
Faculty Scholarship

2010

The Single Member Limited Liability Company as Disregarded Entity: Now You See it, Now You Don't

Daniel S. Kleinberger

Mitchell Hamline School of Law, daniel.kleinberger@mitchellhamline.edu

Publication Information

Business Law Today, August 2010. © The American Bar Association This information or any portion thereof may not be copied or disseminated in any form or by any means or downloaded or stored in an electronic database or retrieval system without the express written consent of the American Bar Association.

Repository Citation

Kleinberger, Daniel S., "The Single Member Limited Liability Company as Disregarded Entity: Now You See it, Now You Don't" (2010). *Faculty Scholarship*. Paper 159.
<http://open.mitchellhamline.edu/facsch/159>

This Article is brought to you for free and open access by Mitchell Hamline Open Access. It has been accepted for inclusion in Faculty Scholarship by an authorized administrator of Mitchell Hamline Open Access. For more information, please contact sean.felhofer@mitchellhamline.edu.

The Single Member Limited Liability Company as Disregarded Entity: Now You See it, Now You Don't

Abstract

The power and complexity of the single member limited liability company (“SMLLC”) comes from a conceptual contradiction: the conflation of owner and organization for tax purposes and the separation of owner and entity for non-tax, state law purposes. The contraction has significant practical consequences, which this article explores and illustrates, considering: • The SMLLC in federal court (single member not permitted to represent the LLC) • The IRS’s tortuous path to determining whether an SMLLC’s sole member is liable for the SMLLC’s unpaid employment taxes (yes; yes vindicated by the courts; then no, as a matter of policy) • Transfer taxes on a single member’s contribution of land to the member’s solely-owned LLC (maybe taxable, maybe not) • Whether the membership transfer restrictions built into LLC statutes in order to prevent the separate creditors of an LLC member from intruding into the business of a multi-member LLC ought to be applied to allow a sole member to shelter assets from the claims of the sole member’s legitimate creditors (under advisement by one state supreme court for more than a year) The article concludes that “practitioners must exercise great caution when working with an SMLLC, because, depending on which legal regime applies, the SMLLC may be as visible and substantial as a stone wall, or as diaphanous and subject to disappearance as the Cheshire Cat.”

Keywords

limited liability company, LLC, single member limited liability company, SMLLC, transparency, pass through taxation, Lattanzio, Hagerman, pro se representation, transfer taxes, transfer restrictions, conflation, entity aggregate

Disciplines

Business Organizations Law | Tax Law

Comments

This article is co-authored by Carter G. Bishop.

*William Mitchell College of Law
Research Paper No. 2010-04*

~and~

*Suffolk University Law School
Research Paper No. 10-12*

The Single Member Limited Liability Company as Disregarded Entity: Now You See it, Now You Don't

Daniel S. Kleinberger
William Mitchell College of Law

Carter G. Bishop
*Suffolk University Law School;
Catholic University of America Columbus School of Law*



**THE SINGLE MEMBER LIMITED LIABILITY COMPANY AS
DISREGARDED ENTITY: NOW YOU SEE IT, NOW YOU DON'T**

© 2010 –Daniel S. Kleinberger and Carter G. Bishop¹
draft – 2/25/10

The power and complexity of the single member limited liability company (“SMLLC”) comes from a conceptual contradiction: the conflation of owner and organization for tax purposes and the separation of owner and entity for non-tax, state law purposes. The contraction has significant practical consequences, which this article explores and illustrates.

Prelude

In 1996, as the Internal Revenue Service prepared to revolutionize tax classification through its “check the box” regulations, the Service’s lawyers and theoreticians faced a knotty conceptual problem. The essence of “check the box” was to accord partnership tax classification, and therefore flow-through tax status, to all non-corporate business entities organized under the law of a U.S. jurisdiction. This approach was destined to, and did, open the floodgates for LLCs having at least two members and, eventually, for limited liability partnerships and limited liability limited partnership as well.

