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Applying Revenue Procedure 95-10 to the Classification of Limited Liability Companies Notes

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by Susan Pace Hamill
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All section references are to the Internal Revenue Code unless otherwise indicated. "LLC" refers to Limited Liability Company; "IRS," to the Internal Revenue Service; "UPA," to the Uniform Partnership Art, 6 U.L.A. 1 (1914 Act) (West 1969); 6 U.L.A. 280 (1994 Act) (West Supp. 1995); and "RULPA," to the Revised Uniform Limited Partnership Act, 6 U.L.A. 407 (1976 Act with 1985 Amendments) (West Supp. 1995). (In Notice 95-14, the IRS has proposed eliminating its partnership classification regulations. For a discussion and analysis of this proposal, *see* Susan Pace Hamill, *A Case For Eliminating the Partnership Classification Regulations*, 68 TAX NOTES 335 (July 17, 1995 – Special Report).

A. Introduction

1. Revenue Procedure 95-10, 1995-3 I.R.B. 20, provides procedural guidelines LLCs must follow to obtain a partnership classification ruling, and it makes Revenue Procedure 89-12, 1989-1 C.B. 798, which provides equivalent guidelines for limited partnerships, inapplicable to LLCs. Revenue Procedure 95-10 expressly states that it does not apply to publicly traded LLCs treated as corporations under section 7704. By statutorily imposing

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per se corporate treatment, section 7704 denies publicly traded partnerships the opportunity to receive partnership classification under the regulations.

2. Revenue Procedures are, as their name implies, procedural in nature and not substantive law; therefore, an LLC that fails to follow Revenue Procedure 95-10 may still successfully obtain partnership classification under the regulations. However, as a practical matter, for most taxpayers using LLCs, Revenue Procedure 95-10 effectively carries the force of substantive law.

   a. For most taxpayers it will be too expensive to obtain the sophisticated tax advice necessary to safely deviate from Revenue Procedure 95-10 without failing the requirements in the partnership classification regulations.

   b. Moreover, the severe tax penalties, for example double taxation or denial of flow-through losses await LLCs inadvertently failing the partnership classification standard.

3. Revenue Procedure 95-10 applies to all LLCs formed under the laws of the United States, any State, or the District of Columbia that are not incorporated organizations, trusts, or partnerships formed under a statute corresponding to the UPA or the RULPA. It also applies to all organizations formed under a foreign law or statute allowing limited liability for any members of the organization. It does not matter if the foreign organization is "incorporated" under a foreign statute.

4. Several states allow LLCs with only one member. To secure partnership classification, Revenue Procedure 95-10 requires the LLC to have two or more members.

   a. Unfortunately, Revenue Procedure 95-10 fails to clearly define the ownership interest necessary to qualify as a member, opting instead to examine all the facts and circumstances.

   b. Revenue Procedure 95-10 does not reveal whether one-member LLCs will receive flow-through treatment as sole proprietors or be subject to the corporate tax provisions.

5. When applying the partnership classification tests for lacking continuity of life, free transferability of interests, and centralized management, Revenue Procedure 95-10 essentially treats LLC managers as general partners and grants LLCs even more flexibility than limited partnerships if the LLC

attempts to lack limited liability. Revenue Procedure 95-10 adds considerable flexibility and certainty to LLC classification thereby minimizing the role partnership classification plays in choosing a form of business entity.

B. The Partnership Classification Rules

1. Under Revenue Procedure 95-10 the IRS will generally rule that LLCs subject to dissolution upon the death, insanity, bankruptcy, retirement, resignation, or expulsion of either any member, or any member-manager, will lack continuity of life unless at least a majority in interest of the remaining members agree to continue. If the LLC ties the dissolution events to the member-managers, they must collectively meet Revenue Procedure 95-10's one per cent ownership and capital account maintenance requirements. LLCs without member-managers must tie the dissolution events to all of the members, while LLCs with member-managers need only tie the dissolution events to all the member-managers.

   a. The IRS will still rule that an LLC lacks continuity of life if the members select less than all, or even just one of these events, as long as the event or events chosen provide a meaningful possibility of dissolution.

   b. The term "majority in interest" contemplates an economic measurement of the LLC or partnership interest rather than a simple head count. LLC members (or partners) with complex economic arrangements for sharing profits, capital, and losses may find it difficult to determine when a majority in interest of the members have agreed to continue.

   c. Revenue Procedure 94-46 provides a safe harbor, calculating a "majority in interest" as a majority of both the profits and capital interests of the LLC (or partnership).

      i. The safe harbor determines each member's capital interest on the date of the dissolution event and if the LLC maintains capital accounts under the section 704(b) safe harbor the members can use those balances.

      ii. The safe harbor calculates a majority in interest based on the reasonable estimation of profits from the date of the dissolution event until the projected termination of the LLC (or partnership).

      iii. Although helpful, a precise calculation of a majority in interest under the safe harbor may be difficult for LLCs with profit ratios that shift over time or upon certain events.

