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Contribution and Distribution Flexibility and Tax Pass-through Entities

Bradley T. Borden

Brett Freudenberg

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CONTRIBUTION AND DISTRIBUTION FLEXIBILITY AND TAX PASS-THROUGH ENTITIES

by

Brett Freudenberg and Bradley T. Borden†*

The way jurisdictions design their tax systems for business operations can be a contentious issue, as they try to balance the competing goals of raising sufficient tax revenue without unduly inhibiting commercial investment and activities. Such tax design can be of particular importance for small and medium enterprises, which due to their size, inherent characteristics, and resources can struggle with tax compliance. Those attributes can also make business tax regressive. A number of countries around the world have adopted business entities that utilise corporate characteristics, such as liability protection for members and separate legal entity status, but have the characteristic of tax pass-through, with members assessed directly on the income and losses of the entity. Examples include limited liability partnerships (LLPs) in the United Kingdom, look-through companies in New Zealand, and limited liability companies (LLCs) in the United States.

In some jurisdictions, these tax pass-through entities have been extremely popular, which in part has been attributed to flexibility for the members in terms of governance and the facilitation of contributions and subsequent distributions. This flexibility is arguably a desired commercial feature of business entities. However, such flexibility with contributions and distributions is seen as a potential risk to tax revenue as there is concern with artificial engineering in order to lower the overall

* Professor—Tax Law, Griffith University; b.freudenberg@griffith.edu.au.

† Professor of Law, Brooklyn Law School; brad.borden@brooklaw.edu.

tax burden. This has led to tax integrity measures, which by their very nature can potentially restrict flexibility.

For example, LLCs and their members are subject to greater (and potentially more complex rules) when it comes to measuring the cost basis of their membership interests; this then influences members' ability to utilise allocated losses and the tax treatment of distributions. The flexibility of contributions and distributions for LLPs in the United Kingdom has also raised concerns with the introduction of tax integrity measures. By comparison, the United States' older tax pass-through entity, the S Corporation, with only one class of membership interest, has fewer integrity rules governing allocations.

This Article will critically assess how the flexibility of contributions and distributions by these tax pass-through entities affects the tax rules that apply to their members. We argue that the flexibility of contributions and distributions appears to be a key characteristic demanded by business entities both for commercial and tax reasons. However, investors need to be cognitive of the inherent complexity and costs that this flexibility may entail. Additionally, it is important for governments and revenue authorities not to unduly restrict flexibility with complex tax integrity rules as it is a fine balance between commercial and revenue needs.

I. Introduction

At the close of the twentieth century, there was a considerable movement internationally towards providing alternative business entities, including some with tax pass-through treatment.[1] The reasons for these new business entities are varied, including facilitating venture capital investment, tax neutrality, response to lobby groups, jurisdictional competition, and efficiency arguments.[2] These new pass-through entities can provide a unique combination of what might be described as partnership and corporation characteristics. For example, the internal governance rules may be based on concepts that relate to general partnerships (such as member-management) but with the corporate characteristics of separate legal entity status and liability protection for members. Additionally, the tax rules that apply to these new business entities can be more akin to those that traditionally apply to general partnerships, that is, a tax aggregate (or tax pass-through) approach, with the income and losses of the business directly attributed to members.[3]

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1. Geoffrey Morse, *Limited Liability Partnerships and Partnership Law Reform in the United Kingdom*, *in* The Governance of Close Corporations and Partnerships: US and European Perspectives 317, 317–18 (Joseph A. McCahery et al. eds., 2004). There were effectively four generic business entities: the sole trader, the general partnership, the limited partnership, and the corporation. *Id.*

2. Brett Freudenberg, *Are Transparent Companies the Way of the Future for Australia?*, 35 Austl. Tax Rev. 200, 200–01 (2006).

3. Numerous terms have been used by authors to describe this tax treatment, including tax transparent companies, tax flow-through companies, pass-through companies/entities, and partnerships. For the purpose of this Article the term "tax pass-through entities" will be used. Note that even though tax transparency applies, at times there can be recognition of the business entity for tax purposes (referred to as entity acknowledgement), such as

There have been numerous arguments that tax pass-through entities are advantageous for closely held businesses.[4] Prominent examples of tax pass-through entities include the United States' Limited Liability Company (LLC) and the United Kingdom's Limited Liability Partnership (LLP). These two structures represent the introduction of new business entities[5] and can be contrasted with tax regimes providing tax pass-through treatment to existing corporate structures that meet special eligibility requirements—for example, the United States' S Corporation and New Zealand's look-through company.[6]

The utilisation of these tax pass-through entities has been attributed to numerous factors, with their tax pass-through treatment featuring prominently. Other touted benefits include improved governance regimes, separate legal entity status, and liability protection, all combining to lead to an improved (or evolved) business entity.[7] Another related concept is the flexibility that they can provide. This flexibility

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the lodgment of information tax returns by the business entity or the selection of depreciation methods.

4. For U.S. LLCs, see, for example, ANDREW HICKS ET AL., 42 ASS'N OF CHARTERED CERTIFIED ACCOUNTANTS RESEARCH REPORT, ALTERNATIVE COMPANY STRUCTURES FOR THE SMALL BUSINESS 53 (1995). For UK LLPs, see, for example, SELECT COMM. ON TRADE & INDUS., FOURTH REPORT: DRAFT LIMITED LIABILITY PARTNERSHIP BILL, 1998–99 HC 59, ¶ 65, https://publications.parliament.uk/pa/cm199899/cmselect/cmtrdind/59/5902.htm; John Birds, *A New Form of Business Association for the Twenty-First Century*, 21 COMPANY LAW. 39, 41 (2000); Morse, *supra* note 1; Statement of Recommended Practice on Accounting by Limited Liability Partnerships (Consultative Comm. of Accountancy Bodies 2002), https://www.icaew.com/-/media/corporate/files/technical/technical-releases/legal-and-regulatory/tech-06-02-limited-liability-partnerships.ashx. However, some have postulated that pass-through entities are not necessarily a benefit to closely held businesses, arguing instead that closely held businesses are beneficial to the implementation of a tax pass-through entity, as it is more feasible and operational for governments and the risk to tax revenue is reduced if they are restricted to small, closely held businesses. *See* Brett Freudenberg, *A Model Idea: Is the ICAA Proposal for a Tax Transparent Company the Ideal Model for Australia?*, 38 AUSTL. TAX REV. 161, 170 (2009).

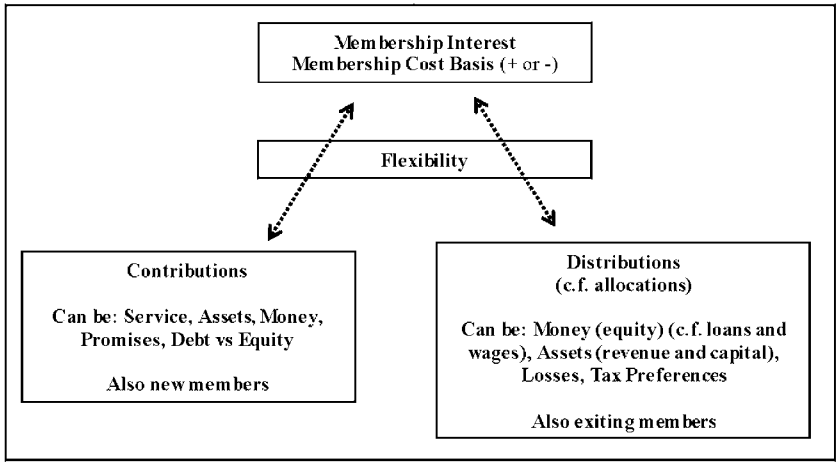
5. LLCs and LLPs have been classified as new form transparent company. *See* Freudenberg, *supra* note 4, at 165.

6. *Id.*

7. Larry E. Ribstein, *Statutory Forms for Closely Held Firms: Theories and Evidence from LLCs*, 73 WASH. U. L.Q. 369, 384 (1995).

can relate to the governance rules that apply, as well as to contributions, membership interests, and distributions.[8] This flexibility provides commercial advantages, in particular allowing different investors to come together for the business operation, as well as the potential to lower the overall tax burden to provide greater after-tax profits to be reinvested in the business. However, such flexibility is seen as a potential concern to tax revenue; it could be used to artificially manipulate tax positions (especially year-on-year, tax profiles of members,[9] and conduit distributions[10]). Figure 1 illustrates how the concept of flexibility could apply to member contributions and to distributions to members. Such flexibility has led to a number of tax integrity rules to ensure that flexibility does not lead to excessive revenue leakage.

Figure 1: Business Entity: Contribution and Distribution Flexibility



8. Denise Fletcher et al., ICAEW, Understanding Limited Liability Partnerships in the Small and Medium-Sized Business Sector 8–10 (2013).

9. "Tax profiles of members" refers to the concept of considering each member's overall tax position (such as the amount and/or type of other income derived in the relevant tax year, as well as any losses carried forward and residency status).

10. "Conduit distributions" refers to whether a receipt will retain its character as it is distributed from the business entity to the member—for example, whether a capital gain realised by the business entity will still be treated as capital gain by the receiving member.

Given that many of the tax pass-through entities provide members some liability protection, tax rules try to take account of member's equity contribution as a proxy for their risk exposure. This is especially an issue for the tax pass-through of losses to members, but it is also important for income allocations as well. The concern with the tax pass-through of losses is that unfettered allocation of losses to members with limited liability exposure to the business operations could potentially distort investment decisions. This is because access to tax losses (and tax preferences) can result in a country's tax system funding (or decreasing) the effective cost of capital for an investor, thereby distorting investment decisions.[11]

Evidence suggests that tax pass-through entities with greater flexibility could have greater compliance cost and complexity (compared with pass-through structures with lower flexibility—such as S corporations, which allow for one class of membership interest).[12] It is suggested that the concept of flexibility is an important consideration when it comes to choice of business entity. However, such flexibility can appear as a concern to revenue authorities as it can give the impression of artificial manipulation rather than genuine commercial endeavours.

It is critical for tax rules to strike the right balance of protecting tax revenue while allowing flexibility. Otherwise, the tax rules could adversely impact these tax pass-through entities with the tax law dictating "how parties must carry on their economic affairs."[13]

Prior research about this international trend has considered the reasons and process of their introduction,[14] the loss restriction rules that apply to protect tax revenue,[15] compliance cost evidence,[16] the financing

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11. *See* Brett Freudenberg, *Losing My Losses: Are the Loss Restriction Rules Applying to Australia's Tax Transparent Companies Adequate?*, 23 AUSTL. TAX F. 125 (2008).

12. Donald DeLuca et al., *Measuring the Tax Compliance Burden of Small Business*, 2005 IRS RES. BULL., PUB. NO. 1500, RECENT RESEARCH ON TAX ADMINISTRATION AND COMPLIANCE 75; *see* Margaret McKerchar et al., *Tax Complexity and Small Business: A Comparison of the Perceptions of Tax Agents in the United States and Australia*, 8 J. AUSTL. TAX'N 289, 290–91 (2005).

13. George K. Yin, *Comments on the Taxation of Passthrough Entities*, 140 TAX NOTES 358, 362 (July 22, 2013).

14. *See, e.g.*, Freudenberg, *supra* note 2.

15. *See, e.g.*, Freudenberg, *supra* note 11.

16. *See, e.g.*, Brett Freudenberg, *Fact or Fiction? A Sustainable Tax Transparent Form for Closely Held Businesses in Australia*, 24 AUSTL. TAX F. 373 (2009).

effect,[17] and governance.[18] To date there has been little detailed analysis of the contribution and distribution flexibility and what part it has played with tax pass-through entities, particularly as a possible threat to tax revenue. This Article analyses why this flexibility is an important commercial characteristic for business, highlights the concerns about flexibility, and considers the advent of tax integrity rules.

Part II of this Article will provide a broad summary of the tax pass-through entities and their utilisation. Part III will then describe what is meant by contribution and distribution flexibility. Part IV will show why flexibility may be a desirable commercial characteristic, especially to address the financial constraints that can confront small and medium closely held businesses. Through this analysis, it will be argued that it is important for governments and revenue authorities not to unduly restrict this flexibility with complex tax integrity rules but instead to aim for the right balance between commercial and revenue needs.

II. Tax Pass-Through Entities

The introduction of formal business entities was an important part of the industrial revolution;[19] they facilitated the drawing together of equity, the sharing of risk, as well as shielding or limiting of liability, and accommodating management rules. Some of these business entities were given legal personality, with an entity established at law that separated its equity members from the people that managed it.

A key issue is whether tax should be imposed on these separate legal business entities, their members, or a combination of both. In this context, taxation models can be perceived in terms of a continuum from an entity approach to an aggregate approach for business entities. National jurisdictions have sought to implement tax regimes that have

17. *See, e.g.*, Brett Freudenberg, *The Financing Effect: Will a Tax Transparent Form for Closely Held Businesses in Australia Assist with Financing?*, 4 J. Australasian Tax Tchrs. Ass'n 121 (2009).

18. *See, e.g.*, Brett Freudenberg, *Lifting the Veil on Foreign Tax Flow-Through Companies: Could Australian Closely Held Business Benefit from Their Governance Regimes?*, 28 Austl. J. Corp. L. 201 (2013).