But what was the Service to do with the “single member LLC” – an LLC with only one owner? It is axiomatic under both state and tax law that a partnership has at least two owners. The Service had neither the statutory nor the jurisprudential basis for announcing that an LLC with only one member would be taxed as a partnership.

¹ Professors Kleinberger and Bishop served as Co-Reporters for the Revised Uniform Limited Liability Company Act and co-author Bishop & Kleinberger, LIMITED LIABILITY COMPANIES: TAX AND BUSINESS LAW (Warren, Gorham & Lamont/RIA; WL db: wgl-llc; 1994 and Supp. 2009-01). Professor Bishop teaches at Suffolk University Law School in Boston, MA. Professor Kleinberger teaches at William Mitchell College of Law, in St. Paul, MN.

The Service's solution was a tour de force; it cut the Gordian knot by declaring that a single member LLC simply does not exist for federal income tax purposes. Put simply, under check the box, unless an SMLLC elects to be classified as a corporation, the SMLLC is a disregarded entity. The sole member of an SMLLC might paraphrase Louis XIV, and say "the entity, it's me."

Since the promulgation of "check the box," the single member LLC has become a centrally important aspect of LLC law and practice. Countless individuals use the SMLLC to provide a liability shield for entrepreneurial activity (activity that for tax purposes disappears into a Schedule C on the individual's tax returns), and SMLLCs also figure prominently in more complicated contexts (ranging from "simply" serving as corporate subsidiaries to playing a pivotal role in structuring "bankruptcy remote" entities for securitization purposes).

Now you see it, ... now you see it: the SMLLC in federal court

The contradiction between tax and non-tax status can be confusing, as illustrated by a pair of recent Circuit Court decisions involving the right of a litigant to appear *pro se* in federal court. *Lattanzio v. COMTA*, 482 F. 3d 137 (2nd Cir. 2007) and *U.S. v. Hagerman*, 545 F.3d 579 (7th Cir 2008) both involved essentially the same legal question. In each case, an LLC's sole owner attempted to appear *pro se* on behalf of the LLC.

In each case, the attempt failed. Although the right to appear *pro se* in federal court is of venerable origin, the right applies to individuals and not to juridic persons. As Chief Justice Marshall explained almost 200 years ago, "a natural person may appear for himself," but "[a] corporation ... can appear only by attorney." *Osborn v. Bank of the United States*, 22 U.S. (9 Wheat.) 738, 830 (1824).

In the *pro se* context, an LLC is very much like a corporation. Conflation is not the paradigm; the owner and the organization are distinct conceptually and legally. Even when the entity is an LLC with only one member, for *pro se* purposes the entity may not be disregarded.

The right to appear *pro se* in federal court has been codified, 28 U.S.C. § 1654, but the codification leaves unchanged the “no conflation” analysis. In *Lattanzio*, for example, the court stated, “the [*pro se* representation] statute does not permit unlicensed laymen to represent anyone else other than themselves.” This limitation prevents “a layperson ... [from] represent[ing] a separate legal entity such as a corporation,” and the limitation extends to “partnerships and single shareholder corporations” and to limited liability companies as well.

For the *Lattanzio* court, it was immaterial that the LLC had only one member. The court acknowledged that “some courts allow sole proprietorships to proceed *pro se*” but sharply distinguished that situation from the situation of a single member LLC: “[A] sole proprietorship has no legal existence apart from its owner. Unlike a sole proprietorship, a sole member limited liability company is a distinct legal entity that is separate from its owner,” with, for example, the power to sue and be sued in its own name.

Having “refus[ed] to distinguish between a single shareholder corporation and a multi-shareholder corporation,” the *Lattanzio* court saw “no reason to distinguish between limited liability companies and sole member or solely-owned limited liability companies.” Like the sole shareholder of a corporation, “a sole member of a limited liability company must bear the burdens that accompany the benefits of the corporate [sic] form and may appear in federal court only through a licensed attorney.” *Lattanzio* at 139-140 (citations and internal quotations omitted).