2. The default provisions in most LLC statutes apply the dissolution events to all members and require either all or a majority in interest of the remaining members to agree to continue the business. As a practical matter, many LLCs will opt out of these provisions because the necessity of obtaining consent from all or even a majority in interest of the members every time any of these dissolution events occur for any of the members decreases the stability of the LLC and causes business problems.

   a. Most LLC statutes allow the members to change the default provisions addressing dissolution by agreement. Revenue Procedure 95-10 allows the members to safely tie the dissolution event or events to the member-managers, which greatly increases business stability.

   b. Members of LLCs with flexible dissolution provisions may further increase business stability by having less than all of the above enumerated dissolution events trigger an agreement to continue the requirement.

      i. Under Revenue Procedure 95-10, the IRS will still rule that the LLC lacks continuity of life if the members select less than all, or even just one, of the listed dissolution events, as long as the members clearly establish in the ruling request that the event or events chosen provide a meaningful possibility of dissolution.

      ii. The IRS does not define the parameters of when dissolution events are considered meaningful. Presumably a dissolution event that will never occur, such as the death of a corporate member, will fail to be meaningful.

      iii. Dissolution events that are legally possible but factually highly unlikely, such as the death of a very young person or the bankruptcy of a corporate subsidiary, should still be considered meaningful and IRS representatives have informally confirmed that "meaningful possibility of dissolution" only requires a legal possibility of dissolution.

   c. LLC members relying on the majority in interest threshold for the consent to continue, whether provided for by agreement or the default provisions, need to ensure that the level of consent in the operating agreement meets or exceeds the majority in interest safe harbor of Revenue Procedure 94-46. For example, to be on the safe side, an agreement could require consent of both two thirds in number and a majority in interest as defined by the safe harbor.

3. Unlike limited partnerships corresponding to RULPA, LLCs with more than one manager still must have a majority in interest of the members at large agree to continue the LLC.

   a. Limited partnerships corresponding to RULPA that have more than one general partner can lack continuity of life even though the remaining general partners, rather than a majority in interest of all partners, agree to continue if a dissolution event occurs with respect to one of the general partners.

   b. Although this difference makes LLCs slightly more vulnerable to unplanned dissolutions, the ability of LLCs to tie the dissolution events to the managers adds significant business stability to LLCs, allowing them to compete with limited partnerships.

4. Under Revenue Procedure 95-10 the IRS generally will rule that an LLC lacks centralized management if the members are managing the LLC exclusively in their membership capacity.

   a. LLCs designating managers have an opportunity to defeat centralized management if the members-managers own at least 20 per cent of the total interests in the LLC. However, even if the LLC member-managers meet the 20 per cent ownership threshold, the LLC still may be viewed as possessing centralized management.

   b. The IRS maintains the right to "consider all the relevant facts and circumstances" including direct or indirect member control of the member-managers.

   c. In addition, if the member-managers are subject to periodic elections by the members at large or if the members have a substantially nonrestricted power to remove the member-managers the IRS will not rule under any circumstances that the LLC lacks centralized management.

5. Most LLC statutes offer flexible alternatives for managing an LLC. The default provisions vest the power to manage the LLC to the members in their membership capacity unless they explicitly designate managers.

   a. Obviously, LLCs without managers automatically lack centralized management. LLCs that need to defeat centralized management, in addition to designating managers meeting the 20 per cent ownership test, must also craft the operating agreement carefully to avoid any inference that the non-managing members have an unrestricted power to remove the manager and must make sure that the manager serves for an indefinite term rather than being subject to periodic election.

b. Because the IRS reserves a great deal of discretion in the centralized management area, risk adverse LLCs with designated managers should probably ensure that the LLC lacks continuity of life and free transferability of interest.

6. Revenue Procedure 89-12 contains no language similar to Revenue Procedure 95-10's refusal to grant a centralized management ruling when member-managers either are subject to unrestricted removal or periodic elections.

   a. The IRS presumably added this language to ensure that LLC member-managers in fact more closely resemble general partners than corporate board members.

   b. However, because both LLCs and limited partnerships faced scrutiny of all the facts and circumstances relevant to control of the manager or general partner, historically neither LLCs nor limited partnerships relied on lacking centralized management.

   c. That trend will likely continue for LLCs using Revenue Procedure 95-10.