19. *See* Sian Elias, *Company Law in the 1990s*, *in* Contemporary Issues in Company Law 1, 3 (John H. Farrar ed., 1987) (referring to quote of Nicholas Murray Butler of Columbia University).

been reflective of different points along this continuum.[20] Tax regimes can extend from the entity (classical) tax system,[21] to systems that tax the entity but provide for tax relief on distributions (an integrated approach),[22] and to an aggregate approach (tax pass-through).

Tax pass-through entities can be perceived as a hybrid of business entities with the attributes of a corporation's separate legal entity status[23] and limited liability,[24] and a general partnership's tax pass-through treatment.[25] For tax purposes, all of the tax pass-through entity's income (whether distributed to members or retained) is allocated and assessed to members each year. When the tax pass-through entity generates losses, as when deductions exceed assessable income, these are similarly directly allocated to members. However, to be able to utilise losses members may need to satisfy a series of requirements, such as the outside cost basis rule, the at-risk rule, the passive activity rule, and the substantial economic effect rule.[26]

This Article will use various terms important in relation to tax pass-through entities. The term "member" is used in this Article to describe an equity investor in the business entity, even though they might be known as "shareholder" or "partner" or otherwise. "Contribution"

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20. Richard J. Vann, *Australia's Policy on Entity Taxation*, 16 AUSTL. TAX F. 33, 44 (2001).

21. The classical tax system describes when the business entity is subject to an entity approach for tax purposes, with no recognition of this tax paid on subsequent distributions to members, nor concessional tax treatment on distribution, such as dividend deductions.

22. This tax relief could be a split rate system, deductible distribution, exempt distributions, or imputation system.

23. Or legal personality.

24. The term "company" is adopted to indicate the characteristics of separate legal entity status and limited liability. (Note that the two features do not always exist with companies. For example, in Australia it is possible to have unlimited companies where members do have liability exposure.).

25. "Tax flow-through treatment is argued to be an attribute of general partnerships, particularly in the Australian context. However, this has not always been the case as between 1915 to 1922 general partnerships (and trusts) were subjected to an entity tax treatment." Freudenberg, *supra* note 18, at 205 n.27 (citing C. John Taylor, *An Old Tax Is a Simple Tax: A Back to the Future Suggestion for the Simplification of Australian Corporate-Shareholder Taxation*, 2 J. AUSTRALASIAN TAX TCHRS. ASS'N 30, 34 (2006)).

26. Freudenberg, *supra* note 11, at 136–59.

refers to what members have contributed to the business entity in return for their equity interest (member interest), and such contributions could consist of money, property, services, or promises.[27] Generally, equity contributions describe contributions made by a member to a business entity, which is not guaranteed a return and instead is contingent on the performance of the business.

In comparison, a debt contribution by a member, such as the lending of money to the business entity, would describe a contribution that effectively has a non-contingent obligation for the business entity to repay the financial benefit. A "member loan" describes transfers of money to an entity by equity members in exchange for payment for such use in the form of interest. Parties who lend money to an entity typically have distribution priority over equity members when an entity liquidates.

"Compensation" is used to describe an amount paid by an entity to an equity member in exchange for services of the member or for the use of their assets. The term can be used broadly to cover amounts paid for use of property (rent), money (interest), and services (wages).

"Allocation" refers to allocating income or losses directly to members for tax purposes, even though legally the income and losses are earned or incurred by the business entity. No actual payment or distribution need occur from the business entity to the member when an allocation occurs. Allocations are bookkeeping and accounting phenomena that establish members' shares of tax items and may establish their rights to distributions.

The related term "distribution" refers to the actual payment or transfer of assets, including money, to members from the business entity on account of a membership interest in the entity or the person's capacity as a member.[28]

Contributions, allocations, and distributions can influence the quantum of the member's "membership cost basis" (outside basis),[29] which broadly describes the equity amount that a member has invested in a tax pass-through entity adjusted to reflect allocations and distributions to the member. Note the way in which the tax pass-through entity

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27. *See* UNIF. LTD. LIAB. CO. ACT §§ 102(2), 402 (UNIF. LAW COMM'N 2006, as amended) [hereinafter RULLCA].

28. *Id.* § 102(4).

29. Also known as "outside cost basis" (United States), "capital contribution" (United Kingdom), and "cost basis" (New Zealand).

is managed can be broadly described as either by the members (member-management)[30] or by a third party (manager-management).[31]

Prominent examples of these tax pass-through entities which involved the creation of a new business entity include the United States' LLC and the United Kingdom's LLP. These entities can be contrasted to tax regimes that have provided tax pass-through treatment to existing corporate forms that meet special eligibility requirements, including the United States' S Corporations and New Zealand's Loss Attribution Qualifying Companies (LAQCs) and Look-Through Companies.[32]

This Article primarily focuses on U.S. LLCs and UK LLPs, although reference will be made at times to other structures to illustrate important points.

A. United States

There are two tax pass-through entities in the United States of particular interest: S Corporations and LLCs. The United States first introduced the S Corporation in 1958, subjected it to extensive reforms in

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30. A member who actively takes part in the management of the business entity. Also known as an "active member."

31. A non-member who is responsible for managing the business entity.

32. The LAQC regime has been replaced by a "look-through company" (LTC) regime, commencing April 1, 2011. Taxation (GST and Remedial Matters) Act 2010 §§ 74(1), 78; Income Tax Act 2007, subpt. HB (as amended) (N.Z.). Other tax transparent entity forms introduced around the world include Singapore's LLP, enacted in April 2005 (Limited Liability Partnerships Act (Chapter 163A), Act No. 5, 2005)); Northern Ireland's LLP, enacted in November 2002 and fully in in force from September 2004 (Limited Liability Partnership Act (Northern Ireland) 2002, c. 12); and Japan's LLP, known as *Godo Kaisha* 'GK,' enacted in May 2005 (有限責任事業組合契約に関する法律 [Limited Liability Partnership Act], Law No. 40 of 2005). (Note that it is not clear whether Japanese LLPs have been granted tax transparent treatment.) Other jurisdictions have introduced entities with some of these attributes, but these entities currently lack separate legal entity status, for example, the German GmbH&Co.KG, which uses a corporation (known as a GmbH) as the general member of a limited partnership (known as a KG); and the French SAS. Additionally, the United States S Corporation and the New Zealand LAQC have been classified as "special tax rule companies." *See* Freudenberg, *supra* note 4, at 165.

the 1980s,[33] and then again in the 1990s.[34] Briefly, the S Corporation is not a new business structure; instead, it is essentially a set of special tax rules for closely held entities. These special tax rules are located in Subchapter S of the Internal Revenue Code, and therefore the name S Corporation is used for entities electing to be taxed according to Subchapter S. Broadly, for S Corporation status to be obtained, the entity itself[35] and its members must be U.S. residents with only one class of membership interest; its membership must not exceed 100; and it must have a valid election for S Corporation status.[36] Additionally, certain trading activities and asset holdings are prohibited.[37] In these circumstances, pass-through tax transparency applies rather than the entity approach for corporations taxed under Subchapter C of the Internal Revenue Code.

In comparison, the LLC has a far more recent history; it was not a state law entity until 1977 when Wyoming passed legislation, but

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33. Subchapter S Revision Act of 1982, Pub. L. No. 97-354, 96 Stat. 1669; William A. Klein & Eric M. Zolt, *Business Form, Limited Liability, and Tax Regimes: Lurching Toward a Coherent Outcome?*, 66 U. COLO. L. REV. 1001, 1004 nn.7, 9–11 (1995). These reforms included (1) a new member accepts S Corporation status as the member finds it; (2) 50% of members can elect to terminate S Corporation election; (3) differences in voting rights do not create a second class of share; (4) unused losses can be carried forward indefinitely; (5) relaxation the passive investment income limitation; and (6) the removal of the termination because of 80% or more foreign income. *Id.* At times, further amendments to Subchapter S are considered. *See, e.g.*, S Corporation Reform Act of 2005, H.R. 4421,109th Cong. (U.S.).

34. *See* Small Business Job Protection Act of 1996, Pub. L. No. 104-188, §§ 1301–17, 110 Stat. 1755, 1777–87.

35. Note technically the business entity does not have to be a "corporation"; it just needs to be a business entity that is taxed pursuant to Subchapter C. Under Treasury Regulations, an S corporation election made by an entity other than a corporation is simultaneously treated as a check-the-box election to be treated as a tax corporation. Reg. § 301.7701–3(c)(1)(v)(C).

36. I.R.C. § 1361(a)(1), (b)(1).

37. For example ineligible members include financial institutions using reserve method of accounting, insurance companies, possession corporations, Domestic International Sales Corporation (DISC), and former DISCs. I.R.C. § 1361(b)(2).

it is now available in all U.S. states.[38] Initially, it was uncertain whether tax pass-through treatment would apply to the LLC given that at the time, if a business entity possessed significantly *corporate* characteristics, the entity would be taxed as a corporation not a partnership, pursuant to the *Kintner* regulations.[39] However, after two decades of uncertainty and dispute, in 1997 the check-the-box regulations were introduced, and from that point forward, the LLC is a tax pass-through unless it elects otherwise,[40] provided it is not a publicly traded

38. Refer to the discussion in Freudenberg, *supra* note 2, at 204.

39. Reg. § 301.7701–2(a)(2) (1960). The four relevant factors were: (1) continuity of life, (2) free transferability of interests, (3) centralized management, and (4) limited liability The rules governing whether a particular business organization will be classified as a certain form for tax purposes can be traced back to the Supreme Court in *Morrissey v. Commissioner*, 296 U.S. 344, 359–60 (1935). Note that there were actually six characteristics but two of the characteristics ((a) associates and (b) objective to carry on business for joint profit) were common to both general partnerships and corporations, so these two were disregarded. *Id.*

40. Technically, by default a multi-member LLC would be classified as a general partnership. Reg. § 301.7701–3(b). By default, a single-member LLC is disregarded as an entity separate from its owner, but it can elect to be classified as a corporation (an association). Reg. § 301.7701–3(b), (c). A state corporation would be taxed under Subchapter C, unless the entity qualifies and elects to be taxed under Subchapter S. Reg. § 301.7701–2(b). State law corporations are corporations formed under corporation acts, such as one based on the Model Business Corporation Act. MODEL BUS. CORP. ACT (2016 REVISION) (AM. BAR ASS'N 2016). In 2016, the Model Business Corporation Act underwent a substantial revision. However, most of the substantive revisions had been previously adopted through the amendment process. Am. Bar Ass'n, *Model Business Corporation Act (2016 Revision) Launches*, BUS. L. TODAY, Jan. 2017, at 1. In addition, the United States lists a number of foreign entities that are always taxed as C Corporations for tax purposes. Reg. § 301.7701–2(b)(8). Normally, the check-the-box regulations list only one type of entity for a particular country as always equivalent to a C Corporation (for example, Australia: Public Limited Company; Canada: Corporation and Company; France: Société Anonyme (SA); Germany: Aktiengesellschaft (AG); Italy: Società per Azioni; Japan: Kabushiki Kaisha; the Netherlands: Naamloze Vennootschap (NV); Sweden: Publika Aktiebolag; Switzerland: Aktiengesellschaft (AG); and the United Kingdom: Public Limited Company

entity.[41] If the LLC has multiple members (but is not publicly traded) and does not elect Subchapter S, it is taxed under Subchapter K (partnership taxation).[42]

In addition to S Corporations and LLCs, the other types of state law tax pass-through entities in the United States are (1) general partnerships,[43] (2) limited partnerships,[44] (3) limited liability partnerships,[45] (4) limited liability limited partnerships, and (5) business trusts. For federal tax purposes, each type of structure can be a partnership or a corporation for federal tax purposes, if the entity has more than one member. If the entity has only a single member for tax purposes, the entity either can be disregarded for tax purposes and the member is assessed directly, or it can elect to be taxed as a C corporation (or as an S corporation, if eligible). C corporations are subject to an entity-level tax, and members are taxed on distributions to them.

In the United States, excluding sole proprietorships, tax pass-through entities, account for a majority of the business entities. While

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(PLC)). *Id.* A U.S. LLC by its nature would not be either a state corporation or one of these foreign entities.

41. I.R.C. § 7704. A "publicly traded partnership" is one which has partnership interests that are either (1) traded on established securities markets, or (2) readily traded on a secondary market. Regulations provide safe harbours for a partnership to avoid being classified as publicly traded, one of which applies if (1) all interests issued in a transaction(s) are not registered under the Securities Act of 1933, and (2) there are no more than 100 members during the year. Reg. § 1.7704–1(h).

42. *See* Reg. § 301.7701–3(b), (c)(1)(v)(C).

43. General partnerships are co-ownerships of property whose members join together for the production of income. Any arrangement that comes within that definition will be a general partnership. Members of general partnerships are jointly and severally liable for the entity's obligations and have equal management rights.

44. Limited partnerships are creations of state law. They are partnerships that have both general and limited partners. General partners are jointly and severally liable for the entity's obligations and have equal management rights. Limited partners are shielded from liability for the entity's obligations and generally have no management rights.

