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The Limited Liability Company Act: Understanding Kentucky's New Organizational Option

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The Limited Liability Company Act: Understanding Kentucky's New Organizational Option

BY THOMAS E. RUTLEDGE*
AND LADY E. BOOTH**

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INTRODUCTION

On April 11, 1994, Governor Brereton Jones signed into law the Kentucky Limited Liability Company Act (the "LLC Act").¹ Thereby, Kentucky became the forty-first state to provide for the formation of these relatively new business structures.² Additional states are considering the

¹ Act of March 21, 1994, ch. 389, §§ 1-119, 1994 Ky. Rev. Stat. & R. Serv. 275 (Baldwin) (codified at KY. REV. STAT. ANN. §§ 275.005-.93) (Michie/Bobbs-Merrill Supp. 1994).

² The following legislation provides for the formation of limited liability companies ("LLCs") in various states: Alabama Limited Liability Company Act, ALA. CODE §§ 10-

12-1 to 10-12-61 (Supp. 1993) (effective Oct. 1, 1993); Arizona Limited Liability Company Act, ARIZ. REV. STAT. ANN. §§ 29-601 to -857 (Supp. 1993) (effective Sept. 30, 1992); Arkansas Small Business Entity Tax Pass Through Act, ARK. CODE ANN. §§ 4-32-101 to 4-32-1316 (Michie Supp. 1993) (effective Oct. 1, 1993); Colorado Limited Liability Company Act, COLO. REV. STAT. ANN. §§ 7-80-101 to -913 (West Supp. 1993) (effective Apr. 18, 1992); Connecticut Limited Liability Company Act §§ 1-74 (1993 Conn. Acts 93-267 (Reg. Sess.)) (effective Oct. 1, 1993); Delaware Limited Liability Company Act, DEL. CODE ANN. tit. 6, §§ 18-101 to -1107 (1993) (effective Oct. 1, 1992); Florida Limited Liability Company Act, FLA. STAT. ch. 608.401-471 (1993) (effective Apr. 21, 1982); Georgia Limited Liability Company Act, GA. CODE ANN. §§ 14-11-1 to -1107 (Supp. 1993) (effective Mar. 1, 1994); Idaho Limited Liability Company Act, IDAHO CODE §§ 53-601 to -672 (1994) (effective July 1, 1993); Illinois Limited Liability Company Act, ILL. REV. STAT. ch. 805, paras. 180/1-1 to 60-1 (Supp. 1994) (effective Jan. 1, 1994); Indiana Business Flexibility Act, IND. CODE §§ 23-18-1-1 to -13-1 (Supp. 1994) (effective July 1, 1993); Iowa Limited Liability Company Act, IOWA CODE §§ 490A.100-.1601 (Supp. 1994) (effective July 1, 1993); Kansas Limited Liability Company Act, KAN. STAT. ANN. §§ 17-7601 to -7651 (1993) (effective July 1, 1990); Louisiana Limited Liability Company Law, LA. REV. STAT. ANN. §§ 12:1301-:1369 (West 1994) (effective July 7, 1992); Maryland Limited Liability Company Act, MD. CODE ANN., CORPS & ASS'NS §§ 4A-101 to -1103 (1993) (effective Oct. 1, 1992); Michigan Limited Liability Company Act, MICH. COMP. LAWS §§ 450.4101-5200 (1994) (effective June 1, 1993); Minnesota Limited Liability Company Act, MINN. STAT. §§ 322B.01-.60 (Supp. 1994) (effective Jan. 1, 1993); Mississippi Limited Liability Company Act, 1994 Miss. Laws 402 §§ 1-87 (effective July 1, 1994); Missouri Limited Liability Company Act, MO. REV. STAT. §§ 351.015-908 (Supp. 1994) (effective Dec. 1, 1993); Montana Limited Liability Company Act, MONT. CODE ANN. §§ 35-8-101 to -1308 (1993) (effective Oct. 1, 1993); Nebraska Limited Liability Company Act, NEB. REV. STAT. §§ 21-2601 to -2645 (1991) (effective Sept. 9, 1993); Nevada Limited Liability Company Act, NEV. REV. STAT. §§ 86.011-.571 (1991) (effective Oct. 1, 1991); New Hampshire Limited Liability Company Act, N.H. REV. STAT. ANN. §§ 304-C:1 to :85 (Supp. 1993) (effective July 1, 1993); New Jersey Limited Liability Company Act, N.J. REV. STAT. §§ 42:2B-1 to -70 (Supp. 1994) (effective Jan. 26, 1994); New Mexico Limited Liability Company Act, N.M. STAT. ANN. §§ 53-19-1 to -74 (Michie Supp. 1994) (effective June 18, 1993); North Carolina Limited Liability Company Act, N.C. GEN. STAT. §§ 57C-1-01 to -10-07 (1993) (effective Oct. 1, 1993); North Dakota Limited Liability Company Act, N.D. CENT. CODE §§ 10-32-01 to -155 (Supp. 1993) (effective Aug. 1, 1993); Ohio Limited Liability Company Act, OHIO REV. CODE ANN. §§ 1705.01-.59 (Anderson Supp. 1994) (effective July 1, 1994); Oklahoma Limited Liability Company Act, OKLA. STAT. tit. 18, §§ 2000-2060 (Supp. 1994) (effective Sept. 1, 1992); Oregon Limited Liability Company Act, OR. REV. STAT. §§ 63.001-990 (1993) (effective Jan. 1, 1994); Rhode Island Limited Liability Company Act, R.I. GEN. LAWS §§ 7-16-1 to -75 (1992) (effective Sept. 21, 1992); South Dakota Limited Liability Company Act, S.D. CODIFIED LAWS ANN. §§ 47-34-1 to -59 (Supp. 1994) (effective July 1, 1993); Texas Limited Liability Company Act, TEX. REV. CIV. STAT. ANN. art. 1528n, §§ 1.01-11.07 (West Supp. 1994) (effective Aug. 26, 1991); Utah Limited Liability Company Act, UTAH CODE ANN. §§ 48-2b-101 to -157 (1994) (effective July 1, 1991); Virginia Limited Liability Company Act, VA. CODE ANN. §§ 13.1-1000 to -1073 (Michie 1993) (effective July 1, 1991); West Virginia Limited Liability Company Act, W. VA. CODE §§ 31-1A-1 to -69 (Supp. 1994) (effective Mar.

adoption of limited liability company statutes.³ If this trend continues, as currently indicated, LLCs will soon be an accepted form of organization nationwide.

An LLC is an unincorporated business structure that combines the business advantages of a corporation with the income tax advantages of a partnership. The centerpiece of the LLC is its provision for limited liability for its members⁴ and managers in regard to the debts and obligations of the LLC, including those arising from the tortious misdeeds of fellow LLC members in connection with the business of the LLC; moreover, the LLC permits all owners to participate in management without waiving liability protection.⁵ In this respect, the LLC enjoys the principal advantage of conducting business in corporate form, while

6, 1992); Wisconsin Limited Liability Company Act, WIS. STAT. §§ 183.0102-1206 (1994); and Wyoming Limited Liability Company Act, WYO. STAT. §§ 17-15-101 to -136 (1989) (effective Mar. 4, 1977).

Subsequent to the passage of the Kentucky LLC Act, LLC legislation was approved by Alaska, Alaska Limited Liability Act, ALASKA STAT. §§ 10.50.010 to .995 (effective July 1, 1995); California, California Limited Liability Company Act, CAL. CORP. CODE §§ 17,000 to 17,705 (effective Sept. 30, 1994); the District of Columbia, Limited Liability Company Act of 1994, D.C. CODE ANN. §§ 29-1301 to -1375 (effective July 23, 1994); Maine, Maine Limited Liability Company Act, ME. REV. STAT. ANN. tit. 31, §§ 601 to 762 (effective Jan. 1, 1995); New York, New York Limited Liability Company Law, N.Y. LIMITED LIABILITY COMPANY LAW §§ 101 to 1403 (McKinney 1994) (effective Oct. 24, 1994); Tennessee, Tennessee Limited Liability Company Act, TENN. CODE ANN. §§ 48A-1-101 to -47-606 (effective June 22, 1994); and Washington, Washington Limited Liability Company Act, WASH. CODE ANN. §§ 25.15.005 to .902 (effective Oct. 1, 1994).

Prior to adopting their current statutes providing for the formation of LLCs, Georgia, Indiana, and Mississippi enacted statutes authorizing foreign LLCs to register and qualify to do business in their respective states. Georgia Foreign Limited Liability Company Act, GA. CODE ANN. §§ 14-11-1 to -19 (Supp. 1992) (effective July 1, 1992; repealed Mar. 1, 1994); Indiana Foreign Limited Liability Companies Act, IND. CODE §§ 23-16-10.1-1 to -10.1-4 (Supp. 1991) (effective July 1, 1990; repealed July 1, 1993); Mississippi Registration of Foreign Limited Liability Company Act, MISS. CODE ANN. §§ 79-6-1 to -37 (Supp. 1993) (effective July 1, 1993; repealed July 1, 1994). LLCs registered to do business in Indiana were affirmatively grandfathered into the foreign LLC registration provisions of the new LLC Indiana bill. IND. CODE § 23-18-11-18.

³ See, e.g., H.R. 777, 17th Leg., 1st Reg. Sess., (1993), available in LEXIS, States Library, HITRCK File (Hawaii); H.R. 1798, 179th Leg., 1994 Reg. Sess., available in LEXIS, States Library, MATRCK File (Massachusetts); S.B. 1719, 178th Gen. Ass., 1993-94 Reg. Sess., available in LEXIS, States Library, PATRCK File (Pennsylvania); S.B. 314, 62 Gen. Ass., 1993-94 Reg. Sess., available in LEXIS, States Library, VTTRCK File (Vermont).

⁴ Ownership units in an LLC are denominated "interests," and owners are denominated "members." KY. REV. STAT. ANN. § 275.015(9), (12).

⁵ *Id.* § 275.150.

avoiding the most serious limitations of the general and limited partnership forms. However, unlike a corporation, the income of an LLC is not subject to taxation at the entity level. Corporate income is taxed first at the entity level by the corporate income tax, and then by the individual income tax when the income is distributed to the shareholders as dividends.⁶ The income of an LLC, provided the LLC is structured so as to be classified as a partnership, “flows through” to the owners without being subject to an entity-level income tax.⁷ Therefore, properly structured, an LLC avoids “double taxation,” the principal disadvantage of doing business in the corporate form.⁸

Under the Internal Revenue Code (the “Code”), the tax classification of an entity depends on the presence or absence of a number of “corporate” characteristics.⁹ If the LLC is properly structured,¹⁰ it will be classified and taxed as a partnership. To achieve partnership classification, LLCs typically are structured to avoid the corporate characteristics of

⁶ See *infra* notes 477-83 and accompanying text.

⁷ I.R.C. § 701 (1994). Unless otherwise indicated, all references are to the 1994 Internal Revenue Code and the regulations thereunder. Section 701 states that “[a] partnership as such shall not be subject to the income tax imposed by this chapter. Persons carrying on business as partners shall be liable for income tax only in their separate or individual capacities.” See J. WILLIAM CALLISON, PARTNERSHIP LAW AND PRACTICE: GENERAL AND LIMITED PARTNERSHIPS § 4.14 (1992) (“[P]artnerships are not subject to taxation, and all partnership income and loss pass through the partnership and are taxed to the partners.”).

It is beyond the scope of this Article to set forth a complete exegesis of the law of partnership taxation. As observed in *Foxman v. Commissioner*, 41 T.C. 535, 551 (1964), *aff’d*, 352 F.2d 466 (3d Cir. 1965):

The distressingly complex and confusing nature of the provisions of Sub Chapter K present [sic] a formidable obstacle to the comprehension of these provisions without the expenditure of a disproportionate amount of time and effort by one who is sophisticated in tax matters with many years of experience in the tax field. . . . Surely, a statute has not achieved “simplicity” when its complex provisions may confidently be dealt with by at most a comparatively small number of specialists who have been initiated into its mysteries.

⁸ See *infra* notes 435-42 and accompanying text.

⁹ See *infra* part II (discussing the criteria used by the Internal Revenue Service (the “Service”) to classify unincorporated entities as either partnerships or as “associations” taxable as corporations).

¹⁰ The Kentucky LLC Act is a “flexible,” as contrasted with a “bullet-proof,” statute. A bullet-proof statute is structured so that the entity will be assured tax classification as a partnership. Under a flexible statute, the LLC’s structure is permitted to vary from the statutory default provisions; these variances permit an LLC to be classified as a corporation or a partnership. These “flexible” provisions concern the characteristics of continuity of life, free transferability of interests, and whether the LLC will be managed directly by the members or by elected or appointed managers.

continuity of life, so that the LLC survives only so long as the composition of its membership is not altered,¹¹ and free transferability of interests, so that while the right to receive the economic benefits of the LLC may be freely transferred, the management rights of membership cannot unilaterally be transferred.¹² Typically, an LLC is structured to be managed directly by its members. Alternatively, an LLC may be managed by elected or appointed managers who may but need not be members.¹³ The LLC's unique combination of taxation as a partnership, limited liability for all participants, and flexibility of structure adds a valuable option to the choice-of-entity analysis.¹⁴

The first part of this Article reviews the structure and operation of the LLC Act.¹⁵ The Article goes on to review the history of the classification analysis used by the Internal Revenue Service (the "Service") and the response of the Service to the classification challenge presented by the LLC.¹⁶ This discussion is followed by an examination of the desirability for partnership classification under the Code, how the structure of LLCs

¹¹ See *infra* notes 352-78 and accompanying text (discussing continuity of life as applied to LLCs).

¹² See *infra* notes 331-51 and accompanying text (discussing free transferability of interests as applied to LLCs).

¹³ An LLC with centralized management will be taxable as a partnership so long as it avoids continuity of life and free transferability. See *infra* notes 379-94 and accompanying text (discussing centralized management as applied to LLCs).

¹⁴ See, e.g., *ABA Tax Section Meeting: LLC Boosters Blitz Passthroughs Sessions*, 55 TAX NOTES 1019 (1992); *Accounting News*, 54 TAX NOTES 1381, 1382 (1992) ("The Limited Liability Company . . . received enthusiastic, but qualified, endorsement as the ideal business vehicle for the '90s."); *Limited Liability Company Bandwagon Is On A Roll, as Legislatures Respond To Interest In Hybrid Entity*, 6 CORP. COUNS. WKLY. (BNA) Aug. 28, 1991, at 8; *ABA Group Finds States Moving In Limited Liability Companies*, 25 Sec. Reg. & L. Rep. (BNA) No. 34, at 1275 (Aug. 23, 1991) ("Efforts to allow the formation of 'Limited Liability Companies'—business entities designed to combine the best attributes of the partnership and corporate forms—are percolating in state legislatures across the country, a survey of LLC enthusiasts shows."); Josephine Marcotty, *State to Allow Business Hybrid that Combines the Advantages of Corporate and Tax Worlds; New Limited Liability Companies Could Replace Partnership*, STAR TRIB. (Minneapolis), Apr. 30, 1992, § D, at 1; Daniel B. Maskowitz, *New Way to Organize Business Is Gaining Wider Acceptance*, WASH. POST, Nov. 4, 1991, § F, at 14; Jeffrey A. Tannebaum, *States are Sanctioning New Form of Business*, WALL ST. J., July 17, 1992, at B1 (quoting Alan J. Wilensky, Deputy Assistant Treasury Secretary for Tax Policy, as stating that LLCs could become "the dominant form of business for nonpublic companies"); Jeffrey A. Tannebaum, *Partnership, Corporation, Aren't Only Ways to Start Out*, WALL ST. J., May 14, 1991, at B1.

¹⁵ See *infra* notes 20-274 and accompanying text.

¹⁶ See *infra* notes 275-326 and accompanying text.

is affected,¹⁷ and, in addition, how certain classification questions are resolved with respect to LLCs.¹⁸ The Article then turns to the LLC in choice-of-entity analysis,¹⁹ by comparing the organizational and tax attributes of a variety of structures and reviewing the advantages and disadvantages of the LLC in certain common situations.

I. THE KENTUCKY LLC ACT

A. *The Pedigree of the Kentucky LLC Act*

The Kentucky LLC Act was introduced to the 1994 General Assembly on February 7, 1994, as Senate Bill 184.²⁰ The Kentucky Business Corporation Act²¹ and the Prototype Limited Liability Company Act (the "Prototype")²² were the primary sources used in drafting the LLC Act.²³

¹⁷ See *infra* notes 327-94 and accompanying text.

¹⁸ See *infra* notes 395-431 and accompanying text.

¹⁹ See *infra* notes 432-585 and accompanying text.

²⁰ Also incorporated within S.B. 184 were provisions for the formation and registration of limited liability partnerships ("LLPs"). S. 184 (Ky.), 1994 Reg. Sess., §§ 94-106 (S.B. 184) (to be codified at KY. REV. STAT. ANN. § 362). Those provisions and LLPs in general are beyond the scope of this Article. Also in S.B. 184 are amendments to the Corporation Act and the Limited Partnership Act addressing mergers of these entities with LLCs and mergers between corporations and limited partnerships.

²¹ KY. REV. STAT. ANN. § 271B (Michie/Bobbs-Merrill 1989) (the "Corporation Act"). The Corporation Act is itself based on the Revised Model Business Corporation Act (1987) ("RMBCA").

²² The Prototype was prepared by an American Bar Association working group organized under the Committee on Partnerships and Unincorporated Business Organizations of the Section of Business Law. Reference was primarily made to the Prototype draft dated November 19, 1992, and all references to the commentary to the Prototype, except as may be indicated, are to the draft of that date. Reference was also made to the Uniform Partnership Act (1914) ("UPA") as codified in § 362 of the Kentucky Revised Statutes and the Revised Uniform Limited Partnership Act (1976, with 1985 amendments) ("RULPA") as codified in § 362 of the Kentucky Revised Statutes (the "Limited Partnership Act"). Also consulted were the National Conference of Commissioners on Uniform State Laws ("NCCUSL") draft Uniform Limited Liability Company Act ("ULLCA") dated February 26, 1993, and to a lesser extent the draft of October 26, 1993. All references to the commentary to the ULLCA, except as may be indicated, are to the draft of February 26, 1993. The ULLCA was approved by NCCUSL in 1994. Reference was also made to a number of previously adopted LLC statutes, including those of Virginia, Maryland, and Delaware.

²³ The LLC Act was drafted by a task force of the Kentucky Bar Association Sections on Taxation and Business Law and the Kentucky Society of Certified Public Accountants. Both authors were members of the LLC Act drafting task force.

B. Organization

1. Formation, Articles of Organization, and the Operating Agreement

Formation of an LLC is accomplished by delivering executed articles of organization to the Kentucky Secretary of State.²⁴ The organizer, while not required to be, may be a member of the LLC.²⁵

The articles of organization of an LLC must include the following: the name of the LLC;²⁶ the street address of the initial registered office and the name of the registered agent of the LLC;²⁷ the mailing address of the initial principal office of the LLC;²⁸ a statement that the LLC has two or more members;²⁹ a statement as to whether the LLC will be managed by managers or by its members;³⁰ and, if the LLC is to have a specific date of dissolution, the latest date on which the LLC is to dissolve.³¹ If the LLC has been organized to render professional services, the articles of organization must state what professional service or services will be practiced through the professional limited liability company ("PLLC").³²

²⁴ KY. REV. STAT. ANN. § 275.020. The articles of organization must also be filed with the county clerk in which the LLC has its registered office. *Id.* § 275.045(11); *accord id.* § 271B.2-030(1) (Michie/Bobbs-Merrill 1989) (stating that corporate existence begins on the date articles of incorporation are filed with the Secretary of State).

²⁵ *Id.* § 275.020. The number of organizers is a question distinct from the minimum number of members.

²⁶ *See infra* notes 49-53 and accompanying text (discussing the requirements relating to the name of the LLC).

²⁷ *See infra* notes 54-56 and accompanying text (discussing the requirements relating to the registered office and registered agent of the LLC).

²⁸ The requirement of the mailing address of the initial principal place of business does not appear in § 202 of the Prototype and was added to conform to § 271B.2-020(1)(d) and § 362.415(1)(d) of the Kentucky Revised Statutes. *See also* KY. REV. STAT. ANN. § 275.040 (requiring that the LLC deliver to the Secretary of State a statement of a change in its principal office).

²⁹ *See infra* note 292 (concerning the requirement that the LLC have at minimum two members). This requirement does not appear in § 202 of the Prototype and was added by the drafting committee.

³⁰ *See infra* notes 66-72, 85-96, and 379-94 and accompanying text (discussing the effect of electing either a member-managed or a manager-managed LLC).

³¹ *See infra* notes 355-57 and accompanying text (discussing the effect of a specific date of dissolution).

³² KY. REV. STAT. ANN. § 275.025(2); *see infra* notes 253-74 and accompanying text (discussing PLLCs).

The articles of organization may, but are not required to, include any matters permitted to be set forth in the operating agreement.³³ Articles of organization must be accompanied by a statement of the registered agent consenting to serve in such capacity.³⁴

The existence of an LLC does not begin until the articles of organization are filed with the Kentucky Secretary of State.³⁵ Articles of amendment may be filed at any time to add or modify a provision required or permitted in the articles of organization or to delete a provision not required.³⁶ Similarly, the articles of organization may be restated.³⁷

The operating agreement functions at a level below the articles of organization as the core document controlling the operation of the LLC.³⁸ The operating agreement may include any provision that does not conflict with the articles of organization or the LLC Act.³⁹ Where the LLC Act provides that a default rule may be modified or excepted from, the courts should enforce such a provision in the operating agreement. Conversely, a mandatory provision of the LLC Act cannot be varied by the operating agreement, and any such provision should not be enforceable.⁴⁰

The initial adoption of an operating agreement requires the unanimous consent of all members of the LLC. Furthermore, unless otherwise provided, amendment of the operating agreement also requires the unanimous approval of the members.⁴¹

³³ KY. REV. STAT. ANN. § 275.025(3); *accord id.* § 271B.2-020(2)(c) (Michie/Bobbs-Merrill 1989) (indicating that the articles of incorporation shall contain any required provisions and may include other provisions not prohibited by law).

³⁴ *Id.* §§ 275.025(4), 275.115(2). A bill to add similar consent requirements to the Corporation Act and the Limited Partnership Act was not approved by the 1994 General Assembly. *See* H.R. 918 (Ky.), 1994 Reg. Sess.

³⁵ KY. REV. STAT. ANN. §§ 275.020, 275.060(1).

³⁶ *Id.* § 275.030.

³⁷ *Id.* § 275.035.

³⁸ *Id.* § 275.015(13).

³⁹ *Id.*; *accord id.* § 271B.2-060(2) (Michie/Bobbs-Merrill 1989) (permitting corporate bylaws to include any provisions not prohibited by law or inconsistent with the articles of incorporation).

⁴⁰ The structure of the LLC Act, when compared with the Corporation Act, magnifies the importance of the operating agreement as opposed to corporate bylaws. The Corporation Act contains detailed default provisions dealing with such topics as minimum notice for board and shareholder meetings, the use of proxies, minimum voting requirements for a number of fundamental transactions, transactions involving a potential conflict of interests, dissenters' rights, and derivative actions. *See generally* KY. REV. STAT. ANN. § 271B. The LLC Act does not provide similar default provisions. Therefore, it is incumbent upon the drafter of the operating agreement to address these issues.

⁴¹ *Id.* § 275.175(2)(a).

The LLC Act does not require that the operating agreement be in writing. However, certain default rules may be modified only by a written operating agreement.⁴² The operating agreement may provide that any amendments are to be in writing, and, as a corollary, that oral modifications of the written agreement are unenforceable.⁴³ An LLC may exist without an operating agreement, in which case it will be governed by the default rules of the LLC Act.⁴⁴

Unlike articles of organization, the operating agreement is not publicly recorded. However, any written operating agreement must be retained as a record at the LLC's principal office.⁴⁵

2. Purposes and Powers

LLCs may be formed for any lawful purpose, including professional services,⁴⁶ and are granted broad and all-inclusive

⁴² See, e.g., *id.* § 275.175(2)(a)-(c) (requiring unanimous vote to amend a written operating agreement, authorize an action in contravention of a written operating agreement, or amend the articles of organization to change the management structure from member-managed to manager-managed or vice versa unless otherwise provided in a written operating agreement); *id.* § 275.210 (providing for allocation of profits and losses on a per capita basis unless otherwise agreed in a written operating agreement); *id.* § 275.265(1) (requiring a unanimous vote to admit a transferee as a member unless otherwise provided in a written operating agreement); *id.* § 275.285(3)(a) (requiring unanimous consent to continue the LLC after an event of disassociation unless otherwise provided in a written operating agreement).

⁴³ *Id.* § 275.015(13).

⁴⁴ This rule differs from that applied to corporations, in which the incorporators or board are required to adopt initial bylaws. *Id.* § 271B.2-060 (Michie/Bobbs-Merrill 1989). Limited partnerships may have an oral partnership agreement. *Id.* § 362.401(9) (Michie/Bobbs-Merrill Supp. 1994).

The tax classification of an LLC governed by the default provisions of the LLC Act, whether due to the lack of an operating agreement or incorporation of the default provisions in an operating agreement, should be as a partnership. See *infra* notes 417-24 and accompanying text.

⁴⁵ See KY. REV. STAT. ANN. § 275.185(1)(d); see also *infra* note 103 and accompanying text.

⁴⁶ See § 275.005 of the Kentucky Revised Statutes, which provides:

A[n LLC] may be organized under this chapter for any lawful purpose, including the provision of one (1) or more professional services conducted in or outside the Commonwealth. Except as otherwise provided in Section 30 of this Act, if the purpose for which a[n LLC] is organized or its activities make it subject to one (1) or more special provisions of law, the [LLC] shall also comply with those provisions.

powers.⁴⁷ Irrespective of the broad range of powers granted to LLCs, those organized to render professional services are not exempted from oversight by the applicable regulatory authorities.⁴⁸

3. Name

The name of an LLC must be distinguishable on the records of the Secretary of State from the name of any other business entity formed or registered to do business in Kentucky⁴⁹ and must clearly place third

Not all states have granted such expansive powers to LLCs. *See, e.g.*, ARIZ. REV. STAT. ANN. § 29-609 (Supp. 1993) (stating that LLCs may not engage in banking or insurance); DEL. CODE ANN. tit. 6, § 18-106 (1993) (stating that LLCs may not engage in insurance or banking); MD. CODE ANN., CORPS & ASS'NS § 4A-201 (1993) (stating that LLCs may not act as an insurer or engage in professional services); OR. REV. STAT. § 63.074(2) (1993) (stating that LLCs may not render professional services); R.I. GEN. LAWS § 7-16-3 (1992) (stating that LLCs may not render professional services). *See infra* notes 253-74 and accompanying text (discussing PLLCs).

⁴⁷ See § 275.010 of the Kentucky Revised Statutes, which provides in part: "Except as otherwise set forth in this chapter or unless the articles of organization or operating agreement provide otherwise, every [LLC] shall have the powers to do all things necessary or convenient to carry out its business and affairs."

The LLC Act does not contain a list of general powers equivalent to that set forth for corporations at § 271B.3-020(1) (providing non-exclusive list of fifteen powers of a corporation). A number of other LLC statutes contain such "laundry lists" of powers. *See, e.g.*, ALA. CODE § 10-12-4(a)-(s) (Supp. 1993); COLO. REV. STAT. ANN. § 7-80-104(1)(a)-(n) (West Supp. 1993); FLA. STAT. ch. 608.404(1)-(17) (1993); MONT. CODE ANN. § 35-8-107(1)-(16) (1993); R.I. GEN. LAWS § 7-16-4(a)-(r) (1992); UTAH CODE ANN. § 48-2b-105(1)(a)-(r) (1994); WYO. STAT. § 17-15-104(a)(i)-(xiv) (1989). Louisiana grants LLCs the powers provided to corporations and partnerships organized under Louisiana law. LA. REV. STAT. ANN. § 12:1303 (West 1994). Georgia empowers each LLC "to do all things necessary to carry out its purpose, business, and affairs." GA. CODE ANN. § 14-11-202 (Supp. 1993).

⁴⁸ Pursuant to § 275.010 of the Kentucky Revised Statutes, PLLCs are governed by the same laws as are generic LLCs. While a professional regulatory board may not modify the rule of limited liability, its authority to license professionals and regulate the practice of the profession through PLLCs, including setting the qualifications for members and managers and imposing requirements on transfers of interests and the types of professional services that may be rendered, is specifically recognized and confirmed. *Id.*

⁴⁹ Section 275.100(2) provides: "Except as authorized in subsections (3) and (4) of this section, the name of a[n] LLC shall be distinguishable from any name on record with the Secretary of State." The "distinguishable upon the records" test is already used in Kentucky with respect to corporations, *id.* § 271B.4-010(2) (Michie/Bobbs-Merrill 1989), and limited partnerships, *id.* § 362.403(3) (Michie/Bobbs-Merrill Supp. 1994). *Cf.* 30 KY. ADMIN. REGS. 1:040 (1993) (regarding application for the use of an indistinguishable name).

parties on notice that they are dealing with an LLC.⁵⁰ An LLC formed to render professional services must also include "professional," or an abbreviation thereof, in its name.⁵¹

LLC names may be reserved,⁵² and foreign LLCs may register their names provided that they conform to the requirements of the LLC Act and are distinguishable upon the records of the Secretary of State.⁵³

4. *Registered Office of, Registered Agent of, and Service on an LLC*

An LLC must at all times maintain a registered office and a registered agent in Kentucky.⁵⁴ Service of process is made on an LLC through its registered agent,⁵⁵ or, where service cannot be accomplished through the registered agent, by registered or certified mail to the principal office of the LLC.⁵⁶

Other states utilize the "distinguishable upon the records" test for LLC names. *See, e.g.,* DEL. CODE ANN. tit. 6, § 18-102(3) (1993); GA. CODE ANN. § 14-11-207(a)(2) (Supp. 1993); ILL. REV. STAT. ch. 805, para. 80/1-10(d) (Supp. 1994); IND. CODE § 23-18-2-8(a)(3) (Supp. 1994); IOWA. CODE § 490A.401(3) (West Supp. 1994); KAN. STAT. ANN. § 17-7606(a) (1993). *Compare with* Prototype Act § 103(b) and ULCCA § 105(b) (using "deceptively similar" standard).

⁵⁰ See § 275.100(1) of the Kentucky Revised Statutes, which provides in part: "The name of each [LLC] as set forth in its articles of organization shall contain the words 'limited liability company' or 'limited company' or the abbreviations 'LLC,' or 'LC.'"

The failure to include this designation in the name, under the law of an undisclosed principal, could subject those doing business through the unidentified LLC to liability for its debts and obligations. *See, e.g.,* Perry v. Ernest R. Hamilton Assocs., Inc., 485 S.W.2d 505, 508 (Ky. 1972) (holding individual who retained engineering firm to work on proposed subdivision and did not disclose that proposed subdivision was owned by a corporation personally liable for professional fees); *see also* Sheldon I. Banoff, *LLC Announcements: Damage Control*, 80 J. TAX'N 255 (1994) (discussing issues involved in announcing conversion of professional practice to LLC form).

The name will also alert a third party that they are dealing with an entity without a predetermined management/agency structure, and that investigation as to who has the ability to bind the entity is warranted.

⁵¹ Section 275.100(1) of the Kentucky Revised Statutes provides in part: "The name of each [LLC] which is a PLLC shall contain the words 'professional limited liability company' or 'professional limited company' or the abbreviations 'PLLC' or 'PLC.'"

⁵² *Id.* § 275.105.

⁵³ *Id.* § 275.110.

⁵⁴ *Id.* § 275.115(1). The statute also provides for the change of registered office or registered agents, *id.* § 275.120, and the resignation of a registered agent, *id.* § 275.125.

⁵⁵ *Id.* § 275.130(1); *accord id.* § 271B.5-040(1) (Michie/Bobbs-Merrill 1989) (establishing methods for serving process on a corporation in Kentucky).

⁵⁶ *Id.* § 275.130(2); *accord id.* § 271B.5-040(2) (Michie/Bobbs-Merrill 1989)

5. *Members, Managers, and Agency*

The LLC Act denominates the owners of an LLC as “members.”⁵⁷ Membership in an LLC is open to individuals, corporations, general and limited partnerships, other LLCs, trusts, estates, associations, and any other entities.⁵⁸ In order to qualify for classification as a partnership for federal income tax purposes, an LLC must have at least two members.⁵⁹

The statutory rights of members include the following: to vote on the adoption of amendments to the operating agreement;⁶⁰ to directly manage the LLC or, in the alternative, to vote for managers of the LLC;⁶¹ to approve or disapprove transfers of a member’s interest to a nonmember;⁶² and to vote upon the continuation of the LLC after the death, retirement, resignation, expulsion, bankruptcy, or dissolution of a member.⁶³ Of course, the members also have the right to receive allocations of profits and losses⁶⁴ and to receive distributions, as made, from the LLC.⁶⁵

Where the members retain the right to manage the LLC, each member is an agent of the LLC for the purpose of carrying on its business and affairs, and such action of any member binds the LLC.⁶⁶ Where the authority to

(establishing alternate methods for serving process on a corporation in Kentucky). Service on an LLC may be made pursuant to Kentucky Rule of Civil Procedure 4.04(4) relating to service on an “unincorporated association subject to suit under a common name.” Service on the registered agent of the LLC, who is “an agent authorized by appointment or by law to receive service on [the LLC’s] behalf,” complies with Rule 4.04(4).

⁵⁷ KY. REV. STAT. ANN. § 275.015(12).

⁵⁸ *Id.* § 275.015(12), (14); *see infra* notes 495-98 and accompanying text (discussing the effect of the flexibility with respect to permissible owners in the choice-of-entity analysis).

⁵⁹ *See infra* note 292 (regarding the need for at least two members in order to ensure classification as a partnership).

⁶⁰ KY. REV. STAT. ANN. § 275.175(2)(a).

⁶¹ *Id.* § 275.135; *see infra* notes 85-101 and accompanying text (discussing the structure and effect of the management of an LLC); *see also infra* notes 379-94 and accompanying text (considering the impact of such elections on the tax classification question).

⁶² KY. REV. STAT. ANN. § 275.265(1); *see infra* notes 137-43 and accompanying text (discussing the members’ right to approve or disapprove transfers of interests); *see also infra* notes 331-51 and accompanying text (considering the impact of such provisions on the tax classification question).

⁶³ KY. REV. STAT. ANN. § 275.280(e); *see infra* notes 166-71 and accompanying text (discussing the continuity of an LLC); *see also infra* notes 352-78 and accompanying text (considering the impact of this issue on the tax classification question).

⁶⁴ KY. REV. STAT. ANN. § 275.205; *see infra* notes 111-13 and accompanying text.

⁶⁵ KY. REV. STAT. ANN. § 275.210; *see infra* notes 113-27 and accompanying text.

⁶⁶ KY. REV. STAT. ANN. § 275.135. This provision states:

manage the LLC is vested in the managers, each member, by virtue of that status alone, ceases to be an agent of the LLC.⁶⁷ Rather, the agency power exclusively vests in the managers, and their acts will, when carried on in the normal conduct of the business or affairs of the LLC, bind the LLC.⁶⁸

The act of an agent of the LLC, whether a member or manager, that is not apparently for the carrying on in the usual way of the business or the affairs of the LLC will not, without specific authorization, bind the LLC.⁶⁹ Persons having knowledge of a restriction on the authority of an agent may not rely upon the general rule of agency.⁷⁰

An admission by either a member or manager agent of the LLC, made within the scope of his or her authority, may be used as evidence

Except as provided in subsection (2) of this section, every member shall be an agent of the [LLC] for the purpose of its business or affairs, and the act of any member, including, but not limited to, the execution in the name of the [LLC] of any instrument, for apparently carrying on in the usual way the business or affairs of the [LLC] of which he is a member, shall bind the [LLC], unless the member so acting has, in fact, no authority to act for the [LLC] in the particular matter, and the person with whom the member is dealing has knowledge or has received notification of the fact that the member has no such authority.

Accord UPA § 9(1); KY. REV. STAT. ANN. § 362.190(1) (Michie/Bobbs-Merrill Supp. 1994) (stating that each partner is an agent of the general partnership).

Providing for direct management by the members in an LLC in which at least some members are not involved in day-to-day operations but rather are passive investors may not be practical. As every member will be an agent of and able to bind the LLC, those actively managing the LLC must closely monitor the activities of the passive members and, to the extent practicable, limit their apparent and actual authority through contract and notice to third parties. *See infra* notes 85-96 and accompanying text.

⁶⁷ KY. REV. STAT. ANN. § 275.135(2).

⁶⁸ *Id.* § 275.135(2)(b). Some statutes clearly permit the members to divide power by vesting some power in managers while retaining some authority in members. Even without such an explicit provision, there is no reason why the members could not, in their operating agreement, allocate some management authority to members in a manager-managed firm. Moreover, the statutes apparently do not prevent the members from dividing power between managers and members differently vis-à-vis the members than with respect to third parties. For example, a provision in the operating agreement may limit the managers' or members' management rights within the firm but may not be binding on third parties. Accordingly, the parties to an LLC conceivably, by certificate provision, could elect management by managers but delegate only ministerial tasks to the managers while the members retain significant powers among themselves. In this situation, the managers essentially would be business agents for the LLC.

⁶⁹ *Id.* § 275.135(3).

⁷⁰ *Id.* § 275.135(1), (2)(b), (4); *see also id.* § 275.305(4) (stating rules of agency upon dissolution of an LLC).

against the LLC.⁷¹ Also, notice to a member in a member-managed LLC, or to a manager in a manager-managed LLC, will constitute notice to the entity.⁷²

C. Limited Liability to Third Parties

The core of the LLC Act is the provision of limited liability for the members and any managers, employees, and/or agents from the debts and obligations of the LLC.⁷³ To this extent, an LLC affords the level of

⁷¹ *Id.* § 275.140(1), (2)(a). In a manager-managed LLC, the admission of a member acting solely in that capacity is not evidence against the LLC. *Id.* § 275.140(2)(b).

⁷² *Id.* § 275.145; accord UPA § 12. In a manager-managed LLC, notice to or knowledge of any member, where such member receives the information solely in his or her capacity as a member, is not notice to the LLC. KY. REV. STAT. ANN. § 275.145(2)(b).

⁷³ Section 275.150 of the Kentucky Revised Statutes provides:

Except as otherwise specifically set forth in this chapter, no member, manager, employee or agent of a[n LLC], including a PLLC, shall be personally liable by reason of being a member, manager, employee or agent of the [LLC], under a judgment, decree or order of a court, agency or tribunal of any type, or in any other manner, in this or any other state, or on any other basis, for a debt, obligation or liability of the [LLC], whether arising in contract, tort or otherwise. The status of a person as a member, manager, employee or agent of a[n LLC], including a PLLC, shall not subject such person to personal liability for the acts or omissions, including any negligence, wrongful act or actionable misconduct of any other member, manager, agent or employee of the [LLC].

See, e.g., ALA. CODE § 10-12-20 (Supp. 1993); ARIZ. REV. STAT. ANN. § 29-651 (Supp. 1993); ARK. CODE ANN. § 4-32-304 (Michie Supp. 1993); COLO. REV. STAT. ANN. § 7-80-705 (West Supp. 1993); 1993 Conn. Acts 93-267 (Reg. Sess.); DEL. CODE ANN. tit. 6, § 18-303 (1993); FLA. STAT. ANN. § 608.436 (West 1993); GA. CODE ANN. § 14-11-303 (Supp. 1993); IDAHO CODE § 53-619 (1994); IND. CODE § 23-18-3-3(a) (Supp. 1994); IOWA CODE § 490A.601 (Supp. 1994); KAN. STAT. ANN. § 17-7620 (1993). The Illinois statute provides limited liability by declaring that a member or a manager shall be liable to the extent that a shareholder or a director, respectively, of an Illinois business corporation would be liable in an analogous situation. ILL. REV. STAT. ch. 805, para. 180 (Supp. 1994). The West Virginia statute provides that members and managers shall have the same rights and liabilities as shareholders and directors, respectively, of a corporation organized or registered under West Virginia law. W. VA. CODE § 31-1A-33 (Supp. 1994).