7. Revenue Procedure 95-10 confirms that LLCs lack free transferability of interests if each member, or at least those members owning more than 20 per cent of the interests, must obtain consent from a majority of the non-transferring members to transfer a complete interest in the LLC to a person not a member.

   a. Also, Revenue Procedure 95-10 expressly states that LLCs still lack free transferability of interests if a majority of the non-transferring member-managers, collectively meeting the one-per cent ownership and capital account maintenance requirements, grant the consent for transfers.

   b. For purposes of lacking free transferability of interests the IRS defines "majority" to include either a majority interest (same definition as applied to continuity of life) or a majority based on capital, or profits, or per capita.

      i. The IRS requires that the restriction be meaningful.

      ii. Other than confirming that meaningful restrictions on transfers requires the consent to be withholdable for any reason however unreasonable, the IRS leaves "meaningful restriction" undefined.

8. The default provisions of most LLC statutes forbid the LLC members from transferring an interest in both the economic and governance rights to a person not a member unless either all or a majority of the non-transferring members consent to the transfer.

   a. Consequently, LLCs that simply keep the default transferability restrictions in place will lack free transferability of interests.

   b. LLCs seeking to increase flexibility while lacking free transferability can provide by agreement that only slightly more than 20 per cent of the interests must obtain consent from a majority of the nontransferring managers.

   c. LLCs with many members freely trading the economic interests or certain LLCs creating multiple classes of interests face a substantial risk of substantively possessing free transferability of interests under the IRS's "meaningful restriction" requirement.

9. Allowing a majority of non-transferring member-managers to consent to a transfer essentially equates member-managers as general partners for free transferability purposes. Although Revenue Procedure 89-12 did not contain the meaningful restriction language, the IRS has always informally denied rulings if the restrictions on the transfers were meaningless.

10. LLC statutes uniformly provide that no member or manager bears personal liability for the debts and obligations of the LLC, therefore causing LLCs to automatically possess limited liability. Before the IRS released Revenue Procedure 95-10, LLCs could not safely lack limited liability.

    a. Revenue Procedure 95-10 allows LLCs to lack limited liability if at least one member assumes personal responsibility for all, not merely part, of the LLC's obligations pursuant to express authority granted in the controlling LLC statute.

       i. In addition, the assuming member (or members) must have an aggregate net worth that initially equals at least 10 per cent of the total contributions to the LLC and expects to continue at that level throughout the life of the LLC.

       ii. The assuming members or members must in the aggregate meet the one per cent ownership and capital account maintenance requirements.

    b. If an assuming member (or members) fails the net worth requirement, the IRS closely examines the facts to determine if the assuming mem-

ber (or the assuming members) has substantial assets (other than the member's interest in the LLC) that could be reached by a creditor of the LLC.

11. The ability of an LLC to lack limited liability should cause a revolutionary expansion in the use of LLCs. LLCs can now safely receive partnership classification by lacking continuity of life and limited liability. Before the IRS released Revenue Procedure 95-10, widely held LLCs could not safely be classified as partnerships. Widely held LLCs substantively possess free transferability of interests because the business arrangement requires the ability to at least freely trade the economic interests. Moreover an LLC with numerous owners must centralize management.

    a. As a business matter, a widely held LLC can not tolerate the hazards of multiple unplanned dissolution events resulting from tying the dissolution events to all of the members. Before Revenue Procedure 95-10, no authority allowed LLCs to lack continuity of life if only the managers could trigger a dissolution and agreement to continue requirement. Before Revenue Procedure 95-10, LLCs could not safely lack limited liability. The ability to lack continuity of life and limited liability under Revenue Procedure 95-10 allows widely held (but not publicly traded) LLCs to compete with limited partnerships.

    b. Many states will have to make technical corrections providing for explicit statutory authority allowing members to assume personal liability for all debts and obligations of the LLC.

        i. Revenue Procedure 95-10 clearly requires the statute to grant this authority and does not recognize liability assumptions based on the enforcement of contracts under local law.

        ii. For domestic LLCs this should prove to be a temporary problem.

        iii. For some foreign LLCs, the inability of contractually assumed liability to provide the necessary liability exposure for U.S. classification purposes will cause more significant problems on a long-term basis.

12. Only the general partner of a limited partnership can provide the necessary liability exposure that causes the limited partnership to lack limited liability.

    a. Unlike limited partnerships, Revenue Procedure 95-10 allows any member in an LLC, even a member without management authority, to provide the necessary liability exposure that causes the LLC to lack

limited liability. Therefore, Revenue Procedure 95-10 allows LLCs more flexibility than limited partnerships when seeking a ruling that it lacks limited liability.

b. Because LLCs (that are not publicly traded) can now be used instead of limited partnerships to raise money in the capital markets business concerns alone rather than entity classification should dictate which entity the participants choose.