Lattanzio was a civil case. *U.S. v. Hagerman* was a criminal matter, but the Seventh Circuit used the same reasoning as the Second Circuit to reach the same conclusion. “[T]he right to conduct business in a form that confers privileges, such as the limited personal liability of the owners for tort or contract claims against the business, carries with it obligations one of which is to hire a lawyer if you want to sue or defend on behalf of the entity. Pro se litigation is a burden on the judiciary, and the burden is not to be borne when the litigant has chosen to do business in entity form. He must take the burdens with the benefits.” *Hagerman* at 581-582 (citations omitted).

*Now you see it, ... now you don't; wait – now you do:
single member liability for employment taxes*

As a matter of state, non-tax law, “[a] limited liability company is an entity distinct from its members.” Revised Uniform Limited Liability Company Act (“Re-ULLCA”), § 104(a). As a result, even when an LLC has only one member: “The debts, obligations, or other liabilities of a limited liability company, whether arising in contract, tort, or otherwise: (1) are solely the debts, obligations, or other liabilities of the company; and (2) do not become the debts, obligations, or other liabilities of a member ... solely by reason of the member acting as a member.” Re-ULLCA, § 304(a).

It would seem to follow, therefore, that, when a SMLLC fails to pay its federal employment taxes, the IRS, like any other creditor of the LLC must:

- content itself with the assets of the LLC to satisfy the entity’s obligations, or
- find a way to use the “controlling person” liability approach applicable to other state law entities, IRC § 6671(b), or

- pursue the elaborate and sometimes difficult path of “piercing the veil” of the LLC to reach the assets of the LLC’s owner.

Federal regulations effective in 2007 do indeed follow this approach, but the IRS’s path to this conclusion has been tortuous. An initial pronouncement, Notice 99-6, 1999-1 CB 321, contended that an SMLLC’s disregarded status meant that conflation was the rule for purposes of employment tax liability just as much as for pass through tax status. “The Service recognized that, because the federal tax classification regulations essentially ignore the separate existence of a disregarded entity, the owner of the disregarded entity, and not the entity itself, is treated as the employer and that traditionally employment tax responsibilities rest with the employer.” Bishop & Kleinberger, *LIMITED LIABILITY COMPANIES: TAX AND BUSINESS LAW*, ¶ 2.07[1][a][i].

That approach was criticized as “lead[ing] to confusion” because, as a matter of state law, “the employees are actually employed by the [tax] disregarded entity.” *Id.* Moreover, the approach conflicted with the Service’s own recognition that it could not directly levy on the assets of an SMLLC to satisfy the separate tax debt of the LLC’s single member. *Id.*

¶ 2..07[1][b][i].

Nonetheless, in 2007, in *Littriello v. U.S.*, 484 F.3d 372 (6th Cir. 2007), the Sixth Circuit approved the Service’s approach and held a sole member automatically liable for the enterprise’s employment taxes. To reach this result, the court applied “*Chevron* deference,” *Chevron U.S.A., Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837 (1984), and upheld the entire “check the box” regime. That holding is *Littriello*’s enduring significance.

Ironically, however, on the employment tax/SMLLC issue, *Littriello* is moot. The case validated a regulatory approach that the Service had already prospectively abandoned. In 2005, the Service had announced its intention to jettison Notice 99-6 and had issued Proposed

Regulations on the subject. The proposed regulations sought to treat a SMLLC as if it were a corporation for employment tax purposes.

The Regulations became final on August 17, 2007. In the context of federal employment taxes, therefore, the disregarded entity has ceased to be transparent.