Personal liability does exist for those engaging in preorganization activities or for those purporting to act on behalf of a non-existent LLC. See § 275.095 of the Kentucky Revised Statutes, which provides: "All persons purporting to act as or on behalf of a[n LLC], knowing there has been no organization under this chapter, shall be jointly and severally liable for all liabilities created while so acting." *Accord id.* § 271B.2-040 (Michie/Bobbs-Merrill 1989).

An issue to be considered is the degree to which the common law doctrine of piercing the corporate veil should apply to LLCs. While the use of the LLC's liability

protection associated with corporate shareholders⁷⁴ and the limited partners of a limited partnership.⁷⁵

Professionals may use an LLC to render services, and the liability shield will apply to the members, managers, employees, and agents of the PLLC.⁷⁶ However, the liability shield will not protect a member, professional or otherwise, from personal liability arising from his or her own acts, as the liability shield is limited to protection from vicarious liability for the acts of other members or agents of the LLC.⁷⁷ In

shield should not be permitted to protect wrongdoers, the application of the law that has developed in this area is questionable. Several states have expressly provided that the law of piercing the corporate veil should apply to LLCs. *See, e.g.*, COLO. REV. STAT. § 7-80-107; ILL. REV. STAT. ch. 805, para. 180/10-10 (Supp. 1994) (providing that a member or manager "shall be personally liable for any act, debt, obligation or liability of the [LLC] or another member or manager to the extent that a shareholder of an Illinois business corporation is liable in analogous circumstances under Illinois law"); MINN. STAT. § 322-B.303(2) (Supp. 1994) (effective Jan. 1, 1993); N.D. CENT. CODE § 10-32-29(3) (Supp. 1993); WIS. STAT. ANN. § 183.0304(2) (1994) ("Nothing in this chapter shall preclude a court from ignoring the [LLC] under principles of law similar to those applicable to business corporations and shareholders in this state and under circumstances that are inconsistent with the purposes of this chapter.").

However, some of the rationales utilized in Kentucky to pierce the corporate veil appear inapplicable to LLCs. These provisions include the failure to follow organizational formalities which are not mandated by the LLC Act. *See, e.g.*, *White v. Winchester Land Dev. Corp.*, 584 S.W.2d 56, 62 (Ky. Ct. App. 1979) (holding that the "failure to observe the formalities of corporate existence" could constitute a factor in support of piercing the corporate veil). The LLC Act does not directly incorporate the law of piercing the corporate veil. However, § 275.185(4) of the Kentucky Revised Statutes provides that the failure to maintain the corporate records of an LLC will not constitute a basis for imposing personal liability on the members and managers.

⁷⁴ *See* KY. REV. STAT. ANN. § 271B.6-220(2) (Michie/Bobbs-Merrill 1989) (general corporation); *id.* § 274.055(1) (professional service corporation ("PSC")). *Contra* UPA § 15(a), (b); KY. REV. STAT. ANN. § 362.220 (Michie/Bobbs-Merrill Supp. 1994) (providing for general partners' joint and several liability for claims against the partnership arising from a partner's wrongful act or breach of trust).

⁷⁵ KY. REV. STAT. ANN. § 362.437.

⁷⁶ *See supra* note 73; *infra* notes 253-63.

⁷⁷ KY. REV. STAT. ANN. § 275.055(1) (Michie/Bobbs-Merrill 1989). As noted in the comments to § 112 of the ULLCA (Oct. 26, 1993 draft):

By practicing as a limited liability company, professionals would continue to be personally liable for their own malpractice but could generally shield themselves from personal liability for the torts of business associates. This is contrasted with general partnership law under which all partners are responsible for their own torts as well as the torts of their partners.

See infra notes 509-14 and accompanying text (discussing the liability shield presently afforded by the PSC and comparing such to that afforded by the LLC).

addition, the assets of the LLC are subject to the claims of creditors, including those injured by the action of a member, manager, employee, or agent of the LLC acting in the course of the ordinary business of the LLC.⁷⁸

D. Interstate Application

The LLC Act empowers LLCs to conduct business and operations in any foreign jurisdiction⁷⁹ and provides that Kentucky law will govern the limited liability afforded to the members, managers, employees, and agents of a Kentucky LLC in any other state or foreign country.⁸⁰

While the LLC Act provides that questions of liability arising in other jurisdictions will be governed by Kentucky law, this provision does not guarantee that a foreign jurisdiction will believe itself bound by this directive. Rather, the foreign court may investigate whether the law of its jurisdiction or that of Kentucky will control.⁸¹

⁷⁸ The LLC Act does not contain an express provision recognizing that the LLC is liable for the acts of its members and managers when such occur during the ordinary business of the LLC. Compare ULLCA § 302, which states:

A[n LLC] is liable for loss or injury caused to a person, or for a penalty incurred, as a result of a wrongful act or omission, or other actionable conduct, of a member or manager acting in the ordinary course of business of the company or with authority of the company.

⁷⁹ Section 275.160(1) of the Kentucky Revised Statutes provides: "A[n LLC] may conduct its business, carry on its operations, and exercise the power granted by this chapter in any state, or in any foreign country."

⁸⁰ Section 275.160(2) of the Kentucky Revised Statutes provides:

The personal liability of members, managers, employees and agents of a[n LLC] to any person or in any action or proceeding for the debts, obligations or liabilities of a[n LLC] or for the acts or omissions of other members, managers, employees or agents of a[n LLC] shall be governed solely and exclusively by this chapter and the laws of this Commonwealth. Whenever a conflict arises between the law of this state and the laws of any other state with regard to the liability of the members of the [LLC] for the debts, obligations and liabilities of the [LLC] or for the acts or omissions of other members, managers, employees or agents of the [LLC], this Commonwealth's law shall be deemed to govern in determining the liability.

⁸¹ See RESTATEMENT (SECOND) OF CONFLICTS § 307 (1969) which provides that, with respect to the liability of a shareholder to the creditors of the corporation, the "local law" of the state of incorporation will control. Reference may then be made to § 298 ("Treatment of Organization as Corporation") to determine whether § 307 should apply to LLCs in assessing the liability of LLC members. See also *Hill-Davis Co. v. Atwell*, 10 P.2d 463, 464-65 (Cal. 1932), where the court explained:

For claims against a partnership, the Restatement (Second) of Conflicts directs that the controlling law is that of the jurisdiction having the most significant contacts with the parties and the events giving rise to the claim.⁸² The rule applying the law of the jurisdiction with most significant contacts is likewise applied to the liability of limited partners.⁸³

If the court determined that these provisions governed the personal liability of the LLC members, it could determine that the law of the situs of the injury should control and hold that, due to the absence of an LLC statute in that jurisdiction, the LLC should be viewed as an unincorporated association for which joint and several liability among the members exists. In addition to the Restatement (Second) of Conflicts, the courts may look to principles such as comity, as well as the Full Faith and Credit Clause and the Commerce Clause, for guidance.⁸⁴

It is elementary law that, when the question arises in one state as to whether a particular association organized under the laws of a sister state is a corporation or merely an unincorporated association, the question will be determined by considering the nature of the association as indicated by the powers and faculties conferred on it by the state of its creation. If the powers and faculties conferred on it are such as to make it essentially a corporation, it will be held to be such, regardless of what or how the state of its creation calls or treats it.

⁸² RESTATEMENT (SECOND) OF CONFLICTS § 174 (regarding vicarious liability for tort claims); *id.* § 295 (regarding contractual liability of partnership, partners, and third persons).

⁸³ *Id.* § 307.

⁸⁴ The case law governing this issue does not set forth a general rule. In the past, courts have refused to recognize the limited liability granted by a foreign jurisdiction to avant-garde business structures. *See, e.g.,* *Ing v. Liberty Nat'l Bank*, 287 S.W. 960, 961 (Ky. 1926) (refusing to recognize, with respect to third parties, limited liability purportedly afforded by organizational documents to investors in unincorporated syndicate); *Thompson v. Schmidt*, 274 S.W.2d 554, 560 (Tex. 1925) (refusing to recognize limited liability of shareholders of Massachusetts business trust); *Means v. Limpia Royalties*, 115 S.W.2d 468, 475 (Tex. Civ. App. 1938) (refusing to recognize limited liability of shareholders of Oklahoma business trust). More recent cases have deferred to the law of the jurisdiction of organization in order to assess an investor's liability. *See, e.g.,* *Downey v. Swan*, 454 N.Y.S.2d 895 (N.Y. App. Div. 1982) (reviewing the limited liability of a member of a dissolved New Jersey partnership association by looking to New Jersey law); *Abu-Nassar v. Elders Futures, Inc.*, No. 88 [Civ.] 7906, 1991 U.S. Dist. LEXIS 3794, at *1 (S.D.N.Y. Mar. 28, 1991) (reviewing question of personal liability of members in Lebanese limited liability company by looking to Lebanese law). Of course, the significance of this question diminishes as more states enact LLC statutes and as LLCs become more broadly accepted.

E. Management

1. Management and Agency

The default rule is that the business and affairs of an LLC will be directly managed by the members of the LLC.⁸⁵ Where members directly manage the LLC, each member is an agent of the LLC and may bind the entity by his or her acts in furtherance of the business and affairs of the LLC.⁸⁶ However, the articles of organization may provide that the LLC will be managed by managers.⁸⁷ Where the articles of organization vest the authority to manage the LLC in managers, the members cease to be agents of the LLC; the managers then have the exclusive power to manage the business and affairs of the LLC, excepting those decisions reserved for the members by the LLC Act, the articles of organization, or the operating agreement.⁸⁸ As the articles of organization require a declaration of the method of management for the LLC, and the terms and provisions of the articles of organization are of public record, all parties dealing with the LLC may ascertain the management structure and consequently the parties who may bind the LLC.⁸⁹

Unless the articles of organization or the operating agreement provides otherwise, managers are elected and removed by a majority vote⁹⁰ of the members voting on a per capita basis.⁹¹ Managers of an

⁸⁵ Section 275.165(1) of the Kentucky Revised Statutes provides:

Unless the articles of organization vest management of the [LLC] in a manager or managers, management of the business and affairs of the [LLC] shall vest in the members. Subject to any provisions in the articles of organization, the operating agreement or this chapter restricting or enlarging the management rights and duties of any person or group or class of persons, the members shall have the right and authority to manage the affairs of the [LLC] and to make all decisions with respect thereto.

⁸⁶ KY. REV. STAT. ANN. § 275.135(1).

⁸⁷ *Id.* §§ 275.025(1)(e), 275.165(2).

⁸⁸ Section 275.165(2) of the Kentucky Revised Statutes provides in part:

If the articles of organization vest management of the [LLC] in one (1) or more managers, except to the extent otherwise provided in the articles of organization, the operating agreement, or this chapter, the manager or managers shall have exclusive power to manage the business and affairs of the [LLC].

⁸⁹ While an LLC ostensibly may be managed by the members where the members have privately contracted that certain of them will not act as agents of the LLC, that contract will not restrict apparent agency authority of the members as to third parties who are without knowledge. *See supra* notes 66-70 and accompanying text.

⁹⁰ *See infra* note 97 and accompanying text.

⁹¹ KY. REV. STAT. ANN. § 275.165(2)(a).

LLC need not be members or natural persons,⁹² and, unless removed or resigned, they hold such office until their successors have been duly elected and qualified.⁹³

2. *Duties of Managers and Members*

Unless the operating agreement provides otherwise, a member or manager is not liable to an LLC or its members for any action or inaction unless that act or omission constituted wanton or reckless misconduct.⁹⁴ A member or manager must account to and hold as a trustee for the LLC any profit or benefit derived from the use of LLC property by that member or manager without the consent of at least one-half of the disinterested members or managers.⁹⁵ A non-manager member in a manager-managed LLC has no duties to the LLC or other members arising solely by virtue of membership status.⁹⁶

⁹² *Id.* § 275.165(2)(b).

⁹³ *Id.* § 275.165(2)(c). This rule is somewhat different from that applied to corporate directors, who as a rule hold their offices for one year from the date of election (assuming such election takes place at the time of the annual meeting of shareholders) and only as a default continue in office until their successors are duly elected and qualified. *Id.* § 271B.8-050(5) (Michie/Bobbs-Merrill 1989).

⁹⁴ *Id.* § 275.170(1). Unlike the Corporation Act, the LLC Act does not define the level of care of those vested with management authority. For example, corporate directors are required to perform their duties in good faith, on an informed basis, and in a manner they honestly believe to be in the best interests of the corporation. *Id.* § 271B.8-300(1)(a)-(c) (Michie/Bobbs-Merrill 1989). Sections 271B.8-300(6)(b) and 275.170(1) of the Kentucky Revised Statutes define the level of culpability required to hold a director/manager liable for monetary damages. The LLC Act neither provides a mechanism for assessing the voidability of a manager's act allegedly tainted by a conflict of interest nor describes what relationships give rise to conflicts of interest. *Compare id.* § 271B.8-310 (Michie/Bobbs-Merrill 1989). As such, transactions between an LLC and its managers are subject to fewer restrictions than are transactions between a corporation and its officers and directors. In the former, the transaction is limited only by the agreement and the managers' obligation of good faith and fair dealing.

Certain other LLC statutes have adopted the corporate model and have imposed statutory levels of care on a manager. The Virginia and Colorado statutes explicitly define the duties of managers. *See* COLO. REV. STAT. § 7-80-406 (West Supp. 1993); VA. CODE ANN. § 13.1-1024.1 (Michie 1993). Because of the uncertain level of duty owed by LLC managers, and in response to objections of the corporate law plaintiff's bar, the Delaware statute provides that any member of a public LLC taxed as a corporation by the federal government, *see infra* note 294, may petition the court of chancery to "grant such relief as may be appropriate to cause the [LLC] to not have any publicly traded [LLC] interests or decree dissolution of the [LLC]." DEL. CODE ANN. tit. 6, § 18-802(b) (1993).

⁹⁵ KY. REV. STAT. ANN. § 275.170(2).

⁹⁶ *Id.* § 275.170(3).

3. *Voting*

As a default provision, LLC members and managers vote on a per capita basis, and unless the operating agreement provides otherwise, the vote of more than one half of the members or managers is necessary to pass on a matter relating to the business of the LLC.⁹⁷ The rule of per capita voting may be modified by a written operating agreement.⁹⁸ However, unless otherwise provided in a written operating agreement, the unanimous vote of all members is required to amend a written operating agreement,⁹⁹ authorize a member or manager to carry out an act on behalf of the LLC that contravenes a written operating agreement,¹⁰⁰ or amend the articles of organization to change the management of the LLC from members to managers or from managers to members.¹⁰¹

4. *Limitation of Liability and Indemnification of Members and Managers*

The operating agreement may eliminate or limit the personal liability of a member or manager for breaches of duty. The operating agreement

⁹⁷ *Id.* § 275.175(1). No uniformity exists among the states on whether the default rule for voting rights should be on a per capita basis or on some other basis, usually contribution. *See, e.g.*, ARK. CODE ANN. § 4-32-403(a) (Michie Supp. 1993) (per capita); IDAHO CODE § 53-623(1) (1994) (per capita); IND. CODE § 23-18-4-3(a) (Supp. 1994) (contribution); LA. REV. STAT. ANN. § 12:1318(A) (West 1994) (per capita); MD. CODE ANN., CORPS. & ASS'NS § 4A-403(1) (1993) (contribution); MONT. CODE ANN. § 35-8-403(1) (1993) (per capita); OKLA. STAT. tit. 18, § 2020(A) (Supp. 1994) (contribution); OR. REV. STAT. § 63.150(2) (1993) (per capita); W. VA. CODE § 31-1A-18(b) (Supp. 1994) (contribution). Under the Kentucky Partnership Act, partners vote on a per capita basis. KY. REV. STAT. ANN. § 362.235(5) (Michie/Bobbs-Merrill Supp. 1994). As noted by commentators, a per capita default voting rule can cause valuation problems:

As compared with a default rule of voting on a per capita basis the pro rata rule raises problems concerning valuing and recording contributions and adjusting for returned contributions, particularly where members make substantial service contributions and give guarantees. This supports a per capita default rule subject to contrary customized agreement where there are suitable records of contributions.

LARRY E. RIBSTEIN & ROBERT R. KEATING, RIBSTEIN AND KEATING ON LIMITED LIABILITY COMPANIES § 8.03 (1994); *see also infra* note 112 (regarding advantages and disadvantages of per capita versus pro rata allocations of profits and losses and in the making of distributions).

⁹⁸ KY. REV. STAT. ANN. § 275.175(1).

⁹⁹ *Id.* § 275.175(2)(a).

¹⁰⁰ *Id.* § 275.175(2)(b).

¹⁰¹ *Id.* § 275.175(2)(c).

may also provide for indemnification of members and managers arising in connection with a proceeding to which said members or managers are a party because of that status.¹⁰²

5. *Records and Information*

LLCs must maintain certain records relating to the structure, operation, and finances of the LLC.¹⁰³ Members may, at their own expense and upon a reasonable written request, inspect and copy any record of the LLC.¹⁰⁴ Members in a member-managed LLC and managers in a manager-managed LLC are required to give full information to all

¹⁰² *Id.* § 275.180; *accord id.* §§ 271B.8-500 to -580 (Michie/Bobbs-Merrill 1989).

¹⁰³ *Id.* § 275.185(1). This provision requires that each LLC maintain the following: current and past lists of the name and last mailing address of each member and manager, *id.* § 275.185(1)(a); copies of the articles of organization and amendments thereto, along with any powers of attorney pursuant to which those articles were executed, *id.* § 275.185(1)(b); copies of the LLC's federal, state, and local income tax returns and financial statements for the three most recent years or, if such were not prepared, copies of the information which was or should have been provided to the members to enable them to prepare their federal, state, and local income tax returns, *id.* § 275.185(1)(c); and copies of any effective written operating agreements and amendments thereto, along with copies of all previous written operating agreements, *id.* § 275.185(1)(d). Unless such is contained in the written operating agreement, each LLC must also maintain a record of the amount or agreed value of all contributions to the LLC and the times or events which will trigger additional contributions, *id.* § 275.185(1)(e)(1); the events upon which the LLC will be dissolved and its affairs wound up, *id.* § 275.185(1)(e)(2); and any other writings required by the operating agreement, *id.* § 275.185(1)(e)(3). The LLC Act expressly provides that the failure to maintain the records and information required by this section is not grounds for imposing personal liability on any member or manager for the debts and obligations of the LLC. *Id.* § 275.185(4).

¹⁰⁴ *Id.* § 275.185(2); *accord id.* § 362.409 (Michie/Bobbs-Merrill Supp. 1994) (listing records that must be maintained by a limited partnership). Like the Limited Partnership Act and RULPA, the LLC Act does not, as does the Corporation Act, draw distinctions between the classes of records which may be reviewed by a member based on the reason for the inquiry. *Compare with* KY. REV. STAT. ANN. § 271B.16-020 (Michie/Bobbs-Merrill 1989).

Note that the LLC Act does not specify who within the LLC bears the burden of preparing and safeguarding the required records. Obviously, in a manager-managed LLC, the task would fall upon the managers as a group, with specific responsibility to be apportioned among the managers as they see fit or as determined by the operating agreement. In a member-managed LLC, the members should apportion the obligation to maintain the records to one or more members, or appoint a third-party to maintain the records. Regardless, the duty to maintain the records should be addressed by the operating agreement.

members on the matters affecting the members.¹⁰⁵ Moreover, every LLC must file an annual report with the Secretary of State.¹⁰⁶

F. Capital

1. Contributions to Capital and Liability for Contribution

Transfers of ownership interests directly from the LLC require a contribution by the member. This contribution may be in cash, property, services performed, or an obligation to contribute services, cash, or property.¹⁰⁷

A promise to make a contribution is not enforceable unless set out in writing and signed by the member,¹⁰⁸ and neither the death nor the disability of the member will render this obligation unenforceable.¹⁰⁹

¹⁰⁵ KY. REV. STAT. ANN. § 275.185(3); accord UPA § 20; KY. REV. STAT. ANN. § 362.245 (Michie/Bobbs-Merrill Supp. 1994).

¹⁰⁶ KY. REV. STAT. ANN. § 275.190(1). This annual report must set forth the name of the LLC and its jurisdiction of organization, *id.* § 275.190(1)(a); the address and name of its registered office and agent in Kentucky, *id.* § 275.190(1)(b); the address of its principal office, *id.* § 275.190(1)(c); and the names and business addresses of its managers, if management is vested in managers, or of one member, if management is reserved to the members, *id.* § 275.190(1)(d). The requirement for an annual report is applicable to foreign as well as domestic LLCs. *Id.* § 275.190(1); accord *id.* 271B.16-220 (Michie/Bobbs-Merrill 1989).

¹⁰⁷ *Id.* § 275.195. The LLC drafting committee determined that the constitutional requirement that stock be issued only for services performed or value paid would not apply to interests in an LLC, *see* KY. CONST. § 193, and that future services or future obligations could serve as consideration for LLC interests. This determination was made with the realization that the Kentucky Constitution defines "corporation" to include joint stock companies and associations, *id.* § 208, and that § 446.010(8) of the Kentucky Revised Statutes provides that "corporation" may include a "partnership, joint stock company or association."

The extent to which the interests in an LLC will constitute "securities" subject to regulation under the federal and state securities laws is not addressed by the LLC Act, and as of the date of publication of this Article has not been addressed by the Division of Securities of the Department of Financial Institutions. Certain other states, either with or subsequent to the adoption of their LLC acts, have expressly addressed the treatment which will be afforded LLC interests. *See, e.g.*, KAN. STAT. ANN. § 17-1262(f) (Supp. 1991). For a general discussion of when LLC interests should constitute securities, *see* Marc I. Steinberg & Karen L. Conway, *The Limited Liability Company as a Security*, 19 PEPP. L. REV. 1105 (Apr. 1992); Thomas E. Geu, *Understanding the Limited Liability Company: A Basic Comparative Primer (Part II)*, 37 S.D. L. REV. 467, 510-18 (1992); and Mark A. Sargent, *Are Limited Liability Company Interests Securities?*, 19 PEPP. L. REV. 1069 (Apr. 1992).

¹⁰⁸ KY. REV. STAT. ANN. § 275.200(1); accord RULPA § 502(a).

¹⁰⁹ KY. REV. STAT. ANN. § 275.200(2); accord RULPA § 502(b). This rule may be

Should a member fail to make a promised contribution of property or services, the LLC may demand the contribution of an equal value of cash.¹¹⁰

2. *Allocation of Profits and Losses*

The default provision for the allocation of profits and losses between members of an LLC is on a per capita basis.¹¹¹ The selection of per capita allocation of profits and losses was made in order to accommodate unsophisticated LLCs in which the members would not maintain and track capital accounts or even develop an operating agreement addressing the sharing of profits and losses. Per capita allocation of profits and losses also avoids the question of valuation of services, know-how, and financing guarantees which will often be incident to the formation of small, especially service-related, LLCs.¹¹² Of course, more sophisticated

modified by the operating agreement. Note that § 275.200(2) of the Kentucky Revised Statutes does *not* require a written operating agreement to depart from this default rule.

¹¹⁰ KY. REV. STAT. ANN. § 275.200(3). Except where the articles of organization or operating agreement provides otherwise, a promise to make a contribution to the LLC may be compromised by the members of the LLC. *Id.* § 275.200(4). However, such a compromise will not be effective against a creditor who has relied upon the obligation to contribute. *Id.* § 275.200(5); *accord* RULPA § 502(b), (c).

¹¹¹ Section 275.205 of the Kentucky Revised Statutes provides: "Profits and losses of a[n LLC] shall be allocated among the members and among classes of members in a manner provided in the operating agreement. If the operating agreement does not otherwise provide, profits and losses shall be allocated on a per capita basis." *Compare* RULPA § 503 (providing default rule for allocation of profits and losses in proportion to value of contributions).

¹¹² See Memorandum from Steve Frost and Jim Reynolds to Carter Bishop, reporter of the ULLCA committee for the NCCUSL (May 6, 1993) (regarding default distribution rules for ULLCA) (copy on file with authors), which provides:

The first principle is that, in the absence of a contrary agreement between the members, the LLCs [sic] profits will be shared equally by all of the members. We believe that many LLCs that lack operating agreements covering distribution rates will be heavily service flavored, involving substantial member contributions of services, know-how, business contracts, or third-party financing guaranties that are not fully compensated by fixed salaries or fees. Consistent with the drafting committee's conclusion on this issue, we believe that it would be unfair to ignore such service contributions in apportioning profits only among those members who contributed cash or other property. Additionally, the value of service contributions is extremely difficult to determine and increases with time, literally resulting in valuations that are subject to change on a daily basis. Accordingly, a profit sharing formula based upon relative valuations of service and property contributions seems extremely impractical to administer. If the members have failed to agree upon their distribution rights, it is unrealistic to expect that they would have agreed upon the

LLCs are free to provide for different allocations of profits and losses.¹¹³

3. *Distribution of Profits*

The default rule for distribution of the cash and other assets of the LLC is on a per capita basis.¹¹⁴ However, like the allocation of profits

valuation of their property and service contributions.

The ULLCA (§ 406(a)) and the Prototype Act (§ 601), like the LLC Act, provide for a default rule of per capita distribution of profits and losses.

¹¹³ See CALLISON, *supra* note 7, § 4.14, which explains:

One tax benefit of partnerships is the partner's ability to agree on how to allocate partnership tax items. For example, a partner can be allocated a specified share of one type of income or loss and a different share of another type of income or loss. Similarly, partnership allocations can "flip-flop" such that the allocations of income or losses among the partners can change during the life of the partnership. This flexibility makes the partnership form particularly useful for businesses, such as tax shelters, when it is desirable to specially allocate tax items among the partners or to change the tax allocations during the life of the partnership.

However, any allocation of profits and losses must be consistent with § 704 of the Code, which mandates that a partner's allocation pursuant to a partnership agreement have "substantial economic effect." CALLISON, *supra* note 7, § 4.19.

¹¹⁴ KY. REV. STAT. ANN. § 275.210. It should be recognized that, under partnership taxation, the sharing of profits is an issue of allocation, while distributions are the means by which the members receive the profits. An allocation of profits, with its consequent tax liability, need not be accompanied by a distribution of profits. As stated in CALLISON, *supra* note 7, § 4.14:

Each partner must include on his or her individual tax return the partner's distributive share of partnership income, gain, loss, deduction, or credit relating to partnership taxable years ending with or within the partner's taxable year. [I.R.C. §§ 702(a), 706(a).] The partner is taxed on his or her distributive share of partnership income regardless of whether distributions are made. The character of each item of income, gain, loss, deduction, or credit in the partner's distributive share is the same as the character of the item at the partnership level. [I.R.C. § 702(b); Treas. Reg. § 1.702-1(b) (as amended in 1991)]. For example, if a partnership sells property which produces long-term capital gain, the gain flows through to the partners as long-term gain.

No generally accepted default rule with respect to the distribution of profits has yet developed. While the per capita model used in Kentucky has been used in other states, many states base the distribution of profits on the pro rata value of the members' contributions to the LLC. *E.g.*, ALA. CODE § 10-12-28 (Supp. 1993) (allocation based on pro rata value of contribution); ARIZ. REV. STAT. ANN. § 29-703(B) (Supp. 1993) (allocations first made in proportion to capital contributions, until all contributions repaid, and then on a per capita basis); ARK. CODE ANN. § 4-32-601 (Supp. 1993) (per capita allocation of distribution); COLO. REV. STAT. ANN. § 7-80-504 (West Supp. 1993)

and losses, the operating agreement may provide a different distribution method.¹¹⁵

4. *Distribution on an Event of Disassociation*

Unless otherwise provided in the operating agreement, a withdrawing member is entitled to receive the fair value of the member's interest as of the date of disassociation.¹¹⁶ In addition, a withdrawing member is entitled to receive any distributions to which he or she was entitled prior to the disassociation.¹¹⁷ The application of these provisions presupposes that the disassociation does not cause the dissolution of the LLC.¹¹⁸ However, no return of contributions may be made if doing so would render the LLC insolvent,¹¹⁹ and all returned contributions are subject to recall if necessary to discharge a liability of the LLC for credit extended while the LLC held that contribution as part of its capital.¹²⁰

5. *Distribution in Kind*

Unless the operating agreement provides otherwise, a member may not demand that distribution be made other than in cash.¹²¹ Furthermore, in-kind distributions are restricted.¹²²

(allocation based on pro rata value of contribution); DEL. CODE ANN. tit. 6, § 18-503 (1993) (allocation based on pro rata value of contribution). The default rule under RULPA is for distributions allocated on the basis of the value of contributions. See RULPA § 504.

¹¹⁵ KY. REV. STAT. ANN. § 275.210. This section of the LLC Act also recognizes that an LLC may have differing classes of interest having different distribution rights.

¹¹⁶ *Id.* § 275.215. The fair value of the member's interest should be the pro rata portion of the entire value of the LLC and not merely the book value of the interest as shown in the ledger accounts. Therefore, the distribution upon withdrawal should be based on an appraisal of the LLC operating on an ongoing basis, i.e., a going concern value which should account for the appreciation and depreciation of LLC assets and the goodwill of the business. Also, as the valuation of the member's interest should be based upon a going concern value, no minority discount should be applied to the distribution.

The LLC operating agreement should address whether the valuation of the withdrawing member's interest includes profits (or losses) accrued between the dates of withdrawal and the date the payment and, similarly, whether interest will be paid on the amount due, how such interest will be calculated, and from what day it will be paid.

¹¹⁷ *Id.* § 275.215.

¹¹⁸ *Id.*

¹¹⁹ *Id.* § 275.225(1).

¹²⁰ *Id.* § 275.200(5).

¹²¹ *Id.* § 275.220(1).

¹²² *Id.* § 275.220(2). These restrictions do not require a member to accept a distribution in kind "to the extent that the percentage of the asset distributed to the

6. *Restrictions on Distribution and Liability Upon Wrongful Distribution*

An LLC is prohibited from making distributions that would render the LLC insolvent or otherwise impair its capital.¹²³ A distribution is forbidden if, after it is made, the LLC would not be able to pay its debts as they became due in the ordinary course of business or the total assets of the LLC would be less than the sum of the total liabilities and the amount necessary to satisfy the dissolution rights of any interests which are superior to the dissolution rights of the member or members receiving the distribution.¹²⁴ If a member votes for or assents to a distribution which violates these provisions, the member is liable to the LLC for the excess of the permissible distribution¹²⁵ for up to two years after the date the distribution is measured.¹²⁶ The declaration of a distribution, like a corporate dividend, creates an obligation to the members of the

member exceeds the percentage that the member would have shared in a cash distribution equal to the value of the property at the time of distribution.” *Id.* In effect, this provision protects a member from receiving a non-cash distribution, the value of which is disproportionate to the non-cash distributions made to other members. This provision can be an important method of protecting members from manipulative valuations by a majority of the members or the managers who may be at odds with the member being called upon to accept a non-cash distribution. However, it may not be advisable to prohibit in-kind distributions as such a prohibition may force the sale of LLC assets in a disadvantageous market, thereby bringing a lower price for the assets and a smaller distribution to the members.

¹²³ *Id.* § 275.225(1)(a)-(b).

¹²⁴ *Id.*; *accord id.* § 271B.6-400(3)(a)-(b) (Michie/Bobbs-Merrill 1989). An LLC may make this determination by reference to financial statements prepared under practices and principles reasonable under the circumstances or a fair valuation or other reasonable method. *Id.* § 275.225(2). Therefore, it is not necessary that the LLC prepare its financial statements in accordance with generally accepted accounting principles (“GAAP”) consistently applied. This flexibility in the preparation of financial statements accommodates many small businesses that prepare financial statements on a cash basis or otherwise do not follow GAAP. The measurement date for a distribution is the date the distribution is authorized, provided payment occurs within 120 days after the authorization date, or, if thereafter, the actual payment date. *Id.* § 275.225(3)(a)-(b).

¹²⁵ *Id.* § 275.230(1). A member or manager liable to the LLC for this excess is entitled to contribution from each other member or manager who could be found liable for violating § 275.230(1) of the Kentucky Revised Statutes and each member who received the impermissible distribution. *Id.* § 275.230(2)(a), (b). *Compare id.* § 271B.8-330(1)(b) (Michie/Bobbs-Merrill 1989) (holding shareholder who received an improper dividend distribution liable for contribution to director(s) only for the amount accepted knowing it to have been improperly declared).

¹²⁶ *Id.* § 275.230(3).

LLC. Unless subordinated by agreement, the member has the rights of an unsecured creditor with regard to this obligation.¹²⁷

7. *Ownership of LLC Property*

The property of an LLC, whether personalty or realty, is that of the entity and not of the individual members.¹²⁸ An LLC may acquire, hold any estate in, and convey real property.¹²⁹

8. *Transfer of LLC Property*

Where the management authority is vested in managers, the LLC's title to property may be transferred by an instrument executed by a manager in the name of the LLC.¹³⁰ Correspondingly, no member, solely by reason of that status, has the authority to transfer the property of a manager-managed LLC.¹³¹

Where direct management has been retained by the members, any member may, in the name of the LLC, execute an instrument of transfer on behalf of the LLC.¹³² Where property has been transferred to a member or manager in his or her capacity as such in the LLC, but without naming the LLC, an instrument of transfer may be executed by the member or manager in whose name that title was held.¹³³

¹²⁷ *Id.* § 275.225(4); *see also id.* § 275.235 (granting to each member the status of and remedies available to creditors of an LLC with respect to any right to receive a distribution). The treatment of distribution indebtedness to members is equivalent to the treatment of dividends under the Corporation Act. *Id.* § 271B.6-400(6) (Michie/Bobbs-Merrill 1989); *Taylor v. Axton-Fisher Tobacco Co.*, 173 S.W.2d 377, 380 (Ky. 1943). A distribution may be made contingent upon the ability of the LLC to make such payments, KY. REV. STAT. ANN. § 275.225(5), in which instance that contingent liability will not be used to assess the propriety of the distribution, *id.* § 275.225(1), but the effect of the payment on that obligation is measured anew, *id.* § 275.225(1), as of the date each payment is actually made. *Id.* § 275.245(6).

¹²⁸ KY. REV. STAT. ANN. § 275.240(1), (2); *accord* UPA § 8(1).

¹²⁹ KY. REV. STAT. ANN. § 275.245(2).

¹³⁰ *Id.* § 275.245(5)(a).

¹³¹ *Id.* § 275.245(5)(b). The provisions relating to the transfer of LLC property are themselves based upon § 302 of RULPA, with revisions made to accommodate the nomenclature of LLCs and address member-managed and manager-managed LLCs. Note that, in challenging a transfer, the burden is upon the LLC to prove there was a lack of authority.

¹³² KY. REV. STAT. ANN. § 275.245(1).

¹³³ *Id.* § 275.245(2). If property has been transferred under § 275.245(1) or 275.245(2) it may be recovered by the LLC if the LLC is able to prove that the instrument of transfer

G. Membership

1. Admission of Members

A person who acquires an interest in an LLC becomes a member upon compliance with the provisions of the operating agreement or, if the operating agreement does not otherwise provide, upon the written consent of all members.¹³⁴ Under the default rules, the admission of a member to an LLC is effective on the latter of the date of formation of the LLC or when it is reflected in the records of the LLC.¹³⁵ However, the operating agreement may provide an effective admission date of any time after the formation of the LLC.¹³⁶

2. Assignment of LLC Interests

Unless the operating agreement provides otherwise, an LLC interest, in whole or part, is assignable.¹³⁷ That assignment entitles the assignee to receive, to the extent assigned, the distributions and other economic rights to which the assignor would be entitled.¹³⁸ An assignment of an LLC interest does not dissolve the LLC.¹³⁹ Furthermore, the assignment

did not bind it, provided that property has not been subsequently transferred to a transferee who gave value without notice that the instrument of transfer had been executed without authority to bind the LLC. *Id.* § 275.245(3). However, if the property of an LLC is held in the name of a person instead of the LLC, and the instrument transferring title does not indicate that it is transferred to him or her in his or her capacity as a member or a manager and does not reference the LLC, the property may be transferred free of any claims of the LLC or the members thereof. This provision is applicable only if the transferee gives value without notice that the property is properly that of the LLC. *Id.* § 275.245(4).

¹³⁴ *Id.* § 275.275(1)(a); *accord id.* § 362.433(2)(a) (Michie/Bobbs-Merrill Supp. 1994) (admission of additional limited partners upon approval of all current partners).

¹³⁵ *Id.* § 275.275(2)(b).

¹³⁶ *Id.* § 275.275(2)(a)-(b).

¹³⁷ *Id.* § 275.255(1)(a). An interest in an LLC is personal property, and, if so provided in the operating agreement, it may be evidenced by a certificate. *Id.* § 275.255(2). The certificate may provide for the assignment or transfer of any interest represented by that certificate. *Id.* A member can grant a security interest in his or her membership interest in order to secure an obligation or for other purposes. U.C.C. § 9-102(a)(1) (1987). Unless the operating agreement provides otherwise, the pledge of, the grant of a security interest in, the lien on, or the encumbrance of an LLC interest is not an assignment and does not terminate or impair the rights of a member. KY. REV. STAT. ANN. § 275.255(3).

¹³⁸ KY. REV. STAT. ANN. § 275.255(1)(b).

¹³⁹ *Id.* § 275.255(1)(c); *accord id.* § 362.280 (Michie/Bobbs-Merrill 1987); RULPA § 702.

does not entitle the assignee to exercise any rights of a member except for the right to receive distributions.¹⁴⁰ An assignor/member remains a member until either the assignee becomes a member or the assignor/member is removed.¹⁴¹ Furthermore, an assignee who has not yet become a member has no liability as a member consequent to the assignment.¹⁴² Conversely, the assignment does not relieve the assignor of any liability incurred while a member.¹⁴³

3. *Right of Assignee to Become a Member*

The default rule provides that an assignee of an LLC interest may become a member, and thereby succeeding to the right to participate in the business and affairs of the LLC, only upon the unanimous consent of the other members.¹⁴⁴ The operating agreement may specify the manner in which the consent will be evidenced; the default provision requires a written instrument signed and dated by all members.¹⁴⁵

Upon becoming a member, an assignee has the rights and powers of a member and similarly is subject to the restrictions and liabilities of a member as determined pursuant to the articles of organization, any operating agreement, and the LLC Act.¹⁴⁶ If the assignor was liable to make a contribution to the LLC,¹⁴⁷ the assignee/member is also liable on that obligation.¹⁴⁸ However, the assignee will not become liable for the

¹⁴⁰ KY. REV. STAT. ANN. § 275.255(1)(b), (c). Membership rights include the rights to participate, either directly or by election, in management, *id.* § 275.165(1); to inspect the records of the LLC, *id.* § 275.185(2); to vote on the admission of replacement or additional members, *id.* § 275.265(1); and to vote on the voluntary dissolution or continuation of the business after a dissolution event, *id.* § 275.285(3)(a).

¹⁴¹ *Id.* § 275.255(1)(d).

¹⁴² *Id.* § 275.255(1)(e).

¹⁴³ See *infra* notes 146-50 and accompanying text.

¹⁴⁴ KY. REV. STAT. ANN. § 275.265(1). This rule may be modified by a written operating agreement. See, e.g., ALA. CODE § 10-12-33(a)(1) (Supp. 1994); DEL. CODE ANN. tit. 6, § 18-704 (1993); KAN. STAT. ANN. § 17-7618 (Supp. 1993); LA. REV. STAT. ANN. § 12:1332 (West Supp. 1994); MD. CODE ANN., CORPS. & ASS'NS § 4A-601(B)(1) (1993); MICH. COMP. LAWS § 450.4506 (1994); OKLA. STAT. tit. 18, § 2035 (1994); OR. REV. STAT. § 63.245(2) (1993); R.I. GEN. LAWS § 7-16-36 (1992). Each of these statutes has a default rule of unanimous consent.

¹⁴⁵ KY. REV. STAT. ANN. § 275.265(1).