C. Ownership Interests and Capital Account Requirements

1. Section 4.02 of Revenue Procedure 95-10 requires that the member-managers of an LLC attempting to lack either continuity of life or free transferability of interests "own in the aggregate, and pursuant to express terms of the operating agreement, at least 1 percent interest in each material item of the LLC's income, gain, loss, deduction, or credit during the entire existence of the LLC."

   a. Section 4.02 also requires that the assuming member (or members) of an LLC attempting to lack limited liability "own in the aggregate, and pursuant to express terms of the operating agreement, at least a 1 percent interest in each material item of the LLC's income, gain, loss, deduction, or credit during the entire existence of the LLC."

2. Section 4.03 of Revenue Procedure 95-10 provides an exception to the ownership requirements, "[i]f the LLC has total contributions exceeding $50 million, the member-managers (or assuming members) need not meet the 1 percent standard," instead they must maintain in the aggregate "an interest at all times during the existence of the LLC in each material item of at least 1 percent divided by the ratio of total contributions to $50 million, and the LLC's operating agreement must expressly incorporate at least the computed percentage."

3. Section 4.04 of Revenue Procedure 95-10 requires that the member-managers, in the aggregate, of an LLC attempting to lack either continuity of life or free transferability of interests "maintain throughout the entire existence of the LLC a minimum capital account balance equal to the lesser of 1 percent of total positive capital account balances or $500,000."

   a. Section 4.04 also requires that the assuming member (or members), in the aggregate, of an LLC attempting to lack limited liability "maintain throughout the entire existence of the LLC a minimum capital account balance equal to the lesser of one per cent of total positive capital account balances of $500,000."

4. Section 4.05 of Revenue Procedure 95-10 sets out an exception to the capital account balance requirement. "If at least one member-manager (or assuming member) . . . required . . . to have and maintain a minimum capital account balance has contributed or will contribute substantial services in the capacity as a member, . . . the capital account standard in section 4.04 does not apply to any of the member-managers (or assuming members). However, the operating agreement of the LLC must expressly provide that, upon the dissolution and termination of the LLC, the member-managers (or assuming members) will contribute capital to the LLC in an amount equal to the lesser of: (1) the aggregate deficit balance, if any, in their capital accounts, or (2) the excess of 1.01 percent of the total capital contributions or the non-managing members (or non-assuming members) over the aggregate capital previously contributed to the LLC by the member-managers (or assuming members)."

   a. The IRS also includes a caveat: "Those services that do not relate to day-to-day operations in the LLC's primary business activity, such as services related to the organization and syndication of the LLC, accounting, financial planning, general business planning, and services in the nature of investment management, will be closely scrutinized by the Service to determine if they are in fact substantial services. In making this determination, the nature of the LLC and its activities will be taken into account."

APPENDIX

Rev. Proc. 95-10

26 C.F.R. 601.201: Rulings and determination letters

(Also Part 1, Sections 7701; 301.7701-2, 301.7701-3.)

1995 IRB LEXIS 23; 1995-3 I.R.B. 20; REV. PROC. 95-10

January 17, 1995

SECTION 1. PURPOSE

.01 This revenue procedure specifies the conditions under which the Internal Revenue Service (Service) will consider a ruling request that relates to classification of a domestic or foreign limited liability company (LLC) as a partnership for federal tax purposes. This revenue procedure modifies Rev. Proc. 89-12, 1989-1 C.B. 798, which specifies the conditions under which the Service will consider a ruling request that relates to the classification of an organization as a partnership for federal tax purposes. Rev. Proc. 89-12 applies to organizations formed as partnerships and also applies to other organizations seeking partnership classification. It also provides that any reference to a "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. Rev. Proc. 89-12 no longer applies to LLCs. See section 6 of this revenue procedure.

.02 This revenue procedure applies to all organizations that are formed as LLCs under the laws of the United States or of any State or the District of Columbia (domestic law) providing for or allowing limited liability to any of their members and that are not incorporated organizations, trusts, or partnerships formed under statutes corresponding to the Uniform Partnership Act or the Revised Uniform Limited Partnership Act. This revenue procedure also applies to all organizations formed under a law other than domestic law (foreign law or foreign statute), where the foreign law or foreign statute provides for or allows limited liability to any of their members (whether or not the foreign organization is "incorporated" under a foreign statute). See Rev. Rul. 88-8, 1988-1 C.B. 403. This revenue procedure does not apply to a publicly traded LLC treated as a corporation under §7704 of the Internal Revenue Code.

.03 Unless the context clearly indicates otherwise, references to the LLC's operating agreement include the articles of organization and all other controlling documents, however designated, entered into by the members of the LLC. If the applicable statute allows for management by one or more designated persons, managers are those persons designated or elected by the members to act on behalf of the LLC.

.04 The Service may decline to issue a ruling under this revenue procedure when warranted by the facts and circumstances of a particular case and when appropriate in the interest of sound tax administration.