45. A limited liability partnership is a general partnership with limited liability features. Partners retain their rights to management after registering the entity as a limited liability partnership.

the most popular business entity in the United States for tax purposes are sole proprietorships (23,553,850 filing tax returns in the 2012 year),[46] LLCs have quickly emerged as a popular business entity. Figure 1 demonstrates that in the United States the most numerous business entities are S Corporations (4,257,909 in 2013) followed by LLCs (2,285,420 in 2013) and C Corporations (1,582,809 in 2014).[47] However, this data needs to be interpreted cautiously, as the tax figures could underreport the number of LLCs.[48] Data that compares the tax filings to state registration of LLCs indicates that the number of LLCs may be more in the vicinity of six million compared to the two million in tax filings.[49] Apparently, many of those LLCs have a single member and do not file a separate tax return. Also, data about asset holdings demonstrates that the favoured business entity is the C Corporation.[50]

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46. Adrian Dungan, *Sole Proprietorship Returns, Tax Year 2014*, 36 STAT. INCOME BULL., no. 2, 2016, at 10 fig.L, https://www.irs.gov/pub/irs-soi/16falbul.pdf. For 2008, it was 22,614,483 and the number of partnership returns filed for 2008 was 3,146,006, while C corporation's accounted for 1,762,483 returns and S corporations for 4,049,944. *Id.*; *see also* Nina Shumofsky & Lauren Lee, *Partnership Returns, 2009*, 31 STAT. INCOME BULL., no. 2, 2011, at 69 fig.B, https://www.irs.gov/pub/irs-soi/11fallbul.pdf; INTERNAL REV. SERV., INCOME TAX RETURNS COMPLETE REPORT 12 fig.I (2011), https://www.irs.gov/pub/irs-soi/11coccr.pdf.

47. INTERNAL REV. SERV., CORPORATION INCOME TAX RETURNS COMPLETE REPORT 9 fig.G (2014), https://www.irs.gov/pub/irs-pdf/p16.pdf; INTERNAL REV. SERV., CORPORATION INCOME TAX RETURNS LINE ITEM ESTIMATES 6 fig.G (2014), https://www.irs.gov/pub/irs-pdf/p5108.pdf; Ron DeCarlo & Nina Shumofsky, *Partnership Returns, 2013*, 34 STAT. INCOME BULL., no. 2, 2015, at 3, 101 tbl.6, https://www.irs.gov/pub/irs-soi/15falbul.pdf.

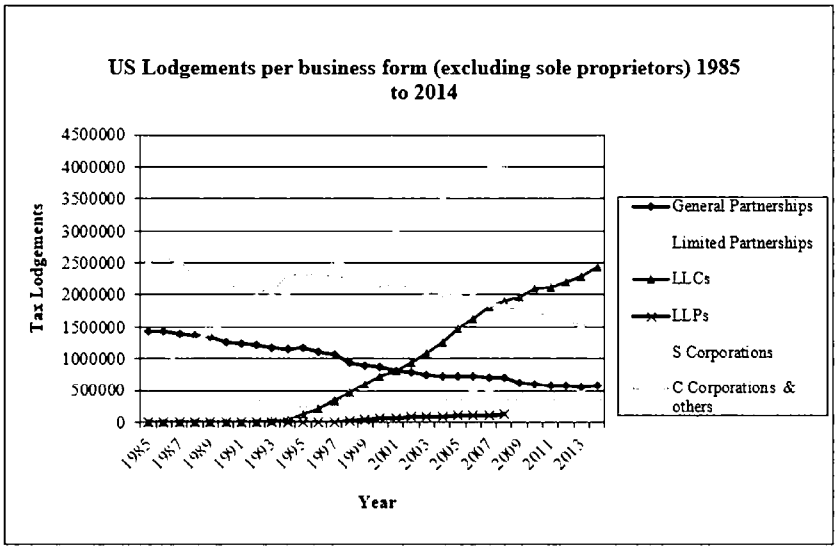
48. This is because a single-member LLC with tax pass-through treatment is treated by the IRS as a "disregarded entity." Disregarded entities are not reported in this tax data as LLCs but are instead included in the figures relating to the member's own status. This could mean that the single-member LLC is included in the figures as a sole proprietor, C Corporation, trust, or a holding LLC. A compounding factor is that from 1997 LLCs may elect tax treatment as a C Corporation or S Corporation and would be reported as such. *See supra* notes 40–42 and accompanying text.

49. BRETT FREUDENBERG, TAX FLOW-THROUGH COMPANIES ¶ 3-242, 68–69 (CCH-ATTA Doctoral Series No. 2, 2011).

50. *Id.*

It has been estimated that 54% of private sector employment occurs via tax pass-through entities;[51] a study found that filing costs in various states could affect choice between LLC and corporations.[52]

Figure 2: U.S. Lodgements



Part of the popularity of tax pass-through entities in the United States has been due to the classical tax system that otherwise applies to corporations under Subchapter C. However, recent C corporate tax reforms have seen this advantage diminish, as the corporate tax rate has been reduced from 35% to 21%.[53] To provide some relief for tax

51. *Small Business Tax Rates and Tax Complexity,* NAT'L FED'N INDEP. BUS. (Jan. 31, 2013), https://www.nfib.com/Portals/0/PDF/AllUsers/research/cribsheets/small-business-tax-rates-cribsheet.pdf.

52. Eden S. Blair et al., *The Disproportionate Costs of Forming LLCs vs. Corporations: The Impact of Small Firm Liability Protection*, 20 J. SMALL BUS. STRATEGY, no. 2, 2009, at 23.

53. I.R.C. § 11. The corporate tax rate cut was passed December 22, 2017, effective beginning 2018. Pub. L. No. 115-97, § 13001(a), 131 Stat. 2054 (2017). Note that once state corporate taxes are added, the final corporate tax rate could be closer to 26%.

pass-through entities, a 20% deduction for qualified business income of certain small businesses and partnerships has been introduced to lower the rate.[54]

In particular, the governance of LLCs is dictated by the state in which the LLCs are formed. There has been an attempt to provide consistency between the states with a recommended uniform act; the *Revised Uniform Limited Liability Company Act of 2006 (RULLCA)* replaced the previous *Uniform Limited Liability Company Act of 1996*.[55] This Article will refer to the *RULLCA* as a consolidation of the LLC's governance provisions. Of course, it needs to be acknowledged that existing LLCs may have different governing rules, with attributes of the *RULLCA* only being adopted prospectively. In addition to legislation, an LLC Operating Agreement (LLC Agreement) can be instrumental in governing the internal affairs of the LLC[56] and so will form part of the analysis.

A number of observations can be made about the growth in the utilisation of LLCs in the United States. In comparison to S Corporations, they can be seen as more appropriate for sophisticated activities, and due to employment taxes, can be more tax effective when there is not member-management. They can also be more appropriate for holding property that will appreciate in value (appreciating property can result in a step-up in membership cost basis for debt[57]). In recent years, there has also been the development of "series LLCs."[58]

It should be noted that, in the United States, the S Corporation continues to be a popular tax pass-through entity, which has in part

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54. *See* I.R.C. § 199A; James R. Repetti, *The Impact of the 2017 Act's Tax Rate Changes on Choice of Entity*, 21 FLA. TAX REV. 686 (2018).

55. RULLCA, *supra* note 27. The National Conference of Commissioners on Uniform State Laws originally approved the RULLCA Act in 2006. *Id.* It was subsequently amended in 2011 and 2013, respectively. *Limited Liability Company Act, Revised*, UNIF. LAW COMM'N, https://www.uniformlaws.org/committees/community-home?communitykey=bbea059c-6853-4f45-b69b-7ca2e49cf740&tab=groupdetails (last visited Oct. 17, 2019). To date, the model act has been implemented in 22 states. *Id.* The legal characteristics of an LLC provide members with limited liability and separate legal entity status. RULLCA, *supra* note 27, §§ 104, 304.

56. RULLCA, *supra* note 27, § 110.

57. *See* I.R.C. § 752(a).

58. *See* Prop. Reg. § 301.7701–1, Series LLCs and Cell Companies, 75 Fed. Reg. 55,699 (Sept. 14, 2010).

been attributed to the lower employment taxes that may be payable for active members compared to LLCs where such active members can be subject to higher employment taxes.[59] This means that S Corporations are the preferred business entity for business activities that generate personal service income. This is compounded by the fact that S Corporations can be disadvantageous for businesses owning assets that appreciate in value, as there can be tax disadvantages on distribution as compared to LLCs. Additionally, S Corporations can be seen as a simpler structure, particularly because they require only one class of membership interest.[60]

B. United Kingdom

As a contrast to the LLC, it is worth considering the United Kingdom's LLP, which has been available since 2001 following enactment of the *Limited Liability Partnerships Act 2000*.[61] In addition, UK LLPs and their members are required to comply with modified sections of the *Companies Act 2006*,[62] the *Insolvency Act 1986*,[63] the *Company Directors Disqualification Act 1986*,[64] and the *Financial Services and Markets Act 2000*.[65] Additionally, the internal governance of an LLP can be influenced by an optional LLP Operating Agreement (LLP Agreement) entered into by members.

Once formed, the LLP is a body corporate, which exists as a legal person separate from its members.[66] Therefore, it is prima facie

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59. *See* Bradley T. Borden, *Ten Reasons to Prefer Tax Partnerships over S-Corporations*, N.Y. Bus. L.J., Winter 2018, at 47, 51–52.

60. However, the requirement for one class of membership interest and the process involved in determining and monitoring it can itself be complicated. For a comparison of the tax benefits of S Corporation and partnerships. *See id.* at 48–52.

61. Limited Liability Partnerships Act 2000, c. 12. In Northern Ireland, similar legislation was enacted in November 2002 and entered fully into force in September 2004. Limited Liability Partnership Act (Northern Ireland) 2002, c. 12.

62. Companies Act 2006, c. 46.

63. Insolvency Act 1986, c. 45.

64. Company Directors Disqualification Act 1986, c. 46.

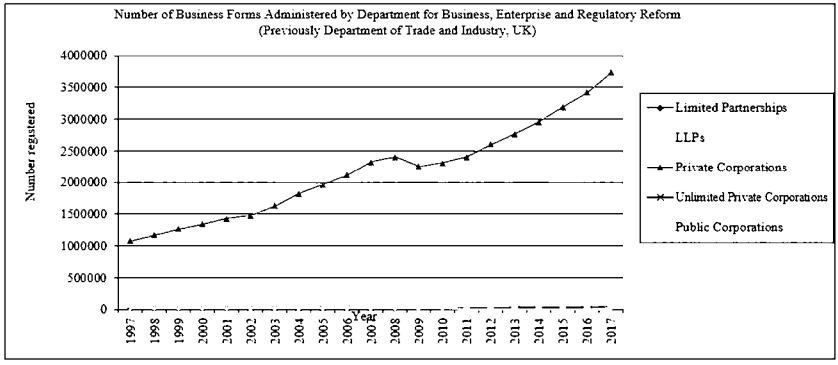
65. Financial Services and Markets Act 2000, c. 8.

66. Limited Liability Partnerships Act 2000, c. 12, § 1(2).

subject to the United Kingdom corporation tax,[67] but this is qualified by legislation so that for most tax purposes, an LLP will be treated instead as a general partnership with tax pass-through status when the LLP carries on a trade, profession, or other business with a view to profit.[68]

In terms of the United Kingdom, Figure 3 demonstrates that, excluding sole proprietorships, the private corporation dominates as the most popular organized business entity, with approximately 2.35 million registered in 2010.[69] However, when private corporations are excluded, it becomes clear that there is growing utilisation of LLPs since their introduction in 2001; Figure 4 shows a total of 40,584 LLPs registered in 2010.[70]

Figure 3: United Kingdom Business Entities[71]



67. Income and Corporation Taxes Act 1988, c. 1, § 832(1).

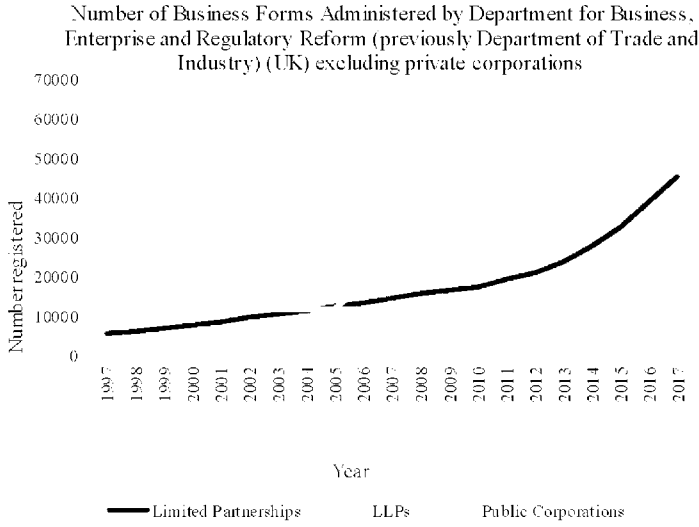
68. Limited Liability Partnerships Act 2000, c. 12, § 10(1), (3) (adding § 118ZA to the Income and Corporation Taxes Act 1988 and § 59A to the Taxation of Chargeable Gains Act 1992); Taxation of Chargeable Gains Act 1992, c. 12, § 59A(1); Income and Corporation Taxes Act 1988, c. 1, §§ 114, 118ZA (providing that LLPs be classified as tax partnerships). This means for the LLP to be taxed as a general partnership, a business must be carried on rather than merely holding passive investments. There must also be a profit motive. *Id.*

69. Companies House, Statistical Tables on Companies Registration Activities 2009–10, at 7, https://webarchive.nationalarchives.gov.uk/20141104110623/http://www.companieshouse.gov.uk/about/companiesRegActivities.shtml.

70. *Id.* at 25–26; *see* Freudenberg, *supra* note 18, at 209.