¹⁴⁶ *Id.* § 275.265(2).

¹⁴⁷ See *supra* notes 141-43 and accompanying text.

¹⁴⁸ KY. REV. STAT. ANN. § 275.265(2). Compare RULPA § 704(b).

contribution obligation if he or she had no knowledge of it at the time he or she became a member and such obligation could not be ascertained from the articles of organization or a written operating agreement.¹⁴⁹ Regardless of whether the assignee becomes liable on the assignor's obligation to make a contribution to the LLC, the assignor/member remains liable to the LLC for the contribution.¹⁵⁰

Permitting the bifurcation of the rights of membership between management rights and economic rights may lead to a situation in which the ownership of an LLC is divided into three camps: members with both economic rights and management rights, transferor members who retain only management rights but have no economic rights, and transferees who have economic rights but no management rights in the LLC. One means of addressing this potential divergence of economic and management rights and their respective agendas is to provide in the operating agreement that, upon a member's transfer of economic rights, the LLC shall have the right, for a nominal consideration, to purchase from the transferor member those management rights. As such, there would not arise a situation in which there exists members with management rights but no economic stake in the LLC. It would then remain for the usual procedures in addressing the admission of a transferee to determine whether those management rights would subsequently be transferred from the LLC to that transferee. Upon the elevation of the assignee to membership, the assignor of an LLC interest ceases to be a member or to have any powers of a member.¹⁵¹

4. *Rights of Judgment Creditor*

A judgment creditor, upon application to the proper court, may charge a member's LLC interest for the payment of a judgment and interest

The LLC Act is silent with respect to whether a transferee member, in addition to becoming liable for the transferor's liability to make a contribution to the LLC, is similarly liable to satisfy any obligation to return a prior distribution from the LLC. Permitting recovery of a distribution from a transferee member may serve as a significant impediment to the transfer of interests. In addition, unlike an obligation to make a contribution, which will increase the capital of the LLC and presumably its ability to carry on business and earn profits, distributions made prior to the time a transferee became a member provide no benefits to him or her.

¹⁴⁹ KY. REV. STAT. ANN. § 275.265(3). *Compare with* RULPA § 704(b) (“[T]he assignee is not obligated for liabilities unknown to the assignee at the time he [or she] became a limited partner.”).

¹⁵⁰ KY. REV. STAT. ANN. § 275.265(3). This rule may be amended by a written operating agreement. *Id.*; accord RULPA § 704(c).

¹⁵¹ KY. REV. STAT. ANN. § 275.265(4). This rule may also be amended by a written operating agreement. *Id.*

thereon.¹⁵² However, the judgment creditor's rights are the same as an assignee;¹⁵³ therefore, the judgment creditor has no right to take part in the management of the LLC.¹⁵⁴ The LLC Act expressly recognizes the applicability of exemption laws to a member's LLC interest.¹⁵⁵

5. Rights of Estate of a Deceased Member or of the Representative of an Incompetent Member

The estate of a deceased member or the representative of an incompetent member has all of the rights of an assignee. As such, the estate does not succeed to the member's right to take part in the business and affairs of the LLC.¹⁵⁶

*H. Dissolution*¹⁵⁷

1. Events of Disassociation

A person ceases to be a member of an LLC if he or she voluntarily withdraws,¹⁵⁸ is removed,¹⁵⁹ or is confessed or adjudged bankrupt or

¹⁵² *Id.* § 275.260; accord UPA § 28(1); RULPA § 703.

¹⁵³ KY. REV. STAT. ANN. § 275.260.

¹⁵⁴ See *supra* note 140 and accompanying text.

¹⁵⁵ KY. REV. STAT. ANN. § 275.260.

¹⁵⁶ *Id.* § 275.270. Compare *id.* § 362.485 (Michie/Bobbs-Merrill Supp. 1994) (allowing estate of deceased general partner to participate as general partner in settling estate or administering property).

¹⁵⁷ An understanding of this section of the LLC Act requires an understanding of the rules of dissolution, winding up, and termination applicable to partnerships in general. As such, the following discussion summarizes the rules regarding partnership dissolutions.

A partnership, for purposes of dissolution, is viewed as the aggregate of its partners and survives for only so long as that aggregate is not disturbed. The "disassociation" of a partner alters that aggregate identity, triggering the "dissolution" of the partnership. UPA § 29. At that point, the remaining partners may elect to "continue" the partnership, in which case it will be reconstituted with a new aggregate identity. *Id.* § 38. Conversely, if there is no agreement to continue the partnership, it will enter the winding up phase. *Id.* § 30. In this period, the assets of the partnership will be valued and, as necessary, liquidated. Simultaneously, the liabilities of the partnership will be identified and provision will be made for their satisfaction. Assets in excess of liabilities will be valued in preparation for distribution to the partners. Finally, upon termination the partnership ceases, as all of the assets have been distributed to creditors and partners. *Id.* § 40.

Note, however, that the addition of a new partner, which analytically alters the aggregate identity of the partnership to the same extent as does the disassociation of a partner, does not trigger dissolution. *Id.* § 30; RULPA § 801.

¹⁵⁸ See generally KY. REV. STAT. ANN. § 275.280(3) (explaining the conditions of a member's withdrawal).

¹⁵⁹ *Id.* § 275.280(1)(c)1.

insolvent;¹⁶⁰ he or she also ceases to be a member, unless otherwise provided in a written operating agreement, upon assignment of all of his or her interest in the LLC.¹⁶¹ Unless otherwise provided in a written operating agreement or by the written consent of all members, a member ceases to be a member if its own legal existence terminates.¹⁶² Moreover, a written operating agreement may provide that other events will terminate membership in the LLC.¹⁶³

Unless restricted by a written operating agreement, a member may withdraw from the LLC upon a thirty-day written notice.¹⁶⁴ If a permitted withdrawal constitutes a breach of the operating agreement or withdrawal is a consequence of otherwise wrongful conduct by the withdrawing member, the LLC may recover from the withdrawing member damages resulting from the breach of the operating agreement or from the wrongful conduct.¹⁶⁵

2. *Dissolution*

An LLC shall be dissolved, and its affairs wound up, upon the time or occurrence of the following events: the time specified in the articles of organization or the operating agreement, the written consent of all the members, the entry of a decree of judicial dissolution, or the filing of

¹⁶⁰ *Id.* § 275.280(1)(d), (e).

¹⁶¹ *Id.* § 275.265(4).

¹⁶² *Id.* § 275.280(1)(f)-(j). A member can be an individual, a trust, another LLC, a corporation, and the like. As such, the termination of member status is dependent upon the structure of the member. For example, an individual member ceases to be a member upon death or incompetency. A trust-member ceases to be a member when the trust is terminated. An LLC or a corporate-member may be voluntarily or involuntarily dissolved which terminates membership. All members are subject to bankruptcy which also terminates membership. *See supra* note 160.

¹⁶³ KY. REV. STAT. ANN. § 275.280(2).

¹⁶⁴ *Id.* § 275.280(3). *Compare with id.* § 362.300 (Michie/Bobbs-Merrill 1987) (listing causes of partnership dissolution), *and id.* § 362.463 (Michie/Bobbs-Merrill Supp. 1994) (allowing general partner in a general or limited partnership to withdraw at any time), *and id.* § 362.465 (Michie/Bobbs-Merrill Supp. 1994) (allowing, if not otherwise provided, limited partner to withdraw on a six-month notice).

¹⁶⁵ *Id.* § 275.280(3). Damages may include the reasonable replacement costs of any services the withdrawing member was obligated to perform. Any damages owed the LLC by the member as a consequence of his or her withdrawal may be offset against the amount distributable to the withdrawing member. Unless varied by the operating agreement, when the LLC has been organized for a definite term or for a particular undertaking, the withdrawal of a member before that expiration date shall constitute a breach of the operating agreement. *Id.*

articles of dissolution.¹⁶⁶ In addition, an LLC will dissolve and its affairs will be wound up upon the disassociation of a member unless, within ninety days following the event of disassociation, all of the remaining members agree to continue the LLC.¹⁶⁷

If the disassociation results in only one remaining member, the admission of a replacement member is necessary before the vote may continue.¹⁶⁸ The default provisions requiring the unanimous consent of the members to continue the LLC after a disassociation may be modified by a written operating agreement.¹⁶⁹

If an LLC suffers bankruptcy, it would likely fall within those provisions regarding corporate, rather than partnership, bankruptcy. While the bankruptcy code does not contain a specific reference to LLCs, a "corporation" is defined therein as including "a partnership association organized under a law that makes only the capital subscribed responsible for the debts of such association."¹⁷⁰ So classified, the members of the LLC should not be subject to contribution as are general partners in the bankruptcy of a partnership.¹⁷¹

3. *Voluntary Dissolution*

An LLC automatically dissolves upon the unanimous written consent of the members.¹⁷² The disadvantages of lacking continuity of life arise

¹⁶⁶ *Id.* § 275.285(1), (2), (4), (5).

¹⁶⁷ *Id.* § 275.285(3); *accord id.* § 362.487(1)-(4) (Michie/Bobbs-Merrill Supp. 1992) (addressing the dissolution of a limited partnership). The requirement for a unanimous vote to continue after an event of disassociation may be modified by a written operating agreement. *See infra* notes 168-97 and accompanying text (discussing the structuring of the disassociation, dissolution, and continuity provisions of the operating agreement).

¹⁶⁸ The election of a replacement member is necessary to ensure that the LLC has at least two members, a characteristic necessary for tax classification reasons. *See infra* note 292 and accompanying text.

¹⁶⁹ KY. REV. STAT. ANN. § 275.285(3); *see infra* notes 360-69 and accompanying text (discussing the tax classification issues that arise upon a departure from the default requirement of the unanimous vote of the members to continue the LLC after an event of disassociation).

¹⁷⁰ 11 U.S.C. § 101(9)(A)(ii) (1988 & Supp. V 1993); *id.* § 723 (providing that general partners of bankrupt partnership are liable for partnership debts).

¹⁷¹ Geu, *supra* note 107, at 504-10; James M. Jorissen, Note, *Member Bankruptcy Under the New Minnesota Limited Liability Company Act: An Executory Contract Analysis*, 77 MINN. L. REV. 953, 982 (Apr. 1993).

¹⁷² KY. REV. STAT. ANN. § 275.285(2). With respect to third parties, even a technical dissolution may have negative consequences in that contracts and agreements may terminate. *See, e.g.,* Fairway Dev. Co. v. Title Ins. Co., 621 F. Supp. 120, 125 (N.D. Ohio

from both the relations among the members as well as the relationship of the LLC with third parties. Internally, the right to withdraw and bring about a dissolution allows a disenchanted member to interfere with an ongoing business for personal reasons. This power is subject to abuse, especially in instances in which there is more than one disenchanted member and a unanimous vote of the non-withdrawing members is required to continue the LLC. One member can withdraw, triggering the need for a vote on continuation, wherein the other disenchanted member can vote in the negative and thereby compel the winding up and distribution of assets.

4. *Judicial Dissolution*

Upon the petition of a member, a circuit court¹⁷³ may grant a decree dissolving the LLC if “it is established that it is not reasonably practicable to carry on the business of the . . . [LLC] in conformity with the operating agreement.”¹⁷⁴ Upon the entry of the decree of dissolution, the LLC will enter the winding-up phase.¹⁷⁵

1985) (explaining that terms of title guaranty issued to a partnership could not be enforced by the partnership which existed after an alteration in the identity of the partners); *Frederick C. Smith Clinic v. Lastrapes*, 170 N.E.2d 497, 501 (Ohio Ct. App. 1959) (explaining that successor partnership which arose after event of disassociation dissolving prior partnership could not enforce terms of non-compete agreement entered into with prior partnership). Therefore, the issue of technical dissolution must be addressed in contracts to which an LLC is a party. The *Fairway Development* case gave rise to the so-called “fairway endorsement” to title policies for property held by partnerships, which provides for continuing title insurance irrespective of the dissolution of the partnership.

¹⁷³ The appropriate circuit court is that for the county in which the principal office of the LLC is located, or if the LLC has no principal office, for the county of the registered office of the LLC. KY. REV. STAT. ANN. § 275.290(1).

¹⁷⁴ *Id.* § 275.290(1); *accord id.* § 362.489 (Michie/Bobbs-Merrill Supp. 1994) (applying “not reasonably practicable” standard to judicial dissolution of a limited partnership). *Compare with id.* § 271B.14-300 (Michie/Bobbs-Merrill 1989) (providing that a corporation may be dissolved by judicial order under the following circumstances: where management is deadlocked, the shareholders are unable to break the deadlock, and irreparable harm to the corporation is being suffered or is threatened; or the business or affairs of the corporation, because of the deadlock, cannot be conducted to the advantage of the shareholders generally; or the directors or those in control of the corporation are acting in an illegal or fraudulent manner; or the shareholders have been unable to resolve a deadlock relating to the election of directors).

¹⁷⁵ *Id.* § 275.290(3). The decree dissolving the LLC is to specify the effective date of the dissolution, and the county clerk delivers it to the Secretary of State for filing. *Id.* § 275.290(2).

5. *Administrative Dissolution*

The Secretary of State may commence a proceeding to dissolve an LLC if it does not satisfy its statutory obligations.¹⁷⁶ The LLC is given notice of the grounds for administrative dissolution¹⁷⁷ and is granted sixty days to correct any defect or demonstrate that no grounds for administrative dissolution exist.¹⁷⁸ Without such a correction or demonstration, the Secretary of State will administratively dissolve the LLC.¹⁷⁹

6. *Winding Up*

The winding up of the affairs of an LLC is carried out by the body with management authority, or, in certain cases involving wrongful conduct, by the circuit court.¹⁸⁰ During the winding-up phase, an LLC is limited to collecting its assets, providing for the satisfaction of its liabilities, and distributing any remaining assets to its members.¹⁸¹

¹⁷⁶ Namely, the LLC must deliver its annual report within 60 days after the date such report is due, *id.* § 275.295(1)(c); maintain a registered agent and registered office in Kentucky, *id.* § 275.295(1)(b); or notify the Secretary of State of a change in its registered agent or registered office, of the resignation of the registered agent, or of the discontinuation of its registered office, *id.* § 275.295(1)(c); *accord id.* § 271B.14-200 (Michie/Bobbs-Merrill 1989).

¹⁷⁷ *Id.* § 275.295(2)(a); *accord id.* § 271B.14-210(1) (Michie/Bobbs-Merrill 1989).

¹⁷⁸ *Id.* § 275.295(2)(b); *accord id.* § 271B.14-210(2) (Michie/Bobbs-Merrill 1989).

¹⁷⁹ An administratively dissolved LLC may petition for reinstatement by filing an application. *Id.* § 275.295(3)(a); *accord id.* § 271B.14-220(1) (Michie/Bobbs-Merrill Supp. 1994). The requirements of that certificate are set forth at *id.* § 275.295(3)(a). *Accord id.* § 271B.14-220(1)(a)-(e) (Michie/Bobbs-Merrill Supp. 1994). If the requirements for reinstatement are met, the Secretary of State will cancel the certificate of dissolution and issue a certificate of reinstatement. *Id.* § 275.295(3)(b); *accord id.* § 271B.14-220(2) (Michie/Bobbs-Merrill 1989 & Supp. 1994). Any reinstatement relates back to and takes effect from the date of the dissolution. *Id.* § 275.295(3)(c); *accord id.* § 271B.14-220(3) (Michie/Bobbs-Merrill Supp. 1994). In effect, therefore, the existence of the LLC is not interrupted, and it is as if the administrative dissolution never took place.

The refusal by the Secretary of State to reinstate the LLC requires written notice to the LLC of the reason for the denial; the denial may be appealed to the circuit court. *Id.* § 275.295(4)(a)-(d); *accord id.* § 271B.14-230 (Michie/Bobbs-Merrill 1989 & Supp. 1994).

¹⁸⁰ *Id.* § 275.300(1). The appropriate circuit court is that of the county in which the LLC maintains its principal office or its registered office. *Id.* § 275.300(1)(b). The LLC Act does not set forth a preference for which a circuit court will oversee the winding up when the principal office and registered office are in different counties.

In addition, the application to the circuit court to oversee the winding up may be made by "any member, any member's legal representative, or assignee." *Id.*

¹⁸¹ *Id.* § 275.300(2). A non-exhaustive list of the actions appropriate to the winding

The dissolution of an LLC does not transfer title to its property, prevent the transfer of an interest, modify the standards of conduct typically applicable to members or managers, change provisions relating to the internal operations of the LLC, interfere with the commencement or continuation of a proceeding by or against the LLC, interfere with the authority of its registered agent, or affect the obligations of the LLC with respect to federal and state tax laws.¹⁸² Furthermore, every member or manager must hold for the benefit of the LLC any gain derived from a transaction relating to the winding up of the affairs of the LLC.¹⁸³

7. *Agency Power of Managers or Members after Dissolution*

During the winding-up phase, an authorized member or manager of the LLC may bind the entity in the course of business appropriate to the winding up of its affairs and for such other purposes as are authorized by the members or managers.¹⁸⁴ With respect to third parties without knowledge of the dissolution, an authorized manager or member may bind the LLC in matters outside those appropriate to winding up.¹⁸⁵ However, the filing of articles of dissolution or a certificate of dissolution or the entry of decree of dissolution is presumptive notice of the dissolution and thus provides some protection to the LLC.¹⁸⁶

8. *Distribution of Assets*

During the winding-up phase, the assets of the LLC must be distributed first for payments to creditors and then to the satisfaction of pre-dissolution declared distributions to members and former members of the LLC.¹⁸⁷ Any remaining assets are distributed to the members and

up of an LLC includes the following: collecting its assets, disposing of assets that will not be distributed in kind to the members, discharging or making provision for discharging liabilities, and distributing its remaining property among its members according to their interests. *Id.* § 275.300(2)(a)-(e); accord *id.* § 271B.14-050 (Michie/Bobbs-Merrill 1989). The claims of creditors include those of members for declared but unmade distributions. See *supra* notes 116-27 and accompanying text.

¹⁸² KY. REV. STAT. ANN. § 275.300(3)(a)-(h).

¹⁸³ *Id.* § 275.170(2)(a). A compromise of this rule must be approved by more than one half of the disinterested managers or members. *Id.* § 275.170(2).

¹⁸⁴ *Id.* § 275.305(1)(a), (c).

¹⁸⁵ *Id.* § 275.305(1)(b).

¹⁸⁶ *Id.* § 275.305(2).

¹⁸⁷ *Id.* § 275.310(1), (2). Creditors will include members to whom the LLC is indebted other than for a declared but unpaid distribution or for the return of a contribution. *Id.*;

former members as a return of contributions and then in proportion to their rights to share in distributions of assets prior to dissolution.¹⁸⁸

9. *Articles of Dissolution*

After dissolution, the LLC must file articles of dissolution which set forth the name of the LLC, the statutory authority pursuant to which it was dissolved, and the effective date of its dissolution. Furthermore, the articles of dissolution may include any other information those filing the articles deem appropriate.¹⁸⁹

10. *Known and Unknown Claims Against a Dissolved LLC*

The LLC Act requires that notice of the dissolution be given to known creditors.¹⁹⁰ This notice must inform them of the deadline for filing claims, the information to include in their claims, the mailing address where the claims must be sent, and the fact that known claims will be barred if not received by the deadline.¹⁹¹ If the LLC denies the claim and notifies the claimant of the rejection but the claimant does not bring an action to enforce the claim within ninety days of the rejection notice, then the claim will be barred.¹⁹²

The LLC Act also requires the LLC to notify unknown creditors by publishing a newspaper notice that sets forth the information which must accompany any claims, the address where the claims must be sent, and the fact that the claims will be barred unless filed within the applicable period.¹⁹³ Unknown claims against an LLC must generally be brought within two years of the dissolution.¹⁹⁴ An unknown claim against a PLLC may be filed up to five years after the dissolution.¹⁹⁵

Unknown claims against an LLC are satisfied first against the LLC's undistributed assets and then against the assets distributed to the

accord id. § 362.493(1), (2) (Michie/Bobbs-Merrill Supp. 1994).

¹⁸⁸ *Id.* § 275.310(3); *accord id.* §§ 362.345(2)(a)-(d), (3); 362.493(3) (Michie/Bobbs-Merrill 1989).

¹⁸⁹ *Id.* § 275.315(4).

¹⁹⁰ *Id.* § 275.320.

¹⁹¹ *Id.* § 275.320(2), (3).

¹⁹² *Id.* § 275.320(3)(b).

¹⁹³ *Id.* § 275.325(1), (2)(a)-(c); *accord id.* § 271B.14-070 (Michie/Bobbs-Merrill 1989).

¹⁹⁴ *Id.* § 275.325(3).

¹⁹⁵ *Id.* Regardless of the type of LLC, an unknown claim which is contingent or based upon events occurring after the date of dissolution may be banned. *Id.* § 275.325(3).

members.¹⁹⁶ However, no member will be liable on a claim for an amount in excess of the amount he or she has received in distribution from the LLC.¹⁹⁷

I. *Suits By and Against an LLC*

1. *Parties to Actions*

Except when the proceeding is to enforce a right of a member against the LLC or to enforce a member's liability to the LLC, a member, by virtue of that status, is not a proper party to a proceeding by or against the LLC; however, this rule may be modified by the operating agreement.¹⁹⁸ An LLC may file suit, and suits may be filed against the LLC, in its own name.¹⁹⁹

2. *Authority to Sue on Behalf of an LLC*

Unless otherwise provided in a written operating agreement, suit may be brought on behalf of and in the name of an LLC by one or more members authorized by more than one half of the members.²⁰⁰ However, the vote of any member having an interest adverse to that of the LLC shall be excluded.²⁰¹ The authority of a member to bring suit is without regard to whether the management powers are vested in managers.²⁰²

¹⁹⁶ *Id.* § 275.325(4)(a)-(b).

¹⁹⁷ *Id.* § 275.325(4)(b).

¹⁹⁸ *Id.* § 275.155.

¹⁹⁹ *Id.* § 275.330. For purposes of bringing and defending suit, an LLC will be viewed as an entity distinct from its members and not merely as an aggregate of the respective members. In contrast, prior to the approval of Senate Bill 184, a Kentucky general partnership could not sue or be sued in its own name. See *Telamarketing Communications, Inc. v. Liberty Partners*, 798 S.W.2d 462, 463 (Ky. 1990).

²⁰⁰ KY. REV. STAT. ANN. § 275.335(1). The vote will be on a per capita basis. *Id.*

²⁰¹ *Id.*

²⁰² The LLC Act does not provide for derivative actions as a means of recovering misappropriated assets or opportunities. However, the LLC Act in no way forbids such suits. To the extent the member bringing suit was personally injured by the misappropriation, he or she should be able to personally recover in such a suit. Conversely, in a derivative action, the recovery is to the corporation or limited partnership. Because these suits are not technically derivative actions, such suits would not be governed by the elaborate procedural limitations imposed on derivative actions under the Kentucky statutory scheme. *Id.* § 271B.7-400 (Michie/Bobbs-Merrill 1989) (addressing derivative action brought by shareholders); *id.* §§ 362.511, .513, .515, .517 (Michie/Bobbs-Merrill Supp. 1994) (addressing derivative action brought by limited partners). Certain other LLC

In addition, suit may be brought by one or more of the LLC managers where the operating agreement vests management in those managers, except, of course, for any manager who has an interest adverse to that of the LLC.²⁰³

3. *Effect of Lack of Authority to Bring Suit*

The lack of authority of a member or manager to file suit on behalf of an LLC may not be used as a defense to an action filed by the LLC. Moreover, this lack of authority is not a basis for the LLC to file a subsequent suit on the same cause of action.²⁰⁴ As such, a lack of capacity to file the original lawsuit should not protect an LLC from the preclusive effects of *res judicata*, collateral estoppel, and similar doctrines.

J. *Merger and Conversion*

1. *Merger*

LLCs are permitted to merge with other LLCs and, provided such is permissible by other applicable law, with other business entities.²⁰⁵ The approval of a merger, unless otherwise provided in a written operating agreement, must be by unanimous consent of the members.²⁰⁶

2. *Plan of Merger*

The LLC and the other business entity must enter into a written plan of merger setting forth the names of the merging entities and the

statutes have set forth express provisions regarding derivative actions by members. *See, e.g.*, ILL. REV. STAT. ch. 805, para. 180/40-10 (1994).

²⁰³ KY. REV. STAT. ANN. § 275.335(2).

²⁰⁴ *Id.* § 275.340.

²⁰⁵ *Id.* § 275.345(1).

²⁰⁶ *Id.* § 275.350(1). For those LLCs in which a merger may be approved by fewer than all members, the statute does not provide for dissenters' rights. *Compare with id.* §§ 271B.13-010, -310 (Michie/Bobbs-Merrill 1989 & Supp. 1994). Unless restricted from doing so by the operating agreement, a member disapproving of a merger could withdraw and, in accord with § 275.215, receive the value of his or her interest. The organizational statute governing the other entity or entities to the merger must permit the merger, and the merger must be approved in the manner and by the vote defined by that statute. *Id.* § 275.350(2). Moreover, each entity to the merger will have such rights to abandon the merger as are set forth in its organizational statute. *Id.* § 275.350(3).

surviving entity, and the terms and conditions of the merger, including whether the surviving entity will have limited liability.²⁰⁷ The writing must also indicate the manner of converting the interests of the entities into those of the surviving entity, any necessary or desired amendments to the organizational document of the surviving entity, and other materials which the various entities may desire to include.²⁰⁸

3. *Articles of Merger*

Following approval of the plan of merger by all of the entities involved, the surviving business entity must file articles of merger executed by each business entity with the Secretary of State. These articles must include the name and jurisdiction of each business entity party to the merger, the plan of merger, the name of the surviving business entity, a statement that the plan was duly authorized and approved by each business in accord with its controlling law, and provisions for service of process on the surviving entity if it is not a Kentucky business entity.²⁰⁹ While the articles of merger are filed with the Secretary of State by the surviving entity, they must be executed by all entities party to the merger.²¹⁰

4. *Effects of Merger*

Other than the surviving entity, all parties to the merger cease to exist.²¹¹ The survivor of the merger possesses all the rights and privileges and restrictions of the businesses merged into it, along with any disabilities and obligations.²¹² The title to all real estate held by the constituent businesses passes without impairment to the surviving entity.²¹³

²⁰⁷ *Id.* § 275.355(1), (2)(a)-(b). The purpose for the requirement of a statement as to whether limited liability is retained in the surviving entity is to protect LLC members from exposure to personal liability consequent to a merger without the member's knowing consent.

²⁰⁸ *Id.* § 275.355(2)(c)-(e).

²⁰⁹ *Id.* § 275.360(1)(a)-(e).

²¹⁰ *Id.* § 275.360. Compare *id.* § 271B.11-050(1) (Michie/Bobbs-Merrill 1989) (providing that articles of merger between corporations need be executed only by surviving entity).

²¹¹ *Id.* § 275.365(2).

²¹² *Id.* § 275.365(3), (4), (6), (7).

²¹³ *Id.* § 275.365(5).

5. *Statutory Conversion*

In addition to the merger provisions, the LLC Act includes a statutory procedure for converting a partnership, general or limited, into an LLC.²¹⁴ A general partnership may convert to an LLC simply by filing articles of organization. The conversion must be approved by all of the partners in the general partnership unless the partnership agreement provides for a different number or percentage.²¹⁵ In addition to the material otherwise required for articles of organization, the following must also be set forth by the converting general partnership: a statement that the LLC was formed by the conversion of a general partnership; the name of the former partnership; the number of votes cast for and against the conversion and, if not unanimous, the number or percentage interest required under the partnership agreement to approve the conversion; and a statement that any assumed names of the former partnership have been cancelled.²¹⁶

A limited partnership may convert to an LLC by using this same procedure.²¹⁷ However, notwithstanding any provision to the contrary in the limited partnership agreement, all partners, general and limited, must approve the conversion.²¹⁸ In addition to those requirements set forth for the conversion of a general partnership to an LLC and the matters required in the articles of organization, the limited partnership must also cancel its certificate of limited partnership.²¹⁹

The conversion of a partnership is effective at the latter of the filing of the articles of organization, or a subsequent effective date set forth therein, or, in the case of the conversion of a limited partnership, upon the filing of the certificate of cancellation of its certificate of limited partnership.²²⁰

The converting general or limited partnership does not dissolve upon conversion.²²¹ Upon conversion, all property owned by the converting partnership vests in the LLC, the obligations of the converting partnership

²¹⁴ *Id.* § 275.370(d).

²¹⁵ *Id.* § 275.375(2).

²¹⁶ *Id.* § 275.370(3)(a)-(c).

²¹⁷ *Id.* § 275.370(1).

²¹⁸ *Id.* § 275.370(2).

²¹⁹ *Id.* § 275.370(3)(d).

²²⁰ *Id.* § 275.370(4). In order to ensure that the conversion of a limited partnership can be accomplished on the desired date, it is advisable to file the articles of organization and the cancellation of the limited partnership certificate simultaneously.

²²¹ *Id.* § 275.375(1).

become obligations of the LLC, and any proceeding pending against the partnership shall continue as if the conversion had not taken place.²²²

This conversion process enables a partnership, simply by filing a single document, to eliminate the personal liability of its general partners for obligations that arise after the conversion.²²³ However, the general partners of the converting partnership remain liable for the pre-conversion debts and obligations of the partnership.²²⁴

K. Foreign LLCs

A foreign LLC is defined as an unincorporated association, organized under the laws of a jurisdiction other than Kentucky, which provides limited liability for each of its members.²²⁵ This broad definition is intended not only to encompass entities formed as LLCs pursuant to the laws of the various states but also to permit the registration of non-U.S. entities such as the *German Gesellschaft mit beschränkter Haftung* (“GmbH”).²²⁶

1. Law Governing

Subject to the Kentucky Constitution, the internal operation and liability of the members of a foreign LLC are governed by the laws of its jurisdiction of organization.²²⁷ Foreign LLCs will not be denied registration in Kentucky because of differences between the laws of its organizational jurisdiction and those of Kentucky.²²⁸ However, irrespective of the law of the jurisdiction of formation, no foreign LLC has greater rights or powers than an LLC organized under Kentucky law.²²⁹

²²² *Id.* § 275.375(2)(a)-(c).

²²³ *Id.* § 275.370(5).

²²⁴ *Id.*

²²⁵ *Id.* § 275.015(6)(a)-(c).

²²⁶ See *infra* notes 335-38 and accompanying text. However, this definition should not be interpreted to encompass situations which are more specifically addressed elsewhere in Kentucky Revised Statutes. For example, while a business trust would fall within this definition, the provisions of §§ 386.370 through 386.440 of the Kentucky Revised Statutes, specifically addressing business trusts, would continue to control their qualification and operation. Note that the definition of a foreign LLC does not reference the tax classification of the foreign entity.

²²⁷ KY. REV. STAT. ANN. § 275.380(1)(a)-(b).

²²⁸ *Id.* § 275.380(1)(b).

²²⁹ *Id.* § 275.380(2). As a corollary, foreign LLCs will not be denied registration in Kentucky because of differences between the laws of its organizational jurisdiction and

2. *Authority to Transact Business Required*

A foreign LLC seeking to do business in Kentucky²³⁰ is required to obtain a certificate of authorization from the Secretary of State.²³¹ The LLC Act sets forth a non-exhaustive list of activities which will not be deemed to constitute doing business.²³²

3. *Transacting Business Without Authority*

While the failure to qualify to do business in Kentucky will not impair any contract or act of the LLC or prevent it from defending a proceeding in Kentucky, a foreign LLC that is not qualified to do business may not bring or maintain an action to enforce its rights in Kentucky.²³³ In addition, a foreign LLC which transacts business in Kentucky without a certificate of authority is subject to a fine of two dollars per day, not to exceed five hundred dollars per annum.²³⁴

4. *Application for and Effect of a Certificate of Authority*

An application to do business is filed with the Secretary of State.²³⁵ The application for a certificate of authority must set forth: the name of the LLC; its jurisdiction of organization; its date of organization; the last date on which it is to dissolve, if any; the street address of the office it is required to maintain in its jurisdiction of organization or, if none, its

those of Kentucky. *Id.* § 275.380(1)(b).

²³⁰ *Id.* § 275.385(2)(a)-(k) (providing a non-exhaustive list of activities which will not be deemed to constitute doing business); *accord id.* § 271B.15-010(2)(a)-(k) (Michie/Bobbs-Merrill Supp. 1994).

²³¹ *Id.* § 275.385(1); *accord id.* § 271B.15-010(1) (Michie/Bobbs-Merrill 1989).

²³² *Id.* § 275.385(2)(a)-(k), (3); *accord id.* § 271B.15-010(2)(a)-(k) (Michie/Bobbs-Merrill 1989). As the provision in the LLC Act mirrors that set forth in the Corporation Act, the case law on what constitutes "doing business" should apply to LLCs.

²³³ *Id.* § 275.390.

²³⁴ *Id.* § 275.390(4); *accord id.* § 271B.15-020 (Michie/Bobbs-Merrill 1989). The failure to qualify to do business should not subject the members and managers to personal liability. *See Virginia Partners, Ltd. v. Day*, 738 S.W.2d 837, 840 (Ky. Ct. App. 1987) (explaining that, where foreign limited partnership failed to qualify to do business, limited partners were not jointly and severally liable on tort claim). The LLC Act does not contain a provision similar to § 362.507(3) of the Kentucky Revised Statutes providing for the appointment of the Secretary of State agent for service of process against a partnership doing business without authority.

²³⁵ *See* KY. REV. STAT. ANN. §§ 275.395(1); *accord id.* § 271B.15-030(1) (Michie/Bobbs-Merrill 1989).

principal office; the name and address of its registered agent in Kentucky; the names and usual business addresses of its current managers, if any; and a statement that, as of the date of filing, the foreign LLC validly exists under the laws of its jurisdiction of formation.²³⁶ A foreign LLC is required to obtain an amended certificate of authority if it changes its name, the last date on which it is to dissolve, or its jurisdiction of organization.²³⁷ A certificate of authority permits a foreign LLC to transact business in Kentucky, granting to that LLC the same rights and privileges as LLCs organized in Kentucky.²³⁸ However, the granting of a certificate of authority does not authorize Kentucky to regulate the organization or internal affairs of a foreign LLC.²³⁹

5. *Name of Foreign LLCs*

The name of a foreign LLC must meet the requirements for domestically formed LLCs²⁴⁰ and must be distinguishable from the names of other organized or registered entities.²⁴¹ As with domestically organized LLCs, foreign LLCs may use a fictitious name.²⁴²

6. *Registered Office, Registered Agent, and Service on a Foreign LLC*

Each foreign LLC must maintain a registered office and a registered agent in Kentucky.²⁴³ The statute also provides for a change in the

²³⁶ *Id.* 275.395(1)(a)-(g); *accord id.* § 271B.15-030(1)(a)-(f), (2) (Michie/Bobbs-Merrill 1989). The statement of valid organization required by *id.* § 275.395(1)(g) may be filed by a member or manager of the LLC and need not be an official document from the jurisdiction of organization. This flexibility with respect to the statement of valid organization is an accommodation to non-U.S. organized LLCs which may be unable to obtain an official "certificate of good standing" because such does not exist under the laws of their jurisdiction of organization. The application must be accompanied by the consent of the registered agent to serve in that capacity. *Id.* § 275.395(2). Note that the application for a certificate of authority must set forth the names and business addresses of the managers of a foreign LLC, a requirement not imposed on domestic LLCs when filing articles of organization.

²³⁷ *Id.* § 275.400(1)(a)-(c).

²³⁸ *Id.* § 275.405(1), (2).

²³⁹ KY. REV. STAT. ANN. § 275.405(3).

²⁴⁰ *Id.* §§ 275.410, 275.100.

²⁴¹ *Id.* § 275.410(2); *accord id.* § 271B.15-060 (Michie/Bobbs-Merrill 1989).

²⁴² *Id.* § 275.410(1)(b).

²⁴³ *Id.* § 275.415.

registered office or registered agent of a foreign LLC²⁴⁴ and for the resignation of a registered agent.²⁴⁵

The registered agent of a foreign LLC acts as its agent for service of process.²⁴⁶ However, a foreign LLC which has had its certificate of authority revoked, or has withdrawn from Kentucky, or otherwise has no registered agent may be served by registered or certified mail at its principal office.²⁴⁷

7. *Withdrawal from Qualification to Do Business*

Foreign LLCs seeking to withdraw from Kentucky must apply for and obtain a certificate of withdrawal from the Secretary of State.²⁴⁸ The application for the certificate of withdrawal must set forth: the name of the LLC, its jurisdiction of organization, a statement that it is not transacting business in Kentucky and surrenders its authority to transact such business, a statement that the authority of its registered agent is revoked and an appointment of the Secretary of State as agent for service of process for proceedings based on a cause of action which arose while qualified to transact business in Kentucky, a mailing address to which any process served may be forwarded, and a commitment to notify the Secretary of State of any future changes in the mailing address.²⁴⁹ Foreign LLCs which have had their certificate of authority revoked, which have withdrawn from Kentucky or who otherwise have no registered agent or if, in reasonable diligence, the registered agent cannot be served, may be served by registered or certified mail at their principal office.²⁵⁰

L. *Kentucky State Taxation of LLCs*

Under the LLC Act, an LLC is classified for purposes of state income taxation as it is classified for federal taxation purposes.²⁵¹ This rule

²⁴⁴ *Id.* § 275.420.

²⁴⁵ *Id.* § 275.425. Failure to maintain or apprise the Secretary of State of a change of a registered office and a registered agent is grounds for revocation of the certificate of authority. *Id.* § 275.440(2), (3).

²⁴⁶ *Id.* § 275.430(1).

²⁴⁷ *Id.* § 275.430(2)(a)-(c).

²⁴⁸ *Id.* § 275.435(1).

²⁴⁹ *Id.* § 275.435(2)(a)-(e); accord *id.* § 271B.15-200 (Michie/Bobbs-Merrill 1989).

²⁵⁰ *Id.* § 275.415(2). Of course, this provision begs the question of making service of process on a foreign LLC that was doing business in Kentucky without qualification, there then being no filing identifying the principal office.

²⁵¹ *Id.* § 141.050(1) (Michie/Bobbs-Merrill 1991). While the LLC Act expressly

applies regardless of whether the LLC is organized in Kentucky or is a foreign LLC doing business in Kentucky.²⁵²

M. *The Kentucky LLC Act and PLLCs*

The LLC Act was drafted with the specific intent to allow professionals to organize their practices as LLCs.²⁵³ A PLLC is an LLC organized under the laws of a jurisdiction “for purposes that include, but are not limited to, the providing of one or more professional services.”²⁵⁴ In

addresses only the income taxation of LLCs, officials of the Kentucky Revenue Cabinet have stated that the classification would be consistently applied for non-income taxes.

²⁵² See *id.* § 275.380(2) (stating that foreign LLCs have equal rights with domestic LLCs in Kentucky).

²⁵³ The Kentucky Society of Certified Public Accountants was a supporter of the LLC Act. This support was in accord with a national program of the American Institute of Certified Public Accountants to support LLC legislation throughout the country as a response to the perceived accountant liability crisis. See, e.g., Lee Burton & Joann S. Lublin, *Seeking Shelter: Partnership Structure is Called in Question as Liability Risk Rises*, WALL ST. J., June 10, 1992, at A1; Phillip R. Lochner, Jr., *Black Days for Accounting Firms*, WALL ST. J., May 22, 1992, at A10; Matt Roush, *Liability is No. 1 Issue for Accountants*, CRAINS DETROIT BUS., Jan. 25, 1993, at 8; David C. Walters, *Liability Risk Worries Accounting Recruits*, CHRISTIAN SCI. MONITOR, Dec. 28, 1992, at 9. Desire for a limited liability structure that may be used by both intrastate and interstate accounting practices but without the limitations of S corporation status also engendered support. See Marvin L. Stone, *In My Opinion—Incorporated CPA Firms*, 177 J. ACCT. 33(2), Mar. 1994 (discussing the need for a widely available limited liability structure for accountants); see generally Gilbert Simonetti, Jr., *Limiting Accountants' Personal Liability Won't Solve the Country's Liability Crisis!*, 177 J. ACCT. 46, Apr. 1994 (arguing that the further availability of limited liability structures is only a first step in addressing liability concerns).