SEC. 2. BACKGROUND

.01 Section 7701(a)(2) defines the term partnership 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 the Code, a trust or estate or a corporation. Sections 301.7701-2 and 301.7701-3 of the Procedure and Administration Regulations set forth rules for determining whether an organization is classified as a partnership or as an association taxable as a corporation for federal tax purposes.

.02 Rev. Rul. 73-254, 1973-1 C.B. 613, provides that the classification of a foreign unincorporated business organization for federal tax purposes will be determined under §7701 and the regulations thereunder. However, it is the local law of the foreign jurisdiction that must be applied in determining the legal relationships of the members of the organization among themselves and with the public at large, as well as the interests of the members of the organization in its assets. Rev. Rul. 88-8 provides that an entity organized under foreign law is considered to be "unincorporated" for purposes of §301.7701-2(a)(3) and, therefore, is classified for federal tax purposes solely on the basis of the characteristics set forth in §301.7701-2.

.03 Rev. Proc. 94-1, 1994-1 C.B. 378, as updated annually, sets forth procedures for taxpayer requests and Service issuance of advance rulings; however, Rev. Proc. 94-3, 1994-1 C.B. 447, and Rev. Proc. 94-7, 1994-1 C.B. 542, as updated annually, list areas in which the Service will not issue, or will not ordinarily issue, advance rulings.

SEC. 3. INFORMATION TO BE SUBMITTED WITH RULING REQUEST

.01 Section 8 of Rev. Proc. 94-1 outlines general requirements concerning the information to be submitted as part of a ruling request, including a classification ruling request. For example, an LLC classification ruling request must contain a complete statement of all facts relating to the classification issue. Among those facts to be included in the statement are the items of information specified in this revenue procedure; therefore, the ruling request must provide all items of information specified below, or at least account for all the items. For example, if no registration statement is required to be filed with the U.S. Securities and Exchange Commission (SEC), the ruling request should so state.

.02 Submission of the documents and supplementary materials required by section 3.04 of this revenue procedure does not satisfy the information requirements contained in section 3.03 of this revenue procedure or in section 8 of Rev. Proc. 94-1. All material facts in documents, including those items required by section 3.03 of this revenue procedure,

must be included in the ruling request and may not merely be incorporated by reference therein. All submitted documents and supplementary materials must contain applicable exhibits, attachments, and amendments.

.03 Required General Information. The following information must be included in the request for a ruling:

(1) The name and taxpayer identification number (if any) of the LLC;

(2) The business of the LLC;

(3) The date and place of filing of the LLC's articles of organization, or the anticipated date and place of filing;

(4) The identification of the domestic or foreign jurisdiction whose law controls the formation and operation of the LLC;

(5) A representation that the LLC has been, and will be at all times, in conformance with the controlling laws of the domestic or foreign jurisdiction;

(6) The nature, amount, and timing of capital contributions made and to be made by the members to the LLC;

(7) The extent of participation of the members and the managers in profits and losses of the LLC, including any possible shift in the profit and loss sharing ratios over time;

(8) A description of the relationships, direct and indirect, between the members and the managers (whether or not also members) that would suggest that the managers, individually or in the aggregate, may not at all times act independently of the members (because of individual or aggregate influence or control by the members in their capacity as such over the managers). These relationships include: (a) ownership by non-manager members of 5 percent or more of the stock or other beneficial interests in a manager; (b) control by non-manager members of 5 percent or more of the voting power in a manager; (c) ownership of 5 percent or more of the stock or other beneficial interests in any manager and in any non-manager members by the same person or persons acting as a group; and (d) control of 5 percent or more of the voting power in any manager and in any non-manager members by the same person or persons acting as a group. A person is considered to own any beneficial interest owned by a related person and is considered to control any voting power controlled by a related person. A person is treated as related to another person if they bear a relationship to each other specified in §267(b) or §707(b)(1). The relationships defined in the first sentence of this section 3.03(8) may also include a debtor-creditor relationship and an employer-employee relationship;

(9) If it is asserted that the LLC lacks the corporate characteristic of limited liability: (a) a description of the legal arrangements supporting the assertion that the LLC lacks limited liability, (b) a representation of the net worth (based on assets at current fair market value) of the member or members assuming personal liability for all obligations of the LLC (assuming member), excluding interests in the LLC held by that member or members, (c) a description of the assuming member's or members' assets and liabilities arising from transactions with the LLC or with a person related to any member or members under §267(b) or §707(b)(1), and (d) a description of all other organizations in which the member or members have an interest;

(10) A detailed description of how each of the applicable provisions of section 5 of this revenue procedure are satisfied;

(11) If the Service has issued a revenue ruling on the applicable domestic or foreign law, a discussion of how the revenue ruling applies to the taxpayer's ruling request.