*Now you see it, ... now you see it, but it doesn't matter:
transfer taxes on land transferred to an SMLLC*

Suppose that a person becomes a member of a limited liability company and in connection with that event contributes land to the LLC (so as to “pay for” the membership). As a matter of state entity and property law, it seems self-evident that the contribution involves the transfer for value of the land from the would-be member to a separate legal person (i.e., the LLC). Under the laws of many states, such a transfer triggers a transfer tax, and certainly under the LLC laws of all states the transfer severs the transferor’s ownership interest in the land.

However, when the LLC has only one member, under the statutes of some states it is possible to re-frame the arrangement to avoid the transfer tax. A Connecticut case shows how.

Mandell v. Gavin, 816 A.2d 619 (Conn. 2003) involved a transfer tax applicable only to transfers made for “consideration,” a term which the court stated “has been used in a specific, legal sense for centuries. “ *Id.* at 624. In that sense, “[t]o constitute consideration, a performance or a return promise must be ... sought by the promisor in exchange for his promise and is given by the promisee in exchange for that promise.”” *Id.* at 624-625 (quoting the Restatement (Second) of Contracts, § 71).

Timing is therefore everything in a consideration analysis. “Past consideration” is no consideration, because the subsequent promise cannot have been exchanged for an action already performed. Through good advice or good fortune (or both), Mr. Mandell got the timing just

right. “The plaintiff formed his company soon after the effective date of [Connecticut’s LLC] legislation, naming himself the sole member. The plaintiff then transferred the real property to his company by quitclaim deed. In the deed, the plaintiff recited that the transfer was ‘for NO CONSIDERATION....’” *Id.* at 622.

Given this sequence, Mr. Mandell’s transfer of land to his LLC could seem gratuitous. After all, his admission into the LLC as its sole member provided him with all the economic and governance rights a person could have as member. His subsequent contribution of the land did nothing to increase his rights as a member.

Of course, anyone who actually believes that Mr. Mandell’s admission as the LLC’s member occurred without contemplation of the land transfer has: (i) never heard of the “step transaction” doctrine; and (ii) like the White Queen in Through the Looking Glass, can “believe[] as many as six impossible things before breakfast.” Indeed, Mr. Mandell contested the transfer tax on an entirely different basis. He argued that “he and his single-member limited liability company should be considered a single entity for taxation purposes, and that any transfer of property between them would fail to satisfy the requirement ... that transfers be for ‘consideration’ to be taxable.... because he, as an ‘individual, owns the real estate both before and after the purported transfer....’” *Id.*

Although the Connecticut Supreme Court chose not to follow Mr. Mandell’s suggested “disregarded entity” approach, the fact that the LLC was an SMLLC was crucial to the Court’s decision. If, for example, the LLC had had just one additional member, it would have been impossible to pretend that the members: (i) had first agreed to become members, with an understanding as to how to share governance rights and allocate profits, and then (ii) had just

happened to make contributions of property to the LLC – fortuitously, gratuitously and not in furtherance of their agreement as to membership.

Care with the Schizoid SMLLC

All transfer tax cases depend heavily on the language of the applicable statute, so the *Mandell* analysis might not apply generally. Nonetheless, the case helps illustrate why lawyers must pay careful attention to schizoid nature of the SMLLC.

Other illustrations are easy enough to find. Take, for instance, a current cause célèbre among LLC practitioners and “asset protection” mavens – i.e., whether the membership transfer restrictions built into LLC statutes in order to prevent the separate creditors of an LLC member from intruding into the business of a multi-member LLC ought to be applied to allow a sole member to shelter assets from the claims of the sole member’s legitimate creditors. The Florida Supreme Court has been contemplating that question for more than a year on a question certified by the Eleventh Circuit. *Olmstead v. FTC*, Case No. SC08-1009. (The Court heard arguments on January 8, 2009, and to date has not issued its opinion.)

Warning; it’s all in how you look at it

In sum, practitioners must exercise great caution when working with an SMLLC, because, depending on which legal regime applies, the SMLLC may be as visible and substantial as a stone wall, or as diaphanous and subject to disappearance as the Cheshire Cat.