²⁵⁴ KY. REV. STAT. ANN. § 275.015(18). The provisions that impose special additional requirements on PLLCs are limited to a discrete and definite list of professions—namely, physicians, osteopaths, optometrists, podiatrists, chiropractors, dentists, psychologists, nurses, pharmacists, occupational therapists, ophthalmologists, veterinarians, engineers, architects, landscape architects, certified public accountants, public accountants, physical therapists, and attorneys. *Id.* § 275.015(19). In contrast, the Kentucky PSC statute contains a non-exhaustive list of the professions which, if seeking to incorporate, must comply with the requirements of that statute. *Id.* § 274.005(3) (Michie/Bobbs-Merrill 1989) (“The personal services which come within the provisions of this chapter are the personal services rendered by, *but not limited to*, . . .”) (emphasis added). Other regulated professions, subject to the rules of the applicable regulatory body, may use the generic LLC form to carry on their respective trade or business. *Id.* § 275.005. The regulating authority of a profession not required by the LLC Act to conform to the PLLC provisions could mandate such compliance.

addition to minimal requirements applied solely to PLLCs,²⁵⁵ PLLCs are subject to the requirements applicable to generic LLC forms.²⁵⁶

The LLC Act as used by professionals is significantly less restrictive with respect to ownership and management structure than is the professional service corporation ("PSC") statute. Under the latter, the issuance or transfer of shares is strictly limited, and any issuance or transfer in violation of those restrictions is void.²⁵⁷ At least one half of the board of directors and, all officers other than the secretary and the treasurer, of a PSC must be individuals licensed to practice the profession or professions for which the PSC was organized.²⁵⁸ In addition, the PSC statute imposes substantive requirements upon the redemption of stock from retired and deceased shareholders.²⁵⁹ The Kentucky LLC Act does not contain similar limitations.²⁶⁰

1. *Limits of the Liability Shield*

The use of an LLC to render professional services will not protect a professional from liability arising from his or her own malpractice. Rather, the limited liability shield will serve only to protect an innocent member from personal liability for claims arising consequent to the actions of other members or agents of the LLC.²⁶¹ In this regard, the LLC statute is no different than that of the PSC²⁶² in that it provides

²⁵⁵ These specific requirements include the requirement that the name contain "professional," "PLLC," or "PLC," *see supra* notes 49-53 and accompanying text, and the requirement that the articles of organization set forth the profession or professions to be carried on through the PLLC, *see supra* note 32 and accompanying text.

²⁵⁶ Section 275.015(18) of the Kentucky Revised Statutes provides in part: "Except as otherwise expressly provided in this chapter, all provisions of this chapter governing limited liability companies shall be applicable to professional [LLCs]."

²⁵⁷ *Id.* § 274.017 (Michie/Bobbs-Merrill 1989).

²⁵⁸ *Id.* § 274.027. In addition, all officers other than the secretary and the treasurer must be professionals. *Id.*

²⁵⁹ *Id.* § 274.095.

²⁶⁰ Other states, while permitting professionals to use LLCs, have imposed requirements restricting membership and management to those licensed to practice the profession. *See, e.g.*, ARIZ. REV. STAT. ANN. § 29-844(B), (C) (Supp. 1993); IOWA CODE §§ 490A.1508, .1515 (Supp. 1994); VA. CODE ANN. §§ 13.1-1103, -1111, -1115, -1118 (Michie 1993) (amended 1994); N.Y. LIMITED LIABILITY COMPANY LAW §§ 1207, 1209-11.

²⁶¹ *See supra* note 77.

²⁶² However, because of ambiguities that have arisen from the judicial interpretation of the PSC statute and the subsequent amendment of that statute, the liability shield afforded by the LLC statute is arguably superior because it lacks these ambiguities.

professionals a structure with which they may avoid joint and several liability for one another's professional malpractice.²⁶³

Some question exists as to whether the liability shield afforded by the Kentucky PSC statute is effective to protect the innocent professional, whose sole contact with the malpractice was as a shareholder of the employer of the negligent professional or employee, from joint and several liability. In *Boyd v. Badenhausen*, 556 S.W.2d 896 (Ky. 1977), the Kentucky Supreme Court reviewed a claim of negligence regarding the actions of a clerical employee of a medical practice PSC. The court held that Dr. Badenhausen, a shareholder of that PSC, was liable for the patient's damages arising from the error of the clerical employee, but it did not clarify the basis upon which that liability was premised. The court wrote: "The question is whether the veil of a professional service corporation protects its [shareholders] from personal responsibility for the negligence of its corporate employees in doing or failing to do those things that are embraced in the duties owed by a physician to his patient. The answer is 'No.'" *Id.* at 898. Adding to the uncertainty on this question is that § 274.055(1) of the Kentucky Revised Statutes was amended, in 1980, to more explicitly address the issue of personal liability for the acts of personnel in a PSC. These amendments were adopted in response to a recommendation that the statute be amended "so as to clearly extend corporate limited liability to non-negligent professional corporation shareholders." LEGISLATIVE RESEARCH COMM'N, RESEARCH REP. NO. 148, THE DESIRABILITY OF ENACTING THE MODEL PROFESSIONAL CORPORATION ACT IN KENTUCKY (1978).

²⁶³ The position that the LLC affords no greater protection than the PSC has not been universally accepted. See, e.g., *N.C. Academy of Trial Lawyers Says The Limited Liability Company Act Significantly Erodes Rights of North Carolina Citizens*, PR. NEWSWIRE, June 25, 1993, available in LEXIS, Nexis Library (arguing that, with the lack of joint and several liability, professionals will have less, if any, incentive to oversee the activities of their fellow practitioners). However, this argument ignores the value of goodwill and the necessity of efforts to protect that value. See, e.g., Larry E. Ribstein, *The Deregulation of Limited Liability and the Death of Partnership*, 70 WASH. U. L.Q. 417, 435 (1992) ("Although injured clients cannot recover against goodwill, the firm invests resources in developing its reputation, and this stake gives it an incentive to minimize malpractice.").

According to some observers:

There are strong policy arguments supporting loosening the restrictions on adoption of limited liability by professionals. First, even a limited liability firm has significant assets at stake, including: the marketable assets of the firm which is generally vicariously liable for malpractice of its members, the assets of the primarily liable member and the assets of all other members whose negligence contributed to the loss. Since the members can be expected to have substantial assets, they have incentives to purchase third-party malpractice insurance and to monitor co-partners to minimize their premiums and protect against liability beyond policy limits and within co-insurance and deductibles.

Second, the firm stands to forfeit some of its reputation in the event of member malpractice, which gives the firm an incentive to minimize malpractice. Indeed, since reputation is uninsurable, this incentive avoids the moral hazard inherent in insuring against legal liability.

Third, even if unlimited liability does increase the firm's exposure to malpractice claims, this increased exposure may not provide significant benefits

2. *Authority of Professional Regulatory Boards*

The LLC Act expressly recognizes the authority of the various professional regulatory boards to regulate those who may choose to practice in the form of an LLC.²⁶⁴ The sole restraint on this authority is that a regulatory board may not alter the rule of limited liability.²⁶⁵ Therefore, a regulatory board could impose limitations on the members and managers of a PLLC similar to those contained in the PSC statute.²⁶⁶

Whether the rules of the various professional regulatory boards must be amended to expressly permit the practice of their respective professions through an LLC is an open question. Certain, albeit dated, opinions of the Attorney General of Kentucky have concluded that the adoption of the Professional Service Corporation Act, with an express provision allowing named professions to use that form, in and of itself authorized members of the named professions to practice in the PSC form, and that a rule of a regulatory board to the contrary would be unenforceable and void.²⁶⁷

to the client. Although lawyers may have some additional incentive under unlimited liability to monitor co-partners, this increased monitoring may not be particularly useful and, indeed, may be counterproductive to the extent that it involves second-guessing complex professional decisions. On the other hand, the clients themselves can effectively monitor their own cases through corporate legal departments, general practitioners who review the work of medical specialists, and, in the United Kingdom, by solicitors who employ barristers to try cases.

RIBSTEIN & KEATING, *supra* note 97, § 15.05.

²⁶⁴ See *supra* notes 46-48 and accompanying text. While § 275.010 of the Kentucky Revised Statutes could be read to imply that a regulatory board has the authority to prohibit members of a profession from practicing through an LLC, the better interpretation is that those boards are delegated the general authority to regulate the provision of professional services through an LLC without the authority to prohibit the enumerated professions from being rendered through an LLC. Under this analysis, the General Assembly will have made a preemptive determination that the professions referenced in § 275.015(19) may be practiced in LLC form.

²⁶⁵ KY. REV. STAT. ANN. § 275.010.

²⁶⁶ *Id.* § 275.010(2)(a)-(c).

²⁶⁷ 63 Op. Att'y Gen. 13 (Ky.) (1963) (accountants); 63 Op. Att'y Gen. 1110 (Ky.) (1963) ("O.A.G. 63-1110") (attorneys at law). It must be noted that O.A.G. 63-1110 predates the 1976 amendments of the Kentucky Constitution which grant the supreme court the power to regulate the bar. KY. CONST. § 116 ("The Supreme Court shall, by rule, govern admission to the bar and the discipline of members of the bar."); see also *Ex parte Auditor of Public Accounts*, 609 S.W.2d 682, 685 (Ky. 1980) ("[T]he judicial branch of this state government has exclusive authority to manage its own affairs.").

The 1994 General Assembly amended the laws governing the practice of accountancy to expand the permissible forms of business through which accountants may practice, thereby permitting accountants to practice as LLCs.²⁶⁸ Requests have been submitted to the Kentucky Supreme Court, the Board of Medical Licensure, and the Board of Dentistry to issue a rule or statement that professionals regulated by those bodies may practice as LLCs.²⁶⁹

3. *Interstate Practice with a PLLC*

The operation of a multi-state professional practice structured as an LLC may raise problems with respect to the limited liability shield. Maryland, Oregon, and Rhode Island prohibit LLCs from rendering professional services.²⁷⁰ Eventually, judicial interpretation may erode the liability shield in other jurisdictions. Therefore, should a malpractice claim arise in a jurisdiction where limited liability does not extend to PLLCs, the claimant could argue that all members should be subject to liability. This argument would have at least two bases. First, any legislative prohibition against PLLCs is a statement of public policy against liability shields for professionals. Second, most LLC statutes provide that foreign LLCs have no greater rights than do domestic LLCs.²⁷¹ As a domestic LLC could not render professional services, allowing a foreign LLC to do so would be a grant of greater rights to a foreign LLC. Thus, the argument would conclude, no liability shield should exist in these jurisdictions.

In addition, a multi-state PLLC must ensure that the rules of the relevant professional regulatory board(s) permit PLLCs. Other than

These developments may have diluted the authority O.A.G. 63-1110 had at the time of its issuance. Conversely, the Kentucky Supreme Court has not issued a rule on what forms of practice may or may not be used by attorneys. Thus, in the absence of a contrary directive, the case can be made that O.A.G. 63-1110 remains authoritative.

²⁶⁸ KY. REV. STAT. ANN. § 325.220(2)(6) (Michie/Bobbs-Merrill Supp. 1994).

²⁶⁹ Copies of correspondence are on file with authors.

²⁷⁰ MD. CODE ANN., CORPS & ASS'NS § 4A-201 (1993); ORE. REV. STAT. § 63.074 (1994); R.I. GEN. LAWS § 7-16-3 (1992). Prior to its 1992 amendment, the Virginia LLC statute also prohibited LLCs from engaging in professional services. VA. CODE ANN. § 13.1-1100-1123 (Michie 1993) (amending VA. CODE ANN. § 13.1-1100-1123 (Michie 1991)). The original Wyoming statute did not expressly grant or deny LLCs the right to render professional services; this ambiguity was addressed in a 1993 amendment which expressly authorizes LLCs to render professional services. WYO. STAT. § 17-15-103(b) (1993) (amending WYO. STAT. § 17-15-103 (1977)).

²⁷¹ See, e.g., KY. REV. STAT. ANN. § 275.380(2).

Kentucky, states that expressly permit the rendering of professional services through an LLC include Alabama, Arizona, Arkansas, Delaware, Georgia, Idaho, Indiana, Iowa, Kansas, Michigan, Minnesota, Montana, New Hampshire, Utah, Virginia, and Wyoming.²⁷²

However, the fact that a PLLC may be used by a particular profession may not be the final word on the introduction of a foreign PLLC. Certain professional boards have imposed substantive requirements on the structure and ownership of PLLCs.²⁷³ A foreign PLLC which does not satisfy these requirements may find itself afoul of the various state regulatory boards.²⁷⁴

II. THE HISTORY OF THE LLC AND THE SERVICE'S RESPONSE TO THE CLASSIFICATION CHALLENGE

The utility of an LLC depends on a determination that the LLC will be treated as a partnership under federal tax law.²⁷⁵ In turn, that objective dictates certain aspects of the LLC's structure. Therefore, one must understand the rules of tax law governing classification in order to structure an LLC without unwittingly triggering corporate taxation. This

²⁷² ALA. CODE § 10-12-45 (Supp. 1993); ARIZ. REV. STAT. ANN. §§ 29-841 to -847 (1994); ARK. CODE ANN. § 4-32-306 (Michie 1993); DEL. CODE ANN. tit. 6, §§ 18-101 to -1107 (1992); GA. CODE ANN. §§ 14-11-201(b) to -314 (1993); IDAHO CODE § 53-615 (1993); IND. CODE § 23-18-2-2(15) (1993); IOWA CODE §§ 490A.1501-.1519 (1992); KAN. STAT. ANN. § 17-7604(q) (1991); MICH. COMP. LAWS ANN. §§ 901-910 (West 1993); MINN. STAT. § 319A.03 (1994); MONT. CODE ANN. §§ 2(18), (19), 72-78 (1993); N.H. REV. STAT. ANN. §§ 304-D-1 to D-20 (1993); UTAH CODE ANN. § 48-2b-105(1)(f) (1991); VA. CODE ANN. §§ 13.1-1100 to -1123 (Michie 1993); WYO. STAT. § 17-15-103(b) (1993).

²⁷³ The Office of the Attorney General of Kansas has opined that, as the Kansas CPA licensing statute permits CPAs to practice as professional corporations, they should likewise be permitted to organize and practice as limited liability companies, remaining at all times subject to the restrictions imposed by the professional corporation law. 92 Op. Att'y Gen. 23 (Kan.) (1992).

²⁷⁴ In such a circumstance, a conflict would arise between the rule that a jurisdiction granting a certificate of authority to a foreign LLC may not thereby regulate the internal operations of that foreign LLC, *see, e.g.*, KY. REV. STAT. ANN. § 275.405(3), and the dual declarations that a foreign LLC may not have greater powers than does a domestic LLC, *see, e.g., id.* § 275.405(2), and that a professional regulatory board has the authority to adopt rules governing the structure of the practices it regulates, *see, e.g., id.* § 275.010.

²⁷⁵ While the flexibility of structure afforded by the LLC may be advantageous even if a particular LLC is classified as an association taxable as a corporation, the literature has neither supplied a compelling reason for desiring such a result nor shown that the available business structures are unable to fill such a need.

is a challenging task due to the Service's somewhat fickle position on LLC classification during the formative years of LLCs.

A. *Classification and the Kintner Regulations*

Broadly speaking, the Code recognizes and provides rules for the taxation of four categories of taxpayers:²⁷⁶ individuals,²⁷⁷ corporations (including "associations"),²⁷⁸ partnerships,²⁷⁹ and trusts and estates.²⁸⁰ Other types of business entities, such as joint stock companies, business trusts, and partnership associations, are placed into one of these categories and taxed accordingly.

A "partnership" is defined by the Code to include "a syndicate, group, pool, joint venture, or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a corporation or a trust or estate."²⁸¹ As such, the Code defines a partnership in the negative by excluding from the scope of "partnership" those businesses carried on as a corporation or a trust or an estate. However, the Code begs the question of how to distinguish a partnership from other business structures.²⁸²

The classification rules are embodied in a set of Treasury regulations known as the *Kintner* regulations.²⁸³ The regulations distinguish be-

²⁷⁶ This generality does not consider the rules governing specialized structures such as REITs, REMICs, RICs, FSCs, CFCs, and insurance companies.

²⁷⁷ I.R.C. subchapters A & B.

²⁷⁸ *Id.* subchapter C.

²⁷⁹ *Id.* subchapter K.

²⁸⁰ *Id.* subchapter J.

²⁸¹ *Id.* § 761(a) (1993).

²⁸² WILLIAM S. MCKEE ET AL., *FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS* ¶ 3.01[1] (2d ed. 1990) ("The most basic, and perhaps most difficult, problem in the taxation of partnerships and partners is the determination whether a particular financial, business or otherwise economic arrangement constitutes a partnership for income tax purposes.").

While the entities subject to this classification procedure are organized under state law, the labels afforded by state law are not determinative of the tax classification question. *Burk-Waggoner Oil Ass'n v. Hopkins*, 269 U.S. 110, 114 (1925).

²⁸³ *Treas. Reg.* § 301.7701-2 (1960). These regulations set forth the characteristics that distinguish among entities taxable as partnerships, "associations" taxable as corporations, and trusts. These regulations may be traced to *United States v. Kintner*, 216 F.2d 418 (9th Cir. 1954) (classifying an unincorporated association as an association taxable as a corporation), *aff'g* 107 F. Supp. 976 (D. Mont. 1952), and before that to *Morrissey v. Commissioner*, 296 U.S. 344 (1935) (classifying a trust as an association taxable as a

tween structures by reference to six²⁸⁴ characteristics:²⁸⁵ asso-

corporation). Works discussing the history of these regulations include MCKEE ET AL., *supra* note 282, ¶ 3.06; and Richard L. Parker, *Corporate Benefits Without Corporate Taxation: Limited Liability Company and Limited Partnership Solutions to the Choice of Entity Dilemma*, 29 SAN DIEGO L. REV. 399 (1992); and Stephen B. Scallen, *Federal Income Taxation of Professional Associations and Corporations*, 49 MINN. L. REV. 603 (1965).

The only significant legislative intrusion on the application of the *Kintner* regulations in recent years has been the adoption in 1987 of § 7704 of the Code, which directs that publicly traded (so-called "master") limited partnerships and other entities with interests which are publicly traded on an established securities market or on a secondary market, with exceptions for those whose income is primarily passive, will be treated as associations taxable as corporations.

²⁸⁴ The *Morrissey* Court discussed a seventh factor, namely, whether the entity's title to its property is affected by changes in the ownership of the entity, as a factor distinguishing other entities from corporations. See *Morrissey*, 296 U.S. at 359. This characteristic has not been carried forward into the *Kintner* regulations.

²⁸⁵ While the *Kintner* regulations state that "other factors" may be relevant in distinguishing partnerships from associations taxable as corporations, the possibility of basing a classification decision on "other factors" has been discussed in detail only on three occasions. See *Larson v. Commissioner*, 66 T.C. 159 (1976), *acq.*, 1979-2 C.B. 1; *Zuckman v. United States*, 524 F.2d 729 (Ct. Cl. 1974), *cert. denied*, 419 U.S. 844 (1975); *Bush #1 c/o Stonestreet Lands Co. v. Commissioner*, 48 T.C. 218 (1967), *acq.*, 1968-2 C.B. 2. In *Zuckman*, the Court of Claims ignored the "other factors" argued by the Service because the entity in question was clearly a partnership due to the absence of the four standard corporate characteristics. 524 F.2d at 733. In *Larson*, the Tax Court held that the seven "other factors" argued by the Service were not relevant to the classification question. 66 T.C. at 184. Shortly thereafter, the Service published Revenue Ruling 79-106, 1979-1 C.B. 448, holding that it would *not* consider the seven *Larson* factors as having relevance independent of their effect on the six regulatory characteristics of a corporation. Those seven factors are as follows:

- (1) [t]he division of limited partnership interests into units or shares and the promotion and marketing of such interests in a manner similar to corporate securities[;]
- (2) the managing partner's right or lack of the discretionary right to retain or distribute profits according to the needs of the business[;]
- (3) the limited partner's right or lack of the right to vote on the removal and election of general partners and the right or lack of the right to vote on the sale of all, or substantially all, of the assets of the partnership[;]
- (4) the limited partnership interests being represented or not being represented by certificates[;]
- (5) the limited partnership's observance or lack of observance of corporate formalities and procedures[;]
- (6) the limited partners being required or not being required to sign the partnership agreement[;] and
- (7) the limited partnership providing a means of pooling investments while limiting the liability of some of the participants.

ciates,²⁸⁶ an objective to carry on a business and divide the gains thereof,²⁸⁷ limited liability,²⁸⁸ free transferability,²⁸⁹ continuity of life,²⁹⁰ and centralized management.²⁹¹

For purposes of distinguishing a structure treated as a corporation from one treated as a partnership, the two characteristics common to both,

Rev. Rul. 79-106, 1979-1 C.B. 448.

This is not to suggest, however, that the Service has completely abandoned any and all belief that “other factors” may be relevant in the classification process. In General Counsel Memorandum 38,036 (Aug. 7, 1979), the office of the Service’s chief counsel concluded, with respect to a Wyoming LLC, that in determining whether the LLC should be classified as a partnership or as an association taxable as a corporation, the fact that the membership was not disclosed to the public is not a significant “other factor.” *See also id.* 39,798 (Oct. 24, 1989) (reciting the six characteristics set forth in Treas. Reg. § 301.7701-2(a)(1) (1960) and stating: “In some cases, however, other factors may be significant in classifying an organization.”); *id.* 39,461 (Dec. 26, 1985) (discussing the six corporate characteristics and stating that other factors may be significant under certain circumstances); *id.* 38,281 (Feb. 15, 1980) (stating that with respect to an LLC, entity treatment under state law could be considered an “other factor”).

²⁸⁶ The term “associates” is not defined in the regulations. The concept has evolved from numerous court decisions and Service rulings that have used the concept to distinguish trusts, which typically do not have associates, from associations taxable as corporations, which by definition have associates. From these rulings and court decisions have emerged several factors considered relevant in determining whether an entity denominated as a “trust” has associates: (1) whether a trust relationship came into existence or continues as a result of volitional activity of the beneficiaries; (2) whether the beneficiaries, as beneficiaries, influence the management activities of the trust; (3) whether the interests of the beneficiaries are freely transferable; and (4) whether the arrangement embodies the traditional indicia of a corporation, such as certificates of beneficial ownership and a board of directors. *See, e.g., Morrissey v. Commissioner*, 296 U.S. 344 (1935); *Elm St. Realty Trust v. Commissioner*, 76 T.C. 803 (1981); *Curt Teich Trust, No. One v. Commissioner*, 25 T.C. 884 (1956), *acq.*, 1956-2 C.B. 8; *Priv. Ltr. Rul.* 90-04-007 (Oct. 19, 1989). In other contexts “the term ‘associates’ refers to those persons who have a beneficial ownership in a business. An associate is like a shareholder of a corporation who provides the capital for the business carried on by the corporation and who has a right to receive the profits of the business.” *Priv. Ltr. Rul.* 93-26-019 (Mar. 31, 1993).

²⁸⁷ In *Helvering v. Coleman-Gilbert Assocs.*, 296 U.S. 369, 374 (1935), the Supreme Court emphasized the paramount status to be accorded the terms of an organization’s governing documents in determining whether an organization formed as a trust has a business objective; if by the terms of these documents the trustee has broad powers to engage in business activity, including the buying or selling of property, then the organization most likely bears this corporate characteristic.

²⁸⁸ *See* Treas. Reg. § 301.7701-2(d) (as amended in 1993) (providing definition).

²⁸⁹ *See id.* § 301.7701-2(e) (providing definition).

²⁹⁰ *See id.* § 301.7701-2(b) (providing definition).

²⁹¹ *See id.* § 301.7701-2(c) (providing definition).

associates²⁹² and an objective to carry on a business and divide the gains thereof, are ignored.²⁹³ Thereafter, the structure is reviewed to determine the number of the four remaining characteristics that the entity bears. If the structure has more than two of the four characteristics, then the structure will be classified as an association taxable as a corporation.²⁹⁴ If, on the other hand, the structure has two or fewer of these

²⁹² Reaching this level of the analysis presupposes that the entity under consideration has at least two owners. It is for this reason that, to ensure tax classification of an LLC as a partnership, at least two members must exist. The need for two or more owners in any entity seeking classification as a partnership has been addressed often. *See, e.g.,* Commissioner v. Culbertson, 337 U.S. 733, 740 (1949); Morrissey v. Commissioner, 296 U.S. 344, 357 (1935); Hynes v. Commissioner, 74 T.C. 1266, 1278 (1980); Knoxville Trust Sales & Serv., Inc. v. Commissioner, 10 T.C. 616, 621 (1948); *see also* Nickelson v. State, 567 S.W.2d 43, 46 (Tex. Ct. App. 1978) (explaining that one person cannot constitute a partnership). However, a trust or a corporation may be taxed as a corporation even if there is but one beneficiary or shareholder. *See, e.g.,* Lombard Trustees, Ltd. v. Commissioner, 136 F.2d 22, 23 (9th Cir. 1943) (trust with single beneficiary treated as having "associates"); Hynes v. Commissioner, 74 T.C. 1266, 1279 (1980) (trust with one beneficiary treated as an association taxable as a corporation); Gen. Couns. Mem. 39,395 (Aug. 5, 1985) ("Despite the fact that under *Lombard Trustees* and *Hynes* a single-member organization can be treated as having associates for purposes of determining if it is an association, we believe that no single-member organization possesses associates in the partnership sense and that an organization with only a single member cannot be a partnership."); Gen. Couns. Mem. 38,707 (May 1, 1981) (trust with one beneficial owner may be classified as an association taxable as a corporation, concurring in result reached by Tax Court in *Hynes*).

Whether an LLC can have only one member and be classified as a partnership remains an unresolved issue. One-member LLCs are allowed by § 201 of the ULLCA. A one-member LLC would provide an alternative to the S corporation for instances in which a limited liability pass-through structure is sought by a sole equity owner. BORIS I. BITTKER & JAMES S. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 2.05[2], at 2-26 to 2-27 (6th ed. 1994). *See generally* Francis J. Wirtz & Kenneth L. Harris, *Tax Classification of the One-Member Limited Liability Company*, TAX NOTES TODAY, June 28, 1993, available in LEXIS, Taxana Library, TNT File, 93 TNT 140-53.

²⁹³ Treas. Reg. § 301.7701-2(a)(2) (as amended in 1993). In distinguishing a trust from either a corporation or a partnership, a trust lacks either associates or an objective to carry on a business and divide the gains thereof. *Id.*

²⁹⁴ *Id.* § 301.7701-2(a)(3). Entities that are formally incorporated under state law are per se taxed as corporations and are not subjected to the classification process. *See* Kleinsasser v. United States, 707 F.2d 1024, 1027 (9th Cir. 1983) ("A corporation cannot be a partnership for federal income tax purposes.") (citations omitted); Gen. Couns. Mem. 37,127 (May 18, 1977), as modified by Gen. Couns. Mem. 37,953 (May 14, 1979). In Private Letter Ruling 79-18-056 (Jan. 30, 1979), the Service reviewed the classification of a closely held corporation under the *Kintner* analysis. However, the Service reconsidered that ruling, *id.* 79-21-084 (Feb. 27, 1979), stating:

characteristics, then it will be classified as a partnership. Under this formulation, no characteristic is given greater weight than any other characteristic in the classification process.²⁹⁵ An appreciation of the classification regime in general, and the place of the LLC in that regime, must begin with an understanding of the history against which the Service drafted the *Kintner* regulations.

B. *The History of the Kintner Regulations*

Until relatively recently, professionals were forbidden, by state statute and professional rules, from incorporating. However, throughout the 1940s and 1950s, in order to use tax-favored employee benefit plans which were available only to corporations, professionals sought to create structures which, while not corporations for state law purposes, would be viewed as corporations for purposes of tax classification.²⁹⁶ The Service, seeking to treat these structures as partnerships, unsuccessfully fought a series of court battles which culminated in *United States v. Kintner*.²⁹⁷ In *Kintner*, a group of physicians, barred by state law from incorporating, formed an unincorporated association through which to practice medicine. In order to be classified as an association taxable as a corporation and to thereby take advantage of tax-favored pension plans, the association had centralized management, the ability to hold property in its own name, and continuity of life.²⁹⁸ The Service sought to classify the association as a partnership but was unsuccessful at both the trial and appellate levels. Unwilling to accept its loss, the Service refused to acquiesce.²⁹⁹

An entity that is "incorporated" as that term was used at common law cannot be a partnership within the meanings of sections 761(a) and 7701(a)(2) of the Code. An incorporated entity must be a corporation within the meaning of section 7701(a)(3) of the Code irrespective of whether it meets the standards set forth in section 301.7701-2 of the regulations for classifications as an association taxable as a corporation.

The inconsistency in looking at state law characteristics to determine whether an unincorporated structure should be treated as a corporation, while relying upon a label of incorporation rather than analyzing the presence or absence of those same state law characteristics, has been often criticized. See, e.g., RIBSTEIN & KEATING, *supra* note 97, at 455-56.

²⁹⁵ *Larson v. Commissioner*, 66 T.C. 159, 185 (1976), *acq.*, 1979-2 C.B. 1.

²⁹⁶ "The urge to incorporate personal service enterprises generally reflected the desire to take advantage of Code provisions that granted more generous deductions or other tax allowances for corporate employee benefit plans than for similar plans created by self-employed individuals." BITTKER & EUSTICE, *supra* note 292, ¶ 2.06, at 2-28.

²⁹⁷ 216 F.2d 418 (9th Cir. 1954).

²⁹⁸ 107 F. Supp. 976, 979 (D. Mont. 1952); see *supra* note 129 and accompanying text (discussing the characteristic of a business holding property in its own name).

²⁹⁹ Rev. Rul. 56-23, 1956-1 C.B. 598, *made obsolete by* Rev. Rul. 72-92, 1972-1 C.B.

A year later, without acquiescing in *Kintner*, the Service stated that so-called *Kintner* associations would be classified under the "usual tests," and that a subsequent revenue ruling would further explain the "usual tests."³⁰⁰ The promised revenue ruling was never issued; rather, the *Kintner* regulations were proposed.³⁰¹

This historical background suggests why the *Kintner* regulations demonstrate a clear bias in favor of partnership classification.³⁰² This bias arose from the policy decision by the Service to limit the availability of classification as an association taxable as a corporation by requiring a preponderance of the corporate characteristics in order to be so classified. Because limited liability could be attained only through a state organization statute,³⁰³ partnership classification could be avoided only if the association had continuity of life, free transferability of interests, and centralized management. In short, the *Kintner* regulations presume, in effect, that an organization is a partnership; the organization can prove, of course, that it is properly classified as an association taxable as a corporation by demonstrating the presence of the relevant characteristics. As this presumption was borne of its milieu, in a different era the presumption could have been reversed.

Professionals seeking to be recognized as corporations responded by persuading state legislatures to authorize professional service corporations.³⁰⁴ Unwilling to accept the treatment of professional practices as corporations, the Service amended the original 1960 regulations by adding a provision applicable only to professional service businesses, the effect of which was to make it virtually impossible for such entities to be classified as corporations.³⁰⁵ That

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³⁰⁰ *Id.* 57-546, 1957-2 C.B. 886.

³⁰¹ T.D. 6503, 1960-2 C.B. 409.

³⁰² As observed by Judge Dawson in *Larson v. Commissioner*, 66 T.C. 159, 187 (1976) (Dawson, J., concurring), "I think the current regulations were drafted with an objective of *limiting* the ability of a partnership or other entity to qualify as a corporation for tax purposes. In fact, it might even be said that the [*Kintner*] regulations are weighed *against* qualification for corporate status."

³⁰³ See *infra* notes 326-30 and accompanying text.

³⁰⁴ MCKEE ET AL., *supra* note 282, ¶ 3.06[1], at 3-50.

³⁰⁵ T.D. 6797, 1965-1 C.B. 553. This provision effectively eviscerated Revenue Ruling 57-546, 1957-2 C.B. 886. See also Rev. Proc. 65-27, 1965-2 C.B. 1017 (setting forth procedures to be followed by Service in applying the professional service organization amendments).

amendment was repeatedly held to be invalid,³⁰⁶ and it was withdrawn in 1977.³⁰⁷

Later in 1977, the Service issued proposed regulations that would have substantially altered the *Kintner* regulations by rejecting the preponderance test and determining that an entity would be classified as an association "when it resembles a corporation with respect to two or more of the four characteristics."³⁰⁸ This proposal was withdrawn after only one day.³⁰⁹ It was into this environment that the LLC was first introduced.

³⁰⁶ *Kurzner v. United States*, 413 F.2d 97, 111 (5th Cir. 1969); *O'Neill v. United States*, 410 F.2d 888, 895 (6th Cir. 1969), *aff'g* 281 F. Supp. 359 (N.D. Ohio 1968); *United States v. Empey*, 406 F.2d 157, 170 (10th Cir. 1969), *aff'g* 272 F. Supp. 851 (D. Co. 1967); *Smith v. United States*, 301 F. Supp. 1016, 1020 (S.D. Fla. 1969); *Cochran v. United States*, 299 F. Supp. 1113, 1115 (D. Ariz. 1969); *Wallace v. United States*, 294 F. Supp. 1225, 1230 (E.D. Ark. 1968); *Holder v. United States*, 289 F. Supp. 160, 165 (N.D. Ga. 1968), *aff'd per curiam*, 412 F.2d 1189 (5th Cir. 1969). As the court observed in *Kurzner*:

In 1965 the IRS responded to the new [PSC] statutes with amendments to the *Kintner* Regulations which, rather incredibly, isolate professional groups and state in no uncertain terms that they cannot be corporations for federal tax purposes. Since the adoption of the 1965 amendments, the IRS has attempted in a number of cases to enforce the new rules. The judicial response has been unanimous: the courts have invalidated the amended regulations as being arbitrary and discriminatory legislation by an administrative agency which is only authorized to interpret congressional acts.

413 F.2d at 106.

³⁰⁷ T.D. 7515, 1977-2 C.B. 482. In 1969, the Service had announced that the rules applicable to professional corporations would be modified. Tech. Info. Rel. 1019, 7 STAND. FED. TAX REP. (CCH) ¶ 6867 (1969). See also Rev. Rul. 70-101, 1970-1 C.B. 278, *amplified* by Rev. Rul. 70-455, 1970-2 C.B. 297, *amplified* by Rev. Rul. 72-468, 1972-2 C.B. 647, *modified* by Rev. Rul. 73-596, 1973-2 C.B. 424, *amplified* by Rev. Rul. 74-439, 1974-2 C.B. 405 (listing organizational statutes for professional practices which would be classified as corporations).

Eventually, the tax laws were revised to provide for substantially equal treatment of retirement plans maintained by corporations and non-corporate businesses. With that development, the primary tax impetus for the incorporation of professional practices vanished. Thereafter, the primary benefit of incorporating professional practices has been the limited liability provisions of the PSC statutes. CALLISON, *supra* note 7, § 2.09.

³⁰⁸ Prop. Treas. Reg. § 301.7701-2(a)(1), 42 Fed. Reg. 1038 (1977).

³⁰⁹ 42 Fed. Reg. 1489 (1977). The withdrawal of the proposed regulations was filed with the Federal Register at 11:15 a.m. on January 6, 1977. This short-lived proposal was said to be based on a decade of study. See DAILY TAX REP. (BNA) No. 3, at G-5 (Jan. 5, 1977). Under the corporate resemblance test, an organization possessed of only two of the corporate characteristics could be classified as a corporation depending on the nature of those characteristics; a preponderance of corporate characteristics was not required. The proposed rules indicated that corporate classification would likely result if one of the two corporate characteristics possessed by the organization was limited liability. In the face of overwhelming objection from the oil and gas industry, those concerned with real estate, and the Department of Housing and Urban Development, the regulations were withdrawn. See also Richard Reichler, *Implications of the IRS's Withdrawal of its Proposals to Amend the Kintner Regs.*, 46 J. TAX'N 138 (1977); Richard A. Fisher, *Classification Under Section 7701: The Past, Present, and Prospects for the Future*, 30 TAX LAW. 627 (1977).

C. *The Early LLC and the Classification Challenge*

The first LLC statute was considered, and in turn rejected, by the Alaska legislature in 1975.³¹⁰ At that time, guidance from the Service was sought on the classification of the LLC. However, no binding determination was rendered on the proposed legislation.³¹¹ Two years later, Wyoming adopted the first LLC statute.³¹² Then, in 1980, the development of LLCs was dealt a near-death blow when the Service announced proposed amendments to the *Kintner* regulations that would have classified as a corporation any entity in which no member would be personally liable for debts of the organization.³¹³ Curiously, these

³¹⁰ H.R. 403 (Alaska), 1975 Reg. Sess. The primary reason for support of the Alaska LLC bill was to generate filing fees from LLCs organized to do business in Alaska and elsewhere with the desire that Alaska become the "Delaware of limited liability companies." *Limited Liability Company Act: Hearings on S.B. 354 Before Alaska Senate Judiciary Committee*, 9th Leg., 2d Sess. (1976) [hereinafter Alaska Hearings].

³¹¹ Joseph A. Rodriguez, Comment, *Wyoming Limited Liability Companies: Limited Liability and Taxation Concerns in Other Jurisdictions*, 27 LAND & WATER L. REV. 539, 544 (1992); see also Alaska Hearings, *supra* note 310 ("IRS has written an 'information letter' regarding this bill. They will not issue a revenue ruling because the bill is in proposed form only. The letter states that they will use the same four tests when looking at such companies, indicating that there will be tax benefits in forming one.").

³¹² WYO. STAT. § 17-15-101 to -136 (1989) (effective Mar. 4, 1977). The proponents of the Wyoming LLC bill were those who had been unsuccessful in Alaska. See Thomas E. Geu, *Understanding the Limited Liability Company: A Basic Comparative Primer*, (Pt. 1), 37 S.D. L. REV. 44, 48 (1992).

³¹³ Prop. Treas. Reg. § 301.7701-2(a), 45 Fed. Reg. 75,709 (1980). The proposed regulations failed to note that refusing partnership classification solely on the basis of limited liability had been rejected by the Board of Tax Appeals in *Glensder Textile Co. v. Commissioner*, 46 B.T.A. 176 (1942). This principle, however, is consistent with certain early classification efforts. See, e.g., Treas. Reg. 33 art. 62 (rev. 1918) (classifying a limited partnership, defined as a "partnership having one or more special partners who may share in the profits of the firm but whose liability for the debts of the company is limited to the amount of capital invested by such special partner or partners," as a corporation).

Arguably, the case may be made that limited liability is the proper touchstone for distinguishing partnerships from associations taxable as corporations because, unlike centralized management, free transferability of interest and continuity of life, this characteristic cannot arise solely as a product of the agreement of the investors but rather must arise by virtue of a state's statutory authorization. UPA § 15 (providing that personal liability of partners for partnership liabilities is not subject to contrary agreement among the partners); see also Tech. Adv. Mem. 79-51-006 (Aug. 21, 1979) ("It is not possible to obtain limited liability by agreement among the parties; it must be bestowed on the organization by the State."); Larry E. Ribstein, *Limited Liability and Theories of the Corporation*, 50 MD. L. REV. 80, 90 (1991) ("Of all the principal 'corporate' features, only limited liability is not explicitly made available by agreement to partnerships.").

proposed regulations were published only one day before the release of a private letter ruling stating that a Wyoming LLC would be classified as a partnership.³¹⁴ Despite the cloud of uncertainty raised by the proposed amendments to the *Kintner* rules,³¹⁵ Florida passed the second LLC statute in 1982.³¹⁶ After several announced postponements of the effective date of the amended regulations,³¹⁷ the Service bowed to negative comments³¹⁸ and withdrew the proposed changes in 1983.³¹⁹

Of course, such a suggestion begs the question of whether the tax classification of a structure should be based upon the absence or presence of state law organizational characteristics which otherwise lack a relationship to taxation. As has been stated,

The fundamental flaw of the classification system is that it attempts to base a mandatory federal classification on an essentially contractual state-law system. Under state law, the parties can draft freely for "partnership" and "corporate" features regardless of what standard form they select. Accordingly, there is no state-law justification for basing tax consequences on the parties' choice of label or terms. The question is whether there [sic] some independent federal tax related basis for attaching these consequences to particular labels or terms.