71. Companies House, *supra* note 69, at 7, 23, 25.

Figure 4: United Kingdom Business Entities (Excluding Private Corporations[72]



It is worthwhile considering employment taxes as well as income taxes for UK LLPs, in particular the United Kingdom's National Insurance Contribution (NIC).[73] For active members in the LLP, the tax

72. *Id.* at 23, 25.

73. The NIC is a hypothecated tax to pay most of the cost of retirement pensions, unemployment benefits, and sickness benefits. In the circumstance that the member was not engaged as an employee by the corporation, it is likely that a non-member would have to be employed with a resulting NIC obligation anyway. Additionally, a self-employed person will qualify to be relieved by pension contributions (subject to annual limits), whereas dividend income cannot be relieved in this way. Nicholas Thompsell, *Look Before You LLP*, ACCT. DAILY (Jan. 1, 2006), https://www.accountancydaily.co/llps-look-you-llp. Normally, a UK LLP member is not to be regarded for any purpose as employed by the LLP unless the member would be regarded as employed by a general partnership in like circumstances. Limited Liability Partnerships Act 2000, c. 12, § 4(4). If treated as an employee, then the LLP member would be within the scope of the Income Tax (Earnings and Pensions) Act 2003, c. 1, and the NIC consequences of employer/employee relationship. PDC Copyright (South) [1997] Sp C 141 (Special Commissioners Decisions).

pass-through can result in a lower NIC rate compared to if a corporation had been utilised.

> When the LLP form is utilised, an LLP member would be regarded as self-employed, and thus, subject to a lower NIC rate. The maximum NIC rate applicable to those who are self-employed is approximately nine percent.[74] . . . compared with up to 23.8 percent for an employee-member of a corporation. Due to this disparity, the LLP can be an attractive alternative to a corporation when the members are actively engaged in the business.[75] The impact of NIC was identified as part of

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74. The following reproduces the footnote, but with updates, that appeared at this point in the original, Freudenberg, supra note 17, at 149 n.187: *Self-Employed National Insurance Rates*, GOV.UK, https://www.gov.uk/self-employed-national-insurance-rates (last visited Dec. 26, 2019). HMRC has confirmed members of LLP will be liable for Class 2, 3, and 4 NIC as appropriate. *Limited Liability Partnerships*, 50 INLAND REV. TAX BULL. 801, 805 (2000), https://webarchive.nationalarchives.gov.uk/20110617054638/http://www.hmrc.gov.uk///bulletins/tb50.pdf. For self-employed persons, they are initially subject to Class 2 NIC, which is a flat £3 per week—although they can be exempted if their yearly profit is below £6,365 per year (2019 year). In addition to Class 2 NIC, self-employed persons can be subject to Class 4 NIC, which is nine percent on profits from £8,632 to £50,000 and then two percent of profits in excess of £50,000. *Self-Employed National Insurance Rates*, *supra*; *National Insurance*, GOV.UK, https://www.gov.uk/national-insurance (last visited Dec. 26, 2019). NIC would apply to a non-employee member of an LLP as there is no requirement that the member carries on the business. M'Dougall v. Smith [1918] 7 TC 134, 136 (Scot.).

75. The following reproduces the footnote, but with updates, that appeared at this point in the original, Freudenberg, supra note 17, at 150 n.188: Claire Crawford & Judith Freedman, *Small Business Taxation*, *in* 1 MIRRLEES REV., DIMENSIONS OF TAX DESIGN 1028, 1045 (Stuart Adam et al. eds., 2008), https://www.ifs.org.uk/publications/7184. Another benefit of self-employment status is that tax deductions may be more accessible due to a less stringent deductibility test compared to employees.

> To make this feasible, the system keeps the availability of tax deductions for employees to a minimum by requiring them to satisfy a strict test of being *incurred wholly, exclusively, and necessarily in the performance of the duties of*

> the reason professional firms lobbied for the introduction of LLPs with general partnership tax treatment. This was despite the fact that the firms could have utilised a corporate form to obtain liability protection.[76]

However, the tax implications of LLPs are mixed, as the United Kingdom has reduced its corporate tax rate over the last decade to 19% and is planning to further reduce it to 17% starting April 2020.[77] Such a corporate tax rate is lower than the highest marginal tax rates that can apply to individuals, which is a 45% rate for taxable income greater than £150,000.[78] This disparity in rates can in part be minimised through the use of a corporate partner in an LLP to minimise or defer tax.[79] Even with the lower corporate tax rate, there can be additional tax payable on the payment out of dividends from companies to shareholders.[80] Due to this additional distribution tax to members, LLPs have been found to

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> *the employment.* A self-employed person has to show only that the expenses are *incurred wholly and exclusively for the purposes of the trade.*

Id. The test for classifying self-employed income turns on whether the income is "incurred wholly and exclusively" for the purpose of trade. Income Tax (Trading and Other Income) Act 2005, c. 5, § 34.

76. Freudenberg, *supra* note 17, at 149–50.

77. HM Rev. & Customs, *Corporation Tax to 17% in 2020*, Gov.UK (Mar. 16, 2016), https://www.gov.uk/government/publications/corporation-tax-to-17-in-2020/corporation-tax-to-17-in-2020.

78. *Income Tax Rates and Personal Allowances*, Gov.UK, https://www.gov.uk/income-tax-rates (2019 tax year) (last visited Dec. 27, 2019).

79. However, the ability to do this will be curtailed once the removal of "corporate directors" has been fully implemented per the Small Business, Enterprise and Employment Act 2015, c. 26, § 87; each director must, however, be a natural person. *See* Phillip Newman, *Should Corporate Directors Be Banned?*, Inform Direct (July 22, 2019), https://www.informdirect.co.uk/officers/should-corporate-directors-be-banned/.

80. Note that for shareholders receiving dividends in the United Kingdom there is a dividend allowance system, which in part reduces the double taxation as corporations pay ividends out of taxed profits. The amount of tax paid by the shareholder will depend upon their other income and the amount of the dividend. The 2019 dividend tax rates are set at 7.5%, 32.5%, and 38.1%, respectively. *Tax on Dividends*, Gov.UK, https://www.gov.uk/tax-on-dividends (last visited Dec. 27, 2019).

be extensively used for holding, property, and investment types of businesses.[81]

Research by Fletcher et al.[82] estimates that 98% of LLPs are small and medium sized enterprises (SMEs).[83] This research also demonstrates that in the United Kingdom there are three major uses for LLPs: special purpose vehicles for collaboration (e.g., asset management), purely investment/tax strategy, and small professional firms (e.g., accounting, engineering, and legal).[84]

C. Small Closely Held Businesses

There have been numerous arguments that tax pass-through entities are advantageous for closely held businesses, including those with small operations.[85] Classifying businesses can be problematic, with various quantitative measures possible.[86] Indeed, sometimes the qualitative characteristics inherent for a closely held business can be more meaningful in that such membership interest is not widely dispersed, or publicly traded.[87] Normally, a closely held business is one that is independently owned and operated with most, if not all, capital contributed by members and managers. Furthermore, members are likely to participate in the management of the business (member management).[88]

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81. FLETCHER ET AL., *supra* note 8, at 2, 8–9.

82. *Id.*

83. *Id.* at 2 (using the Balance Sheet Total on the Financial Analysis Made Easy (FAME) database).

84. *Id.* at 9.

85. *See supra* note 4 and accompanying text.

86. Businesses can be classified according to size, industry, membership structure, or business entity. The criterion of size may be further measured by such things as turnover, asset holdings, employee numbers, or equity raising.

87. Scott Holmes & Brian Gibson, *Definition of Small Business* 8 (Univ. of Newcastle 2001), https://web.archive.org/web/20030512111350/www.setel.com.au/smeforum2002/tp/BP01a.pdf; *see* SMALL BUS. DEREGULATION TASK FORCE, TIME FOR BUSINESS 13 (1996); Cynthia Coleman & Chris Evans, *Tax Compliance Issues for Small Business in Australia*, *in* TAXING SMALL BUSINESS: DEVELOPING GOOD TAX POLICIES 147, 165–68 (Neil Warren ed., 2003).

88. PETER ANDREW HARRIS, CORPORATE/SHAREHOLDER INCOME TAXATION AND ALLOCATING TAXING RIGHTS BETWEEN COUNTRIES 45–46 (1996).

It is important to reflect on one of the problems confronting closely held businesses in terms of financing, whether from internal or external sources. To an extent, the financing problem can be self-inflicted. Research demonstrates that very few small businesses attract any equity other than from active members.[89] Consequently, equity finance from active members can be an essential source of financing, especially in the early years of operation.[90] Some research has indicated that equity (including retained profits) is a less important source of financing for small businesses than for widely held corporations.[91] However, this research must be qualified, as much of the long-term debt for closely held business is in the form of member loans,[92] with member guarantees and personal assets used as security not being recorded on the balance sheet.

An inhibitor to attracting additional equity investment is that existing members may want to retain control and can resist attracting additional members because of concerns with the dilution of control.[93] This can apply when operations are small or large, as there can be a high value placed on the freedom and opportunity to control.[94] For some closely held businesses, there may be little desire for business growth.[95] However, for those businesses wanting to expand, this financing problem means that they may not possess

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89. Andrew Hicks, *Legislating for the Needs of the Small Business*, *in* THE QUEST FOR AN IDEAL LEGAL FORM FOR SMALL BUSINESS 35, 58–59 (Barry A.K. Rider & Mads Andenas eds., 1999).

90. In the years of operation, the business may not have the track record to satisfy creditors nor have tangible assets that can stand as security for the loans.

91. B.L. JOHNS ET AL., SMALL BUSINESS IN AUSTRALIA: PROBLEMS AND PROSPECTS 111 tbl.7.1 (1978).

92. *Id.* at 111–13. Note that the study refers to "director loans"; however, this appears to be a mistake in the correct nature of the loans given the prior discussion in the document.

93. *Id.* at 30; Judith Freedman, *Small Business and the Corporate Form: Burden or Privilege?*, 57 MOD. L. REV. 555, 581 (1994) ("Small business research has shown clearly that one of the major barriers to growth of small firms is the desire for independence and the unwillingness to part with control, particularly by the alienation of equity in a company.").

94. *See* JOHNS ET AL., *supra* note 91, at 30; SJ Naudé, *The Need for a New Legal Form for Small Business*, 4 MOD. BUS. L. 5, 5 (1982).

95. *See* JOHNS ET AL., *supra* note 91, at 30.

sufficient capital or retained earnings to carry their expansion opportunities to fruition.[96]

With respect to sourcing outside loans, there can be a number of intrinsic problems.[97] Regardless of size, external financiers may be reluctant to finance closely held businesses, particularly if there is no tangible property to secure the financing or no viable business track record.[98] Another factor is that such outside loans are often regarded as risky, so financial institutions may charge a funding premium (often in the form of higher interest rates), particularly if operations are small. This means closely held businesses can face higher borrowing costs than larger businesses and that such businesses do not qualify for normal business loans.[99] Additionally, outside loans will generally require interest to be paid regularly, whereas a business that raises capital through equity will not be required to make regular distributions, except in unusual circumstances. Regular payments to an external financier require a matching of cash flows to obligations, and this can present difficulties for closely held businesses, which may have lumpy cash flows or may be unsophisticated in carrying out the precise provisioning required. This can lead to defaults on outside loans, even though the business is expanding.

These circumstances can lead to small, closely held businesses relying more heavily on overdraft facilities, which may increase costs

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96. *See* STEPHEN BARKOCZY & DANIEL SANDLER, GOVERNMENT VENTURE CAPITAL INCENTIVES: A MULTI-JURISDICTION COMPARATIVE ANALYSIS 20 (2007); MORE TIME FOR BUSINESS: STATEMENT BY THE PRIME MINISTER, THE HONOURABLE JOHN HOWARD, MP 15 (1997) ("Many small businesses are constrained in their development and growth by a lack of access to appropriate sources of finance. If small businesses are to innovate, take up new technology and export, they need an accessible financial market that offers a wide range of financial products.").

97. *See* BARKOCZY & SANDLER, *supra* note 96, at 20–21.

98. It has been said that the finance gap applies to new and start-up businesses rather than established small businesses. GRAHAM REVIEW OF THE SMALL FIRMS LOAN GUARANTEE: RECOMMENDATIONS 17–18 (2004).

99. Peter Hendy, *Threats to Small and Medium Sized Enterprises from Tax and Other Regulations*, *in* TAXING SMALL BUSINESS, *supra* note 87, at 113, 127 ("Banks in lending to SMEs often incorporate a substantial risk margin. This can increase SME variable rates by up to 5 percentage-lending points.").

dues to charges.[100] Furthermore, to support outside loans, members may be required to give personal guarantees as to such debt or to offer personal assets as security.[101] Such personal guarantees would prejudice any limited liability protection that may be provided by the business entity as the guarantee makes the member liable for principal and interest payments on default. Flexibility becomes important for entities facing these types of financing issues.

III. Flexibility

The issues affecting the selection of business entities are numerous and complex. One is the consideration of the regulatory burdens, including governing statutes, industry practice, and the ability to raise finance. Another is the potential tax implications, which could extend to considering the applicable tax rate, use of losses, complexity, state taxes, and eventual sale of the business.[102] Khandekar and Young suggest that, when advising a client on business entity selection, an advisor must consider the advantages and disadvantages of the tax issues and the non-tax issues of each structure available.[103] In evaluating these, a clear understanding of the client's objectives is critical as these should be the essential driver. For small business owners, the dominant objectives may relate to control and management of the business, liability protection, and the minimisation of both professional fees and tax liability.[104]

An essential part of a business entity can be to bring together different investors with different capacities to contribute and share risk.