.04 Required Copies of Documents and Supplementary Materials. The following copies of documents and materials must be submitted with the ruling request:

(1) The LLC's articles of organization filed or to be filed with the domestic or foreign jurisdiction in which the LLC is formed;

(2) The LLC's operating agreement (exclusive of the articles of organization);

(3) The registration statement (or comparable document under foreign law) filed or to be filed with the SEC or comparable foreign regulatory body. (A draft that is final in all material respects is acceptable);

(4) If a registration statement (or comparable document under foreign law) is not required to be filed with the SEC or comparable foreign regulatory body, the documents filed or to be filed with any domestic federal or state (or comparable foreign) agency engaged in the regulation of securities and any private offering memorandum (or comparable documents under foreign law). (Drafts that are final in all material respects are acceptable);

(5) A copy of the applicable domestic or foreign law, and amendments, under which the LLC was or will be formed;

(6) An outline or copies of all promotional material used to sell interests in the LLC, highlighting statements about probable domestic and foreign tax consequences and the effect of the requested ruling upon the tax consequences;

(7) An English translation of all documents in a foreign language.

SEC. 4. GENERAL PROVISIONS AND OWNERSHIP TESTS

.01 General. The Service will consider a ruling request that relates to classification of an LLC as a partnership for federal tax purposes only if the LLC has at least two members and, to the extent applicable, the conditions in sections 4 and 5 of this revenue procedure are satisfied. The determination of whether the LLC has at least two members is based on all the facts and circumstances. Section 5.01 relates solely to the corporate characteristic of continuity of life described in §301.7701-2(b); section 5.02 relates solely to the corporate characteristic of free transferability of interests described in §301.7701-2(e); section 5.03 relates solely to the corporate characteristic of centralized management described in §301.7701-2(c); and section 5.04 relates solely to the corporate characteristic of limited liability described in §301.7701-2(d). Section 4.02 through 4.05 of this revenue procedure provides minimum ownership requirements that must be satisfied if the taxpayer requests a ruling that the LLC lacks continuity of life under section 5.01(1) (pertaining to dissolution events relating solely to member-managers), free transferability of interests under section 5.02(1) (pertaining to consent to transfer solely by member-managers), or limited liability under section 5.04. Failure to satisfy any of the above sections only precludes a ruling that the LLC lacks the particular corporate characteristic addressed by the relevant section and does not necessarily preclude the issuance of a partnership classification ruling by the Service. If the LLC is issued a ruling under this revenue procedure that it is classified as a partnership and the LLC subsequently has only one member, the letter ruling ceases to be effective because the LLC's status as a partnership for federal tax purposes terminates as of the relevant date specified in §708 and §736.

.02 General Rule as to Profit and Loss Interests. Unless section 4.03 of this revenue procedure applies, if the taxpayer requests a ruling that the LLC lacks continuity of life under section 5.01(1) or free transferability of interests under section 5.02(1), the member-managers in the aggregate must own, pursuant to the express terms of the operating agreement, at least a 1 percent interest in each material item of the LLC's income, gain, loss, deduction, or credit during the entire existence of the LLC. Further, unless section 4.03 applies, if the taxpayer requests a ruling that the LLC lacks limited liability under section 5.04, the assuming member or members must in the aggregate own, pursuant to the express terms of the operating agreement, at least a 1 percent interest in each material item of the LLC's income, gain, loss, deduction, or credit during the entire existence of the LLC. However, it will generally not be considered a violation of this section 4.02 if a required allocation under either §704(b) or §704(c), or corresponding Income Tax Regulations, temporarily causes less than 1 percent of the LLC's income, gain, loss, deduction, or credit to be allocable to the party otherwise required under this section 4.02 to receive the allocation; in these cases, the ruling request must describe any required allocations and explain why the allocation is required under §704(b) or §704(c), as appropriate. Any other

temporary allocation causing less than 1 percent of any material item of the LLC's income, gain, loss, deduction, or credit to be allocable to the necessary parties will be considered a violation of this section 4.02, unless the LLC clearly establishes in the ruling request that the member-managers or the assuming members (as the case may be) have a material interest in net profits and losses over the LLC's anticipated life. For this purpose, a profits interest generally will not be considered material unless it substantially exceeds 1 percent and will be in effect for a substantial period of time during which the LLC reasonably expects to generate profits. For example, a 20 percent interest in profits that begins 4 years after the LLC's formation and continues for the life of the LLC generally would be considered material if the LLC is expected to generate profits for a substantial period of time beyond the initial 4-year period.