Ribstein, *supra* note 97, at 451.

³¹⁴ Priv. Ltr. Rul. 81-06-082 (Nov. 18, 1980).

³¹⁵ Indicating further uncertainty within the Service on the classification of LLCs, General Counsel Memorandum 38,281 (Feb. 15, 1980), prepared in response to a request to clarify the basis upon which the Service could classify an LLC as an association taxable as a corporation, discusses a draft revenue ruling that would have classified a Wyoming LLC as a partnership. That memorandum reviewed whether an LLC could be classified as an association taxable as a corporation on the grounds that it bore the "other factor" of being afforded entity treatment, as evidenced by its ability to own property and to sue and be sued in its own name. "Wyoming law treats a limited liability company exclusively as an entity separate from its owners. We believe that such entity treatment is a corporate characteristic that can be considered significant within the meaning of Treas. Reg. § 301.7701-2(a)(1)." The memorandum concluded, however, that partnership classification is proper.

³¹⁶ FLA. STAT. ch. 608.401-471 (1993) (effective Apr. 21, 1982). This uncertainty not only impacted the adoption of additional LLC statutes but also apparently dissuaded the use of the statutes in place. As of February 22, 1988, only 26 LLCs in Wyoming and 63 LLCs in Florida had been formed. See Ernest A. Seemann, *The Florida Limited Liability Company: An Update*, 14 NOVA L. REV. 901, 903 (1990).

³¹⁷ Announc. 82-140, 1982-45 I.R.B. 30; Announc. 82-60, 1982-17 I.R.B. 23; Announc. 81-166, 1981-43 I.R.B. 21.

³¹⁸ See, e.g., *Proposed Regulations on "Limited Liability Companies" Are Criticized As Contrary to Congressional Intent and Detrimental To Overseas Investment*, 15 TAX NOTES 187 (1982).

³¹⁹ Announc. 83-4, 1983-2 I.R.B. 31 (1983). Additional amendments to the *Kintner* regulations were made in 1983. See T.D. 7889, 1983-1 C.B. 362; 48 Fed. Reg. 18,804 (1983). The 1983 amendments related to the classification of limited partnerships, the power of limited partners to remove a general partner, and the limitations on the liability of a general partner.

At the same time, the Service began a study of the criteria applied in the classification of non-corporate entities.³²⁰ The further adoption of LLC statutes languished until the Service issued Revenue Ruling 88-76,³²¹ which classified a Wyoming LLC as a partnership for federal income tax purposes. With the federal tax classification somewhat clarified, other states moved to adopt LLC statutes.³²² After a delay of several years in publishing further binding pronouncements on the classification of LLCs, beginning in early 1993 the Service issued a series of additional revenue rulings addressing LLCs formed pursuant to the Virginia, Colorado, Nevada, Delaware, Illinois, West Virginia, Florida, Rhode Island, Utah, Oklahoma, Arizona, Louisiana, Alabama, Kansas, and New Jersey statutes.³²³ The Service has also issued numerous private letter rulings

³²⁰ Announc. 83-4, 1983-2 I.R.B. 31 (1983). This study focused on the Service's acquiescence in *Larson v. Commissioner*, 66 T.C. 159 (1976), *acq.*, 1979-2 C.B. 1, in which it was held that each of the four corporate characteristics will be given equal weight in distinguishing partnerships from associations taxed as corporations. *See supra* notes 277-95 and accompanying text. The Service also announced it would not issue further private letter rulings on the classification of LLCs until the completion of the study. Rev. Proc. 83-15, 1983-1 C.B. 676, *superseded by* Rev. Proc. 83-22, 1984-1 C.B. 449; and Rev. Proc. 85-22, 1985-1 C.B. 550, *superseded by* Rev. Proc. 86-3, 1986-1 C.B. 416, *superseded by* Rev. Proc. 87-3, 1987-1 C.B. 523, *superseded by* Rev. Proc. 88-3, 1988-1 C.B. 579, *modified by* Rev. Proc. 88-44, 1988-2 C.B. 634. Prior to the withdrawal of the proposed regulations, the Service released Private Letter Ruling 83-04-138 (Oct. 29, 1982), classifying an LLC as a corporation because it possessed limited liability, centralized management, and continuity of life.

³²¹ 1988-2 C.B. 360, Announc. 88-118, 1988-38 I.R.B. 26, released with Revenue Ruling 88-76, announced, albeit cryptically, the results of the study discussed in Announcement 83-4, including the continued acquiescence in *Larson*, as well as the Service's intention to review its procedures for the granting of advance rulings to entities seeking partnership classification and the possible application of minimum net worth standards to certain entities classified as partnerships. This study led to the promulgation of Revenue Procedure 89-12, 1989-1 C.B. 798, discussed *infra* notes 395-405 and accompanying text. *See infra* notes 395-405 and accompanying text (discussing recent indications of congressional interest in revisiting the classification system and the classification of LLCs).

³²² *See supra* note 2.

³²³ Rev. Rul. 93-5, 1993-1 C.B. 227 (Virginia); *id.* 93-6, 1993-1 C.B. 229 (Colorado); *id.* 93-30, 1993-1 C.B. 231 (Nevada); *id.* 93-38, 1993-1 C.B. 233 (Delaware); *id.* 93-49, 1993-2 C.B. 308 (Illinois); *id.* 93-50, 1993-2 C.B. 310 (West Virginia); *id.* 93-53, 1993-2 C.B. 312 (Florida); *id.* 93-81, 1993-2 C.B. 314 (Rhode Island); *id.* 93-91, 1993-2 C.B. 316 (Utah); *id.* 93-92, 1993-2 C.B. 318 (Oklahoma); *id.* 93-93, 1993-2 C.B. 321 (Arizona); *id.* 94-5, 1994-2 I.R.B. 21 (Louisiana); *id.* 94-6, 1994-3 I.R.B. 11 (Alabama); *id.* 94-30, 1994-19 I.R.B. 6 (Kansas); *id.* 94-51, 1994-32 I.R.B. 11 (New Jersey).

indicating whether or not a particular LLC qualifies for partnership classification.³²⁴

This history should not suggest, however, that the chapter is closed on LLC classification. Rather, Congress has indicated an interest in reviewing this issue and possibly addressing it through legislation. On February 2, 1993, the Subcommittee on Select Revenue Measures of the Ways & Means Committee of the United States House of Representatives announced that it would schedule a hearing to "review the revenue impact of [the] LLC, and [its] effect on the two-tier corporate tax structure and the adequacies of the current classification analysis."³²⁵

³²⁴ See, e.g., Priv. Ltr. Rul. 94-33-008 (May 6, 1994); *id.* 94-07-030 (Nov. 24, 1993); *id.* 94-04-021 (Nov. 1, 1993); *id.* 93-50-013 (Sept. 15, 1993); *id.* 93-35-063 (June 11, 1993); *id.* 93-35-062 (June 11, 1993); *id.* 93-35-032 (June 4, 1993); *id.* 93-33-032 (May 24, 1993); *id.* 93-31-010 (May 5, 1993); *id.* 93-25-048 (Mar. 30, 1993); *id.* 93-25-039 (Mar. 26, 1993); *id.* 93-21-070 (Mar. 3, 1993); *id.* 93-21-047 (Feb. 25, 1993); *id.* 93-20-045 (Feb. 24, 1993); *id.* 93-20-019 (Feb. 18, 1993); *id.* 93-18-011 (Feb. 3, 1993); *id.* 93-13-009 (Dec. 17, 1992); *id.* 92-10-019 (Dec. 6, 1992); *id.* 93-08-039 (Dec. 2, 1992); *id.* 93-08-027 (Nov. 27, 1992); *id.* 92-42-025 (July 22, 1992); *id.* 92-27-033 (Apr. 8, 1992); *id.* 92-26-035 (Mar. 26, 1992); *id.* 92-18-078 (Jan. 31, 1992); *id.* 91-47-017 (Aug. 12, 1991); *id.* 91-19-029 (Feb. 7, 1991); *id.* 91-19-029 (Feb. 7, 1991); *id.* 90-52-039 (Oct. 2, 1990); *id.* 90-30-013 (Apr. 25, 1990); *id.* 90-29-019 (Apr. 19, 1990); *id.* 90-10-027 (Dec. 7, 1989); *id.* 89-37-010 (June 16, 1989); *id.* 83-04-138 (Oct. 29, 1982). Private Letter Rulings 83-04-138 and 94-33-008 (May 6, 1994) are the only private letter rulings issued to date in which an LLC did not receive partnership classification. Of course, private letter rulings are without precedential authority and may not be relied upon by parties other than those to whom they are addressed. I.R.C. § 6110(j)(3).

³²⁵ *Ways and Means Select Revenues Subcommittee Report on Referred Tax Issues*, TAX NOTES TODAY, Feb. 3, 1993, available in LEXIS, Taxana Library, TNT File, 93 TNT 25-22. The full text of the announcement, as it relates to LLCs, reads:

PURPOSE

The hearing would focus on so-called "limited liability companies," which have been utilized as an alternative to doing business as a partnership. These companies represent a relatively new and unique business structure, and concerns have been raised that one purpose of the entity is to avoid the corporate income tax while providing economic benefits of doing business as an entity. Because of the unique structure of limited liability companies, a review of current law and possible modifications would be considered as part of the hearing.

ISSUE

Limited liability companies have evolved within the past five to six years as a new form of doing business. These companies originate from state law, with each state statute that allows for the creation of such entities being slightly different. The structure of these entities generally resembles a hybrid between a partnership and a corporation, incorporating certain aspects of a partnership such as pass-through treatment for tax purposes, flexibility regarding [the]

D. *The Continuing Classification Challenge*

The grudging acceptance by the Service of LLCs as pass-through entities has not fully resolved the classification issue. Rather, the focus

number of, and who can be, owners, and the use of the entity's debt to increase the basis of the owner's interest. At the same time, limited liability companies retain unique characteristics of a corporation such as continuity of life of the entity, operation of the day-to-day business like a corporation, and absence of personal liability of owners.

Because of the structure of these companies, there has been growing concern that the test currently used to determine whether an entity is a corporation or a partnership, for tax purposes, is inadequate. At the very heart of the dispute are Treasury regulations that were issued in the 1960s for purposes totally unrelated to testing limited liability companies but which are used for such purpose. The regulations, which were drafted to discourage the use of the corporate form as a means of abusing the pension rules, generally establish[ed] a four-factor-test that favors the finding of a partnership entity. When this test is applied to limited liability companies, the result, for tax purposes, may not accurately reflect the true nature of the entity.

Limited liability companies appear to be structured to take advantage of the tax benefits of a particular "business form" without the corresponding burdens or limitations. Although the growth of these entities is relatively new, if left unchecked, there is some concern that these companies could be a sanctioned way to undercut the two-tier system of corporate taxation.

Those hearings were never scheduled. Telephone interview by Thomas Rutledge with Gloria Bryant, House Ways and Means Committee, Sept. 30, 1994; see Barbara Kirchheimer, *Revenue Constraints and Lack of Momentum May Hinder S Corp Reform*, *Danforth Aide Says*, TAX NOTES TODAY, Dec. 22, 1993, available in LEXIS, Taxana Library, TNT File, 93 TNT 259-2.

Another source has indicated that Congress is interested in regulating LLCs.

On a related note, Weinberger [tax counsel to Senator Danforth] said it is time for Congress to "wake up and at least look at the issue of limited liability companies. While the IRS has basically deemed these entities worthy of being subjected to only a single level of tax, Congress has legislated rules at the federal level requiring corporations to meet all the requirements of subchapter S. 'You have the Treasury Department, the IRS, going with limited liability companies as the model of integration,' Weinberger said. These companies, however, have no congressional oversights. He suggested Congress at least hold hearings and look into whether these companies cause a revenue drain, and are bad policy, or whether LLCs should replace S corporations."

LLC's Status May Be Subject to Congressional Scrutiny, 1 J. OF LIMITED LIABILITY COMPANIES 47 (1994); *Congress May Examine IRS' Position on LLCs in Future*; *Subchapter S Bill Gains Speed*, DAILY TAX REP. (BNA) No. 72, at G-7 (Apr. 15, 1994); *Tax Aide Discusses LLCs, S Corporations, and Health Care*, TAX NOTES TODAY, Apr. 15, 1994, available in LEXIS, Taxana Library, TNT File, 94 TNT 73-5; *Surge In Limited Liability Co. Laws Seen Driving Move to Corporate Integration*, DAILY TAX REP. (BNA) No. 58, at G-2 (May 26, 1993).

has shifted from whether such classification is possible to how each of the four *Kintner* characteristics will be analyzed and applied to LLCs and how partnership classification may be achieved in a particular instance. These issues are addressed below.

1. *Limited Liability*

The grant of limited liability to the members and managers of an LLC constitutes the core provision of any LLC statute.³²⁶ Limited liability exists in an organization "if under local law there is no member who is personally liable for the debts of or claims against the organization."³²⁷ As contrasted with limited liability, unlimited liability exists if a creditor may seek recovery from an organization's members if the assets of the organization are insufficient to satisfy that creditor's claim.³²⁸ However, contractual agreements purporting to limit recourse to the entity's assets or insurance coverage do not provide limited liability.³²⁹

In the context of any LLC, but especially PLLCs, the personal liability of an individual for his or her own acts and omissions, which exists independently of the entity's liability under respondeat superior and similar doctrines, does not mean that the entity lacks the characteristic of limited liability. The personal liability of the party whose actions or inactions gave rise to the claim is separate and distinct from the liability of the entity to the injured party.³³⁰

³²⁶ See *supra* notes 73-78 and accompanying text.

³²⁷ Treas. Reg. § 301.7701-2(d)(1) (as amended in 1993).

³²⁸ *Id.*

³²⁹ Tech. Adv. Mem. 79-51-006 (Aug. 21, 1979). According to this document:

It is not possible to obtain limited liability by agreement among the parties; it must be bestowed on the organization by the State. The amount of assets committed to an undertaking, the fact that those dealing with the organization agree to look to specific property or the existence of liability insurance are not considerations in a determination regarding the existence of limited liability since it is limited liability under local law that is necessary in order to find the corporate characteristic of limited liability.

³³⁰ *Treasury's Jackel Says LLC Guidance Is Forthcoming*, TAX NOTES TODAY (1993), available in LEXIS, Taxana Library, TNT File, 93 TNT 234-6 [hereinafter *Jackel Guidance*] ("Jackel also expects the government to issue a separate statement regarding professional LLCs that professional malpractice exposure of a member will not cause the entity to lack the corporate characteristic of limited liability."); see also Rev. Rul. 93-91, 1993-2 C.B. 316 (stating that personal liability of professional for his or her own performance does not abrogate presence of limited liability); *id.* 93-93, 1993-2 C.B. 321 (explaining that personal liability of professional for his or her own performance or for

Limited liability is the centerpiece of any LLC statute. Thus, in the context of classification questions, no dispute over the presence of this characteristic has arisen.

2. *Free Transferability of Interests*

Free transferability of interests exists if a member, without the consent of the other members, may transfer to a non-member all of the attributes of ownership of an interest in the entity.³³¹ Free transferability may be avoided by permitting the unrestricted transfer of all prospective *economic* rights, namely the right to receive distributions of profits and distributions upon liquidation, while restricting transfers of the right to participate in management without the requisite consent.³³² Moreover, the regulations provide that, even if a member may transfer his entire interest, free transferability will be lacking if, under local law, the transfer of a member's interest causes the termination of the old entity and the birth of a new entity.³³³

those under his or her supervision or direction does not abrogate presence of limited liability); *id.* 94-30, 1994-19 I.R.B. 6 (stating that personal liability of professional for his or her own performance does not abrogate presence of limited liability).

³³¹ Treas. Reg. § 301.7701-2(e)(1) (as amended in 1993).

³³² Under the regulations proposed in 1977, *see supra* notes 308-09 and accompanying text, free transferability of interests would have been present even where only the prospective economic rights of membership could have been transferred without the consent of the other members. "An interest is considered transferable despite the inability of the holder to substitute another person as a member of the organization if the primary attributes of the interest, such as the rights to share in the profits and to a return of a contribution of capital, are assignable rights." Prop. Treas. Reg. § 301.7701-2(g)(2), 45 Fed. Reg. 75,709 (1980).

While the regulations provide that free transferability will be lacking if the transferor is unable, without the requisite consent of the other members, to transfer the full right to become a member, for tax purposes the Service may deem the partial transferee, lacking only the non-economic rights of membership, to be a full member. *See, e.g., Nichols v. Commissioner*, 32 T.C. 1322, 1330-31 (1959) (explaining that while partnership between physician husband and non-physician wife was illegal for state law purposes, partnership would be recognized for tax purposes); Rev. Rul. 77-332, 1977-2 C.B. 483 (finding that non-CPAs who, for state law purposes, could not be "partners" in accounting firm, and who were designated "principals," were partners for tax purposes.); *id.* 77-137, 1977-1 C.B. 178; Priv. Ltr. Rul. 84-34-047 (May 21, 1984); Gen. Couns. Mem. 36,960 (Dec. 20, 1976).

³³³ Treas. Reg. § 301.7701-2(e)(1) (as amended in 1993) ("Furthermore, although the agreement provides for the transfer of a member's interest, there is no power of substitution and no free transferability of interest if under local law a transfer of a member's interest results in the dissolution of the old organization and the formation of

a. *The "Separate Interest" Test*

The separate interest test examines the degree to which the members of an entity are independent of one another, the independence being deemed to contribute to the contingent nature of a vote on transferability. Where there are insufficient competing interests or where one person may determine the outcome of the vote, separate interests will be lacking and free transferability will be present.

In Revenue Ruling 77-214,³³⁴ the Service considered the classification of a *GmbH*³³⁵ formed by two subsidiaries of a corporate parent. The Service found that as one entity controlled the vote on transferability³³⁶ and continuity,³³⁷ the *GmbH* should be classified as a corporation.³³⁸ The

a new organization." Under this provision, as a transferee is automatically admitted as a full member, because the mutual agency between the transferor/member and the non-transferring members has been altered, the partnership has been dissolved, and a new entity has been created in its place.

³³⁴ 1977-1 C.B. 408, *modified by* Rev. Rul. 93-4, 1993-1 C.B. 225. Revenue Ruling 93-4 is discussed *infra* notes 358-59 and accompanying text. Non-U.S. as well as U.S.-organized entities are classified under the same rules and procedures. *Id.* 73-254, 1973-1 C.B. 613; *id.* 88-8, 1988-1 C.B. 403; Gen. Coms. Mem. 36,910 (Nov. 4, 1976). Therefore, classification guidance on foreign business structures may be applied to domestic entities. However, the *per se* rule on classification of domestic corporations, *supra* note 294, is not applied to foreign organized entities.

³³⁵ "*Gesellschaft mit beschränkter Haftung*" ("*GmbH*"), a German juridical person that is formed by two or more persons, for a specified commercial purpose, by a memorandum of association and that provides limited liability for its owners. Rev. Rul. 77-214, 1977-1 C.B. 408.

³³⁶ "[S]ince two wholly-owned domestic subsidiaries owned 100 percent of the quotas of the [*GmbH*], it is apparent that the controlling parent could make all the transfer decisions . . ." *Id.*

³³⁷ "[B]ecause control of a *GmbH* is exercised by a single corporate entity that has the power to dissolve or continue the *GmbH* in accordance with its own business objective, *GmbH* will possess . . . continuity of life." *Id.*; see *infra* notes 358-59 and accompanying text (discussing the Service's determination that the separate interest test would not be applied to continuity of life).

³³⁸ Rev. Rul. 77-214; see also *MCA Inc. v. United States*, 502 F. Supp. 838, 844-47 (C.D. Cal. 1980) (applying the separate interests test to various foreign organizations controlled by U.S. corporation and its affiliates), *rev'd on other grounds*, 685 F.2d. 1099 (9th Cir. 1982); Priv. Ltr. Rul. 78-41-008 (June 20, 1978) (classifying Italian *societa a responsabilita limitata* wholly owned by U.S. corporation and two of its wholly-owned subsidiaries as an association); *id.* 79-36-050 (June 8, 1979) (classifying Chilean *sociedad de responsabilidad limitada* wholly owned by U.S. corporation and its wholly-owned subsidiary as an association); *id.* 80-34-094 (May 29, 1980) (classifying a German *GmbH* limited commercial partnership as an association taxable as a corporation); *id.* 84-01-001 (June 16, 1983) (classifying Brazilian *sociedade for quotas responsabilidade limitada*

Service has been inconsistent in its application of the "separate interest" test to LLCs.³³⁹

b. Restricting the Right to Deny Consent

Care must be taken in structuring the transferability provisions of an LLC operating agreement to ensure that a right to refuse consent to a transfer is not restricted to such a degree that the Service may find that free transferability exists in fact. The *Larson* court found free transferability where, although the consent of the general partner was required, the agreement provided that the consent to a transfer could not unreasonably be withheld.³⁴⁰

c. Who Approves a Transfer

If the unanimous consent of the non-transferring members is required to approve the transfer of an interest to a third party, free transferability of interests will be lacking.³⁴¹ It also has been held repeatedly that free transferability of interests will be lacking if the right to approve the transfer of an interest to a third party may be made by a majority of the non-transferring members.³⁴²

wholly owned by two wholly owned U.S. subsidiaries of a U.S. corporation as an association); Gen. Couns. Mem. 36,910 (Nov. 4, 1976) (applying the separate interest test to *sociedad de responsabilidad limitada* wholly owned by quotaholder and its subsidiary and classifying it as an association). *Contra* Priv. Ltr. Rul. 82-43-193 (July 29, 1982) (classifying partnership organized under German law in which U.S. corporation and its subsidiary were partners as a partnership). However, the same classification rules should be applied to domestic and foreign structures. *See* Rev. Rul. 73-254, 1973-1 C.B. 613; *id.* 88-8, 1988-1 C.B. 403.

³³⁹ In Private Letter Ruling 94-04-021 (Nov. 1, 1993), the Service held, albeit without analysis, that an LLC would lack free transferability of interest where its sole members were two corporations, one the wholly owned subsidiary of the other. While conforming to Private Letter Ruling 82-43-193 (July 29, 1982), *supra* note 338, this determination conflicts with Revenue Ruling 77-214.

³⁴⁰ *Larson v. Commissioner*, 66 T.C. 159, 183 (1976). This is not to suggest, however, that the right to disapprove may be used in an oppressive manner. *See, e.g., Rafe v. Hindin*, 288 N.Y.S.2d 662, 664 (N.Y. App. Div.) (declaring invalid a stock restriction agreement which required that, in order to effectuate any sale to a third party, (a) the stock must first be offered to the other shareholder and (b) any transferee must be approved by the other shareholder, who could unreasonably withhold consent to the transfer of stock to a third party), *aff'd mem.*, 244 N.E.2d 469 (N.Y. 1968).

³⁴¹ *See, e.g., Treas. Reg. § 301.7701-2(g)* (as amended in 1993), *Ex. (2), (3)*; Rev. Rul. 88-76, 1988-2 C.B. 360.

³⁴² *See, e.g., Rev. Rul. 94-30, 1994-19 I.R.B. 6.*

Another means of lessening the burden of addressing transfers of interests is to vest in a body of managers the power to review and pass upon transfers. Such restrictions have been found sufficient to prevent a finding of free transferability in the context of other business structures³⁴³ and in the context of the LLC.³⁴⁴ However, care must be taken to ensure that only members have the consent authority.³⁴⁵ Another alternative is to allow transfers to be approved by less than the unanimous consent of all members.³⁴⁶

d. Rights of First Refusal

A right of first refusal that permits either the entity or the other members to purchase an interest that has been offered to a third party is defined in the *Kintner* regulations and the examples thereto as “a modified form of free transferability.” However, this modification, in and

³⁴³ See, e.g., Rev. Rul. 88-79, 1988-2 C.B. 361 (finding no continuity of life where transfers of interests in a Missouri business trust were subject to approval by majority by number of trust managers); Gen. Couns. Mem. 36,411 (Sept. 11, 1985) (discussing approval of management company and majority of owners, without clarifying if majority is by number or by interests, of venture of undetermined classification).

³⁴⁴ Priv. Ltr. Rul. 93-25-039 (Mar. 26, 1993) (requiring unanimous consent of executive committee before interests could be made subject to voluntary or involuntary transfer) (revoked pending reconsideration of unstated issues); *id.* 93-33-032 (May 24, 1993) (requiring unanimous consent of executive committee before interests could be made subject to voluntary or involuntary transfer); *id.* 92-18-078 (Jan. 31, 1992) (requiring consent of member-manager or two-thirds of membership interests to approve a transfer); *id.* 92-10-019 (Dec. 6, 1991) (requiring consent of manager or, if manager not a member, a majority in interest of the members to approve a transfer).

³⁴⁵ Treas. Reg. § 301.7701-2(e)(1) (as amended in 1993).

³⁴⁶ Priv. Ltr. Rul. 93-50-013 (Sept. 15, 1993) (requiring consent of majority interest of members to approve a transfer); *id.* 92-19-022 (Feb. 6, 1992) (requiring consent of majority interest to approve a transfer); *id.* 92-18-078 (Jan. 31, 1992) (finding approval of member-manager or two thirds of membership interests required to transfer); *id.* 92-10-019 (Dec. 6, 1991) (requiring consent of manager, or, if manager not a member, a majority in interest of the members to approve a transfer). In Private Letter Ruling 93-08-027 (Nov. 27, 1992) the Service found no free transferability of interests where the LLC interests were divided into two classes, with the unanimous consent of the members of the other class being required to approve a transfer. See also *id.* 79-03-084 (Oct. 20, 1978) (requiring majority of participants, without clarifying if majority is by number or by interests, in a non-profit co-ownership/leasing arrangement to consent); *id.* 78-12-058 (Dec. 22, 1977) (requiring approval of 75% of capital interest of Saudi Arabia limited liability partnership); Gen. Couns. Mem. 34,407 (Jan. 22, 1971) (requiring consent of majority by number and by interest of limited partnership association).

of itself, is not a sufficient limitation on transferability to avoid a finding of free transferability.³⁴⁷

e. Transfers Pursuant to State Law

Transfers pursuant to state law receive differing treatments depending upon the facts surrounding the transfer. For example, transfers pursuant to the laws of descent and distribution are permitted without giving rise to free transferability.³⁴⁸ However, a transfer pursuant to a merger or consolidation of a member may give rise to free transferability.³⁴⁹

f. What Interests Must Be Restricted

Not every member's interest need be subject to transferability restrictions to avoid free transferability. In Revenue Procedure 92-33,³⁵⁰ the Service took the position that, for advance ruling purposes, free

³⁴⁷ Treas. Reg. §§ 301.7701-2(e)(2), -2(g), *Ex.* (4), (5), (6); *see also* Priv. Ltr. Rul. 88-28-022 (Apr. 13, 1988) (finding that right of first refusal in other owners in foreign limited liability company constituted a modified form of free transferability); *id.* 87-52-087 (Oct. 1, 1987) (finding that right of first refusal in other owners in foreign limited liability company constituted a modified form of free transferability); Tech. Adv. Mem. 85-10-001 (Sept. 28, 1984) (finding that right of first refusal in other beneficiaries of trust constituted a modified form of free transferability); Gen. Couns. Mem. 37,758 (Aug. 31, 1978) (finding that right of first refusal in condominium association to purchase condominium unit constituted a modified form of free transferability); Rev. Rul. 71-277, 1971-1 C.B. 422 (classifying partnership association as an association taxable as a corporation when continuity of life, centralized management, and a modified form of free transferability were present); Gen. Couns. Mem. 34,449 (Mar. 8, 1971) (finding a modified form of free transferability with respect to interest in a professional association where the transfer of an interest to the third-party professional required an offer of first refusal to the professional association, the right of second refusal to the remaining associates, and an offering price of fair market value of the interest as determined at the last annual meeting prior to the date of offer); *id.* 34,078 (Mar. 20, 1969) (finding a modified form of free transferability where right of first refusal was possessed by other members of organization before transfer to third party).

³⁴⁸ *See, e.g.*, Priv. Ltr. Rul. 92-53-013 (Sept. 30, 1992).

³⁴⁹ Gen. Couns. Mem. 38,012 (July 13, 1979) (finding a modified form of free transferability from the ability of one corporate member of a business trust to substitute another corporate member by merging the former into the latter or consolidating the former with the latter). However, in Private Letter Ruling 91-14-009 (Jan. 3, 1991), the Service stated that, while one corporate limited partner could fully substitute a third party for itself through use of a business combination, doing so would require divesting itself of certain assets. The Service concluded that free transferability was not present because "it is unlikely that a limited partner would use this exception as a means to avoid the general unanimous consent requirement."

³⁵⁰ 1992-1 C.B. 782.

transferability is absent if at least twenty percent of the interests are subject to restrictions.³⁵¹ To date, the Service has not responded to an effort by an LLC to use this provision.

3. *Continuity of Life*

For purposes of tax classification, continuity of life is lacking if the structure is subject to dissolution upon a "change in the relationship between its members as determined under local law."³⁵² An alteration in the relationship of the members may come about as a consequence of the "death, insanity, bankruptcy, retirement, resignation, or expulsion of any member."³⁵³ This restriction is typically met by providing that the LLC will dissolve upon any of the events listed in the *Kintner* regulations.³⁵⁴ However, lack of continuity of life does not mandate the dissolution of an entity or require or imply that the organization must cease to carry on its business activities. Rather, a vote, within a specified time after the dissolution event, of the members to continue the LLC will reconstitute the LLC and permit it to carry on its business.

a. *Maximum Duration*

Several LLC statutes provide for a maximum duration, often thirty years from formation, or require that an LLC otherwise have a determinable

³⁵¹ In so doing, Revenue Procedure 92-33 interprets the phrase "or those members owning substantially all of the interests in the organization" of Treasury Regulation § 301.7701-2(e)(1) (as amended in 1993).

³⁵² Treas. Reg. § 301.7701-2(b)(3); *see also* *Larson v. Commissioner*, 66 T.C. 159, 175 (1976). Proposed Treasury Regulation § 301.7701-2(d) (*published* 42 Fed. Reg. 1038 (Jan. 5, 1977), *withdrawn* 42 Fed. Reg. 1489 (Jan. 7, 1977)), would have revised the continuity of life test to provide that continuity existed if the parties holding a majority of the interests had the power to continue the business notwithstanding an alteration of the relationship of the members.

³⁵³ Treas. Reg. § 301.7701-2(b)(1). Conversely, continuity of life is present if an alteration of the relationship of the owners does not alter the ability of the agents of the entity to bind the entity and, if applicable, the other owners. As stated in *Larson*:

The significant difference between a corporation and a partnership as regards continuity of life, then, is that a partner can always opt out of continued participation in and exposure to the risks of the enterprise. A corporate shareholder's investment is locked in unless liquidation is voted or he can find a purchaser to buy him out.

66 T.C. at 173.

³⁵⁴ Another situation in which continuity of life may be lacking is where, without triggering the termination or dissolution of the entity, an investor may at will withdraw his or her investment. *E.g.*, *Estate of Smith v. Commissioner*, 313 F.2d 724, 735-36 (8th Cir. 1963).

life.³⁵⁵ These statutes appear to have included this provision as a fail-safe to ensure the lack of continuity of life. However, such a provision is not necessary and in fact does not contribute to the argument that continuity of life does not exist. The *Kintner* regulations address the continued membership of those in the organization and do not address the length of time the jurisdiction of organization will permit the entity to exist.³⁵⁶ Simply put, an organization which will have a limited life, but whose life may not be shortened by a dissolution brought about by a member, will have continuity of life.³⁵⁷

b. The "Separate Interest" Test

With the adoption of Revenue Ruling 93-4,³⁵⁸ the separate interest test ceased to be applied to the characteristic of continuity of life. By implication,

³⁵⁵ A Kentucky LLC may, but is not required to, have a definite date of dissolution. KY. REV. STAT. ANN. § 275.025(1)(f). LLC statutes have addressed the question of duration in a variety of manners. Several require the articles of organization to set forth the duration, which may not exceed 30 years. Others require the articles of incorporation to set forth the period of duration or to set forth the latest date on which the LLC is to dissolve, but in neither instance setting a statutory maximum duration. Certain other states, like Kentucky, allow an LLC to have a definite date of dissolution, but without requiring such or having a statutorily determined maximum duration. *See, e.g.*, ALA. CODE § 10-12-10a(2) (1994) (period of duration); ARIZ. REV. STAT. ANN. § 29-632(A)(4) (1993) (latest date on which LLC is to dissolve); ARK. CODE ANN. § 4-32-202(c) (Michie 1993) (latest date on which LLC is to dissolve); COLO. REV. STAT. § 7-80-204(b) (1993) (not to exceed 30 years); 1993 Conn. Acts. 267 (Reg. Sess.) (latest date on which LLC is to dissolve); DEL. CODE ANN. tit. 6, § 18-201(a)(3) (1993) (latest date of dissolution, if any); FLA. STAT. ch. 608.407(1)(b) (1993) (period of duration); IDAHO CODE § 53-608(3) (1994) (latest date on which LLC is to dissolve).

³⁵⁶ Treas. Reg. § 301.7701-2(b)(1).

³⁵⁷ *Id.* § 301.7701-2(b)(3).

[I]f the agreement provides that the organization is to continue for a stated period or until the completion of a stated transaction, the organization has continuity of life if the effect of the agreement is that no member has the power to dissolve the organization in contravention of the agreement.

Id.; *see also id.* § 301.7701-2(g), Ex. (5); Rev. Rul. 71-434, 1971-2 C.B. 430 (finding that a limited partnership association with durational limit of 20 years but which could not be earlier dissolved by act of less than a majority in number and interest of the members had continuity of life.); Gen. Couns. Mem. 36,910 (Nov. 4, 1976) (finding that *societa a responsabilita limitata* possessed continuity of life where existence limited to a term of years).

³⁵⁸ 1993-1 C.B. 225. This ruling modified and superseded Revenue Ruling 77-214 to provide that the separate interest test would be applied only with respect to free transferability, and it would not be an issue in reviewing questions of continuity of life. According to the ruling:

It subsequently has been determined that the presence or absence of separate interests is not relevant to the determination of whether an entity possesses continuity of life. Because the memorandum of association of the GmbH requires dissolution upon the bankruptcy of either "quota holder" without further action, the GmbH lacks continuity of life.

Id.

this ruling adopted the policy that continuity of life is purely a question of a disturbance of the identity of the members.³⁵⁹

c. Continuation Vote Requirements

If the unanimous consent of the non-disassociating members is required to approve the continuation of the LLC, then continuity of life will be lacking.³⁶⁰ It also has repeatedly been held that continuity of life will be lacking if the right to approve the continuation of the LLC after an event of disassociation may be made by a majority in interests of the non-disassociating members to which the contingency of a vote to continue is not relevant.³⁶¹

Despite the abandonment of the separate interest test as applied to the presence of continuity of life, the Service continues not only to look at whether the identity of the members of the organization has been disturbed or altered, but also to review and assess the contingencies surrounding any subsequent continuation vote. As set forth in Revenue Procedure 83-50, the Service will not issue an advance ruling on whether a limited partnership lacks continuity of life where, upon the removal of the sole general partner, a majority in interests of the limited partners is not required to elect a new general partner to continue the partnership.³⁶²

³⁵⁹ Treas. Reg. § 301.7701-2(b)(3).

³⁶⁰ See, e.g., *id.* § 301.7701-2(b)(1) (as amended in 1993); Rev. Rul. 88-76, 1988-2 C.B. 360; *id.* 94-5, 1994-2 I.R.B. 21; Priv. Ltr. Rul. 93-35-062 (June 11, 1993).

³⁶¹ See, e.g., Rev. Rul. 93-91, 1993-2 C.B. 316; *id.* 93-93, 1993-2 C.B. 321; Priv. Ltr. Rul. 93-50-013. Curiously, the Utah LLC Act has been amended subsequent to the issuance of Revenue Ruling 93-91, and now contains a default provision requiring unanimous consent of the non-disassociating members in order to continue an LLC after an event of disassociation.

Revenue Ruling 94-46, 1994-28 I.R.B. 129 set forth a safe harbor for determining the "majority in interests" necessary to meet the test for avoiding continuity of life. Under the safe harbor, a majority in interests to continue after an event of disassociation will be made up of the "remaining partners owning a majority of the profits interests and a majority of the capital interests owned by all the remaining partners." *Id.* The ruling goes on to define how profits and capital are to be measured. *Id.*

³⁶² 1983-2 C.B. 555, *superseded by* Rev. Proc. 84-22, 1984-1 C.B. 449, *superseded by* Rev. Proc. 85-22, 1985-1 C.B. 550, *superseded by* Rev. Proc. 86-3, 1986-1 C.B. 416, *superseded by* Rev. Proc. 87-3, 1987-1 C.B. 523, *superseded by* Rev. Proc. 88-3, 1988-1, C.B. 579, *superseded by* Rev. Proc. 89-3, 1989-1 C.B. 761, *modified by* Rev. Proc. 89-5, 1989-1 C.B. 774, *modified by* 89-12, 1989-1 C.B. 798, *amplified by* Rev. Proc. 91-13, 1991-1 C.B. 477, *supplemented by* Rev. Proc. 92-33, 1992-1 C.B. 782, *modified by* Rev. Proc. 92-87, 1992-2 C.B. 496, *superseded by* Rev. Proc. 93-3A, 1993-1 C.B. 381.

Under the regulations proposed in 1977, *see supra* notes 352-53 and accompanying text, continuity of life would be present if a mere majority of interests in the organization

Analytically, it is not entirely clear whether a vote of even a majority (by interests) of the members to continue the business after a dissolution event is necessary in order to avoid continuity of life. In a number of revenue procedures, the Service has stated that, following the removal of a general partner, a continuation vote requiring less than a majority in interests of the limited partners would bar an advance ruling on continuity of life.³⁶³ This limitation, however, applies solely to requests for an advance determination, and it is not controlling on a classification audit. In the context of an LLC, the Service has not issued a determinative pronouncement that continuation of the enterprise on a vote of less than a majority in interests gives rise to continuity of life.³⁶⁴

It has been suggested that a private letter ruling³⁶⁵ was revoked because, as issued, it held that an LLC lacked continuity of life where a vote to continue required the "written acceptance of two-thirds in number" of the remaining members.³⁶⁶ That commentator suggests that

could vote to continue the enterprise after an event of disassociation. *See* Prop. Treas. Reg. § 301.7701-2(d)(2)(i).

³⁶³ Rev. Proc. 92-35, 1992-1 C.B. 790; *id.* 89-12, § 4.05, 1989-1 C.B. 798; *id.* 85-22, § 3.01.41, 1985-1 C.B. 550; *id.* 84-22, § 3.01.45, 1984-1 C.B. 449; *id.* 83-50, 1983-2 C.B. 555, *supra* note 362. Section 41 of Revenue Procedure 85-22 provided that no ruling or determination will be made as to:

[w]hether an organization, formed in a state that has a statute corresponding to the Uniform Limited Partnership Act or the Revised Uniform Limited Partnership Act, lacks the corporate characteristic of continuity of life where, in the case of the removal of a general partner, the partnership agreement allows less than a majority in interest of limited partners to elect a new one to continue the partnership.

This language was repeated from Revenue Procedure 83-50, 1983-2 C.B. 555, and Revenue Procedure 84-22, 1984-1 C.B. 449.

³⁶⁴ The 1993 amendments to Treasury Regulation § 301.7701-2(b)(1), which in part provides that continuity of life may be avoided where the partnership may be continued by a vote of a majority in interests of the remaining partners, does not constitute such a determinative pronouncement. The Service refused suggestions that the amendment "be clarified to state that the regulations apply to any unincorporated organization, not simply to limited partnerships," and "that a reference be made to limited liability companies." T.D. 8475, 1993-23 I.R.B. 11. Therefore, the case may be made that "limited partnership," at least in Treasury Regulation § 301.7701-2(b)(1), should not be read as the equivalent of "unincorporated entity seeking classification as a partnership."