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100. *See* Josephine Bisacre, *A European Perspective on Small Business and the Law*, *in* The Quest for an Ideal Legal Form for Small Business, *supra* note 89, at 87, 89.

101. *See* Johns et al., *supra* note 91, at 114–15. Given that personal guarantees are not recorded in the balance sheet, this practice can sometimes give the misleading impression that the bank is providing more funds to start the business than the member. *See id.*

102. Gregory A. Porcaro, *The Choice-of-Entity Maze*, J. Acct. (Mar. 1, 2007), https://www.journalofaccountancy.com/issues/2007/mar/thechoiceofentitymaze.html.

103. Rajendra P. Khandekar & John E. Young, *Selecting a Legal Structure: A Strategic Decision*, 23 J. Small Bus. Mgmt., no. 1, 1985, at 47, 48.

104. Alan R. Sumutka, *Selecting a Form of Business*, CPA J. (Apr. 1997), http://archives.cpajournal.com/1997/0497/features/f24.htm.

Part of how these different investors are brought together is the flexibility of their arrangements. The concept of flexibility in terms of business entities can be considered in a number of different ways. For example, the flexibility of internal governance rules—which could cover management structure (i.e., member-managed or manager-managed), ability to alter the default rules, voting rights, issuance and cancellation of membership interest, responsibilities, board of directors requirements, audit requirements, meeting requirements, setup procedures, and annual fees—are all flexible. Additionally, there could be flexibility in the ability to issue new membership interests, to transfer existing membership interests, and to change the total number of members. Also, flexibility can be in respect of how contributions, allocations, and distributions can occur. Such flexibility can allow the business entity to adjust for the unique characteristics of the business and for business growth or change in circumstances.

It is acknowledged that flexibility (whether in terms of governance, contribution, or distribution) is not the only characteristic that is taken into account when deciding which business entity is most appropriate. Indeed, many prior studies that have explored the reasons behind the choice of business entities have not even explicitly explored the flexibility in contributions and distributions when surveying advisors and business owners.[105] However, it appears that for tax pass-through

105. For example, reasons discussed include: limited liability; prestige and credibility; tax reasons; definition of membership interest; ease of interest transfer; facilitation of raising capital from outside investors; protection of business name; offering of floating security to bank; for trading purposes; reflection of the size of business; to run business through separate legal entity; continuation of original status after purchase; and benefit of discipline in running business through company. According to research conducted by Freedman and Godwin, the top 12 reasons for setting up a sole proprietor or general partnership are as follows: personal control; simple accounting requirements; few formal meetings; easy to start; property owned in own name; control over selecting partners; confidential financial records; easy to retrieve capital; tax reasons; no need to find second shareholder; prestige and credibility; and raising finance. Judith Freedman & Michael Godwin, *Legal Form, Tax and the Micro Business* 43 (paper presented at the sixth ESRC Small Bus. Initiative Meeting, 1991). In terms of a corporation, Freedman and Godwin found the top 10 reasons to be: limited liability to third parties (66.4%); prestige and credibility (50.4%); tax reasons (38.4%); accounting reasons (35.2%); administrative convenience (29.6%); owning

entities, flexibility has been noted as an advantage. The flexibility of LLCs was highlighted by the Alberta Municipal Affairs Registries: "The obvious advantage to creating an LLC is that the members can tailor the operating agreement to suit their individual needs. This offers the members tremendous flexibility over their internal governance. This allows the members to choose their own procedures for matters like calling of meetings, voting, and quorums."[106]

Also, LLCs can facilitate greater flexibility by assigning specific tax attributes.[107] In the United Kingdom, a flexible structure was the third top reason (13%) for choosing an LLP,[108] although the major

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property in firms name (26.4%); pension advantages available (25.6%); finance (24%); ease of transferring shares (17.6%); and ease of formation (10%). Judith Freedman & Michael Godwin, *Incorporating the Micro Business: Perceptions and Misperceptions*, *in* FINANCE AND THE SMALL FIRM 232, 245–47 (Alan Hughes & David J. Storey eds., 1994). In an Australian study, Freudenberg used the following 10 factors: asset protection; tax benefit/saving; business expansion; level of risk; limited liability; capital gains tax concessions; succession planning; compliance costs; equity raising; and prestige. Brett Freudenberg, *Tax on My Mind: Advisors' Recommendations for Choice of Business Form*, 42 AUSTL. TAX REV. 33, 45 (2013). In a study performed by Barbara Trad and Brett Freudenberg, the following factors were considered: asset protection; limited liability; small business capital gains tax concessions; retaining income at lower tax rate; overall understanding of the structure; tax rate; minimizing tax liabilities; capital gains tax discount; flow-through of tax concessions; equity raising; compliance cost; income splitting; business expansion; management function; utilization of the tax losses; meeting regulatory compliance; succession planning; and accelerated tax depreciation/write-off. Barbara Trad & Brett Freudenberg, *All Things Being Equal: Small Business Structure Choice*, 12 J. AUSTRALASIAN TAX TCHRS. ASS'N 136, 151–52 (2017).

106. ALTA. L. REFORM INST., LIMITED LIABILITY PARTNERSHIPS AND OTHER HYBRID BUSINESS ENTITIES 172 (1998), http://www.assembly.ab.ca/lao/library/egovdocs/1998/alilr/52262.pdf (quoting ALTA. MUN. AFFAIRS REGISTRIES, A DISCUSSION ON THE LAW OF BUSINESS CORPORATIONS 25 (1995)).

107. Howard M. Friedman, *The Silent LLC Revolution—The Social Cost of Academic Neglect*, 38 CREIGHTON L. REV. 35, 49–52, 86–90 (2004); Mark P. Altieri & William J. Cenker, *Partnerships, LLCs, LLPs, and S Corporations*, CPA J. (Oct. 2002), http://archives.cpajournal.com/2002/1002/features/f104002.htm.

108. FLETCHER ET AL., *supra* note 8, at 35.

reasons were related to tax benefits (first at 35%)[109] and limited liability (second at 32%).[110] In exploring what the notion of flexibility meant, participants in a UK study discussed terms for profit sharing ratios,[111] succession planning with members joining[112] or exiting,[113] allowing for different levels of member activity in terms of their contribution to the business,[114] as well as allowing for different property shares between members.[115]

For example, UK LLPs were seen as facilitating the ability to pool money together from different investors through multiple LLPs as quasi-collected investment pools.[116] "It is very flexible, you can add and

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109. *Id.* The tax reasons included: tax planning, self-employed status (re NIC), and use of a corporate member of the LLP (to allow for holding of profits for the LLP in case of a "rainy day"—rather than making a distribution of all profits). *Id.* at 34.

110. *Id.* at 35. The limitation of liability was seen as more precautionary—as most firms carried professional indemnity insurance. *Id.* at 3.

111. *Id.* at 65 ("Profit sharing ratios ranged from an equal division between partners, unequal but fixed division and variable, determinable annually.").

112. *Id.* at 26–27 (noting that LLPs provided for evolution of the business and succession planning, i.e., allowing new members to come in).

113. *Id.* at 36 ("It is very flexible, you can add and remove partners, you can apportion profits and losses any way you want and you can pretty well choose the timing of your expenditure." (quoting study participant commentary)).

114. *Id.* ("A further advantage is that we can have flexible employment. . . . in our partnership if you don't work you don't get paid; so we have partners who are workers and we pay them by the hour (via a contract) and we deduct the cost of the material and pay them 50% of the profit." (quoting study participant commentary)).

115. *Id.* at 62 ("[T]he Big Four director said that he had encountered extensive use of LLPs in the property investment sector, whereby an LLP was as an SPV for individual properties, as it allowed great flexibility, for instance, in dealing with property shares between partners." (quoting study participant commentary)).

116. *Id.* at 20 ("[W]hat it did was enable us to pool all our investors together in one pot. . . . with five hundred investing in fifty LLPs and then what we do is we pool those into five pots in what we call fund LLPs so there is sort of a tiered LLP structure; we have got fifty odd LLPs' clients investing and they basically invest in other LLPs' funds. . . .") (quoting study participant commentary)).

remove partners, you can apportion profits and losses any way you want and you can pretty well choose the timing of your expenditure."[117] Some found, however, that there were examples of how rules could impinge on the potential flexibility. For example, in the United Kingdom, for the LLP to not fall within the collected investment rules, all members need to make decisions, which may not be desirable.[118]

Arguably, the flexibility can assist in addressing the financing issues facing many small and closely held businesses, as well as in taking into account how different members may contribute to the business (e.g., through capital and/or through services) as well as subsequent distributions to recognize these varying contributions by members. Additionally, some members may have variations in income levels, and some investors may change status from debtors to members (remembering that the advantage of equity contributions is they do not require continual servicing as does debt).

Of particular relevance to this Article is the concept of the flexibility of contributions and distributions. The reasons for this flexibility can relate to (1) the original (and subsequent) equity contributions by members, (2) the capital and liquidity needs of members, (3) the ability to incentivize active members or manager-members, (4) the risk profiles of members (such as differences of opinions about different assets purchased and used in the business), and (5) the tax profiles of members.

For example, flexibility of contributions may allow for members to contribute various types of equity to help fund the business operations (which could include in-kind services) and, thus, save the business from having to raise more debt financing from creditors, which can require servicing. Also, it may be possible to raise equity from key employees, which can have benefits in terms of financing but also can reduce agency costs and provide for succession planning. The ability to allocate profits of the business for tax purposes, but for these to remain unpaid, can assist in retaining income in the business to assist with future financing. Additionally, allowing for a variety of contributions

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117. *Id.* at 36. Comments are made with respect to the United Kingdom's LLPs.

118. *Id.* at 42 ("The LLP is not so flexible; the biggest problem revolves around the need for members to take decisions to avoid become CIS. Would not use this structure again for quasi-investment fund.") (quoting study participant commentary)).

to be made can allow members to make meaningful contributions in recognition of their own available finances and skills, with such possible contributions including money, property, services, promises, and performance-adjusted interest determinations. In recognition of such a variety of contributions, there could be a variety of classes of membership interest that allow for different rights to income, capital, and voting. Even the number of allowable members can be of benefit to raise additional equity for the business operations, as well as the ability to use multiple tax pass-through entities together for one business operation to allow for a separation and distinguishing of members in terms of liabilities, contributions, and rights. Variety in contributions then leads to a variety of possible distributions in recognition of the different ways and times members have contributed. Also, with tax pass-through, it may be possible with distributions to members that the receipts and expenditure by the business retain their character (conduit) and thus allow members to access different tax treatments, such as capital receipts, which may be subject to concessional tax treatment.

A. Types of Contributions

The raising of equity is a highly significant issue, and the capacity of a business entity to facilitate it has been identified as an important feature of entity choice. Central to the notion of any business entity are the members that provide equity and other contributions to help fund the business. Indeed, the history of the variety of business entities affects the pooling of resources and the determination of rights and obligations of such members (as between themselves, the managers of the business, as well as creditors or tortfeasors of the business entity). The reasons for various contributions could relate to the wealth of members, availability of liquid funds, expertise, time of members, ability to service debt from third parties, asset protection, and availability of assets (including intellectual property). Sometimes, all members will contribute proportionally, but it may be that, for example, some of the members contribute only services and the other members contribute only capital.

As an illustration, a business entity can use an allocation-dependent equity structure for when members contribute capital and services proportionately.[119] If the members' contributions of capital and

119. *See* BRADLEY T. BORDEN, LLCS AND PARTNERSHIPS: LAW, FINANCE, AND TAX PLANNING ¶ 9.02[A] (2019).

services are proportionate, no member should receive preferential distributions because the distributions the entity makes to such members should be in proportion to their contributions. However, some arrangements may adopt allocation-dependent equity structures, even if the contributions of services and capital are not proportionate. For instance, one member may agree to provide a disproportionately large share of the management services (i.e., "sweat equity") in exchange for a share of profits that exceeds the member's share of contributed capital.

A distribution-dependent equity structure can be appropriate when there are clearly defined manager and member roles. Such arrangements typically provide that one or more members will contribute capital to the entity, and a manager may procure an investment; manage it, which may include developing property or restructuring an organization; and generally dispose of it after the manager makes the planned changes to increase the value of the property. In such scenarios, the entity will typically distribute first to the members until they have received the full amount of their contributions and a preferred return on those contributions. The entity will then distribute any remaining available cash to both the investors and the manager in predetermined percentages. Such arrangements reflect the order of typical distribution waterfalls. The amount paid to a manager after the entity has returned capital and paid the preferred return is referred to as a "carry" or "promote."[120]

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120. Id. ¶ 3.07[C] n.119 ("Managers may invest capital in such arrangements and participate in the preferred return as an investor with respect to any invested capital. Typically, the amount of capital, if any, that managers contribute is small compared to the amounts that the investors contribute. Nonetheless, investors typically like to see managers contribute some amount of capital to the arrangement, so that they have capital at risk like the investors, to better align the parties' interests and heighten managers' vigilance in preserving and growing the value of the entity's assets. In such situations, a manager's investment will be treated the same as other investments and earn a preferred return and then be returned before the entity begins distributing any remaining available cash. Managers' share of the carry will typically pay them more than they would receive under the preferential return, so the managers typically seek to maximize the carry. To illustrate, if a manager contributes 10% of an entity's capital, . . . they will receive 10% of distributions returning capital and paying the preferred return. A typical promote is at least 20% of a distribution, so the manager would prefer to receive distributions under the promote tier as quickly as possible.").