.03 Exception to General Rule as to Minimum Profits and Loss Interests. If the LLC has total contributions exceeding $50 million, the member-managers (or assuming members) need not meet the 1 percent standard in section 4.02 of this revenue procedure. However, except for a temporary allocation or nonconformance specified in section 4.02, the member-managers (or assuming members) in the aggregate must maintain an interest at all times during the existence of the LLC in each material item of at least 1 percent divided by the ratio of total contributions to $ 50 million, and the LLC's operating agreement must expressly incorporate at least the computed percentage. For example, if total contributions are $ 125 million, the interest in each material item must be at least .4 percent, that is, 1 percent divided by 125/50. In no event, however, other than as a result of a temporary allocation or nonconformance specified in section 4.02, may the member-managers' (or assuming members') aggregate interest at any time during the existence of the LLC in any material item be less than .2 percent.

.04 General Rule as to Capital Account Balances. Unless section 4.05 of this revenue procedure applies, if the taxpayer requests a ruling that the LLC lacks continuity of life under section 5.01(1), or free transferability of interests under section 5.02(1), the member-managers, in the aggregate, must maintain throughout the entire existence of the LLC a minimum capital account balance equal to the lesser of 1 percent of total positive capital account balances or $ 500,000. Further, unless section 4.05 applies, if the taxpayer requests a ruling that the LLC lacks limited liability under section 5.04, the assuming member or members must maintain a minimum capital account balance in accordance with the rules of the preceding sentence. Whenever a non-managing member (or non-assuming member) makes a capital contribution, the member-managers (or assuming members) must be obligated, pursuant to the express terms of the operating agreement, to contribute immediately to the LLC capital equal to 1.01 percent of the non-managing members' (or non-assuming members') capital contributions or a lesser amount (including zero) that causes the sum of the member-managers' (or assuming members') capital account balances to equal the lesser of 1 percent of total positive capital account balances for the LLC or $ 500,000. If no member has a positive capital account balance, then the member-managers (or assuming members) in the LLC need not have a positive capital account balance to satisfy this section 4.04. Capital accounts and the value of contributions are determined under the rules of §1.704-1(b)(2)(iv) of the Income Tax Regulations.

.05 Exception to General Rule of Minimum Capital Account Balances. If at least one member-manager (or assuming member) otherwise required under section 4.04 of this revenue procedure to have and maintain a minimum capital account balance has contributed or will contribute substantial services in the capacity as a member, apart from services for which guaranteed payments under §707(c) are made, the capital account standard in section 4.04 does not apply to any of the member-managers (or assuming members). However, the operating agreement of the LLC must expressly provide that, upon the dissolution and termination of the LLC, the member-managers (or assuming members) will contribute capital to the LLC in an amount equal to the lesser of: (1) the aggregate deficit balance, if any, in their capital accounts, or (2) the excess of 1.01 percent of the total capital contributions of the non-managing members (or non-assuming members) over the aggregate capital previously contributed to the LLC by the member-managers (or assuming members). Those services that do not relate to day-to-day operations in the LLC's

primary business activity, such as services related to the organization and syndication of the LLC, accounting, financial planning, general business planning, and services in the nature of investment management, will be closely scrutinized by the Service to determine if they are in fact substantial services. In making this determination, the nature of the LLC and its activities will be taken into account.

SEC. 5. RULING GUIDELINES FOR SPECIFIC CORPORATE CHARACTERISTICS

.01 Continuity of Life.

(1) Dissolution Events Relating Solely to Member-Managers. If the members of the LLC designate or elect one or more members as managers and the controlling statute, or the operating agreement pursuant to the controlling statute, provides that the death, insanity, bankruptcy, retirement, resignation, or expulsion of any member-manager causes a dissolution of the LLC without further action of the members, unless the LLC is continued by the consent of not less than a majority in interest of the remaining members, the Service will generally rule that the LLC lacks continuity of life. For purposes of the preceding sentence all the member-managers must be subject to the specified dissolution events. For example, if the LLC is managed by A, B, and C, it must be provided that a dissolution event with respect to A, B, or C will dissolve the LLC, and not a dissolution event with respect to only one of the named managers (i.e., a dissolution event only with respect to A but not B or C).

(2) Dissolution Events Relating to Members. If the members of the LLC do not designate or elect one or more members as managers (or if the LLC requests a ruling under this section 5.01(2) despite the presence of member-managers) and the controlling statute, or the operating agreement pursuant to the controlling statute, provides that the death, insanity, bankruptcy, retirement, resignation, or expulsion of any member dissolves the LLC without further action of the members, unless the LLC is continued by the consent of not less than a majority in interest of the remaining members, the Service generally will rule that the LLC lacks continuity of life. For purposes of the preceding sentence, all the members must be subject to the specified dissolution events.

(3) Majority in Interest. See Rev. Proc. 94-46, 1894-28 I.R.B. 129, pertaining to majority in interest, for purposes of applying section 5.01(1) and (2) of this revenue procedure.