³⁶⁵ Priv. Ltr. Rul. 93-25-039 (Mar. 26, 1993).

³⁶⁶ *Majority in Interest, and Not Majority in Number, Must Vote to Continue Partnership Business Under New Continuity of Life Regulation*, Tax Mgmt. (BNA) No. 34, at 241, 242 (1993), which explains:

Tax Management understands that the ruling was revoked because of the statement of the facts contained in the ruling request that approval to continue the LLC's business by all the remaining members was deemed to occur upon the approval of two-thirds in number of the remaining members. Tax Manage-

the revocation was precipitated by the failure of the LLC in question to require a majority in interests to continue after dissolution,³⁶⁷ as required by the 1993 amendments to the continuity of life regulations.³⁶⁸ This inconsistency in applying the "majority in interests" requirement to LLCs seeking to avoid continuity of life has also appeared in informal comments of the Service to LLC drafting efforts.³⁶⁹

d. Limiting Events of Disassociation

In order to avoid continuity of life, it is not necessary for the entity to undergo dissolution upon the occurrence of any and all of the events of disassociation listed in the *Kintner* regulations.³⁷⁰ Rather, an entity may limit the possible disruptive effects of a dissolution, and the consequent need for a vote on continuing the business, by making itself subject to dissolution only upon the occurrence of one of the events of disassociation listed in the *Kintner* regulations.³⁷¹ This approach has been used by an LLC which received an advance classification ruling holding that continuity of life did not exist.³⁷²

Yet another possibility for restricting events of disassociation would be to limit dissolution events to those affecting members holding a certain

ment further understands that the IRS will insist that approval to continue the business of a dissolved LLC or partnership be obtained by at least a majority in interest of the remaining members or partners in order for the entity to lack the corporate characteristic of continuity of life.

³⁶⁷ *Id.*

³⁶⁸ T.D. 8475, 1993-23 I.R.B. 11.

³⁶⁹ In a letter from Paul E. Kugler, Assistant Chief Counsel, Passthroughs & Special Industries, Internal Revenue Service, to Edward I. Cutler, Esq., Chair of the ULLCA Drafting Committee of NCCUSL (July 26, 1993) (copy on file with authors) [hereinafter Kugler/Cutler Letter] setting forth "the preliminary and informal views of this office," Kugler wrote:

The Uniform Act contains two provisions; however, that cause us concern. First, section 101(11) of the Uniform Act defines majority in interest as a majority of the members determined on a per capita basis. The continuity of life regulation, which permits a limited partnership to lack continuity of life notwithstanding that a majority in interest of the remaining partners of the partnership may agree to continue the partnership after a dissolution event, do not define the term "majority in interest." Existing authority interpreting those regulations; however, weighs against a per capita definition and focuses on the members' interests in the LLC's capital, profits and losses. Thus, the Uniform Act does not follow the rule contained in the regulations.

³⁷⁰ See *supra* note 363 and accompanying text.

³⁷¹ *MCA Inc. v. United States*, 502 F. Supp. 838, 842 (C.D. Cal. 1980) ("[I]f any one of these factors *does* cause dissolution of the organization then 'continuity of life' is *not* present.") (emphasis added).

³⁷² Priv. Ltr. Rul. 92-10-019 (Dec. 6, 1991) (finding no continuity of life when dissolution was restricted to bankruptcy of corporate member/manager and unanimous vote of members was required to continue LLC after that dissolution event).

percentage interest in the LLC³⁷³ or those holding managerial positions.³⁷⁴

e. Business Continuation Agreements

Yet another mechanism for limiting the potential disruption of disassociation and the contingent nature of a continuity vote is to contractually limit members' freedom to reject continuation and thereby bind the members to approve continuation of the entity. Under such an agreement, the members bind themselves, in the event of a disassociation, to vote to continue the LLC. By its terms, breach of the agreement exposes the dissenting member to contract damages, but the agreement cannot be enforced by specific performance. The *Kintner* regulations draw a distinction between the power to reject continuation and the contractual obligation to vote in favor of continuation, with only the former being necessary in order to avoid continuity of life.³⁷⁵ Therefore, if a member's breach of obligation to vote to continue the LLC may be remedied only by an award of damages, the member has not given up the power to reject continuation of the LLC. Under this rationale, despite the agreement of a member to vote to continue the LLC after dissolution, the power of the member to breach that agreement and thereby bring about a failed vote to continue, and thus, the dissolution of the LLC is sufficient to avoid continuity of life.³⁷⁶

However, the viability of this reasoning may be questioned should the Service analogize a continuity vote to a vote on the transfer of an interest

³⁷³ See *id.* 78-12-058 (Dec. 20, 1977) (finding that limited liability partnership formed pursuant to Saudi Arabian law lacked continuity of life when dissolution was limited to insolvency, dissolution, or bankruptcy of partner with at least a 50% ownership interest).

³⁷⁴ Rev. Rul. 88-79, 1988-2 C.B. 361 (finding no continuity of life in a purported trust where disassociation of a manager, but not of a passive investor, would trigger dissolution); Priv. Ltr. Rul. 92-10-019, *supra* note 372.

³⁷⁵ Treas. Reg. § 301.7701-2(b)(3) (as amended in 1993).

³⁷⁶ *Zuckman v. United States*, 524 F.2d 729, 735 (Ct. Cl. 1975) (finding no continuity of life even though the general partners of a limited partnership, as a condition of certain financing arrangements, contracted to continue the limited partnership); *Foster v. Commissioner*, 80 T.C. 34, 187-88 (1983), *aff'd in part and vacated in part on other grounds*, 756 F.2d 1430 (9th Cir. 1985), *cert. denied*, 474 U.S. 1055 (1986). The court stated:

Although a partner who wrongfully dissolves a partnership may be answerable in damages and may forfeit his right to wind up the partnership's affairs, . . . the fact remains that such a partner has the power to dissolve the partnership. And it is the power, not the right, to dissolve which is the touchstone of the regulation.

Id. at 187-88.

However, if the agreement to vote in favor of continuation may be enforced by means of an injunction compelling specific performance against a dissenting member, thereby raising the specter of an injunction depriving a member of the ability to vote against continuation, the LLC would likely be deemed to have continuity of life.

and cite as authority its earlier pronouncements that free transferability of interests may exist where the right to object to a transfer was restricted.³⁷⁷ This result would be especially likely if the failure to vote to continue the LLC subjected the member to more than nominal damages. Informally, the Service has expressed reservations as to whether an LLC with a business continuation agreement can lack continuity of life.³⁷⁸

4. Centralized Management

Centralized management³⁷⁹ exists where any group which is not co-extensive with the membership has the continuing and exclusive authority

³⁷⁷ *Larson v. Commissioner*, 66 T.C. 159, 183 (1976); *see supra* note 302 and accompanying text.

³⁷⁸ Kugler/Cutler Letter, *supra* note 369, explained:

Second, sections 101(2) and 406(c) of the Uniform Act allow members to enter into "Business Succession Agreements," a mechanism where members elect to bind themselves to continue the LLC in a successor organization if the original LLC dissolves. Under section 701(c) of the Uniform Act, members who breach Business Succession Agreements are subject to damages that are offset against the member's buyout price. Although the Business Succession Agreement is designed to continue the LLC in a successor organization only when the original LLC has dissolved, these agreements would nevertheless create uncertainty on the continuity of life issue. Arguably, a pre-agreement to continue the LLC as a successor organization, coupled with the threat of damages, would substantively undermine a member's right to vote against continuing the original LLC upon a dissolution event. Therefore, our current belief is that LLCs with Business Succession Agreements may not be able to establish that they lack continuity of life.

³⁷⁹ Nearly all statutes adopted to date provide that management of the LLC rests initially in the members, a form typically associated with general partnerships. These statutes go on to provide that the members may elect managers and vest in them the right to manage the LLC. *See, e.g.*, ALA. CODE § 10-12-2-2(h) (Supp. 1993); ARIZ. REV. STAT. ANN. § 29-681(A) (Supp. 1993); ARK. CODE ANN. § 4-32-401(a) (Michie Supp. 1993); 1993 Conn. Acts. 267 (Reg. Sess.); DEL. CODE ANN. tit. 6, § 18-402 (1993); KY. REV. STAT. ANN. § 275.135(1). One exception, Colorado, requires that management be vested in elected managers, who must be natural persons. *See* COLO. REV. STAT. ANN. § 7-80-401(1) (West Supp. 1993). Other exceptions are Minnesota, MINN. STAT. § 322B.606 (effective Jan. 1, 1993), Oklahoma, OKLA. STAT. ANN. tit. 18, §§ 2013, 2015 (West Supp. 1994) and Texas, TEX. REV. CIV. STAT. ANN. art. 1528n, § 2.12 (West Supp. 1994), which reverse the typical regime by vesting management in elected managers but allowing the articles of organization to transfer management to the members. Most clearly departing from the majority rule, Colorado mandates that management authority be vested in managers, without providing the option of reserving management authority to the members. COL. REV. STAT. ANN. § 7-80-401(1). The Minnesota statute, while permitting management authority to be reserved to the members, mandates that each LLC have one or more managers, who must be natural persons, "exercising the functions of the offices, however designated, of chief manager and treasurer." MINN. STAT. § 322B.67.

to make management decisions necessary to conduct the business of the organization.³⁸⁰ Conversely, where all members of an entity, as is the case in a general partnership, act as agents of the business,³⁸¹ centralized management is lacking.³⁸²

In the context of limited partnerships, the case law surrounding the centralized management question has drawn distinctions between entities in which the general partner holds a "substantial" interest versus ones in which it holds a lesser interest. Where the general partner's interest is substantial, the entity lacks centralized management. Conversely, where that interest is less than substantial, the entity possesses centralized management. This distinction, based upon the degree of proprietary interest of the general partner, finds its roots in the case of *Glensder Textile Co. v. Commissioner*.³⁸³ The *Glensder* court held that where the general partners owned forty-two percent of the interest in the limited partnership, no centralized management existed because the general partners "were acting in their own interest . . . and not merely in a representative capacity for a body of persons having a limited investment in a limited liability."³⁸⁴ The "representative" focus was continued in *Zuckman v. United States*,³⁸⁵ wherein the court noted that the question is not so much the "centralized" nature of the management but rather whether such management is merely "representative."³⁸⁶

The representative test was also applied in *Richlands Medical Center v. Commissioner*,³⁸⁷ wherein the shareholders in a Virginia partnership association, each of whom was elected a manager, were unsuccessful in arguing that centralized management did not exist on the grounds that

³⁸⁰ Treas. Reg. § 301.7701-2(c)(1) (as amended in 1993). The regulations go on to analogize those vested with management authority to the directors of a statutory corporation. See also *id.* § 301.7701-2(g), Ex. (7) (applying "ministerial officer" statement in regulations).

³⁸¹ *E.g.*, KY. REV. STAT. ANN. § 362.190(1) (Michie/Bobbs-Merrill Supp. 1994).

³⁸² Treas. Reg. § 301.7701-2(c)(4).

³⁸³ 46 B.T.A. 176 (1942), *acq.*, 1942-1 C.B. 8.

³⁸⁴ *Id.* at 185.

³⁸⁵ 524 F.2d 729, 738 (Ct. Cl. 1975).

³⁸⁶ The representative analysis leads to the somewhat counter-intuitive rule that where the non-managing members have the power to remove those with managerial authority, centralized management is present, while it is not present if there is no power to remove the managers. T.D. 7889, 1983-1 C.B. 362.

Of course, the conclusion that a general partner holding a substantial interest in the limited partnership will act in its own interest as well as those of the limited partners ignores the moderating influence of the general partner's fiduciary duties to the limited partners.

³⁸⁷ 60 T.C.M. (CCH) 1572 (1990), *aff'd mem.*, 953 F.2d 639 (4th Cir. 1992).

there was complete uniformity between the ownership and the management structures. The finding of centralized management was supported because the shareholders held their power to manage not due to their position as shareholders, but rather because they had been elected as managers.³⁸⁸

In the context of LLCs, centralized management has received the least analysis of the characteristics which may or may not be present, and it has been nearly ignored in the revenue rulings issued to date. With only two exceptions, the revenue rulings have examined LLCs having a total of twenty-five members, three of whom have been elected managers. Without any discussion of the interests held by the three managers/members or a discussion of what constitutes centralized management, the revenue rulings have concluded that centralized management exists. Further, very few of the private letter rulings have addressed this issue.³⁸⁹

Two clear statements may be made with respect to centralized management. First, where management is reserved to the members in proportion to their interest, centralized management is lacking.³⁹⁰ At the

³⁸⁸ This conclusion is consistent with that in General Counsel Memorandum 34,407 (Jan. 22, 1971), which provides in part:

Thus, even though all the associates . . . happen to be members of the management group at a particular time, this does not preclude . . . centralized management inasmuch as the authority to make management decisions is not vested in the entire membership of the organization as such. Rather, under local law and the organization's operating agreement, the continuing exclusive authority to make management decisions necessary for the conduct of the business is vested in a clearly defined group of . . . managers which need not include all or any of the associates.

See also id. 37,013 (Feb. 25, 1977) ("Thus every GmbH like the one under consideration also possesses the corporate characteristic of centralization of management.").

While not addressed in the analysis published to date, there is some question as to whether continuity of life can ever be absent in an LLC which had been structured with centralized management. In such an LLC, there is no agency between the LLC and its members; that is, members solely by reason of being members, do not have the ability to bind the LLC. Therefore, there is no mutual agency between the members to be altered by reason of the "death, insanity, bankruptcy, retirement, resignation, or expulsion of any member." *See supra* note 353 and accompanying text. There being no mutual agency to be altered, it could be concluded that, where centralized management is present, continuity of life must also be present.

³⁸⁹ *See infra* notes 395-405 and accompanying text (discussing the difficulties arising from the Service's classification scheme as applied to centralized management in LLCs).

³⁹⁰ *See, e.g.*, Rev. Rul. 93-38, 1993-21 I.R.B. 4 (reviewing a fact situation in which management authority was reserved to the members in proportion to their interests and

other end of the spectrum, centralized management exists where the management authority is reserved to managers who are themselves not members of the LLC.³⁹¹ Between these two extremes, the bounds of centralized management are not clear.

Complicating the analysis of centralized management in LLCs is Revenue Ruling 93-6.³⁹² Therein, the Service reviewed an LLC in which each of the five members was an elected manager. The ruling concluded that centralized management existed because, despite the fact that the management and ownership groups were co-extensive, management authority would be exercised in the capacity as a manager, and not in the capacity as a member.³⁹³ However, the broad applicability of Revenue Ruling 93-6 is questionable because the Colorado statute involved mandated bifurcation of ownership and management. Thus, this ruling may be a unique response to a unique question, and any extrapolation of its analysis of centralized management to non-Colorado LLCs may be unwarranted. Furthermore, Revenue Ruling 93-6 may itself contain a solution to this quagmire. If the significance of the finding of centralized management in Revenue Rule 93-6 is that the five managers/members exercise their managerial authority solely due to their managerial election and not as a consequence of their equity position, what conclusion would be reached in an LLC that not only requires every member to be a manager, but also wherein managerial authority in

finding that centralized management was lacking); Priv. Ltr. Rul. 90-10-027 (Dec. 7, 1989) (finding no centralized management where managerial authority was reserved to members in proportion to their interest); *id.* 93-20-045 (Feb. 24, 1993) (finding no centralized management where managerial authority was reserved to members in proportion to their interest); *id.* 93-18-011 (Feb. 3, 1993) (finding no centralized management where managerial authority was reserved to members in proportion to their interest); *id.* 93-20-019 (Feb. 18, 1993) (finding no centralized management where managerial authority was reserved to members in proportion to their interest); *id.* 93-21-070 (Mar. 31, 1993) (finding no centralized management where managerial authority was reserved to members in proportion to their interest); *id.* 93-25-048 (Mar. 30, 1993) (finding no centralized management where managerial authority was reserved to members in proportion to their interest); *id.* 93-35-032 (June 4, 1993) (finding no centralized management where managerial authority was reserved to members in proportion to their interest).

³⁹¹ While the question of centralized management was not addressed, the facts in Private Letter Rulings 90-30-013 (Apr. 25, 1990) and 92-27-033 (Apr. 8, 1992), wherein the LLCs in question were managed by non-member managers, would have supported a finding of centralized management.

³⁹² 1993-1 C.B. 229 (reviewing the Colorado LLC statute).

³⁹³ This conclusion is consistent with the conclusions reached in *Richlands Medical Assoc. v. Commissioner*, 60 T.C.M. (CCH) 1572 (1990), *aff'd*, 953 F.2d 639 (4th Cir. 1992) and General Counsel Memorandum 34,407 (Jan. 22, 1971). See *supra* notes 387-88 and accompanying text.

office is a function of ownership? Ownership and authority to bind the LLC would be unified, and that unity would be a result of the LLC's structure and not an election by the owners. Under these circumstances, it may be argued that the LLC lacks centralized management.³⁹⁴

5. *Seeking Partnership Classification and Revenue Procedure 89-12*

One of the chief challenges facing particular LLCs seeking a private letter ruling on classification has been Revenue Procedure 89-12.³⁹⁵ An unincorporated entity seeking classification as a partnership must comply with this revenue procedure.³⁹⁶ However, Revenue Procedure 89-12 was drafted primarily to address the classification of general and limited partnerships, and it contains only minimal direction on its application to other structures.³⁹⁷ Thus, compliance by LLCs with Revenue Procedure 89-12 has been difficult to achieve. In fact, the Service has itself been inconsistent in requiring LLCs that have received a classification ruling to comply with the mandates of Revenue Procedure 89-12.³⁹⁸

³⁹⁴ *Richlands Medical Assoc.*, 60 T.C.M. (CCH) at 1574 ("Finally, there is no requirement in petitioner's governing instruments that petitioner's board of directors include all of petitioner's associates."); Gen. Couns. Mem. 34,407 (Jan. 22, 1971); see also Rev. Rul. 71-574, 1971-2 C.B. 432 (finding centralized management where members not required to be directors).

³⁹⁵ 1989-1 C.B. 798.

³⁹⁶ Revenue Procedure 89-12, 1989-1 C.B. 798, § 1.02, which provides in part: "Organizations covered by this revenue procedure include both those formed as partnerships and other organizations seeking partnership classification."

³⁹⁷ While Revenue Procedure 89-12 is drafted in terms of "limited" and "general" partners, it offers de minimis direction on the application of those categories to non-partnership entities. Section 1.02 of Revenue Procedure 89-12 states in part:

In the case of an organization not formed as a partnership, references to "partnership" documents, including the "partnership agreement," apply to the organization's comparable documents, however designated. Any reference to "limited partnership" includes an organization formed as a limited partnership under applicable state law and any other organization formed under a law that limits the liability of any member for the organization's debts and other obligations to a determinable fixed amount. References to "general partners" and "limited partners" apply [sic] also to comparable members of an organization not designated as a partnership under controlling law and documents; the "general partners" of such an organization will ordinarily be those with significant management authority relative to the other members.

³⁹⁸ The following Private Letter Rulings have not mentioned Revenue Procedure 89-12: Priv. Ltr. Rul. 92-10-019 (Dec. 6, 1991), 92-19-022 (Feb. 6, 1992), and 92-42-025 (July 22, 1992). The following Private Letter Rulings have required compliance with Revenue Procedure 89-12: Priv. Ltr. Rul. 89-37-010 (June 16, 1989), 90-10-027 (Dec. 7,

On the issue of complying with Revenue Procedure 89-12, several requirements appear inapplicable. For example, sections 4.01³⁹⁹ and 4.03⁴⁰⁰ relate to allocations to and the capital accounts of the "general partners." However, these requirements are inapplicable to at least those LLCs which have chosen to be managed by a non-member. In unsophisticated LLCs for which the default rule of per capita allocation applies, fluctuations as the number of members increases or decreases make section 4.01 nearly impossible to satisfy.⁴⁰¹

Another ambiguity is the safe harbor from a finding of centralized management found in section 4.06 of Revenue Procedure 89-12.⁴⁰² This provision provides that no centralized management exists where the managers hold at least twenty percent of the interests in the entity. However, no private letter ruling issued to date has referred to section 4.06, and the Service has not issued guidelines on whether this safe harbor is available to LLCs.⁴⁰³

1989), 91-19-029 (Feb. 7, 1991), 91-47-017 (Aug. 12, 1991), and 92-26-035 (Mar. 26, 1992). The following Private Letter Rulings have required compliance with Revenue Procedure 89-12 "to the extent applicable": Priv. Ltr. Rul. 93-08-027 (Nov. 27, 1992), 93-13-009 (Dec. 17, 1992), 93-08-039 (Dec. 2, 1992), 93-18-011 (Feb. 3, 1993), 93-25-039 (Mar. 26, 1993), 93-31-010 (May 5, 1993), and 93-50-013 (Sept. 15, 1993). The following Private Letter Rulings have required compliance with "in particular §§ 4.01 and 4.03" of Revenue Procedure 89-12: Priv. Ltr. Rul. 90-29-019 (Apr. 19, 1990), and 92-18-078 (Jan. 31, 1992). Other Private Letter Rulings have required compliance with Revenue Procedure 89-12, "except § 4": Priv. Ltr. Rul. 90-30-013 (Apr. 25, 1990), 92-27-033 (Apr. 8, 1992), 93-21-047 (Feb. 25, 1993), 93-20-045 (Feb. 24, 1993), 93-20-019 (Feb. 18, 1993), 93-21-070 (Mar. 3, 1993), and 93-25-048 (Mar. 30, 1993).

³⁹⁹ Section 4.01, in part, provides:

[T]he interests . . . of all the general partners, taken together, in each material item of partnership income, gain, loss, deduction, or credit must be equal to at least 1 percent of each such item at all times during the existence of the partnership, and the partnership agreement must expressly so provide.

⁴⁰⁰ Section 4.03, in part, provides that "[u]nless section 4.04 applies, the general partners, taken together, must maintain a minimum capital account balance equal to either 1 percent of total positive capital account balances for the partnership or \$500,000, whichever is less."

⁴⁰¹ While § 4.05 and § 4.06 need not be satisfied in order to receive a classification ruling, no similar exception exists for § 4.01 or § 4.03. Section 4.07 of Revenue Procedure 89-12, dealing with the corporate characteristic of limited liability, does not apply to LLCs. Gen. Couns. Mem. 39,798 n.3 (Oct. 24, 1989).

⁴⁰² Section 4.06 of Revenue Procedure 89-12 provides:

Limited partner interests, excluding those held by general partners, may not exceed 80 percent of the total interests in the partnership, or the Service will not rule that the partnership lacks centralized management. In addition, the Service will consider all the facts and circumstances, including limited partner control of the general partners (whether direct or indirect), in determining whether the partnership lacks centralized management.

⁴⁰³ Note that § 1.02, in describing parties or entities equivalent to general partners for

The Service has recognized the problems involved in requiring LLCs to comply with Revenue Procedure 89-12 and the need for a classification regime tailored to the structure of LLCs, and it is crafting a responsive revenue procedure.⁴⁰⁴ The draft of a revenue procedure has been submitted to the Service.⁴⁰⁵

purposes of Revenue Procedure 89-12, addresses only the "management authority" and does not mention the issue of personal liability of the general partner analogues. Additionally, the *Kintner* regulations do not address personal liability in discussing centralized management. Therefore, neither Revenue Procedure 89-12 nor the *Kintner* regulations seemingly deny application of the § 4.06 safe harbor to LLCs on the ground that LLC managers are not subject to the personal liability of a general partner. Lady E. Booth & Thomas E. Rutledge, *Centralized Management and Revenue Procedure 89-12: The Search for a Consistent Answer*, 94 L.L.C. REP. 209 (1994); see also Letter from American Bar Association Section on Taxation, Committee on Partnerships, to the Honorable Shirley D. Peterson, Commissioner, Internal Revenue Service (Mar. 12, 1992) (available on LEXIS, Fedtax Library, TNT File, 92 TNT 60-42) stating:

Further guidance is needed concerning the extent to which anything less than complete reservation of management to all the members would cause centralized management to exist. For example, the Service has adopted a ruling position for limited partnerships providing that management by persons holding 20 percent or less of the ownership interests is centralized management Consideration might be given to developing a similar position for LLCs, if they are to be analogized to limited partnerships for the purposes of determining centralized management.

The Service is reviewing this issue. See *Jackel Guidance*, *supra* note 330 ("[T]hrough the presence of elected managers points to centralized management, a corporate characteristic, Treasury is studying whether an organization managed by elected members who own 20 percent or more of its interests will lack centralized management").

⁴⁰⁴ The Service's 1993 business plan included the publication of a revenue procedure providing advanced rules and guidelines for LLCs. I.R.S. News Release NB-2142 (Jan. 5, 1993). Susan Pace Hamill of the Service's Office of Pass-Throughs and Special Industries stated that the LLC revenue procedure would hopefully be released late in the first quarter of 1994. Telephone Interview with Susan Pace Hamill, IRS Office of Pass-Throughs and Special Industries (Dec. 27, 1993); see also *Jackel Guidance*, *supra* note 330, stating:

Monte Jackel, an attorney-adviser in Treasury's Office of Tax Legislative Counsel, told participants at a November 12 seminar on limited liability companies that within the next few months the government would issue an LLC counterpart to Rev. Proc. 89-12, 1989-2 C.B. 798, explaining how to get a ruling on partnership tax classification.

IRS Likely To Issue Limited Liability Guidelines Early This Year, Official Says, DAILY TAX REP. (BNA) No. 7, at G-3 (Jan. 11, 1994) ("[T]he revenue procedure was on IRS' 1993 business plan and remained a priority project for the Service. The revenue procedure is likely to be issued in the first or second quarter of this year").

⁴⁰⁵ *Ruling Guidelines for Determining Whether a Limited Liability Company is a Partnership or an Association Taxable as a Corporation* ABA Taxation Section, Limited Liability Task Force (Draft Revenue Procedure 1993), reprinted in MICHAEL A.

6. *Method of Accounting*

One early, and to a certain extent still lingering, cloud over the use of LLCs has been whether such entities will be forced to use the accrual method, rather than the commonly preferred cash method, of accounting. This issue arises due to the question of whether certain LLCs will, for purposes of this analysis, be treated as "tax shelters."

As a general rule, taxpayers are permitted to calculate their taxable income under either the cash or the accrual method.⁴⁰⁶ However, C corporations, partnerships which have a C corporation as a partner, and tax shelters are required to use accrual method accounting.⁴⁰⁷ Professional service corporations structured as C corporations are exempted from the requirements of using accrual method accounting.⁴⁰⁸ A partnership having a C corporation PSC as a partner may treat the C corporation PSC as an individual.⁴⁰⁹ A "tax shelter" is defined⁴¹⁰ to include a "syndicate,"⁴¹¹ which in turn is defined as "any partnership or other entity (other than a corporation which is not an S corporation) if more than 35 percent of the losses of such entity during the taxable year are allocable to limited partners or limited entrepreneurs (within the meaning of section 464(e)(2))."⁴¹² A "limited entrepreneur" is defined as "a person who (A) has an interest in an enterprise other than as a limited partner and (B) does not participate in the management of such enterprise."⁴¹³ Alternately, an entity may be a "tax shelter" if it meets the definition of that term.⁴¹⁴ If LLC members are deemed equivalent to either limited partners or limited entrepreneurs, then these rules would compel accrual method accounting by the LLC. If the LLC is deemed equivalent to a limited partnership lacking a general partner, and, thus, no individual is liable for the debts of the LLC, all of the losses would be allocated to deemed limited partners. Under this analysis, an LLC would

BAMBERGER ET AL., LIMITED LIABILITY COMPANIES AND LIMITED LIABILITY PARTNERSHIPS 92 (1993).

⁴⁰⁶ I.R.C. § 446(c).

⁴⁰⁷ *Id.* § 448(a).

⁴⁰⁸ *Id.* § 448(b)(2).

⁴⁰⁹ *Id.* § 448(a), (b)(2).

⁴¹⁰ *Id.* § 448(d)(3) referring to the definition of a "tax shelter" in *id.* § 461(i)(3).

⁴¹¹ *Id.* § 461(i)(3)(B).

⁴¹² *Id.* § 1256(e)(3)(B).

⁴¹³ *Id.* § 464(e)(2).

⁴¹⁴ *Id.* § 6662(d)(2)(C)(ii) (A tax shelter is a partnership, entity, plan, or arrangement which has as its principal purpose the "avoidance or evasion of Federal income tax.").

be considered a syndicate, and, in turn, a tax shelter required to use accrual method accounting. If the Service were to analyze members under the limited entrepreneur provisions, it would be necessary to review the allocation of losses between the manager and non-member managers. If more than thirty-five percent of the losses are to be allocated to non-manager members, and if these non-manager members are determined to be "limited entrepreneurs," then the LLC could be viewed as a syndicate. Regardless of the method of analysis applied, a determination by the Service that accrual method accounting is necessary would make an LLC a much less attractive vehicle for operating many types of businesses.⁴¹⁵

A number of private letter rulings, all issued to PLLCs, have stated that cash method accounting could continue to be used.⁴¹⁶ However, guidance with respect to generic LLC forms has not been forthcoming. This issue remains particularly troubling with respect to the application of the limited entrepreneur provisions to manager-managed LLCs.

7. *Classification of a Kentucky LLC*

Because of its flexibility, the tax classification of a Kentucky organized LLC is not dictated by the terms of the LLC Act.⁴¹⁷ However, a Kentucky LLC that operates under the default rules should be classified as a partnership.

⁴¹⁵ This issue is especially sensitive to those professional practices which have sought to use the form of the LLC rather than the general partnership or, more recently, the registered limited liability partnership. Cash method accounting is generally preferred by professional practices because of the time lag in collections and the broad unwillingness to charge and collect finance charges on late payments for professional services. Upon conversion from a general partnership utilizing the cash method to an LLC required to use the accrual method, the entity would be forced to accelerate into immediately taxable income all outstanding receivables, thereby giving rise to an immediate tax liability without an automatic receipt of the funds with which to satisfy that liability. The relief from accrual of amounts that experience indicates will not be collected, while helpful, does not address this problem of immediate tax liability on what remains of the outstanding receivables. *Id.* § 448(d)(5) (1993); Treas. Reg. § 1.448-2T (as amended in 1988).

⁴¹⁶ Priv. Ltr. Rul. 94-07-030 (Nov. 24, 1993); *id.* 93-50-013 (Sept. 15, 1993); *id.* 93-21-047 (Feb. 25, 1993); *id.* 93-28-005 (Dec. 21, 1992); *see also* Thomas E. Rutledge & Lady E. Booth, *IRS Clarifies Use of Cash Method Accounting by Professional LLCs While Adding Uncertainty to Centralized Management*, 5 L.L.C. REP. 513 (1993). *See generally* Sheldon I. Banoff, *New IRS Ruling Encourages Professionals to Form Limited Liability Companies*, 79 J. TAX'N 68 (1993); *Use of Cash Method by Limited Liability Company Not Precluded by § 448*, 34 TAX MGMT. MEM. 242 (1993).

⁴¹⁷ *See supra* note 10.

Of course, the LLC Act provides for limited liability.⁴¹⁸ Therefore, a Kentucky LLC must avoid two of the three remaining corporate characteristics in order to achieve partnership status for federal taxation purposes.

Under the default provision, free transferability of interests is avoided because the unanimous consent of the non-transferring members is required in order for a member to transfer the non-economic rights of membership to a non-member.⁴¹⁹ Under the *Kintner* regulations and the revenue rulings applying the regulations to LLCs, free transferability of interests will not be present.⁴²⁰

Under the default provision, continuity of life is avoided because the unanimous consent of the non-disassociating members is required to continue the LLC after a dissolution brought about by the disassociation of a member.⁴²¹ Under the *Kintner* regulations and the revenue rulings applying the regulations to LLCs, continuity of life will not be present.⁴²²

Under the default provision, centralized management is avoided because the management and agency authority is retained by the members.⁴²³ Under the *Kintner* regulations and the one revenue ruling applying the regulations to an LLC in which management was reserved to the entirety of the members, centralized management will not be present.⁴²⁴

8. State Classification

In addition to understanding classification under federal law, an LLC must also address how it will be classified, and therefore taxed, by its state of organization and by those states in which it does business.⁴²⁵

⁴¹⁸ See *supra* notes 73-78 and accompanying text.

⁴¹⁹ See *supra* notes 134-51 and accompanying text.

⁴²⁰ See *supra* notes 331-51 and accompanying text.

⁴²¹ See *supra* notes 157-65 and accompanying text.

⁴²² See *supra* notes 352-78 and accompanying text.

⁴²³ See *supra* notes 85-102 and accompanying text.

⁴²⁴ See *supra* notes 379-94 and accompanying text.

⁴²⁵ A state is not required to conform its tax classification of an entity to the federal classification scheme or to provide the tax benefits afforded by federal law. See, e.g., *Commonwealth v. N.I., Inc.*, 375 A.2d 898 (Pa. Commw. Ct. 1977) (holding non-recognition of federal S corporation status by Pennsylvania not to violate Supremacy Clause), *aff'd mem.*, 393 A.2d 653 (Pa. 1978); *Garlin v. Murphy*, 344 N.Y.S.2d 402, 404 (N.Y. 1973), *aff'd mem.*, 359 N.Y.S.2d 552 (N.Y. 1974) (holding non-recognition of federal S corporation status by New York not to violate the Fourteenth Amendment).

For purposes of state taxation, several states treat LLCs that have met the requirements of partnership classification for federal purposes as partnerships.⁴²⁶ Other states, regardless of the classification for federal tax purposes, tax LLCs as corporations. For example, Florida imposes a corporate income tax on LLCs that are organized or do business in Florida.⁴²⁷ Texas imposes its franchise tax, which is a tax on earned surplus that has the effect of a corporate income tax, on LLCs.⁴²⁸

Arizona, Maryland, Minnesota, and Virginia classify LLCs as partnerships under their state tax laws if the entities in question have been so classified for federal tax purposes.⁴²⁹ By default, Iowa should classify LLCs as partnerships.⁴³⁰

The differing requirements imposed on LLCs may, at least with respect to multi-state entities, dictate the choice of jurisdiction under which the LLC will be organized. In addition to being subject to the taxes imposed by the jurisdiction of organization, LLCs will be subject to at least the possibility of taxation in those jurisdictions in which they do business. Except where protected by Public Law 86-272 and where there is a sufficient nexus to meet the Due Process and Commerce Clause standards, LLCs can expect to be required to file an information return and to possibly pay entity-level taxes in those states where they do

⁴²⁶ E.g., KY. REV. STAT. ANN. § 141.208 (Michie/Bobbs-Merrill 1991); COLO. REV. STAT. § 39-22-201.5 (1991); Letter from G. H. Spriggs, Director of Income Tax Division of Maryland Comptroller of the Treasury, to Stuart Levine (May 21, 1991) (on file with authors); Cal. Franchise Tax Bd. Notice 92-5 (Aug. 21, 1992). Prior to Connecticut's adoption of an LLC act, the Connecticut Department of Revenue Services stated that its treatment of LLCs would conform to that afforded by federal law. Policy Statement 92(12). Alabama, subsequent to its adoption of an LLC Act, stated that it also would treat individual LLCs in conformity with the federal classification. Bruce P. Ely & Chip Browder, *Alabama Revenue Department Elects to Adopt IRS Methodology for Determining LLC Tax Status*, STATE TAX NOTES, Aug. 5, 1993, available in LEXIS, Taxana Library, TNT File, 93 STN 150-1; *Full Text: Alabama DOR Letter of July 14 on LLCs*, STATE TAX NOTES, Aug. 5, 1993, available in LEXIS, Taxana Library, TNT File, 93 STN 150-2.

⁴²⁷ FLA. STAT. ch. 608.471 (1993). House Bill 633, introduced during the 1989 Florida Legislative Session, would have changed this provision to tax domestic and foreign LLCs as partnerships for purposes of Florida state taxation. This bill failed in committee.

⁴²⁸ TEX. TAX CODE ANN. § 171.001(a)-(b) (West 1991). Because of constitutional limitations, neither Florida nor Texas has a personal income tax. FLA. CONST. art. VII, § 5; TEX. CONST. art. VIII, § 1-C. Therefore, were LLCs taxed as pass-through entities, neither of these states would receive tax revenues from LLCs.

⁴²⁹ ARIZ. REV. STAT. ANN. § 29-857 (1993); MD. CODE ANN., TAX-GEN. § 10-104(9) (1993); MINN. STAT. § 290.01 (1993); VA. CODE ANN. § 58.1-301.A (Michie 1994); VA. REGS. REG. § 360-3-302.15.

⁴³⁰ IOWA ADMIN. CODE r. 45.1(422) (Supp. 1994) (requiring an organization to file an Iowa partnership return if it is required to file a federal return on Form 1065).

business or have income. An issue coincident to the state classification question is whether LLCs present a threat to state revenues. This question has been extensively debated but has not been resolved.⁴³¹

III. THE LLC IN A CHOICE-OF-ENTITY ANALYSIS

It is beyond the scope of this Article to present a complete review of the various considerations necessary to a choice-of-entity analysis. The business and personal desires of the investors, combined with state organizational options and federal and state tax concerns, quickly yield a bewildering range of possibilities. That being the case, this part of the Article identifies and discusses various issues which are of relevance in comparing the LLC to other available options.⁴³² In each instance, it is assumed that the LLC has been structured to be classified as a partnership for federal tax purposes and that it is doing business in states and jurisdictions that conform to the federal classification scheme.⁴³³

⁴³¹ See, e.g., Kevin Sack, *New Type of Company Stirs Tax Worry in Albany*, N.Y. TIMES, June 20, 1992, § 1, at 36 ("State lawmakers said this week that efforts to create a new kind of business entity in New York had been seriously wounded by new projections showing that the businesses could mean the state would lose up to \$65 million a year in tax revenue."); CALIFORNIA FRANCHISE TAX BOARD—RESEARCH BUREAU, ASSESSING THE STATE REVENUE IMPLICATIONS OF LIMITED LIABILITY COMPANY LEGISLATION, Mar. 1993 (copy on file with authors); Lee A. Sheppard, *New York Contemplates Cost of Partnership Treatment for Limited Liability Companies*, TAX NOTES TODAY, Dec. 7, 1992, available in LEXIS, Taxana Library, TNT File, 92 TNT 243-10 (as amended by *Correction: New York Limited Liability Companies*, TAX NOTES TODAY, Dec. 8, 1992, available in LEXIS, Taxana Library, TNT File, 92 TNT 244-19); Marilis Carson, *Tax Revenues Will Suffer, But LLCs May Be Here To Stay*, STATE TAX NOTES, Nov. 30, 1992, available in LEXIS, Taxana Library, TNT File, 92 SIN 276-34; F.R. Nagle, *California FTB Members Explain Revenue Consequences of LLC Bill*, TAX NOTES TODAY, Nov. 17, 1993, available in LEXIS, Taxana Library, TNT Files, 93 TNT 235-35. Efforts to loosen the limitations on S corporations and thereby increase their utility and utilization, including increasing the maximum number of shareholders to 50 and permitting non-resident aliens to be shareholders, have been challenged because of the potential revenue loss. Barbara Kirchheimer, *Revenue Constraints and Lack of Momentum May Hinder S Corp Reform, Danforth Aide Says*, TAX NOTES TODAY, Dec. 22, 1993, available in LEXIS, Taxana Library, TNT File, 93 TNT 259-2.

⁴³² Due to their limited applicability, peculiar structures such as the partnership association and the business trust are not considered in this analysis.

⁴³³ This analysis touches upon certain tax issues incident to the use of LLCs which were not addressed in the tax classification discussion set forth in part II. This part is not, however, intended to be a complete exegesis of partnership taxation and its application

*A. Alternative Business Structures**1. The Corporation*

Historically, the corporation has been the favored entity choice for a new business enterprise for the principal reason that it permits investors to provide capital while limiting their potential loss to the capital contributed. The corporate form also offers the advantages of perpetual existence and, absent a contract to the contrary, ownership interests that are freely transferable among shareholders and third parties. Management is indirect, with the shareholders electing a board of directors, which in turn delegates operational control to officers especially suited for management of the particular type of enterprise.