Arrangements adopt distribution-dependent equity structures for numerous reasons. First, because members put their capital at risk, they typically require the arrangement to pay them a preferred return and a return of their capital before the manager shares in the arrangement's profits. Managers agree to the preferred return and priority return of the members' capital to attract capital investment to the ventures the managers promote. Second, the promote incentivizes managers to maximize the arrangement's profitability. Because the managers will primarily share in profit only after the arrangement has both repaid the investors' capital and paid them a preferred return, the arrangement must have fairly significant profit before the manager receives a share of it. The share of profit that the manager receives as part of a carry can be very significant, so managers should be highly motivated to help the arrangement return a significant profit. The members are willing to provide the carry to the managers, who do not contribute significant capital because, by the time the arrangement distributes the carry, the members have received their contributed capital and their return on investment.

Parties may create entities that adopt equity structures that rely upon both allocation and distribution formulas to determine parties' rights to distributions. Such hybrid arrangements may be most appropriate when the nature of the entity changes over time. For instance, parties may form an entity for which an allocation-dependent equity structure is appropriate, but the need for additional capital may require them to add additional members or to call upon existing members to contribute additional capital. In such situations, the parties making the additional capital contributions may demand that they receive a preferred return, and the existing members may be hesitant to grant them a share, or larger share, of the arrangement's upside by allowing them to share in profit allocations. The parties may be able to satisfy both by providing a preferred return and return of capital to the additional members and retaining the allocation of profits for any distributions in excess of those amounts.

For an LLC, a contribution is a transfer of property or other benefit to the LLC to become a member of the entity or in the capacity as a member,[121] and these contributions may be in the form of money/property (capital), promises, and personal services.[122] Each of these

121. *See* RULLCA, *supra* note 27, § 102(2).

122. *See id.* § 402.

forms is discussed below, but the discussion is concerned with equity contributions, whether such contributions occur at the formation stage of the business entity or at other times during the lifecycle of the business. These equity contributions can be contrasted with debt or financing to a business.

It is important to appreciate, with these various types of contributions (including if made at different points in time), that members may make disproportionate contributions. It needs to be determined how such disproportionate additional contributions will affect the overall members' interests—both control and financial interests—as the overall interest cannot exceed 100%. That is, if one member's overall contribution percentage increases, then the other members' contribution percentages will need to decrease.

1. Contributions of Money

In simplest terms, members may contribute money for their membership interest. The ability for members to contribute money can provide the commercial advantage of ease of liquidity for the business as working capital in funding its operations. Generally, the contribution of cash for a membership interest will not be a taxable event.

2. Contributions of Property

Another form of contribution by members could be in other property (aside from money), including real estate, intangible property such as patents or copyrights, or securities or membership interests in other business entities. These property contributions may provide key assets to the business, such as land, essential intellectual know-who, or rights. The contribution of such property can be in recognition of asset-rich, income-poor members, which allows them to make a meaningful contribution to the business entity for equity even if they do not have readily available cash. An additional issue is how to value this property contribution, which depending upon the asset type can be problematic.[123] Members will need to decide how they will value it,

123. Property that is publicly traded, such as securities, has readily ascertainable value, whereas many types of property, such as business assets, real estate, and intangible property, do not have readily ascertainable values.

and they will need to consider the relevant tax authorities' positions on valuation.[124]

How this property contribution to the business entity is recognised for tax purposes is important, because if it is a taxing point then this will essentially decrease the overall amount available for equity financing (and can be problematic in an asset-rich, income-poor circumstance).

Given the aggregate approach that tax pass-through implies, there can be a theoretical assertion that the member continues to own the property transferred to the business entity. For example, the contribution of appreciated property to an LLC by a member does not result in a disposal for tax purposes, irrespective of control issues, as the LLC inherits the cost basis of the property.[125] In this way, the contributing LLC member's capital gains tax is deferred until the property is sold by the LLC, or the member sells the LLC interest.[126] However, there may be additional complexities in relation to the LLC treatment because the identity of the contributing member needs to be maintained as the pre-contribution gain will be required later to be assessed to them.[127] Also,

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124. *See* Reg. § 20.2031–1(b). One definition of value is the amount that a willing buyer would pay a willing seller for property, if neither was under compulsion to act and both had reasonable knowledge of the relevant facts. *Id.*

125. I.R.C. §§ 721, 723. However, this does not extend to transactions between the member and the LLC when the member is not acting in the capacity of a member. I.R.C. § 707(a); Kirk J. Stark & Eric M. Zolt, *United States Partnership Taxation: Current Structure and Proposals for Reform*, 54 BULL. INT'L BUREAU FISCAL DOCUMENTATION 326, 330 (2000). However, the non-recognition provisions of § 721 do not apply where: (1) appreciated membership interests are contributed to an investment LLC (defined as one with more than 80% of assets consisting of marketable securities, interest in mutual funds, or real estate) (I.R.C. § 721(b)); (2) the transaction is essentially a taxable exchange of properties; (3) the transaction is a disguised sale of properties (that is, within a two-year period of LLC transfer, the LLC transfers money or consideration back to the member (I.R.C. § 707; Reg. § 1.707–3(c)); or (4) the membership interest is received in exchange for services rendered to the LLC by the member. A similar result occurs when a non-resident member contributes appreciated property to an LLC, unless it is U.S. real property. Reg. § 1.897–1(c).

126. I.R.C. § 704(c).

127. There will be a mandatory allocation of pre-contribution gain or loss to the original contributing member. I.R.C. § 704(c).

there are potential adverse consequences if the contributed LLC asset is distributed to another member.[128]

In comparison, for a member contributing appreciated property to an S Corporation, there is a disposal of the property by the member for tax purposes, with a resulting liability for capital gains tax for that member.[129] However, this tax liability will be deferred in restricted circumstances if the member and other contemporaneous property contributors have control of the S Corporation.[130]

The United Kingdom's LLP has a more complete aggregate approach for asset holdings, with each LLP member treated as having direct fractional interests in the LLP's assets.[131] However, the strict legal treatment of capital gains for UK LLPs generally is unclear because there is no legislative codification of the practice. Rather, the processes are governed by a Statement of Practice by Her Majesty's Revenue and Customs.[132]

This complete aggregate approach means that the contribution of an appreciated asset by a new member to an LLP[133] generates a disposal by the new member of some of his or her fractional interests in

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128. Note that there is an exception if contributed appreciated property is distributed to another member within seven years of contribution, I.R.C. § 704(c)(1)(B), or if the LLC distributes any property to the original contributor of appreciated property within seven years, I.R.C. § 737(a)–(b).

129. I.R.C. § 1001.

130. I.R.C. § 351(a). Control exists if the property-transferring members own 80% or more of the membership interest in the S Corporation immediately after the exchange. I.R.C. § 368(c). With this deferral, the membership cost basis will be the contributed property's cost basis, and the S Corporation inherits the lower cost basis in respect of the property. I.R.C. §§ 358(a)(1), 362(a). This deferral does not apply to future contributions of property, unless the control requirement is again met in the subsequent exchange.

131. Taxation of Chargeable Gains Act 1992, c. 12 § 59A; HM Rev. & Customs, *Statement of Practice D12*, Gov.UK, https://www.gov.uk/government/publications/statement-of-practice-d12/statement-of-practice-d12 (last revised Sept. 14, 2015).

132. *See id.*

133. Income Tax (Trading and Other Income) Act 2005, c. 5, § 852(2)(a). On the introduction of a member, the member is deemed to have his or her own trade commencing on their introduction. *Id.*

the contributed asset to the other LLP members.[134] The contributing member could have tax consequences for this fractional disposal if the contribution is undertaken in connection with a payment or with prior revaluation of existing assets, or if the contribution is not at arm's length.[135]

3. Contributions of Services

Another contribution type consists of members providing their services to the business entity, which is known colloquially as sweat equity.

The advantage of such equity for services is that it allows for rewarding key employees for prior services and allows the employees to obtain a membership interest in the business entity. This can be critical for those who do not have the wealth to make equity contributions in the form of money or property. This can have the added advantage of attracting and retaining top talent by granting future employees equity in the entity.

Such a granted equity interest can be in the form of a capital interest or an interest in the entity's future profits. The nature of the interest transferred can affect the tax consequences to the service-provider and the entity.[136] If the potential equity interest relates to future services to be provided, then there may be contractual rights that are forfeited should the services not be provided[137] as well as a

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134. HM Rev. & Customs, *supra* note 131, § 5. Where fractional share in a LLP asset is built up in stages (that is, acquired at different times), such acquisitions are pooled for capital gains tax purposes. HM REV. & CUSTOMS, CAPITAL GAINS MANUAL, PARTNERSHIPS CG27300, https://www.gov.uk/hmrc-internal-manuals/capital-gains-manual/cg27000c (last visited Dec. 27, 2019); HM Rev. & Customs, *supra* note 131, § 11.

135. HM Rev. & Customs, *supra* note 131, §§ 4, 6–8. In certain circumstances, Her Majesty's Revenue and Customs (HMRC) allows for members to defer their tax consequences for changes in their fractional shares by allowing the sale proceeds to equal the relevant fraction of the current balance sheet value. *Id.* § 4.1. When deferral applies, members carry forward either a smaller or a greater fractional interest in the underlying LLP asset. *Id.* § 4.3.

136. *See* Rev. Proc. 2001–43, 2001–2 C.B. 191; Rev. Proc. 93–27, 1993–2 C.B. 343; *see also* Notice 2005–43, 2005–24 I.R.B. 1221.

137. For example, the equity received for future service may be subject to risk of forfeiture to ensure that the service-provider does not receive

requirement that the service provider remain with the business for a specified period of time or risk forfeiture of the membership interest.

Services can be significantly different from other forms of contributions. Nonetheless, freedom of contract allows parties to negotiate to exchange equity for services and to determine the nature of the equity transferred in exchange for the agreed upon services.

There can be issues about the valuation of service, as well as about how they are accounted for given there is no intangible or tangible asset provided in exchange for the membership interest.[138] This can mean that there is a taxable capital shift, if the service provider receives a capital interest in exchange for the contributed services. Again, a contribution of future service may be a taxable event, depending upon the type of interest received for the future services.[139]

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the benefit of the equity interest prior to providing services. *See* I.R.C. § 83. The entity may also include a removal provision that allows the entity, through the vote of other members, to remove a service provider who fails to provide promised services or does not perform them competently.

138. Contributed services do not create a debit entry, i.e., contributed services are not an asset. Thus, crediting a services provider's capital to reflect the transfer of an equity interest in exchange for contributed services requires debiting the capital account of one or more other members. Treasury regulations proposed in 2005 would, in effect, treat the exchange of services for a capital interest in an existing partnership as a deemed cash contribution by the service member and a deemed payment for those services by the other members. Prop. Reg. §§ 1.704–1(b)(2)(iv)(*b*)(1); 1.721–1(b), 70 Fed. Reg. 29,675, 29,681, 29, 683 (May 24, 2005).

139. The contribution of "future services" for a membership interest will have different treatments between the two United State tax pass-through entities. This is because entity acknowledgement is taken with S Corporations, whereas an aggregate approach is taken for LLCs. An S Corporation member will be assessable for the receipt of property (the property being the membership interest in the S Corporation) as consideration for services. I.R.C. § 83. Unlike the capital gains tax on contributed appreciated property by a member, an S Corporation member may not defer this tax liability, as performance of a service is not treated as "property." I.R.C. § 351(a). On May 24, 2005, the IRS proposed regulations that would treat the receipt of an LLC membership interest for services as a taxable event regardless of whether the member had received a current interest in the LLC capital. The proposed regulations, however, allow the LLC to elect to treat the fair market value of the interest as being the value of the member's interest in the LLC capital. Thus, if the service member has not received a current membership

4. Performance-Adjusted Interest Determination

Performance-adjusted interest determinations take into account both the amount of contributions and the performance of the tax pass-through entity prior to additional contributions. Consider two types of performance-adjusted interest determinations: (1) historical-performance determinations and (2) mark-to-market determinations.[140]

Under the historical-performance interest determination, the entity takes into account initial contributions, the entity's historical performance, and the amount of the additional contributions to determine the members' interests following a disproportionate additional contribution. The entity might account for historical performance by using the capital accounts to determine member interests.

Members of some tax pass-through entities may prefer to take the entity's value into consideration when determining the members' interests in the entity following an additional contribution. Adjustments to reflect changes in value give credit to non-contributing members for changes in the entity's value that occur prior to additional contributions. From the viewpoint of the non-contributing members, if the value of the entity has increased prior to the additional contributions, they own a share of that increased value and should retain their value in those shares of the entity's value. Thus, they prefer that members' interests account for changes in value. Inversely, if the entity's value decreases prior to the additional contribution, the member making the additional contribution will insist that the members' interests reflect that diminished value.

5. Contributions of Promises

In addition, members may promise to contribute property, services, or other benefits to the entity. A contributed promise may take the form of nothing more than a provision in an entity agreement stating that the person will contribute property, services, or some other benefit in the future.[141] Freedom of contract allows the parties to treat contributed

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interest in the LLC capital and the election is made, the member will not recognize income. Prop. Reg. § 1.83–3(*l*), 70 Fed. Reg. 29,675 (May 24, 2005); *see also* Notice 2005–43, 2005–24 I.R.B. 1221.