(4) Limitation on Dissolution Events. If the controlling statute, or the operating agreement pursuant to the controlling statute, provides that less than all of the dissolution events listed above with respect to the member-managers (when applying section 5.01(1)) or the members (when applying section 5.01(2)) dissolves the LLC, the Service will not rule that the LLC lacks continuity of life unless the taxpayer clearly establishes in the ruling request that the event or events selected provide a meaningful possibility of dissolution.

.02 Free Transferability of Interests.

(1) Consent to Transfer Solely by Member-Managers. If the members of the LLC designate or elect one or more members as managers, and the controlling statute, or the operating agreement pursuant to the controlling statute, provides that each member, or those members owning more than 20 percent of all interests in the LLC's capital, income, gain, loss, deduction, and credit, does not have the power to confer upon a non-member all the attributes of the member's interests in the LLC's capital, income, gain, loss, deduction, and credit, does not have the power to confer upon a non-member all the attributes the member's interests in the LLC without the consent of not less than a majority of the non-transferring member-managers, the Service will generally rule that the LLC lacks free transferability of interests. See Rev. Proc. 92-33, 1992-1 C.B. 782.

(2) Consent to Transfer by Members. If the members of the LLC do not designate or elect one or more members as managers (or if the LLC requests a ruling under this section 5.02(2) despite the presence of member-managers), and the controlling statute, or the operating agreement pursuant to the controlling statute, provides that each member, or those members owning more than 20 percent of all interests in the LLC's capital, income,

gain, loss, deduction, and credit, does not have the power to confer upon a non-member all the attributes of the member's interests in the LLC without the consent of not less than a majority of the non-transferring members, the Service will generally rule that the LLC lacks free transferability of interests. See Rev. Proc. 92-33.

(3) Majority Defined. For purposes of applying sections 5.02(1) and 5.02(2) of this revenue procedure, consent of a majority includes either a majority in interest (see Rev. Proc. 94-46 pertaining to majority in interest), a majority of either the capital or profits interests in the LLC, or a majority determined on a per capita basis.

(4) Meaningful Consent. The Service will not rule that the LLC lacks free transferability of interests unless the power to withhold consent to the transfer constitutes a meaningful restriction on the transfer of the interests. For example, a power to withhold consent to a transfer is not a meaningful restriction if the consent may not be unreasonably withheld.

.03 Centralization of Management.

(1) Members Manage LLC Without Managers. If the controlling statute, or the operating agreement pursuant to the controlling statute, provides that the LLC is managed by the members exclusively in their membership capacity, the Service generally will rule that the LLC lacks centralized management.

(2) Members Designated or Elected as Managers. If the members of the LLC designate or elect one or more members as managers of the LLC, the Service will not rule that the LLC lacks centralized management unless the member-managers in the aggregate own at least 20 percent of the total interests in the LLC. However, even if the aggregate ownership requirement is satisfied, the Service will consider all the relevant facts and circumstances, including, particularly, member control of the member-managers (whether direct or indirect), in determining whether the LLC lacks centralized management. The Service will not rule that the LLC lacks centralized management if the member-managers are subject to periodic elections by the members, or, alternatively, the non-managing members have a substantially non-restricted power to remove the member-managers.

.04 Limited Liability. The Service generally will not rule that an LLC lacks limited liability unless at least one assuming member validly assumes personal liability for all (but not less than all) obligations of the LLC, pursuant to express authority granted in the controlling statute. In addition, the Service generally will not rule that an LLC lacks limited liability unless the assuming members have an aggregate net worth that, at the time of the ruling request, equals at least 10 percent of the total contributions to the LLC and is expected to continue to equal at least 10 percent of total contributions to the LLC throughout the life of the LLC. In the case of an LLC in which the assuming members do not satisfy the safe harbor described in the preceding sentence, close scrutiny will be applied to determine whether the LLC lacks limited liability. In that connection, it must be demonstrated that an assuming member has (or the assuming members collectively have) substantial assets (other than the member's interest in the LLC) that could be reached by a creditor of the LLC. In determining the net worth of the assuming member (or assuming members), the principles contained in section 4.03 of Rev. Proc. 92-88, 1992-2 C.B. 496, are to be applied.

SEC. 6. EFFECT ON OTHER REVENUE PROCEDURES

Rev. Proc. 89-12 is modified so that it does not apply to ruling requests submitted by LLCs described in this revenue procedure.

SEC. 7. EFFECTIVE DATE

This revenue procedure applies to all ruling requests received in the National Office on or after January 17, 1995.

DRAFTING INFORMATION

The principal author of this revenue procedure is D. Lindsay Russell of the Office of Assistant Chief Counsel (Passthroughs & Special Industries). For further information regarding this revenue procedure contact Mr. Russell at (202) 622-3050.

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