The corporation provides certainty in planning due to a thoroughly developed body of corporate law dating back to the eighteenth century. Sophisticated corporate statutes address the procedural requirements and formalities of maintaining corporate existence while balancing the respective rights and obligations of management and shareholders.⁴³⁴ Indeed, were it not for tax considerations, it is doubtful that the corporate form of doing business would have a significant competitor in the choice-of-entity arena. However, since the adoption of the corporate income tax in 1909,⁴³⁵ the partnership and other entities designed to be taxed on a flow-through basis have become more attractive as a business structure.⁴³⁶

to LLCs.

⁴³⁴ LAWRENCE M. FRIEDMAN, *A HISTORY OF AMERICAN LAW* 446-63 (1973).

⁴³⁵ The corporate income tax has been continuously imposed since the Payne-Aldrich Tariff Act, ch. 6, § 38, 36 Stat. 11, 112-16 (1909), which antedated the adoption of the Sixteenth Amendment by four years. See BORIS I. BITTKER & JAMES S. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* ¶ 1.01 (6th ed. 1994). An earlier corporate income tax was imposed in 1894 but was struck down as unconstitutional in 1895. See *Pollock v. Farmers' Loan and Trust Co.*, 158 U.S. 601 (1895) (deeming it a direct tax and holding it invalid because it was not apportioned according to representation).

⁴³⁶ The use of unincorporated, but corporate-like, entities in an attempt to avoid corporate double-taxation has generally been short-lived because they so closely resembled corporations that the Service and Congress treated them as such for tax purposes. These structures include joint stock companies, which are now included within the definition of a corporation under § 7701(a)(3) of the Code, and the Massachusetts Business Trust, which achieved pass-through tax treatment in the early part of this century, see *Crocker v. Malley*, 249 U.S. 223 (1919), until the Supreme Court reversed itself in 1924 and extended the corporate tax to business trusts in *Hecht v. Malley*, 265

The corporate tax is imposed on the corporate income at the prevailing tax rate.⁴³⁷ The "double tax" results when this income is taxed again as distributed to the shareholders in the form of dividends or upon liquidation.⁴³⁸

The burden of the corporate two-tier tax system has varied through the years,⁴³⁹ depending on the relative corporate and individual tax rates as well as the ability of investors to manipulate the corporation's structure or operations, thereby effectively "integrating" the corporate and individual tax.⁴⁴⁰ The burden of corporate double-taxation reached its

U.S. 144 (1924).

⁴³⁷ I.R.C. § 11. Corporate income is currently taxed at a rate of 34% for taxable income between \$75,000 and \$10,000,000 and 35% for taxable income in excess of \$10,000,000. *Id.* (ignoring temporary rates that apply at certain brackets to eliminate the effect of graduated rates).

⁴³⁸ *Id.* §§ 301, 316. Dividends are taxed to shareholders as "ordinary income." The maximum ordinary income tax rate for individuals is currently 39.6%. *Id.* § 1. If corporate earnings are not distributed to the shareholders as dividends, the individual shareholder will be subject to tax upon liquidation of the corporation or upon the sale or redemption of the shareholder's stock. In either of those events, the shareholder recoups his or her basis in the stock and is taxed on any appreciation in the stock's value at the capital gain rate of 28%, *id.* § 1(h), assuming the stock is a capital asset in the hands of the shareholder under the principles of § 1221 and has been held for at least one year.

⁴³⁹ At one point in history, corporations were deemed more desirable, even from a tax perspective, than partnerships for some types of business. Prior to the enactment of legislation permitting professionals to practice in the corporate form through PSCs, professional groups attempted to form entities that would be treated as corporations rather than partnerships for tax purposes, so that they could take advantage of favorable tax rules governing retirement plans and fringe benefits that were only available to corporations. The *Kintner* regulations were drafted during this era, hence their bias in favor of partnership classification. *See supra* notes 296-309 and accompanying text.

⁴⁴⁰ The elimination of one level of the tax, or "integration," is attempted by PSCs and other businesses wherein personal services are the major income producer. Corporate income may be paid to the shareholders as deductible compensation—so long as it is reasonable in amount—rather than as dividends, which are not deductible by the corporation. Mitigation of double taxation is also attempted through debt capitalization (interest payments to bondholders are deductible to the corporation) and leasing arrangements with shareholders whereby corporate earnings are paid to the shareholders on a deductible basis by the corporation. These techniques, however, may not survive scrutiny by the Service. For example, the payment of compensation is deductible only if it is reasonable in amount; if compensation is deemed unreasonably high, the excess is treated as a nondeductible dividend. *See, e.g.,* *Patton v. Commissioner*, 168 F.2d 28, 31 (6th Cir. 1948); *Curtis v. Commissioner*, 67 T.C.M. (CCH) 1958 (1994). *See also infra* note 481 and accompanying text.

Integration was also achievable when individual income tax rates greatly exceeded the maximum corporate income tax rate. When corporate earnings were retained on a long-term basis or invested in new corporate capital, the lower current rate of corporate

peak with the passage of the Tax Reform Act of 1986, which lowered the highest marginal tax rate for individuals below that for corporations, repealed the *General Utilities* doctrine⁴⁴¹ (thereby imposing a corporate-level tax on all distributions of appreciated property), and narrowed the spread between capital gain and ordinary income rates.⁴⁴² After 1986, businesses began to look more vigorously for alternative vehicles that would permit flow-through taxation.

2. *The S Corporation*

Subchapter S of the Code permits a corporation to elect to have its income passed through to the shareholders in a manner similar to that of a partnership.⁴⁴³ However, the "S corporation,"⁴⁴⁴ as it is commonly known, is constrained by tax and business limitations not applicable to "normal" corporations. The most obvious of these is a restriction of

income taxation could effectively eliminate the economic burden of a second level of taxation on shareholders.

⁴⁴¹ I.R.C. § 311(b). The *General Utilities* doctrine originated in *General Utilities & Operating Co. v. Helvering*, 296 U.S. 200 (1935), and generally stood for the principle that a corporation did not recognize gain or loss upon the distribution of appreciated property to shareholders as a dividend or upon liquidation or redemption of the shareholders' interest. Only the shareholders paid tax on the gain inherent in the appreciated property (reflected by the appreciation in the stock's value). Under § 311(b) of the Code, as modified by the Tax Reform Act of 1986, a corporation must recognize gain on the distribution of appreciated property as if such property were sold to the distributee at its fair market value on the distribution date. Upon distribution, the shareholder is again taxed, either on the difference between the fair market value of the property received and the shareholder's stock basis in the event of a redemption, or upon the entire value of the property in the event of a dividend. For a discussion of the *General Utilities* doctrine and its repeal, see Sheldon M. Bonovitz, *Impact of the TRA Repeal of General Utilities*, 65 J. TAX'N 388 (1986); Davis Shores, *Repeal of General Utilities and the Triple Taxation of Corporate Income*, 46 TAX LAW. 177 (1992); and George K. Yin, *Taxing Corporate Liquidations (and Related Matters) After the Tax Reform Act of 1986*, 42 TAX L. REV. 573 (1987).

⁴⁴² The elimination of the capital gain/ordinary income rate differential meant that corporate earnings were taxed to shareholders at the same rate, whether distributed as dividends or upon disposal of the shareholders' interest in the corporation. Shareholders thus could no longer lessen the burden of the second level of tax on corporate earnings by holding the stock long-term and taking advantage of the lower capital gain rate upon disposition. Combined with the inversion of the corporate and individual income tax rates and the repeal of the *General Utilities* doctrine, this change subjected corporate earnings to a "purer" double tax.

⁴⁴³ I.R.C. §§ 1361-78.

⁴⁴⁴ Corporations other than S corporations are taxed under subchapter C of the Code, hence the vernacular "C corporation."

thirty-five shareholders, which may be only individuals, estates and certain qualified trusts.⁴⁴⁵ Moreover, the S corporation's taxation structure differs from a partnership in ways that could result in a significantly greater tax liability on the shareholders of an S corporation than would be incurred by partners in a partnership.⁴⁴⁶

3. *The Professional Service Corporation*

The PSC is a form of corporation used to organize professional practices that historically could not incorporate.⁴⁴⁷ The attributes of a PSC are generally those of a regular corporation⁴⁴⁸ but typically include additional limitations on the composition of management and permissible types of shareholders.⁴⁴⁹ For example, shares in a Kentucky PSC may be transferred only to natural persons authorized to render a professional service permitted by the PSC articles of incorporation, a general partnership in which all partners are qualified to render the professional service and at least one is licensed in Kentucky to render that professional service, or a domestic or foreign PSC authorized to render a professional service permitted the PSC by its articles of incorporation.⁴⁵⁰ In addition,

⁴⁴⁵ I.R.C. § 1361(b)(1)(A), (B). In addition to the 35-shareholder limit, an S corporation must be a domestic corporation, *id.* § 1361(b)(1), cannot have nonresident aliens as shareholders, *id.* § 1361(b)(1)(C); cannot have more than one class of stock, *id.* § 1361(b)(1)(D); cannot be a member of an affiliated group, *id.* § 1361(b)(2)(A); cannot be a financial institution, *id.* § 1361(b)(2)(B); cannot be an insurance company, *id.* § 1361(b)(2)(C); cannot be a corporation to which § 936 (relating to Puerto Rico and U.S. possessions tax credits) applies, *id.* § 1361(b)(2)(D); and cannot be a domestic international sales corporation, *id.* § 1361(b)(2)(E).

⁴⁴⁶ See *infra* note 507 and accompanying text; see also Irving M. Grant, *Subchapter S Corporations vs. Partnerships as Investment Vehicles*, 36 U. S. CAL. INST. ON FED. TAX'N 13 (1984); James E. Maule, *Report on the Comparison of S Corporations and Partnerships*, 44 TAX LAW. 483 (1991); John R. McGowan & David W. Joy, *A Comparison of Partnerships and S Corporations After the Tax Reform Act of 1986*, 33 ST. LOUIS U. L.J. 971 (1989).

⁴⁴⁷ See *supra* notes 296-309 and accompanying text.

⁴⁴⁸ 1A WILLIAM M. FLETCHER, *FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS* § 112.10 (perm. ed. rev. vol. 1990) ("General corporate law requirements are applicable in addition to and not in substitution for the professional service corporation requirement. Although general corporation laws are applicable to professional corporations, professional corporation laws take precedence over any specific provision of the general corporate law.") (citations omitted).

⁴⁴⁹ See, e.g., KY. REV. STAT. ANN. § 274.017(1)(a)-(c) and 274.027 (requiring that at least one-half of the directors of a PSC and all officers except for the secretary and treasurer be qualified to own shares in the PSC).

⁴⁵⁰ *Id.* § 274.027(1)(a)-(c). A transfer in violation of these restrictions is void. *Id.* §

under current statutory and common law, the PSC may provide less protection for shareholders from the debts and obligations of the PSC than would be expected in a non-professional corporation.⁴⁵¹

Being a species of corporation, the PSC is subject to an entity-level tax on earnings and profits. However, the PSC is denied the benefits of graduated taxation,⁴⁵² paying instead a flat rate income tax.⁴⁵³ A PSC may elect to be taxed under Subchapter S.⁴⁵⁴

4. *The General Partnership*

A partnership arises from the association of two or more persons to carry on as co-owners of a business for profit.⁴⁵⁵ A creature of common law and later subject to state legislative regulation, the general partnership is a highly flexible structure in which the partners define their relative rights and obligations. As to third parties, each partner is an agent of the partnership.⁴⁵⁶ The law alternatively views a partnership as an entity⁴⁵⁷ and as an aggregate of the partners.⁴⁵⁸ While minimal formalities of organization exist, each partner is subject to joint and several liability for claims against the partnership that exceed the assets of the partnership,⁴⁵⁹ and partnership interests are not freely transferable.⁴⁶⁰ In addition, the partnership lacks continuity of existence in that it undergoes a dissolution whenever a partner disassociates.⁴⁶¹

Partnerships are not subject to a federal entity-level tax. Rather, the profits and losses of the partnership are passed through to the partners who report such items on their individual tax returns.⁴⁶²

274.017(2).

⁴⁵¹ See, e.g., *First Bank & Trust Co. v. Zagoria*, 302 S.E.2d 674 (Ga. 1983) (holding one shareholder in a law firm PSC liable on claims arising solely from actions of another PSC shareholder); *Boyd v. Badenhause*n, 556 S.W.2d 896, 898 (Ky. 1977); see also *supra* note 262 (discussing *Boyd*).

⁴⁵² I.R.C. § 11.

⁴⁵³ *Id.* § 11(b)(2). Currently that rate is 35%. *Id.*

⁴⁵⁴ *Id.* § 1362.

⁴⁵⁵ UPA § 6(1).

⁴⁵⁶ *Id.* § 9(1).

⁴⁵⁷ For example, a partnership is viewed as an entity in that it is permitted to acquire, hold, and convey real property in the partnership name. *Id.* §§ 8, 10.

⁴⁵⁸ For example, a partnership is treated as an aggregate of its members insofar as, unless expressly authorized by statute, a partnership is not permitted to sue or be sued in its common name. See *supra* note 199.

⁴⁵⁹ UPA § 15.

⁴⁶⁰ *Id.* § 27.

⁴⁶¹ *Id.* § 31.

⁴⁶² See *supra* notes 7-8 and accompanying text.

5. *The Limited Partnership*

A limited partnership, as compared to the general partnership, is a product of statutory law rather than common law. A limited partnership is made up of the general partner or partners, who are charged with the control and management of the business, and the limited partners, who passively invest capital. Legal relationships among and between the general partners and third parties and the partnership are governed by general partnership and agency law. Limited partners enjoy limited liability,⁴⁶³ and, as a statutory counterbalance, limited partners may not take part in the management of the business.⁴⁶⁴ Should a limited partner participate in management of the business, the limited partner may be deemed a general partner and become subject to general liability for the debts and obligations of the limited partnership.⁴⁶⁵ Conversely, the general partners are jointly and severally liable for the debts and obligations of the limited partnership⁴⁶⁶ but enjoy the rights and powers associated with the status of a partner in a general partnership.⁴⁶⁷

Being a creature of statute, a limited partnership involves more formalities than does a general partnership.⁴⁶⁸ As management is vested

⁴⁶³ RULPA § 303(a).

⁴⁶⁴ *Id.* § 303(b).

⁴⁶⁵ *Id.* § 303(a). A limited partner who takes part in the control of the business will be liable to third parties who are doing business with the limited partnership and who reasonably believe that, based on the limited partner's conduct, the limited partner is a general partner. *Id.*

⁴⁶⁶ *Id.* § 403(b). While a special purpose corporation, taxed under either Subchapter C or Subchapter S, may be formed to serve as the general partner and thereby place a liability shield between the investors and potential liabilities of the partnership, such a scheme raises tax classification problems. For example, in order to receive an advance classification ruling on the absence of centralized management, Revenue Procedure 89-12, 1989-1 C.B. 798, § 4.06, requires that the general partner(s) hold at least 20% of the interests in the entity. *See also supra* note 403. Section 4.07 imposes minimum net worth and contribution requirements on corporate general partners in limited partnerships which seek a ruling on the absence of limited liability. If a corporate general partner is merely a "dummy acting as an agent of the limited partners" and has no substantial assets, the limited partnership may possess the characteristic of limited liability. Treas. Reg. § 301.7701-2(d)(2) (as amended in 1993). If the limited partners control the general partner, then the separate interest test could lead to a finding of free transferability of interest. *See supra* notes 334-39 and accompanying text. Furthermore, those in control of the general partner must avoid actions which could cause a third party to infer that they personally are general partners. *See supra* note 465.

⁴⁶⁷ RULPA § 403(a).

⁴⁶⁸ *See, e.g., id.* § 104 ("Specified Office and Agent"); *id.* § 105 ("Records to be Kept"); *id.* § 201 ("Certificate of Limited Partnership"); *id.* § 206 ("Filing in Office of

entirely in the general partners, the limited partners do not act as agents of the business. However, the transfer of limited partnership interests is subject to the consent of the remaining partners,⁴⁶⁹ and the withdrawal of a general partner may bring about a dissolution of the partnership.⁴⁷⁰

Like a general partnership, the limited partnership is not subject to an entity-level tax.⁴⁷¹ Rather, profits and losses pass through to the general and limited partners, where such items receive tax treatment at the individual level.⁴⁷²

6. *The Limited Liability Partnership*⁴⁷³

The limited liability partnership ("LLP") is in all respects a general partnership, save for a revision in the rule of joint and several liability of all partners for the debts and obligations of the LLP. For claims based on negligence, malpractice, wrongful acts, or misconduct, an LLP provides limited liability for those partners not directly involved in the activity giving rise to the claim.⁴⁷⁴ Therefore, any tort recovery is limited to the

Secretary of State").

⁴⁶⁹ *Id.* §§ 702, 704.

⁴⁷⁰ *Id.* §§ 602, 801.

⁴⁷¹ Of course, those limited partnerships subject to § 7704 of the Code may be subjected to an entity-level tax. See *supra* notes 275-95 and accompanying text.

⁴⁷² See *supra* notes 7-8 and accompanying text.

⁴⁷³ Limited liability partnership ("LLP") legislation has been adopted in a number of jurisdictions, including Connecticut, Delaware, the District of Columbia, Kansas, Kentucky, Louisiana, Mississippi (providing for the qualification and registration of foreign limited liability partnerships), North Carolina, South Carolina, and Texas. Discussions of this business structure include Dennis R. Anderson et al., *Registered LLPs*, 55 TEX. B.J. 728 (1992); W. Philip Clinton & Douglas N. Currault, II, *The Birth of Two Business Entities: Limited Liability Companies and Registered Limited Liability Partnerships*, 40 LA. B.J. 289 (1992); Nicholas G. Karambelas, *The D.C. Registered Limited Liability Partnership Amendment Act of 1993*, 8 WASH. LAW. 25 (1994); Martin I. Lubaroff, *Registered Limited Liability Partnerships: The Next Wave*, 8 INSIGHTS (P-H Law & Business) 23 (May 1994), reprinted in FORMING AND USING LIMITED LIABILITY COMPANIES AND LIMITED LIABILITY PARTNERSHIPS 503 (1994) (PLI Corp. Law & Practice Handbook Series No. 84-7055); and Tom Weidlich, *Limiting Lawyers' Liability; LLPs Can Protect Assets of Innocent Partners*, NAT'L L.J., Feb. 7, 1994, at 1.

⁴⁷⁴ See, e.g., DEL. CODE ANN. tit. 6, § 1515(b) (1993); D.C. CODE ANN. § 41-146 (1994); KY. REV. STAT. ANN. § 362.190(2) (Michie/Bobbs-Merrill Supp. 1994); LA. REV. STAT. ANN. § 3431 (West 1994); S.C. CODE ANN. §§ 33-42-430 (Law Co-op. 1990); TEX. REV. CIV. STAT. ANN. art. 1528 (West Supp. 1994). The Kentucky statute provides that:

Subject to subsection (3) of this section and subject to any agreement among the partners, a partner in a registered limited liability partnership shall not be

assets of the LLP and those directly responsible for the negligent acts. Additionally, LLPs are taxed as partnerships.⁴⁷⁵

B. Comparing Other Structures with the LLC

From a tax perspective, the LLC clearly offers a superior alternative to the non-public C corporation.⁴⁷⁶ The LLC is taxed similarly to an S corporation but provides much greater flexibility and versatility. Furthermore, the LLC offers greater liability protection and organizational advantages over a partnership whether the form is general, limited, or LLP.

1. Comparison of an LLC with a C Corporation

The advantages of an LLC over a C corporation, from a tax perspective, have been alluded to throughout this Article. Assuming it is properly structured,⁴⁷⁷ the LLC will be taxed as a partnership, a classification which permits all items of income, loss, deduction, and credit to pass through the entity to the individual members, who are taxed in their individual capacities on such items.⁴⁷⁸

The corporation, on the other hand, is taxed once at the corporate level on its earnings, and again at the shareholder level when earnings are distributed as dividends or upon liquidation, sale, or redemption of the

liable directly or indirectly, including by way of indemnification, contribution, assessment or otherwise, for debts, obligations, and liabilities of or chargeable to the partnership, whether arising in tort, contract, or otherwise, arising from negligence, malpractice, wrongful acts, or misconduct committed while the partnership is a registered limited liability partnership and in the partnership business by another partner or an employee, agent, or representative of the partnership.

KY. REV. STAT. ANN. § 362.190(2). The terminology with respect to the types of claims for which liability is limited varies among the LLP acts. The emphasized language of the LLP limited liability provision was drafted with the objective of defeating efforts to circumvent the liability shield by bringing tort claims, such as malpractice, under a theory of contract such as breach of an express or implied contract or breach of warranty.

⁴⁷⁵ Priv. Ltr. Rul. 92-29-016 (Apr. 16, 1992) (classifying an LLP as a partnership based on the absence of the corporate characteristics of continuity of life and free transferability of interests).

⁴⁷⁶ The publicly traded C corporation is certainly not in danger of extinction, however, due to the LLC's limitations on free transferability and continuity of life.

⁴⁷⁷ See *supra* notes 275-431 and accompanying text (discussing the tax classification rules and how to structure the LLC to ensure partnership taxation).

⁴⁷⁸ See *supra* notes 7-8 and accompanying text.

shareholder's stock.⁴⁷⁹ In addition, if the corporation distributes or sells appreciated property, the gain inherent in that property is subject to two levels of taxation.⁴⁸⁰ Personal service corporations and other types of businesses for which capital is not a major income-producing factor may mitigate the impact of double-taxation by making deductible payments to shareholders/employees, such as salaries and rent payments, or, to a limited extent, by retaining income in corporate form. However, the payment of compensation is deductible only if it is reasonable in amount; if any compensation is deemed unreasonably high, the excess is treated as a nondeductible dividend.⁴⁸¹

Attempts to mitigate double-taxation by retaining earnings in the corporation are limited by a tax on excessive accumulation of earnings⁴⁸² and a tax on personal holding company income. The latter tax applies only when five or fewer individuals own fifty percent or more of a corporation for which at least sixty percent of its ordinary gross income is equal to "personal holding company income." Personal holding company income consists of passive type income such as dividends, interest, rents, and royalties.⁴⁸³

The C corporation, on the other hand, is not entirely without advantages from either a business or a tax perspective. For example, members/employees of an LLC or a partnership may not be eligible for certain tax-favored employee fringe benefits that are available to employees of C corporations.⁴⁸⁴ When these limitations apply to a

⁴⁷⁹ See *supra* note 438.

⁴⁸⁰ See *supra* notes 441-42 and accompanying text. In a partnership, liquidating and operating distributions of property usually do not result in recognition of gain to the partners. Instead, distributions reduce the partner's outside basis by the amount of money and the inside basis of property distributed. Thus, the LLC is not saddled with the tax burden that S corporations and C corporations must bear upon the distribution of appreciated property. See I.R.C. § 331(b).

⁴⁸¹ See, e.g., *Patton v. Commissioner*, 168 F.2d 28 (6th Cir. 1948). The doctrine of reasonable compensation is becoming an increasingly popular tool for thwarting corporate tax-avoidance schemes. See, e.g., *Curtis v. Commissioner*, 67 T.C.M. (CCH) 1958 (1994) (reviewing the two tests used in ascertaining unreasonable compensation, applying the factors of one test, and holding that the compensation paid a CEO/shareholder of a PSC was excessive).

⁴⁸² This tax is imposed on amounts accumulated in excess of \$250,000 for S corporations and \$150,000 for certain service corporations, and it is equal to 39.6% of the accumulated income. I.R.C. §§ 531, 535.

⁴⁸³ The personal holding company tax equals 39.6% of undistributed personal holding company income. *Id.* §§ 541-543.

⁴⁸⁴ These limitations are imposed on the partners/employees of a general partnership and those shareholders/employees of S corporations holding more than two percent of the issued and outstanding shares. As such, to the degree that these limitations support a finding that a C

member of an LLC, the recipient of certain fringe benefits is taxed on the value of: (a) the excess of life insurance benefits over \$5,000,⁴⁸⁵ (b) accident and health insurance premiums,⁴⁸⁶ (c) the cost of up to \$50,000 of group-term life insurance on the employee's life,⁴⁸⁷ and (d) the value of meals or lodging furnished for the convenience of the employer.⁴⁸⁸

Organizationally, the corporation offers certainty in organizational structure and operation.⁴⁸⁹ A large body of corporate law, replete with statutes that are reviewed and revised as necessary, governs a structure familiar to both owners and the attorneys who advise them. This familiarity is shared by creditors who understand the relevant rules of agency and of limited liability. Furthermore, the clear bifurcation of ownership from management authority and agency, with respect to third parties, ensures the passivity of investors. Additionally, a large body of law, governing directors' fiduciary duties and duties of loyalty and permitting derivative actions and suits for oppression of minority shareholders, has developed to protect passive investors.⁴⁹⁰ Due to their relative novelty, LLCs are not supported by such a deep jurisprudential foundation.

Finally, in at least two situations, a corporation will almost undoubtedly be preferable to an LLC: widely-held ventures and sole proprietorships seeking a limited liability structure. The perpetual existence of the C corporation, the free transferability of interests, and the lack of limitations on either the number or the character of shareholders will preserve the C corporation's status as the entity of choice for broadly held ventures.⁴⁹¹ Because an LLC must have at least two members in order

corporation is a preferable form of organization to an LLC, any such conclusion is equally applicable to the general partnership and the S corporation.

⁴⁸⁵ I.R.C. § 101(b)(2)(A).

⁴⁸⁶ *Id.* §§ 105(b), 106.

⁴⁸⁷ *Id.* § 79.

⁴⁸⁸ *Id.* § 119. For the application of these provisions to S corporations, see § 1372(a) of the Code.

⁴⁸⁹ The very lack of such a settled and agreed upon structure for LLCs may be viewed as an advantage, however. For example, it is not necessary to bifurcate ownership from management. This flexibility permits an LLC to avoid the necessity of electing a set of officers and a board of directors, bodies which, in small corporations, are usually co-extensive with ownership.

⁴⁹⁰ However, many small corporations find the corporate formalities, as well as the necessary distinctions between shareholders, directors, and officers, to be burdensome and unnecessary where management and ownership are substantially, if not entirely, co-extensive.

⁴⁹¹ See, e.g., *Limited Liability Company, Though Spreading Quickly as Option, Not*

to achieve partnership classification, a sole proprietor cannot adopt the LLC structure without imparting at least a fraction of the ownership to a co-investor.⁴⁹²

2. *Comparison of an LLC with an S Corporation*⁴⁹³

As noted earlier, an S corporation is treated as a pass-through entity similar to a partnership. Generally, no corporate income tax, accumulated earnings tax, or personal holding company tax applies so long as the Subchapter S election is in effect.⁴⁹⁴ In this regard, the S corporation and the LLC are comparable. In addition, by years of experience, many accountants are more comfortable with the rules applicable to S corporations than they are with those applied to LLCs and other structures taxed under Subchapter K.

However, despite their gross similarity as pass-through vehicles, the LLC is quite often a more attractive structure than the S corporation. For example, an S corporation is subject to numerous restrictions, such as type and number of owners, that do not apply to other structures.⁴⁹⁵ An LLC, on the other hand, may have an unlimited number of members; members can include individuals, corporations, trusts, other LLCs, partnerships, associations, and basically any other kind of entity, regardless of whether foreign or domestic.⁴⁹⁶ An S corporation may not

Seen as Displacing Traditional Corporation, 8 CORP. COUNS. WKLY. (BNA) 8 (Apr. 14, 1993); *Use of Limited Liability Companies Seen Not Jeopardizing Corporate Tax Base*, DAILY TAX REP. (BNA) No. 59, at D-24 (Mar. 30, 1993); Bernard Wolfman, *Self-Help Integration (LLCs) or Otherwise*, 62 TAX NOTES 769 (1994).

⁴⁹² See *supra* note 292 and accompanying text. Efforts to satisfy this requirement through the use of a wholly owned subsidiary corporation may run afoul of the separate interest test, possibly imperiling the tax classification of the LLC. See *supra* notes 334-39 and accompanying text.

⁴⁹³ For a general comparison of S corporations and LLCs, see generally Edward J. Roche, Jr. et al., *Limited Liability Companies Offer Pass-through Benefits Without S Corp. Restrictions*, 74 J. TAX'N 248 (1991).

⁴⁹⁴ However, several exceptions to this rule exist. An S corporation that was formerly a C corporation may be taxed on: (a) the built-in gain recognized on unrealized appreciation of assets upon conversion during the 10-year period commencing after the S corporation election, I.R.C. § 1374; (b) the "excess net passive income" of an S corporation that had accumulated earnings and profits upon conversion from the former C corporation (generally defined as investment income in excess of 25% of gross receipts), *id.* § 1375; and (c) the LIFO recapture for S corporations that accounted for inventory under the LIFO method while it was a C corporation, *id.* § 1363(d).

⁴⁹⁵ See *supra* notes 443-46 and accompanying text.

⁴⁹⁶ See *supra* notes 57-72 and accompanying text.

own more than eighty percent of another corporation or have a corporate shareholder.⁴⁹⁷ An LLC, on the other hand, may be wholly owned by other corporations and may hold the entire stock of another corporation.⁴⁹⁸ This flexibility provides the LLC a significant advantage over the S corporation in that, through the use of subsidiaries, the LLC may mutually shelter the assets of different types of business from the liabilities of the others.

Another important distinction between an LLC and an S corporation is that an S corporation may issue only one class of stock.⁴⁹⁹ This limitation constrains the ability of an S corporation to satisfy the varying investment objectives of its investors, such as by providing owners with preferences as to earnings or assets of the business. An LLC, on the other hand, is governed in this regard by the partnership tax regime and thus may allocate items of income, deduction, gain, or loss disproportionately among its members, so long as the allocations have "substantial economic effect."⁵⁰⁰

Another advantage of the LLC over the S corporation is that an LLC member's tax basis in the LLC includes such member's share of the LLC's liabilities.⁵⁰¹ An S corporation shareholder's basis is increased only by loans made by the shareholder to the corporation and does not include

⁴⁹⁷ I.R.C. §§ 1361(b)(1)(B); 1361(b)(2)(A).

⁴⁹⁸ See *supra* notes 57-72 and accompanying text.

⁴⁹⁹ I.R.C. § 1361(b). The division of a single class of stock into voting and non-voting shares does not violate this prohibition. Thus, the flow-through of items of income, deduction, gain, and loss to shareholders of an S corporation is made in proportion to their stock ownership. *Id.*

⁵⁰⁰ *Id.* § 704(b). Although an S corporation may satisfy an investor's preference objectives by issuing debt in addition to stock, small businesses, particular service-oriented businesses, are often ill-suited for heavy debt-capitalization. Additionally, the issuance of a long-term note to an investor contributing appreciated property could trigger tax to the investor as a result of amendments to § 351(a) of the Code by the Revenue Reconciliation Act of 1989. Prior to 1989, an investor receiving long-term debt that constituted a "security" under § 351(a) could receive tax-free treatment upon contribution of the property to the corporation so long as 80% control was obtained by the group of transferors upon such contribution. Now, § 351 provides for tax-free treatment only upon receipt of "stock" in exchange for money or other property.

⁵⁰¹ *Id.* § 752. An LLC member will share in recourse liabilities only to the extent that the member is obligated to make contributions to the partnership or to pay the creditor directly (as in a personal guarantee of the obligation), to restore a deficit balance in his or her capital account upon liquidation, or to reimburse another partner under an indemnity arrangement for a payment made by the other partner. Treas. Reg. § 1.752-2 (1992). A member will share in non-recourse liabilities in proportion to his or her interest in the partnership. *Id.* § 1.752-3 (1991).

indebtedness of the corporation to third parties.⁵⁰² This difference means that an LLC member has more flexibility than an S corporation shareholder to deduct losses incurred in the business, assuming such deductions are not precluded by the “at-risk” rules of I.R.C. section 465 of the Code⁵⁰³ and the passive activity loss rules of I.R.C. section 469 of the Code.⁵⁰⁴

⁵⁰² I.R.C. § 1366(d)(2).

⁵⁰³ Generally, an LLC member will be able to deduct losses flowing from the LLC only if the member is considered “at risk” with respect to his or her investment in the LLC. A member is considered at risk for the money and the adjusted basis of any property contributed to the LLC, as well as for a portion of the LLC’s debt for which the member is personally liable or that the member has guaranteed. *Id.* § 465(b). As regards a guarantee, a member will be “at risk” only if the guarantee renders the member personally liable under state law and no contribution or subrogation rights to inherit from others exist. Prop. Treas. Reg. § 1.465-24(a)(2); *see also* *Abramson v. Commissioner*, 86 T.C. 360 (1986) (explaining that limited partner was at risk with respect to non-recourse debt that he guaranteed). The LLC member will not be at risk, however, with respect to LLC debt that is non-recourse and for which he or she is not personally liable *unless* the debt is attributable to a real estate activity and is “qualified non-recourse financing.” I.R.C. § 465(b)(6)(C). Qualified non-recourse financing is financing borrowed from a qualified person (generally a person in the business of lending money) for the activity of holding real property. *Id.* Except as provided in the regulations, no person can be personally liable for the loan. Thus, an LLC member will be at risk with respect to a traditional non-recourse loan secured by a piece of property used for the activity of holding the real property. Note that it is unclear, however, whether a loan secured by all of the LLC’s assets would qualify under these rules, given that no “person,” including the LLC, can be personally liable for the debt. This is another area in which many practitioners are awaiting guidance from the Service regarding how these rules will be applied to the LLC.

⁵⁰⁴ Under the passive activity loss rules, LLC members that are individuals, trusts, estates or personal service corporations may deduct “passive” losses only against passive income; “active” losses can be deducted against “active” income, which includes ordinary income from wages, salaries, and compensation. In order for a loss to be considered active, a taxpayer must materially participate in the entity that generates the loss. For LLC members who actively participate in the management of the LLC, the material participation test of the rules should be met, thus allowing the LLC member to deduct losses of the LLC against income from other active trades or businesses, including wages and compensation income. I.R.C. § 469.

A distributive share of the LLC’s losses from a “passive activity” that exceeds the member’s income from all passive activities is carried over until the member has passive income to offset the loss. *Id.* § 469. The passive loss rules also apply, but in a less restrictive way, to certain closely held C corporations. The passive activity loss rules prohibit taxpayers from using net losses from passive activities to offset other taxable income, specifically, portfolio income (e.g., interest, dividends, and certain royalties) and active income (e.g., salary and wages). Passive activities include rental activities (except certain real estate rental activities in which a member “actively participates”) and trade or business activities in which the member does not “materially participate.” *Id.* § 469(c)(1)(B). Material participation is generally defined as active involvement in the

Upon formation, a transfer of appreciated property to an S corporation in exchange for the S corporation stock is a taxable event to the shareholder unless at the time of transfer the transferors receive stock constituting at least eighty percent of the S corporation's voting power after the exchange.⁵⁰⁵ In forming an LLC, on the other hand, members may transfer, free of tax, appreciated property in exchange for the LLC interest.⁵⁰⁶

operations of the business on a regular, continuous, and substantial basis. *Id.* § 469(h). Treasury regulations set out seven brightline, alternative tests that a taxpayer may use to establish material participation. Temp. Treas. Reg. § 1.469-5T(a)(1)-(7) (as amended in 1992).

The regulations apply a more stringent material participation test to limited partners than that applied to general partners and S corporation shareholders; the test includes the requirement that the partner participate in the activity for more than 500 hours during the year or during a minimum number of prior years. Temp. Treas. Reg. § 1.469-1T(e)(2) (as amended in 1994). The regulations broadly define limited partner to include all holders that are not personally liable for the entity's debts, even if the entity is not a state law limited partnership. *Id.* § 1.469-1T(e)(2). Thus, the question is raised whether this more stringent material participation test will apply to an LLC member by virtue of the broad regulatory definition of a limited partner. Strong policy arguments can be made that the LLC member is more analogous to a general partner or an S corporation shareholder than a limited partner because the LLC permits active involvement by LLC members in the management of the business. Until the Service addresses the issue, however, LLC members should plan to meet the stricter material participation test applicable to limited partners to ensure that the losses flowing through the LLC are not subject to the passive activity loss limitations.

It should be noted that the Revenue Reconciliation Act of 1993 liberalized the passive activity loss rules as applied to rental real estate. Rental real estate will no longer be a per se passive activity if the taxpayer satisfies a two-pronged test: (1) more than one half of the taxpayer's services must be performed in real property trades or businesses in which the taxpayer materially participates, and (2) the taxpayer must perform more than 750 hours of service during the taxable year in real property trades or businesses in which the taxpayer materially participates. I.R.C. § 469(c)(7)(B). Real property trades or businesses include development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage business. *Id.* § 469(c)(7)(C). In order for an activity to be applied toward the 750-hour and the one half of personal services requirements, the LLC member must materially participate in the activity. Thus, an LLC member must materially participate (under the restrictive rules discussed above) in each rental real estate activity that is to be counted toward the rental real estate material participation test. *Id.* § 469(c)(7)(A).

⁵⁰⁵ I.R.C. § 351(a).

⁵⁰⁶ *Id.* § 721. This result occurs only if any liabilities transferred to the LLC by a contributing member do not exceed the total of the transferor's bases in property contributed plus the transferor's share of the LLC's liabilities. *Id.* §§ 723, 752.

Generally, LLC members will recognize no gain or loss upon contributing cash or property to the LLC in exchange for a capital interest. *Id.* § 721. The basis of the

An LLC may also provide an advantage over an S corporation upon distributions of property to individual investors or upon termination of an investor's interest in the venture. Due to the mechanics of the partnership tax rules, distributions of appreciated property to an LLC member may result in more favorable tax consequences than such distributions to an S corporation shareholder.⁵⁰⁷

As an S corporation does not differ from a C corporation with respect to its organization under state law, the relative advantages and disadvantages of a C corporation as compared to an LLC, from a business perspective, apply equally to S corporations.⁵⁰⁸

3. Comparison of a PLLC with a PSC

From a tax perspective, the PLLC is an advantageous structure in that it avoids the double taxation of C corporations and the need to distribute

contributing member's interest in the LLC ("outside" basis) generally equals the amount of cash and the basis of the property contributed. *Id.* § 722. Even if a member contributes property encumbered with debt in excess of the property's basis, the member will be entitled to an increase in its outside basis in the LLC to the extent of the member's share of the debt at the LLC level (plus the property's basis); the member then receives a deemed cash distribution, decreasing its outside basis by the amount of the debt encumbering the property. Thus, the contributing member will recognize gain only to the extent that the amount of the debt exceeds the member's share of the debt at the LLC level plus the basis of the contributed property. *Id.* §§ 731(a), 752(b); Treas. Reg. § 1.752-1(f) (1991). The LLC differs from the S corporation in this respect, as shareholders contributing encumbered property to the latter will recognize gain to the full extent that the transferred debt exceeds the contributed property's basis. I.R.C. § 357(c). An S corporation shareholder may not increase his or her outside basis by debt of the corporation. *See id.* Note also that if a member contributes property with a fair market value in excess of or less than its adjusted basis upon contribution, the built-in gain or loss must be allocated back to the contributing partner. *Id.* § 704(c).

⁵⁰⁷ Distributions of appreciated property to an LLC member will not trigger gain recognition unless the LLC's basis in the property exceeds the member's outside basis in the LLC. I.R.C. § 731(a). Rather, the LLC member will generally acquire a basis in the distributed property equal to the LLC's basis plus any gain recognized on the transfer (called a "transferred" basis). *Id.* § 732(a)(1). The S corporation, on the other hand, recognizes income on the distribution of appreciated property. *Id.* § 311(b). Although the shareholder receives an increase in basis for his or her share of the gain recognized, *id.* § 1367, if there is more than one shareholder, the basis so increased generally will not offset the value of the property distributed; thus double taxation on part of the gain will occur. For a detailed comparison of the taxation of partnerships and S corporations, see ABA Taxation Section Comm. on S Corporations, Subcommittee on the Comparison of S Corporations and Partnerships, *Report on the Comparison of S Corporations and Partnerships* (pts. 1 & 2), 44 TAX LAW. 483, 813 (1991).

