 94, 25,581 (1994) (to be codified at 26 C.F.R. 1.701-2).

183. *Id.*

184. *See supra* note 164.

185. *See supra* note 6.

186. As recently as August 5, 1994, the National Conference of Commissioners on Uniform State Laws adopted the first Uniform Limited Liability Company Act. The Uniform Act is a flexible act.

187. *See Anderson, supra* note 3, at 80 n.157 (comparing Colorado's bulletproof act with second generation acts and predicting a change in Colorado's act).

188. ZALUDA, *supra* note 168, at 21 (pondering whether, in an appropriate situation, an LLC planner should engage in "forum shopping").

and operating LLCs and to include specific provisions for professional LLCs. By adopting a flexible act with appropriate default provisions, West Virginia will encourage LLC organizers to consider West Virginia as a potential forum. Although West Virginia has a progressive history with respect to LLC legislation, it must act now by amending its LLC Act in order to remain competitive in an ever changing market.

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