140. *See* BORDEN, *supra* note 119, at § 8.04[D][1].

141. A contributed promise could also take the form of a promissory note. *See, e.g.*, Gowin v. Granite Depot, LLC, 634 S.E.2d 714, 720–21 (Va. 2006).

promises in any manner they choose. Thus, they may treat the promise as a current contribution, admit the promisor as a member at the time of the promise, and give the person an interest reflecting the amount of the promise. Alternatively, they may treat the promise as an obligation to make a future contribution and wait to recognize the promisor as a member until the promised item is actually contributed.[142]

The advantage of allowing contributions of promises is that it provides the opportunity for potential members to specify their participation in the business either currently or in the future and provides some certainty and expectation for others.

Accordingly, it can be appreciated that there is great flexibility in the ways that contributions can be made to a tax pass-through entity, allowing for the different financial resources and skills of members and allowing for a variety of ways that members could contribute equity to a business entity. Such variation may mean that the membership interests issued to members also vary, as illustrated in the following discussion.

B. Types of Membership Interests

Different types and numbers of membership interests can provide flexibility in recognising the variety of contributions made by members. Given the different circumstances of the equity investors in terms of what and when they can contribute, as well as their involvement in the business (or not), some membership interests may grant control rights but not financial rights, and some membership interests may grant financial rights but not grant control rights. For instance, family members could form an entity that grants parents the control rights and grants children the financial rights.

Additionally, the control and financial composition of membership interests may change over the life of the entity as existing members make additional contributions and receive distributions in

142. Tax law takes the latter approach, treating a contribution as occurring when the promisor satisfies the promise. Even with contributed notes, tax law waits until the promisor makes a payment on the note or the entity sells the note to recognize a contribution, unless the note is readily tradeable on an established securities market. *See* Reg. § 1.704–1(b)(2)(iv)(*d*)(2). The note may, however, have the effect of increasing a member's share of debt basis. Reg. § 1.752–2(b).

different proportions, or if the entity admits a new member. It would normally be the case that accepting contributions from new members generally will affect the other members' control and financial rights.

For some tax pass-through entities, there can be effective restrictions on the actual quantum of members allowed to invest in the tax pass-through entity as well as on having different types of membership interests. These effective restrictions can be due to tax legislation requirements that grant the tax pass-through treatment or other regulatory provisions (such as governing rules). It is argued that such restrictions on the number or type of membership interests may inhibit the ability to raise the required equity capital for the business operations. This is because new equity members may require preferred membership interests or, alternatively, interests with specific rights attached to them to invest equity so as to expand operations.

However, it should be acknowledged that it could be the case that only having one member is more appropriate for the business, which is especially the case for those operations that do not wish to grow.[143] In terms of just single membership, whether the governing rules are drafted to adequately cater to single membership is debateable. That is, do the governance rules cater to single membership in a meaningful manner or is it an add-on imposed on a governance framework drafted for multiple members with provisions dealing with agency issues between members and managers?

For LLCs it is possible to have single membership,[144] although Ribstein questions whether a single member LLC is appropriate, due to

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143. For example, the vast majority of businesses in the United States are owned by one or a few members. Friedman, *supra* note 107, at 45. Similarly, a large proportion of UK businesses have one member. Over 70% of corporations have only one or two members. Some 90% have fewer than five members. CO. LAW REVIEW STEERING GRP., MODERN COMPANY LAW FOR A COMPETITIVE ECONOMY: DEVELOPING THE FRAMEWORK ¶ 6.9 (2000), https://webarchive.nationalarchives.gov.uk/20020805224955/http://www.dti.gov.uk:80/cld/modcolaw.htm#pdf.

144. Massachusetts changed its laws in 2003 to allow for a single member LLC, being the last U.S. state to do so. *See* Mary FitzSimons, *Have Disparities in State Tax Treatment of Single Member Limited Liability Companies Created a Tax Overlap for Interstate Businesses?*, 3 ENTREPRENEURIAL BUS. L.J. 19, 23 nn.26–27 (2008).

the default rules obviously being drafted for multiple members. Ribstein expresses concerns about interpretation problems that could arise from such a mismatch.[145]

The other popular tax pass-through entity in the United States, the S Corporation, may also have single membership.[146] However, the actual default governance rules of the S Corporation may not be suited for such single membership, as the corporate governance structure used for S Corporations uses a Board of Directors to manage the business.[147] This requires such formalities as mandatory annual member meetings,[148] special member meetings,[149] meeting notice rules,[150] and required officers.[151] Commentators have argued that this automatic separation between management and members means this corporate model is more appropriate for widely held businesses,[152] which are characterised by this separation.

However, this position for S Corporations can be altered through drafting to make the management structure more appropriate for closely

145. Larry E. Ribstein & Mark A. Sargent, *Check-the-Box and Beyond: The Future of Limited Liability Entities*, 52 BUS. LAW. 605, 638 (1997). This is because LLCs are built on a contractual model, which implies an agreement amongst members. In such circumstances, there is a danger that LLC default rules will be applied, for example, to give rights to non-owner associates, such as managerial employees. To address this, Ribstein wonders whether a new non-corporate statutory form, the limited liability sole proprietorship, would be a better alternative. *Id.*

146. *See* MODEL BUS. CORP. ACT (2016 REVISION) ch. 7 (AM. BAR ASS'N 2017).

147. For example, the mandatory rules for running of the corporation include that all corporate powers are to be exercised by the Board of Directors. § 8.01(b). It is generally mandatory for a corporation to have a Board of Directors. *Id.* § 8.01(a).

148. *Id.* § 7.01.

149. *Id.* § 7.02(a) (on call by Board of Directors or by 10% of members).

150. *Id.* § 7.05.

151. *Id.* § 8.40.

152. Friedman, *supra* note 107, at 79–81; Hicks, *supra* note 89, at 51–54; Ribstein & Sargent, *supra* note 145, at 631.

held businesses.[153] For S Corporations,[154] the *Model Business Corporation Act* achieves this through a unanimous member approval,[155] which can eliminate or restrict the Board of Directors,[156] regulate the authorisation of distributions,[157] specify the division of voting power between members and directors,[158] and transfer to one or more members (or others) power to manage the business and affairs of the corporation.[159] Additionally, the agreement (provided it is not against public policy) can otherwise govern the existence of the corporation, powers, management, and relationships between members and directors.[160]

The flexibility of such an agreement is acknowledged by the *Model Business Corporation Act* insofar as it indicates that such an agreement may treat "the corporation as a [general] partnership or result in failure to observe corporate formalities."[161] However, the act specifies

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153. The internal governing rules of a U.S. corporation are known as its bylaws, which can alter the application of the non-mandatory default rules. MODEL BUS. CORP. ACT (2016 REVISION) §§ 2.02, 2.06 (AM. BAR ASS'N 2017); *see also id.*§ 7.32(d) ("If the agreement ceases to be effective for any reason, the board of directors may, if the agreement is contained or referred to in the corporation's articles of incorporation or bylaws, adopt an amendment to the articles of incorporation or bylaws, without shareholder action, to delete the agreement and any references to it.).

154. The *Model Business Corporation Act* provides for substantial organizational flexibility to adopt rules of private ordering that differ from the typical mandatory default rules within the Act. *Id.* §§ 2.02, 2.06, 7.32, & cmt. § 7.32. Note that prior to the publication of the Fourth Edition of the Act, much of this flexibility was provided for in the Statutory Close Corporation Supplement. The Supplement was subsequently discontinued in 2008, and these principles have since been incorporated in the main text of the Act. *See* William H. Clark, Jr., *The Relationship of the Model Business Corporation Act to Other Entity Laws*, 74 J.L. & CONTEMP. PROBS. 57, 63 n.47 (2011).

155. *Id.* § 7.32(b). If such a member agreement is entered into, its existence must be clearly stated on certificates for membership interests. *Id.* § 7.32(c). Such a member agreement must list any duration limits if applicable. *Id.* § 732(h). If issued under a previous version of the Act, the shareholder agreement is normally valid only for 10 years unless it provides otherwise. *Id.*

156. *Id.* § 7.32(a)(1).

157. *Id.* § 7.32(a)(2) (subject to the capital protection rule).

158. *Id.* § 7.32(a)(4).

159. *Id.* § 7.32(a)(6).

160. *Id.* § 7.32(a)(8).

161. *Id.* § 7.32(f).

that such treatment internally as a general partnership does not mean that a member has personal liability.[162] While such drafting is of assistance to make the United States' corporate form more appropriate for closely held businesses, the presence of a members' agreement could present blending problems. This is because general partnership law may be referred to by courts in solving corporate disputes when partnership-type principles have been utilised. Furthermore, if there is great variation among members' agreements, then this could diminish the potential to develop any meaningful networking benefits that can arise with standard default rules.[163]

However, by eliminating the Board of Directors, member-management of an S Corporation can be achieved, and a number of corporation rules perceived unsuitable for closely held businesses can be removed.[164] The effect of a members' agreement in improving the governance of a corporation can be overlooked by commentators who champion the LLC as providing a more suitable governance framework in the United States.[165]

While single-membership of the United States' tax pass-through entities may not be perfect, they are preferable to the United Kingdom's LLP. This is because the LLP does not allow for single membership at all—requiring at least two members.[166] It is argued that the requirement of

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162. *Id.*

163. *See* Freudenberg, *supra* note 18, at 214

164. For example, rules that are perceived as unsuitable for closely held corporations include requiring the annual election of managers, requiring decisions be made in formal meetings, requiring that there be an annual meeting of members (with certain notice periods), requiring a detailed list of members be available, requiring that various records (including resolution of directors) be kept and be available for inspection by members, specifying how the Articles of Incorporation are to be amended, requiring mandatory annual member meetings, providing for special member meetings on call by Board of Directors or by 10% of members, providing for meeting notice rules and specifying required officers.

165. For example, see Larry E. Ribstein, *The Important Role of Non-Organization Law*, 40 WAKE FOREST L. REV. 751, 772–88 (2005). When the author explains the non-tax reasons for adopting an LLC over the corporation, Ribstein does not explicitly consider the implications of a shareholder agreement improving a corporation's flexibility. *Id.*

166. *See, e.g.*, Limited Liability Partnerships Act 2000, c. 12, § 2(1)(a) (requiring an LLP to have two or more persons associated for carrying on

two members is inconsistent with the overall corporate nature of LLPs. Even though the LLP's name—limited liability partnership—connotes that its governance is partnership based, it is argued that the LLP is essentially corporate in nature.[167] Indeed, others have questioned whether the label partnership is appropriate at all in describing the LLP.[168]

It is argued that the requirement for two members may frustrate closely held businesses and could thereby compel the utilisation of non-active members to fulfil the requisite condition.[169] However, enticing a person to become a non-active member of an LLP could be difficult due to the extensive obligations placed on its members.[170]

At the other end of the spectrum, both LLCs and LLPs do not have a limit on the maximum quantum of members. This can be contrasted with S Corporations, which are allowed a maximum of 100 members. While this is a substantial increase from the original 10

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a lawful business with a view to profit); § 8(2) (requiring an LLP to have at least two designated members). However, the legislation expressly envisages that the LLP can continue to carry on business although it has only one member, although this will lead to liability exposure for members. Companies Act 1985, c. 6, § 24. There is some relief for LLP membership falling to one member provided it is rectified within six months. *Id.*

167. This corporate context is illustrated by the fact that there is no expressed duty between the LLP members, compared to general partners in a general partnership. This is because a large volume of corporation law is contained in regulations.

168. GEOFFREY MORSE, PARTNERSHIP LAW 293 (6th ed., 2006); John F. Avery Jones et al., *Characterization of Other States' Partnerships for Income Tax*, 56 BULL. INT'L TAX'N: TAX TREATY MONITOR 288, 305 (2002); Judith Freedman, *Limited Liability Partnerships in the United Kingdom: Do They Have a Role for Small Firms?*, *in* THE GOVERNANCE OF CLOSE CORPORATIONS AND PARTNERSHIPS, supra note 1, at 293, 294–95. Such an observation is reinforced by the fact that it is expressly stated in the first section of the UK LLP Act that the law relating to partnerships does not apply to an LLP, except so far as the Act itself, or any other act, provides. Limited Liability Partnerships Act 2000, c. 12, § 1(5).

169. Other terms that could be used to describe non-active members are "silent members" or "nominee members." It should be recalled that this is what occurred in the famous decision of *Salomon v. Salomon & Co.*, where six nominee members where utilised to ensure the minimum membership of seven at the time was satisfied. [1897] AC 22 (HL).

170. The obligations for a non-active LLP member are explored later in this Article.

allowed,[171] it does, nevertheless, place an arbitrary cap on the number of members.[172] While there has been liberalisation of the S Corporation's eligibility requirements in 1996[173] and 2004,[174] there is a continued push for further relaxation.[175]

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171. Originally, back in 1958, only 10 members were allowed; subsequent amendments raised the number to 15 (1976), then 25 (1981), then one year later to 35 (1982), then 75 (1997), and finally, the *American Jobs Creation Act of 2004* raised the number 100. Zev Landau, *Recent Reform and Simplifications for S Corporations*, CPA J. (Nov. 2005), http://archives.cpajournal.com/printversions/cpaj/2005/1105/p46.htm. This limitation applies to the number of members at any one time during the taxable year. I.R.C. § 1361(b)(1).