⁵⁰⁸ *Supra* notes 476-92 and accompanying text.

income in a manner designed to avoid the double taxation of C corporation and the accumulated earnings tax.⁵⁰⁹ Also, the PLLC effectively eliminates challenges to compensation as unreasonable.⁵¹⁰ As compared to a PSC that has made an S election, the PLLC avoids concerns regarding the continued qualification of the S election and the potential tax pitfalls previously discussed.⁵¹¹

From an organizational perspective, depending on the state or states in which the PLLC is doing business, the PLLC may or may not offer advantages. Initially, in some jurisdictions, either by statutory prohibition⁵¹² or by a professional regulatory body's proscription of the use of the PLLC for their respective professions, the LLC may not be an available organizational option. Other states, while expressly providing for the organization of PLLCs, have expressly imposed upon them restrictions similar if not identical to those imposed on the PSC.⁵¹³ In these situations, the PLLC will not be a significantly more flexible structure than the PSC, save for the former's lack of the latter's required corporate formalities.

Other states, including Kentucky, expressly authorize PLLCs but without imposing PSC-like restrictions on membership and management.⁵¹⁴ Assuming no regulatory restrictions exist in a given jurisdiction, a PLLC is a more flexible structure than the PSC in that the PLLC may have non-professional members, thereby greatly increasing access to capital and providing flexibility in ownership often desired for estate planning purposes. Of course, in a PLLC which has non-professional members, organizational safeguards must be established so that non-

⁵⁰⁹ See *supra* note 482.

⁵¹⁰ See *supra* notes 443-46 and accompanying text.

⁵¹¹ See *supra* notes 447-54 and accompanying text.

⁵¹² See, e.g., OR. REV. STAT. § 63.074(2) (1993); R.I. GEN. LAWS § 7-16-3 (1992).

⁵¹³ See, e.g., ARIZ. REV. STAT. ANN. § 29-844 (Supp. 1993); IOWA CODE ANN. § 490A.1501-.1519 (West 1992); VA. CODE ANN. § 13.1-1100 to -1123 (Michie 1994); see also Conn. Bar Ass'n, Informal Op. 94-2 (1994) (finding that Connecticut attorneys may practice in the form of a PLLC, with the Connecticut LLC Act imposing PSC-like limitations on PLLCs); Kansas Bar Ass'n Comm. of Ethics and Professional Responsibility Op. 91-6 (Dec. 23, 1991) (finding that Kansas attorneys may practice in the form of a PLLC provided the PLLC complies with the limitations imposed on PSCs); Marcia M. McBrien, *Ethics Opinion OK's PLLCs for Lawyers; Significance of Limited Liability Company Must Be Explained if Client Asks*, MICH. LAW., Jan. 24, 1994, at 1.

⁵¹⁴ KY. REV. STAT. ANN. § 275.025. However, the LLC Act recognizes both the continuing authority of the professional regulatory boards to regulate those practicing the profession, including those practicing through a PLLC, and the right to impose restrictions analogous to those extant in the PSC statute. See *infra* notes 57-72 and accompanying text.

professionals do not have a voice with respect to the rendering of professional services and to ensure that loyalties to non-professional members will not impact the professional services rendered to clients.

4. *Comparison of an LLC with a General Partnership*

Organizationally, the primary disadvantage of the general partnership is joint and several liability of all partners for claims arising in connection with the business.⁵¹⁵ The LLC does not require that any individual or entity, other than the LLC itself, be generally liable for the debts and obligations of the LLC.⁵¹⁶ In this regard, the LLC is clearly preferable to a general partnership.

On the issue of agency, the LLC provides more flexibility than a general partnership by allowing the LLC to customize its agency structure according to its particular needs. If unrestricted agency is desired, management may be retained by the members. However, if restricted agency is desired, the LLC may provide for centralized management and reserve agency authority to those elected or designated as managers.⁵¹⁷

5. *Comparison of an LLC with a Limited Partnership*

As discussed above, an LLC, if properly structured, will be taxed as a partnership. Therefore, from a tax perspective, the limited partnership and the LLC are comparable.⁵¹⁸ The LLC bears a significant business

⁵¹⁵ See *supra* notes 455-62 and accompanying text.

⁵¹⁶ See *supra* notes 73-78 and accompanying text.

⁵¹⁷ See *supra* notes 87-88 and accompanying text.

⁵¹⁸ Some wrinkles in the application of partnership tax law to LLCs, stem from the quandary as to whether an LLC member is more analogous to a general partner or to a limited partner. See *supra* notes 406-16 and accompanying text (regarding the method of accounting as an example of this problem).

Another example is the application of the rules regarding self-employment taxes. A limited partner's distributive share of income or loss from a limited partnership, other than a guaranteed payment, is excluded from earnings for self-employment tax purposes. I.R.C. § 1402(a)(13). The effect of this provision is that self-employment tax is generally not owed by limited partners with respect to income of the partnership that is not a guaranteed payment. Such income is also not included for purposes of determining the amount of contributions to or benefit from a qualified retirement plan. It is unclear how this provision will be applied to members of an LLC. The recurring issue is again revisited: whether a member of an LLC, for purposes of the self-employment tax, should be treated as a limited partner or a general partner. The provision was designed to prevent passive investors from including investment income in earnings on which social security benefits are based. Thus, an LLC member, particularly an active member of a PLLC, does

advantage over a limited partnership, however, in that all members of an LLC have limited liability regardless of how actively they participate in the management of the LLC. In a limited partnership, a limited partner may be held personally liable for partnership obligations to the extent that he or she transacts business with persons who reasonably believe, based on the limited partner's conduct, that the limited partner is a general partner.⁵¹⁹ In addition, a limited partnership must be managed by a general partner who is subject to unlimited liability for the debts of the partnership.⁵²⁰ While this burden may be alleviated by the use of a corporation as general partner, the Service imposes minimum net worth requirements, which can be difficult to satisfy, on the corporation prior to issuing an advance ruling on the existence or non-existence of limited liability in classifying the partnership.⁵²¹ Another advantage of an LLC is that members may be allocated non-recourse liabilities to increase their bases in the LLC proportionate to their interest in the LLC. In a limited partnership, non-recourse liabilities are typically allocated entirely to the general partners.⁵²²

6. *Comparison of an LLC with an LLP*

Since both structures are taxed as partnerships, the LLC and the LLP should be equivalent from a tax perspective. Organizationally, an LLP is for most purposes a general partnership, except in relation to third parties with actual knowledge, so it is not possible to restrict the apparent agency of a partner. As such, the LLP is not a viable structure for enterprises in which the restriction of an agency is necessary. Furthermore, assuming the entity must be structured to avoid continuity of life and free transferability of interests to insure partnership classification, the LLC and the LLP will equally bear these limitations.

It is with respect to the provision of limited liability for the partners/members that the LLP and the LLC are most divergent and the advantage of the LLC over the LLP most apparent. Two significant problems exist with the efficacy of the liability protection afforded by the LLP as compared to the LLC. These problems arise in the LLP's

not fall within the rationale of this rule. However, an LLC could avoid application of this rule by making guaranteed payments to its LLC members, as do limited partnerships. No guidance has as yet been issued by the Service on this issue.

⁵¹⁹ See *supra* note 465 and accompanying text.

⁵²⁰ See *supra* notes 463-70.

⁵²¹ Rev. Proc. 89-12, § 4.07, 1989-1 C.B. 798.

⁵²² See *supra* notes 463-72 and accompanying text.

distinction between claims based in tort and those arising in contract, as well as the use of the LLP in interstate transactions.⁵²³ Initially, the LLP draws a bright-line distinction between claims based on tort and those based on contract, providing limited liability for the former but preserving joint and several liability for the latter.⁵²⁴ However, many claims may be cast both as breach of a tort duty of care and breach of contract. One example of this dual character is a claim of accounting malpractice, which ordinarily means a breach of the standard of care, but which also could be characterized as a breach of the engagement letter, the contract between the accountant and the client. While that breach of contract could and likely should fall within the statutory scope of those acts for which limited liability is provided, a court may be willing to view it as a claim not addressed by the LLP statute and therefore find that, as a claim for breach of contract, limited liability is not present. In that instance, all partners would be jointly and severally liable on the claim.⁵²⁵

Of greater concern is the recognition of the LLP's liability shield in interstate commerce. As of this writing, fewer than twenty states have adopted LLP legislation.⁵²⁶ For LLPs engaged in transactions in those jurisdictions that have not adopted LLP legislation,⁵²⁷ a substantial question arises as to whether the liability shield will be recognized. As previously discussed,⁵²⁸ states are not obligated to recognize the limited liability afforded by foreign jurisdictions. In the case of a partnership, the law of the jurisdiction with the most significant contacts with the parties and the events giving rise to the claim should control.⁵²⁹ Under this analysis, the court could hold that the non-LLP jurisdiction has the most

⁵²³ See generally Weidlich, *supra* note 473.

⁵²⁴ Of the structures available in the United States, only the LLP draws a distinction between claims arising in tort versus contract by providing limited liability for one but not the other. All other limited liability structures shield investors, managers, and agents from personal liability regardless of the basis of the claim.

⁵²⁵ See *supra* notes 473-75.

⁵²⁶ John R. Maxfield et al., *New 0.1 and Gas Exploration and Investment Vehicle: The Limited Liability Company*, 38 ROCKY MTN. MIN. L. INST. § 17.01 (1992).

⁵²⁷ The "Big Six" accounting firms have registered or are registering as LLPs. See Rick Telberg, *Big 6 "Doomsday" Plan: Switch to LLPs—ASAP*, ACCT. TODAY, Apr. 4, 1994, at 2; Bart Ziegler, *Top Accountants to Shield Partners from Lawsuits*, WALL ST. J., July 29, 1994, at C15.

⁵²⁸ See *supra* note 81 and accompanying text.

⁵²⁹ RESTATEMENT (SECOND) OF CONFLICTS §§ 174, 295 (1971) (discussing application of law for vicarious liability and contractual liability in partnership cases); see *supra* note 82 and accompanying text.

significant contacts with the situs of the injury and the parties and, as such jurisdiction does not authorize LLPs, local law on the liability of partners should control. Therefore, by engaging in transactions in non-LLP jurisdictions, the partners of an LLP may be exposing themselves to joint and several liability on all claims, regardless of their character.

The LLC is unaffected by the tort/contract distinction, and the jurisdictional danger is significantly less given the number of states with LLC statutes. First, the liability protection afforded by an LLC is not dependent upon the character of the claim. Therefore, there is no concern that a claim will be recharacterized so as to defeat the liability protection. Second, as of this writing, only four non-LLC jurisdictions exist,⁵³⁰ and conflicts of law analysis supports limited liability protection for members, managers, and agents even in those jurisdictions.⁵³¹

C. *The Choice of the LLC in Particular Circumstances*

1. *Real Estate*

Organizationally, an LLC is an excellent vehicle for real estate ventures, as the liability shield protects members from liability for contractual claims under mortgages and financing and leasing arrangements⁵³² as well as for traditional tort claims associated with an injury incurred on the property.⁵³³ Furthermore, the LLC has the advantage

⁵³⁰ See *supra* note 2.

⁵³¹ See *supra* note 84 and accompanying text.

⁵³² Where necessary to secure a contractual obligation, the personal guarantees of the members may substitute for joint and several liability. See *supra* note 326 and accompanying text.

⁵³³ Note, however, that an LLC will not offer greater protection than a traditional corporation from personal liability under the Comprehensive Environmental Response, Compensation and Liability Act ("CERCLA"), 42 U.S.C.A. § 9601 (1980), and the Resource Conservation and Recovery Act ("RCRA"), 42 U.S.C.A. § 6901 (1976). According to § 9607 of CERCLA, personal joint and several liability exists among all current and former owners and operators of a site where hazardous substances were released, as well as with the "generator" of the hazardous substances and those who transported the hazardous substances. Under these laws, individuals may be held personally liable for actions they carried out in their corporate capacities. See, e.g., *New York v. Shore Realty Corp.*, 759 F.2d 1032 (2d Cir. 1985) (stockholder and officer liable as operator under CERCLA); *United States v. Conservation Chem. Co.*, 628 F. Supp. 391 (W.D. Mo. 1985) (personal liability under CERCLA); *United States v. Mottolo*, 629 F. Supp. 56 (D.N.H. 1984) (corporate officer liable under CERCLA); *United States v. Northeastern Pharmaceutical & Chem. Co.*, 579 F. Supp. 823 (W.D. Mo. 1984) (liability for hazardous waste clean-up under CERCLA), *aff'd in part, rev'd in part on other grounds*, 810 F.2d 726 (8th Cir. 1986), *cert. denied*, 484 U.S. 848 (1987).

that the members may be actively involved in the oversight and direction of the real estate venture without risking the loss of their liability protection. In contrast, in the traditional venture organized as a limited partnership, the limited partners are actively involved only at the risk of losing their liability shield.⁵³⁴ Also, under the LLC scheme there is no need for a general partner subject to full liability.⁵³⁵

From a tax perspective, LLCs are particularly well suited for use in real estate ventures because they are typically highly leveraged with a limited number of participants. While retaining pass-through tax treatment without the need for a general partner with unlimited liability, the LLC permits the bases of members to be increased through the use of entity-level debt.⁵³⁶ While this result can be achieved in a limited partnership, the LLC has greater flexibility in the ability to increase the bases of all interests through the use of non-recourse debt.⁵³⁷ In a limited partnership, generally speaking, only the basis of the general partner is increased by non-recourse debt.⁵³⁸ Organizationally, the LLC may be preferred as a more flexible structure than title holding companies, REITs, REMICs, or group trusts.⁵³⁹

⁵³⁴ See *supra* note 465 and accompanying text; see also Jim Connolly, *Limited Liability Cost: Use Rises in Real Estate Deals*, NAT'L UNDERWRITER LIFE & HEALTH-FINANCIAL SERVICES EDITION, May 2, 1994, at 67 (describing advantages of LLC for real estate investors).

⁵³⁵ See *supra* note 522 and accompanying text; see also Gerry Donohue, *New Business Entity Attracts Builders; Limited Liability Companies Combine the Best of Partnerships and Corporations*, BUILDER, May, 1994, at 156 (discussing advantages of LLC over S corporations for developers); Terry Williams, *Funds Try New Realty Route; Limited Liability Company Used as Investment Vehicle*, PENS. AND INVESTMENTS, Mar. 21, 1994, at 52. Commenting on the desirability of LLCs for pension funds, the article stated:

The structure's appeal is it offers pension funds more control and alignment of interest with their real estate advisors. It provides the limited liability of a corporation with partnership tax treatment. To date, most co-investments have been structured as limited partnerships, which limits the pension funds' control as limited partners.

Id.

⁵³⁶ See *infra* notes 560-63 and accompanying text.

⁵³⁷ See *supra* notes 501-04 and accompanying text.

⁵³⁸ See *supra* notes 521-22 and accompanying text.

⁵³⁹ See, e.g., Lawrence J. Hass & Kenneth D. Alderfer, *A Limited Liability Company as a Vehicle for Pension Funds in Real Estate*, INST'L REAL EST. LETTER, May 1991, at 12; Luke V. McCarthy, *LLCs A Flexible Alternative for Pension Plan Investment*, PENS. WORLD, Aug. 1992, at 40 (describing advantages and disadvantages of LLC over REITs, REMICs and group trusts). Indeed, it has been suggested that an LLC may be an advantageous replacement for the REIT:

2. *Professional Practices*⁵⁴⁰

The explosive growth of LLCs across the country can, in part, be credited to the support of the American Institute of Certified Public Accountants and its state chapters as part of a lobbying program designed to develop legislation permitting accountants to shield themselves from losses occasioned by the malpractice of another accountant/partner.⁵⁴¹ As such, it is not surprising that the PLLC is an excellent vehicle for the organization of a practice, assuming that both the applicable statute and the rules of the relevant professional regulatory board permit the practice of a profession through the PLLC. In some jurisdictions, doing so will allow greater flexibility than that available under the traditional PSC statute,⁵⁴² while at the same time avoiding corporate formalities.⁵⁴³ The PLLC avoids the year-end crunch to "cash-out" C corporation PSCs so as to avoid dual-level taxation, an activity which may run afoul of the reasonable compensation rules.⁵⁴⁴ While dual-level taxation and reasonable compensation problems do not impact S corporation PSCs, numerous limitations attend S corporations.⁵⁴⁵ The PLLC avoids all of these problems.

The mechanism for accomplishing [flow-through tax treatment under I.R.C. § 856 et seq.] is through a deduction to the REIT for dividends paid to its owners. The REIT is usually organized as a corporation to enjoy the benefit of limited liability for the investors. Now that this tax trait is also associated with an LLC, investors can obtain REIT tax benefits and at the same time take advantage of all other LLC features.

REITs are subject to extremely complex tax rules, very few of which are imposed on an LLC. In addition, use of an LLC to achieve "pass-through" tax treatment avoids all of the formalities required in the running of a corporation. Therefore, a real estate business that would otherwise organize as a REIT should consider the merits of avoiding the pitfalls of breaching complex tax rules by organizing as an LLC.

Tra Meislik, *Where Limited Liability Companies May Be Used*, N.J. L.J., Mar. 14, 1994, at 11.

⁵⁴⁰ See generally Jimmy G. McLaughlin, *The Limited Liability Company: A Prime Choice for Professionals*, 45 ALA. L. REV. 231 (1993) (discussing the use of LLCs to structure a professional practice).

⁵⁴¹ See *supra* note 253 and accompanying text.

⁵⁴² See *supra* notes 509-14 and accompanying text.

⁵⁴³ See *supra* notes 477-92 and accompanying text.

⁵⁴⁴ See *supra* notes 510-11 and accompanying text.

⁵⁴⁵ See *supra* notes 494-508 and accompanying text.

PLLCs want to ensure that they will not unknowingly be forced into the use of accrual method accounting.⁵⁴⁶ Such assurance can be provided through a private letter ruling on the question.

Problems may arise in the use of PLLCs to render services across state lines in jurisdictions in which PLLCs in general or those devoted to that profession are not permitted. All LLC statutes provide that foreign LLCs, while having the same rights as domestic LLCs, shall have no greater rights.⁵⁴⁷ A PLLC rendering services in a generic LLC form jurisdiction may be viewed as violating this limitation. Thus, a party injured in the course of, or consequent to, those professional services could argue that as the liability shield is not available to a domestic professional practice it should not be available to a foreign PLLC.

3. *International Transactions*

In many instances an LLC will be a structure familiar to foreign entities and investors. Similar structures⁵⁴⁸ are already available in Germany,⁵⁴⁹ France,⁵⁵⁰ Great Britain,⁵⁵¹ Portugal,⁵⁵² Japan,⁵⁵³

⁵⁴⁶ See *supra* notes 406-16 and accompanying text.

⁵⁴⁷ See, e.g., KY. REV. STAT. ANN. § 275.380 (Michie/Bobbs-Merrill 1989).

⁵⁴⁸ For these purposes, a similar structure is defined as one providing limited liability to investors and managers, the ability to participate in management without the loss of limited liability, and the lack of the formality imposed on publicly held corporations.

⁵⁴⁹ In Germany, the structure is called *Gesellschaft mit beschränkter Haftung*. See *supra* notes 334-35 and accompanying text; see also Mark R. von Sternberg, *The Close Corporation's Counterparts in France, Germany and the United Kingdom*, 5 HASTINGS INT'L & COMP. L. REV. 291 (1982) (describing entities in France, Germany, and the United Kingdom which parallel LLCs in the U.S.).

⁵⁵⁰ In France, the structure is called *Société à Responsabilité Limitée*. See Rainer M. Kohler, *The New Limited Liability Company Law of France*, 24 BUS. LAW. 435 (1969) (analyzing the then-new LLC in France).

⁵⁵¹ In Great Britain, the structure is called the Company Limited by Shares. Richard A. Blum, *Update on U.S. Classification of U.K. LLCs; Limited Liability Companies*, 5 TAX ADVISER 86 (1994) (finding that advantages of the LLC in the United Kingdom include foreign corporate treatment and U.S. partnership treatment); Rev. Rul. 88-8, 1988-1 C.B. 403.

⁵⁵² In Portugal, the structure is called *Sociedade por quotas de responsabilidade limitada*. See, e.g., Priv. Ltr. Rul. 78-26-023 (Mar. 28, 1978) (classifying a Portugese *Sociedade por quotas de responsabilidade limitada* as an association taxable as a corporation).

⁵⁵³ In Japan, the structure is called *Yugen-Kaisha*. See, e.g., Priv. Ltr. Rul. 78-41-047 (July 14, 1978) (classifying a *yugen-kaisha* as a partnership); see also *JCT Releases Report Comparing Tax Systems of U.S., Germany, Japan and U.K.*, TAX NOTES TODAY, July 21, 1992, available in LEXIS, Taxana Library, TNT File, 92 TNT 148-1 (comparing

Saudi Arabia⁵⁵⁴ and various Latin American countries.⁵⁵⁵ This international familiarity may be advantageous both when an LLC is seeking investment and/or participation in a U.S.-based venture as well as when an LLC is transacting business in one of these jurisdictions.⁵⁵⁶ The use of the LLC in a U.S.-based venture permits pass-through taxation, not otherwise possible in a C corporation or with foreign participation which precludes S corporation status.⁵⁵⁷ Furthermore, the assets of the investors in an LLC are protected from liability for the debts and obligations of the venture.

When certain foreign entities are doing business in the United States, they may be able to register and qualify to do business as foreign LLCs,⁵⁵⁸ thereby gaining not only legal recognition for their presence but also the limited liability shield afforded by the jurisdiction of organization. It should be noted, however, that while these entities may be able to register and qualify to do business as LLCs, in certain instances these foreign structures will be taxed as corporations.⁵⁵⁹

4. *Corporate Joint Ventures*

The LLC, combining limited liability with pass-through taxation, is seemingly a perfect structure for the organization of corporate joint ventures.

tax systems and providing insight into differing economics).

⁵⁵⁴ In Saudi Arabia, the structure is called the Limited Liability Partnership; see *supra* note 338. See also Priv. Ltr. Rul. 80-06-086 (Nov. 19, 1979) (classifying a Saudi limited liability partnership as an association taxable as a corporation); *id.* 77-37-049 (June 17, 1977) (classifying a Saudi limited liability partnership as a partnership).

⁵⁵⁵ In Latin American countries, the structure is called the *Limitada*. See, e.g., Priv. Ltr. Rul. 78-17-129 (July 30, 1978) (treating Brazilian *Limitada* as partnership under U.S. tax law); *id.* 80-03-072 (Oct. 25, 1979) (treating Brazilian *Limitada* which lacked continuity of life as partnership for U.S. tax purposes). See generally Jack Burstein, *The Limitada: Partnership or Corporation?*, 6 INT'L J. TAX 32 (1989).

⁵⁵⁶ See, e.g., Pam Black, *Limited Liability: A Safer Strategy for Small Business*, BUS. WK., July 18, 1994, at 90 (describing the use of the LLC in Ukraine where S corporation was unavailable due to foreign investor participation and general partnership law was unfamiliar to officials).

⁵⁵⁷ See *supra* notes 444-46 and accompanying text. However, save where reduced or eliminated by tax treaty, a foreign member's distributive share is subject to a federal withholding rate of 31% for individuals, I.R.C. § 1446; 34% for corporations, *id.* § 11(b)(1); or 30% for "branch profits", *id.* § 884.

⁵⁵⁸ See *supra* notes 225-50 and accompanying text.

⁵⁵⁹ See, e.g., Rev. Rul. 93-4, 1993-1 C.B. 225, *supra* notes 358-59 (classifying a German *GmbH* which lacked continuity of life as an association taxable as corporation); Rev. Rul. 88-8, 1988-1 C.B. 403 (explaining that foreign entities will be classified under Treas. Reg. § 301.7701-2) (as amended in 1993)).

When joint ventures are organized as partnerships between corporations, pass-through taxation is achieved, but each entity is liable for the debts and obligations of the joint venture. Special purpose subsidiaries may be interposed to limit each venturer's liability; however, this creates additional complexity and may give rise to state income tax problems.⁵⁶⁰

Although limited liability can be achieved through incorporation of the joint venture, with each joint venture becoming a shareholder, the modified pass-through taxation of an S corporation is not available due to the prohibition against corporate shareholders.⁵⁶¹ As a C corporation, the earnings of the incorporated joint venture may be subject to at least partial dual-level taxation.⁵⁶²

As an LLC, the earnings of the joint venture are passed through without taxation while the flexibility, through special allocations, to accommodate the economic agreement of the parties is retained. Furthermore, limited liability is available to protect the assets of the joint venturers, without the need for special purpose subsidiaries. When the joint venture involves a non-U.S. entity, familiarity with the LLC structure may be advantageous.⁵⁶³

5. Estate Planning

In many instances the LLC provides opportunities in estate planning because it avoids certain limitations imposed on other commonly used vehicles such as the limited partnership and S corporation. As compared to the limited partnership, the LLC retains partnership taxation without exposing a general partner to joint and several liability. Further, in the LLC, the liability shield is not subject to erosion due to the involvement of members in managing and directing the LLC.⁵⁶⁴ Also, the LLC does not have the limitations imposed on S corporation shareholders. Therefore, trusts which could not be shareholders in an S corporation, including

⁵⁶⁰ Because Kentucky does not generally permit consolidated return filing on the state income tax level, profits of the coventurer's special purpose subsidiaries could be subject to double state income taxation. This problem is avoided if an LLC is used to organize the joint venture.

⁵⁶¹ See *supra* note 445 and accompanying text.

⁵⁶² A parent corporation may deduct 70% of the dividends it receives from a subsidiary, I.R.C. § 243(a)(1), unless it owns at least 20% of the stock of the subsidiary, in which case either 80% of the dividends may be deducted, *id.* § 243(c), or 100% for certain affiliated groups. *Id.* § 243(a)(2)-(3).

⁵⁶³ See *supra* notes 225-50 and accompanying text.

⁵⁶⁴ See *supra* notes 73-78 and accompanying text.

trusts with more than one beneficial owner and trusts without a definite income beneficiary, may serve as LLC members. Further, because an LLC is not limited to a single class of stock, different distributions may be made through the use of either multiple classes of interests or special allocations.⁵⁶⁵

An LLC may be used to facilitate the distribution of annual exclusion gifts⁵⁶⁶ to family members, especially those involving difficult-to-divide assets such as real estate. Real estate may be contributed to an LLC, and an undivided interest in the real estate may be transferred to family members via LLC interests. Again, differing rights may be distributed through the use of a multiple-class LLC or one in which special allocations are made. If the LLC has continuity of life, then annual exclusion gifts may be facilitated, and reduction in value may result from the lack of marketability and minority interest discounts.⁵⁶⁷ When an

⁵⁶⁵ See *supra* notes 499-500 and accompanying text.

⁵⁶⁶ Each taxpayer may make gifts of up to \$10,000 per donee per year without federal gift tax consequences. I.R.C. § 2503(b). A spouse may make gifts of \$20,000 per donee if the other spouse agrees to split the gift. *Id.* In addition to facilitating exclusionary gifts, multiple-class LLCs may also be used to effect an "estate freeze" by permitting the transfer of assets expected to appreciate in value to an LLC or to a class of LLC interests which are in turn transferred to the younger generation, while retaining non-appreciating assets in an LLC or in a class of LLC interests held by the senior generation. *Id.*

⁵⁶⁷ For purposes of estate and gift tax valuation, the Service will not assume that, in determining whether transferred shares should be valued as part of a controlling interest, all voting power held by family members should be aggregated. Rev. Rul. 93-12, 1993-1 C.B. 202, *revoking* Rev. Rul. 81-253, 1981-2 C.B. 187. Therefore, minority discounts will not be disallowed solely because the transferred interest, if aggregated with interests held by other family members, would be part of a controlling interest. *Id.* 93-12.

However, caution must be exercised to avoid problems with the special valuation under § 2704(b)(1) of the Code, pursuant to which an "applicable restriction" on the donee's right to liquidate his or her interest may be disregarded for purposes of a discount valuation. An "applicable restriction" is defined as any restriction which effectively limits the ability of the entity to liquidate and either lapses after transfer or can be removed by the transferor or any member of the family, alone or collectively. I.R.C. § 2704(b)(2). If the restriction is disregarded, then the transferred interest is valued as if the restriction were not in place, with the rights of the transferee being assessed as they would under state law in the absence of the restriction. Consequently, the value of the transferred interest will be determined on the basis of its liquidation value, that is, based on the underlying assets, rather than future cash distributions.

An "applicable restriction" is further defined as a limitation on the ability of the transferee to, in whole or in part, liquidate the entity if such restriction is more limiting than restrictions generally applied by state law. *Id.* Furthermore, such a limitation is only a restriction to the extent that either (a) by its terms the restriction will lapse at any time after the transfer or (b) the transferor or his or her estate and members or the transferors family can remove the liquidation restriction immediately after the transfer. Treas. Reg.

LLC is used for these estate-planning purposes, it must comply with the estate freeze rules of the Code.⁵⁶⁸

If an interest in an LLC with appreciated assets is sold, exchanged, or passed by inheritance, the transferee may make an election under § 754 of the Code, which gives the transferee a stepped-up basis (to fair market value) in the LLC's assets.⁵⁶⁹ The purpose of this election is to prevent an incoming member from recognizing taxable gain due to appreciation that occurred before the interest was acquired. The ability to make a section 754 election is a significant advantage in the ownership of appreciating property in an LLC as compared to a corporation.⁵⁷⁰

§ 25.2704-2(b) (as amended in 1993). Therefore, if the LLC's operating agreement is crafted so that restrictions on the member's right to liquidate his or her interest are not "too" restrictive, the "applicable restriction" problems under § 2704 of the Code can be avoided.

When a limited partnership is used instead of an LLC, avoiding a restriction more onerous than that generally applied under state law may be accomplished by providing that the limited partnership will exist for a term of years. The partnership agreement may state that a limited partner may not withdraw prior to the expiration of the fixed term and that any general partner withdrawing prior to the expiration of that term shall, by reason of that breach of the partnership agreement, will suffer having the general partnership interest convert into a limited partnership interest. However, Revenue Ruling 93-12 indicates that values should be determined in the hands of the assignee of the interest; as an assignee/member does not have the ability to withdraw interest, a discount should continue to apply.

Attention must also be focused on the effect of § 2704(a) of the Code, which provides that the lapse of voting or liquidation rights in a corporation or partnership will be treated as a transfer for gift or state tax purposes if the transferee and members of his or her family control the corporation or partnership both before and after the voting or liquidation rights. I.R.C. § 2704(a)(1). Voting or liquidation rights lapse at the time a presently exercisable right is restricted or eliminated regardless of whether such lapse occurs by reason of an organizational charter, by reason of an agreement among the shareholders or partners, or by reason of state law. Treas. Reg. §§ 25.2704-1(b), (c); 25.2704-1(a)(4) (1994). For valuation purposes, the amount of the transfer is equal to the value of the interest immediately before the lapse, assuming that the liquidation and voting rights were themselves non-lapsing, less the value of the interest after the lapse of the voting and liquidation rights. I.R.C. § 2704(a)(2).

Section 2704(a) can present problems when a general partner has the prior-death ability to dissolve and liquidate the partnership and thereby receive the value attributable to his or her partnership interest. I.R.C. § 2704(c). In many instances an LLC will avoid this problem because no individual member has the right to compel the liquidation of the LLC. See *supra* notes 166-72 and accompanying text.

⁵⁶⁸ I.R.C. § 2036.

⁵⁶⁹ *Id.* § 743(b). This step up in basis applies only to a purchasing member's share of the inside basis of the assets, of course.

⁵⁷⁰ No corporate equivalent to § 754 exists. See, e.g., §§ 1014 (basis of property received by decedent), 1015 (basis of property received by gift).

The LLC may also offer a more flexible means of achieving the goals of a family limited partnership. In a family limited partnership, assets are contributed to the entity in return for the general and limited partnership interests, and the limited partner interests are then distributed as gifts to family members or trusts for their benefit.⁵⁷¹ The general partner retains the power to manage the assets of the partnership as well as the power to determine when distributions of income are made and in what amount. The transferred limited partnership interests should not be included in the general partner's taxable estate.⁵⁷²

By using an LLC in place of family limited partnerships, the donor of the property avoids the joint and several liability associated with general partner status while retaining the power to control, through the structuring of the voting provisions in the LLC operating agreement, the LLC assets. Provided the proper restrictions are placed on the interests, the minority and marketability discounts should apply.⁵⁷³

6. *Venture Capital*

By providing venture capital to a business organized as an LLC, the investors have limited liability while retaining the power to be actively involved in management. As many traditional sources of venture capital⁵⁷⁴ may not qualify as S corporation shareholders, this structure, with its modified pass-through taxation, has not been available to venture capital operations. The flexibility to make special allocations permits the LLC to offer a preferred return to the original entrepreneurs,⁵⁷⁵ as well

⁵⁷¹ See Alan Halperin, *Family Limited Partnerships Offer Best of Both Worlds*, N.Y. L.J., Jan. 28, 1994, at 1 (explaining the process and advantages for using LLC in estate planning).

⁵⁷² *Id.*

⁵⁷³ *Id.*

⁵⁷⁴ Examples of traditional sources of venture capital include pension funds, insurance companies, financial institutions, and dedicated venture capital funds organized as corporations.

⁵⁷⁵ Furthermore, it has been suggested that, in venture capital operations in which patents are significant value-producing assets and compensation is paid to the original entrepreneurs as royalties, under § 1235 of the Code the members may individually qualify as owners of the patent and receive capital gains treatment on its transfer. See Meislik, *supra* note 539, at 18; Stuart Levine & Marshall B. Paul, *Putting Limited Liability Companies To Use, or What You Can Do Now That You Have Your New Toy*, Address at ABA Tax Conference on LLCs, TAX NOTES TODAY, Mar. 21, 1992, available in LEXIS, Taxana Library, TNT File, 92 TNT 107-68, § 7 (outlining value of LLC in limiting liability of licensor of patent).

as to employees⁵⁷⁶ and lenders who may have supported the business in its early development.

7. *Natural Resource Development*

Not surprisingly, LLCs offer significant advantages when used in the structuring of natural resource extraction and development enterprises.⁵⁷⁷

It is common in natural resource development situations for the owner of a working interest in the site, generally designated the “farmor,” to assign that working interest to an operator, designated the “farmee,” in exchange for the farmee’s agreement to develop the resources. Often the farmor retains a royalty interest in the resources, at times with an option to convert that royalty interest into a working interest subsequent to the farmee’s recovery of initial extraction costs.⁵⁷⁸

Organized as a C corporation, this arrangement would have to be structured with multiple classes of stock, with at least one class having conversion rights. Income and appreciation would be subject to two levels of income taxation, while losses would be retained at the corporate level and carried forward until such time as the corporation had offsetting income. Special allocations of items of credit or deduction could not be

⁵⁷⁶ In an LLC, a member may receive a profits interest in return for a contribution of services. Revenue Procedure 93-27, 1993-2 C.B. 343, provides that the receipt of a partnership profits interest in exchange for services to the partnership generally does not trigger ordinary income recognition by the contributing partner. Exceptions, *inter alia*, are for the receipt of profits interests relating to a “substantially certain and predictable stream of income from partnership assets,” or for the receipt of a profits interest by a partner who disposes of the interest within two years of receipt. Rev. Proc. 93-27, § 4.02. Prior case law had established that the receipt of a partnership *capital* interest in exchange for services rendered to a partnership resulted in the immediate recognition of ordinary income by the contributing partner, and the case law had been somewhat divided over the taxability of receipt of a profits interest. *Campbell v. Commissioner*, 943 F.2d 815 (8th Cir. 1991) (finding profit interest to be income); *Diamond v. Commissioner*, 492 F.2d 286 (7th Cir. 1974) (holding the receipt of a right to a share of profit or loss in a real estate venture to be ordinary income). In a corporation, the receipt of stock in compensation for services requires ordinary income recognition. I.R.C. § 61(a)(1).

⁵⁷⁷ The LLC was initially conceived as a vehicle for oil and gas development enterprises. See Frank Burke & A. Sessions, *The Wyoming Limited Liability Company, an Alternative to Sub S and Limited Partnerships?*, 54 J. TAX’N 232, 234 (1991); Joseph P. Fonfara & Corey R. McCool, *The Wyoming Limited Liability: A Viable Alternative to the S Corporation and the Limited Partnership?*, 23 LAND & WATER L. REV. 523, 535 (1988).

⁵⁷⁸ See Burke & Sessions, *supra* note 577, at 234-36.

made among the shareholders, such items being retained and used at the corporate level.⁵⁷⁹

As an S corporation, due to the single class of stock limitation, it is possible to draw economic distinctions between the farmor and the farmee. Further, the farmor and farmee may not themselves be eligible S corporation shareholders.⁵⁸⁰ While this arrangement could be mimicked by tracing the working interest in an S corporation, making the farmee the sole shareholder during the initial development phase and granting the farmor a royalty interest with an option to become a shareholder after the farmee's development costs were recovered, the option might violate the prohibition against more than one class of stock. Moreover, there is still no ability to make special allocations of items of income, credit, deduction, or loss between the farmor and farmee.

Organizing as a general partnership would enable the farmor and farmee to make special allocations, but at the cost of taking on joint and several liability for claims connected with the enterprise. To the extent a special purpose corporation served as the general partner, the classification as a partnership may be imperiled. With both the farmor and the farmee as ostensible limited partners, the extent of their activities may cause them to be deemed general partners subject to personal liability for claims against the enterprise. Further, as limited partners, any losses incurred by the enterprise may be treated as passive rather than active losses at the individual level.⁵⁸¹

8. *Family Businesses*

The traditional closely held family business is a prime candidate for organization as an LLC. The availability of both organizational and tax flexibility allows the structuring of the business to the expectations of the owners. As estate planning goals are often of paramount concern in the structuring of closely held businesses,⁵⁸² the options available in an

⁵⁷⁹ See *supra* notes 477-81 and accompanying text.

⁵⁸⁰ See *supra* note 445 and accompanying text.

⁵⁸¹ For a discussion of the application of the passive loss rules to investments in oil and gas ventures, see Paul R. Erickson, *Limited Liability with Material Participation: Avoiding Passive Loss Status for "Nonworking" Oil or Gas Investments*, 42 OIL & GAS TAX Q. 39 (Sept. 1993).

⁵⁸² EDWIN T. HOOD ET AL., *CLOSELY HELD CORPORATIONS IN BUSINESS AND ESTATE PLANNING* § 1.0 (1982), states:

Some of the most unique and challenging problems are presented when the business and estate planner advises the owner of a small-to-medium sized business. Frequently the business not only constitutes a major portion of the

LLC are advantageous.⁵⁸³ Further, the ability to award an ownership interest to a valued employee without triggering ordinary income⁵⁸⁴ leaves open the flexibility to encourage employee productivity and loyalty.

CONCLUSION

The rapid spread of the LLC format across nearly all the states in the six years following the publication of Revenue Ruling 88-76⁵⁸⁵ clearly indicates that the combination of limited liability, organizational flexibility, and taxation as a partnership fills an existing gap in the previously available business structures. While often requiring greater attention to the tax classification issue than is required for other organizational options, the LLC provides numerous advantages which justify the effort as an acceptable cost. As very few situations do not require at least consideration of the LLC, its use will be limited only by the knowledge of business owners and their advisors.

owner's livelihood but also supplies a significant amount of ego satisfaction. In many situations, the owner has built the business from scratch and wishes to leave it as a legacy to family members at, if not before, his death. At the same time, the owner is concerned about increasing his lifetime estate and minimizing any shrinkage at death due to excessive administrative costs and transfer taxes.

⁵⁸³ See *supra* notes 564-73 and accompanying text.

⁵⁸⁴ See *supra* note 506 and accompanying text.

⁵⁸⁵ See *supra* note 321.