172. However, the number of potential shareholders of an S Corporation may exceed 100, due to the treatment of family members. I.R.C. § 1361(c)(1). A family is defined to include members with a common ancestor, lineal descendants, and any spouses (or former spouse) of any common ancestor or lineal descendant. § 1361(c)(1)(B)(i). Common ancestor is defined to include any person who, at the time of the election, is six or fewer generations from the youngest generation of shareholders. § 1361(c)(1)(B)(ii). Prior to January 1, 2005, most joint owners were counted separately (Reg. § 1.1371–1(d)(1)); however, spouses (and their estates) could be treated as one member. I.R.C. § 1361(c)(1).

173. These are in addition to the reforms that occurred in 1981 and 1982. The 1982 reforms saw removal of the 80% foreign income restriction (I.R.C. § 1372(e) (1976); Subchapter S Revision Act of 1982, Pub. L. No. 97-354, § 2, 96 Stat. 1669, 1682) and specified that differences in transfer and voting rights did not create a second class of membership interest. I.R.C. § 1361(c)(4). In 1996, certain trusts were allowed to hold membership interests, and S Corporations were able to hold 100% of subsidiary corporations. I.R.C. § 1361(b)(3), (c)(2); Small Business Job Protection Act of 1996, Pub. L. No. 104-188, §§ 1302, 1308, 110 Stat. 1755, 1777, 1782–83.

174. The 2004 amendments included allowing some bank trading activity, the creation of employee stock ownership plans, and providing for the increase in membership number to 100 (with the aggregation of family members in this count). I.R.C. § 1361(b)(1)(A), (c)(1)(A); American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 231 *et seq.*, 118 Stat. 1418, 1433.

175. Most recently, the Tax Cuts and Jobs Act, Pub. L. No. 115-97, § 13541, 131 Stat. 2054 (2017) (codified at I.R.C. § 1361(c)(2)(B)(v)), eliminated the disallowance of non-resident alien beneficiaries of electing small business trusts. This effectively permits non-resident aliens to be indirect S corporation shareholders. Commentators have noted, "This change is only the most recent in a trend to liberalize S corporation requirements and allow greater flexibility in structuring S corporations and their ownership." T. Christopher D'Avico, *Nonresident Alien as an Indirect S Corp. Shareholder*,

Nevertheless, arguably there is in effect some limitation of the quantum of members allowed for an LLC as publicly traded partnerships are excluded from being able to make check-the-box election for transparency. This generally prevents an LLC undertaking an initial public offering as a tax pass-through entity.[176] Indeed, for an LLC and its members to rely on safe harbour provisions pursuant to regulations, it is prudent that the number of LLC members be restricted to 100.[177]

In the United Kingdom, the laws pertaining to LLPs do not have an upper limit on the number of members allowed;[178] an LLP is prohibited from offering its membership interests (or other securities) to the public.[179] There are some current examples of LLPs being utilised

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TAX ADVISOR (Apr. 1, 2019), https://www.thetaxadviser.com/issues/2019/apr/nonresident-alien-indirect-s-corp-shareholder.html. And they anticipate that "there will continue to be those who will push for further changes to S corporation requirements on permissible shareholders and classes of stock to allow for even greater flexibility." *Id.*

176. I.R.C. § 7704(a); Reg. § 301.7701–3(a). An example of a "publicly traded partnership" is one with partnership interests that are either traded on established securities markets or readily traded on a secondary market.

177. Regulations provide safe harbours for a partnership to avoid being classified as publicly traded. One such safe harbour provides that a partnership will not be classified as publicly traded if (1) no interests issued in a transaction(s) are registered under the Securities Act of 1933, and (2) the partnership does not have more than 100 members during the year. Reg. § 1.7704–1(h).

178. The absence of an explicit upper limit compares favourably to the previous limit of 20 members, which was imposed on general partnerships and limited partnerships. E.A.L. Rowlands & I.P. Zieder, *Limited Partnerships and Limited Liability Partnerships*, *in* TOLLEY'S TAX PLANNING 2019–20, at 1711 (Rebecca Forster ed., 2019). Another potential restriction for UK LLPs raising equity is that a "person" may be an LLP member. The definition of "person" includes individuals, corporations, LLPs, and other forms of corporate entities. Interpretation Act 1978, c. 30, § 5 & sched. 1 (defining "person" to include an incorporated body of persons). However, the Registrar does not accept an unincorporated body such as a trust or general partnership being an LLP member and requires members to have their own legal personality. JOHN WHITTAKER ET AL., THE LAW OF LIMITED LIABILITY PARTNERSHIPS 14 (2d ed., 2004).

179. For example, a public corporation can offer membership interests publicly, provided it has, amongst other things, a minimum membership capital of at least £50,000. Companies Act 2006, c. 46, § 763. Under reforms in the Companies Act 2006, a private company that engages in a public offering will no longer be treated as having committed a criminal offence. *Id.* §§ 755,

for widely held operations, particularly as property investment vehicles as well as for very large professional firms of solicitors and accountants.[180] Additionally, there can be restrictions on who can be a member of a tax pass-through entity, and, thus, those excluded members potentially inhibit raising equity from them.

The check-the-box regulations exclude certain foreign corporations and all corporations formed within the United States from the election for transparency under Subchapter K.[181] It should be noted that it is possible for a C Corporation to hold membership interests in an LLC, whereas it cannot readily do so for an S Corporation.[182] An S Corporation may raise equity only from resident individuals—except in restricted circumstances.[183] This restriction means, in effect, that a C Corporation could not become a member of an S Corporation. For S Corporations, it is understood that non-residents were excluded due to the potential risk that revenue allocated to a non-resident member may escape taxation in the United States. This is because if a non-resident S Corporation member was not actively involved in the business, then as a non-resident, only fixed income (e.g., interest and dividends) sourced in the United States would be taxed, with other income not subject to

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758, 759. Instead, the company may be required to register as a public corporation, make remediation payments, or the court may issue an order for the compulsory winding up of the company. *Id.* explanatory notes ¶¶ 1049–61.

180. In *Cabvision*, there was a plan for an LLP to raise capital to finance a project in the vicinity of £22.5 million by the issue of membership interests. Cabvision Ltd. v. Feetum [2005] EWCA (Civ) 1601 (appeal taken from Eng.). The United Kingdom has been concerned about LLPs being used in this way and has brought in a number of counter provisions.

181. *See supra* note 40 and accompanying discussion.

182. In the circumstances that a single C Corporation holds all the membership interests in the LLC, then the LLC would be a disregarded entity, meaning all of the LLC's activity is treated as being that of the C Corporation, which saves the need for using formal consolidated tax filings and can facilitate tax free reorganizations, depending on the form used. *Compare* Reg. § 1.368–2(b)(1)(iii), Ex (4), *with* Reg. § 1.368–2(b)(1)(iii), Exs. 6–7.

183. I.R.C. § 1361(b)(1)(C). Only in highly restricted circumstances can a member be an entity. S Corporations can hold a 100% interest in a subsidiary and can elect to treat the subsidiary as a Qualified Subchapter S Corporation. I.R.C. § 1361(b)(3)(B). Additional rules include I.R.C. § 1361(c)(2) (certain trusts as shareholders), § 1361(c)(3) (bankruptcy estate), and § 1361(c)(6) (certain tax-exempt entities as shareholders).

tax.[184] However, others have pointed out that rather than excluding nonresident members, this could be addressed by applying withholding tax rules.[185]

Given the prior discussion about the different types of contributions, a tax pass-through entity may wish to issue different types of membership interests that have a variety of rights, whether it be in relation to profits,[186] losses, capital,[187] or voting.

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184. A foreign member is allowed a credit for the tax withheld. *See* I.R.C. § 1446; GEORGE MUNDSTOCK, A UNIFIED APPROACH TO SUBCHAPTERS K & S 229 n.7 (2d ed., 2006). If the income is not effectively connected with trade in the United States, then the withholding tax rate is generally 30%, unless a treaty applies a lower rate. *See* I.R.C. § 1441.

185. *See* Am. Bar Ass'n Section of Tax'n, Subcomm. on the Comparison of S Corps. & Partnerships, *Report on the Comparison of S Corporations and Partnerships: Part I*, 44 TAX LAW. 483, 494 (1991) (James Edward Maule, subcomm. chair). U.S. LLC members are regarded as engaged in the business activity conducted by the LLC, and accordingly they are automatically subject to withholding tax on allocations to them. *See* MUNDSTOCK, *supra* note 184, at 229 n.7; *Partnership Withholding*, IRS.GOV, https://www.irs.gov/individuals/international-taxpayers/partnership-withholding (last updated Dec. 20, 2019).

186. Profits-only interests bestow upon the holder of such interests a right to receive a share of future profits. A person holds a profits-only interest if the person has a right to share in future profits but would receive nothing if the entity were to liquidate. *See* Rev. Proc. 93–27, 1993–2 C.B. 343. The receipt of profits-only interests is not unusual. LLCs and partnerships that provide equity compensation often do so in the form of profits-only interests. At the time of grant, the profits-only interest bestows on the recipient the right to receive a share of the entity's future profits but no right to receive current capital. A profits-only interest can quickly turn into a capital interest. The holder of a profits-only interest shares in the accrual of an entity's profits. Thus, if the entity is profitable, the holder of a profits-only interest would have a right to receive a distribution from the entity after profits have accrued.

187. Interests in capital bestow upon equity holders the right to receive an interest in the entity's existing assets. One way to determine whether a person has a capital interest is to ask whether the person would receive a distribution if the entity were to sell all of its assets and distribute the proceeds (i.e., liquidate). Liquidation value is the approach taken in proposed regulations. *See supra* note 139; Notice 2005–43, 2005–24 I.R.B. 1221; *see also* Rev. Proc. 2001–43, 2001–2 C.B. 191; Rev. Proc. 93–27, 1993–2 C.B. 343.

Membership interests establish the manner in which members share in an entity's profits. The membership interests may grant the holder a share of profits and losses based upon allocation percentages in an entity with an allocation-dependent equity structure or may grant the holder a right to receive distributions according to a distribution waterfall in an entity with a distribution-dependent capital structure. The profit sharing structure may affect the consequences of additional contributions. For entities with allocation-dependent equity structures, for instance, disproportionate additional contributions will most likely alter the profit sharing arrangement. Disproportionate additional contributions to entities with distribution-dependent equity structures can affect each member's share of distributions for each tier, create a new tier for additional contributions, or simply grant the contributor an interest in the residual-equity tier of the waterfall.

Both U.S. LLCs and UK LLPs can grant different classes (rights) of membership interests, and thus they have the ability to issue membership interests with different distribution, voting, or management rights. Accordingly, members of LLCs and LLPs that allow disproportionate additional contributions can account for those additional contributions by granting the contributors of additional capital a preferred return on their additional contributions.[188] In comparison, S Corporations may only have one class of membership interest[189] (although transfer rights do not of themselves create different membership interests), so they are more restricted in how they compensate for additional contributions.[190]

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188. They can incorporate the additional contribution in an existing distribution waterfall, or they can layer the preferred return into an existing allocation-dependent equity structure, as the situation may warrant. Layering a preferred return within an existing allocation-dependent structure creates a hybrid structure, which ends up functioning like a distribution-dependent structure. The entity will distribute available cash to the members who make the additional capital contributions until they receive a return of their additional capital contributions and a preferred return. Thereafter, the entity will distribute proceeds according to percentage interests, most likely based upon the initial contributions.

189. I.R.C. § 1361(b)(1)(D).

190. Note that since 1982, S Corporation restrictions on transfer rights do not create a second class of membership interest. Rev. Rul. 85–161, 1985–2 C.B. 191.

C. Multiple Entities

At this point, it is worth noting that multiple entities may be used for one business venture. Having multiple entities can provide more ease in separating assets from liabilities and differing member contributions. For example, in the United States, it is possible to have a series LLC with one or more members' interests or assets (and able to protect assets from other liabilities that other series entities may have).[191] Similarly, in the United Kingdom there are examples of multiple LLPs being used for investment purposes.[192] The variations of membership interest will influence to what extent such members are entitled to allocations and subsequent distributions from the business entity and what form those distributions take.

D. Types of Allocations and Distributions

The freedom of contract that LLCs typically possess allows the members of such entities to create any type of distributions they would like. Such freedom would, at first blush, appear to bestow unlimited creativity and an infinite number of distribution structures. While the specifics of distribution structures may create an infinite number of structures, in practice, most distribution structures fall within just a few different types. The discretion and freedom provided by the primacy of contractual freedom is bounded by reasonableness and relative consistency among business and property ownership practices. Undoubtedly, profession rules of ethics requiring competency and diligence also affect the breadth of types of distribution structures that entities adopt.

Distribution structures typically are an interconnected part of an entity's financial structure, which often includes one or more of the following components: contributions; member compensation; loans, including member loans; and allocations.

The allocation and distributions to members can generally affect the cost basis of their membership interest. In addition, such a variety

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191. *See supra* note 58 and accompanying text.

192. *See, e.g.*, FLETCHER ET AL., *supra* note 8, at 9 (study found "one asset management LLP was a collective of 51 LLPs utilised for investment purposes").

of contributions could influence how the members of the tax pass-through entity will agree to share profit and losses, and eventually residual assets.[193]

The reason for the flexibility in distributions can relate to the original (and subsequent) equity contributions by members, the capital and liquidity needs of members, the ability to incentivise active members or manager-members, the risk profiles of members (such as differences of opinions about assets to purchase and use in the business), as well as the tax profiles of members.

It is worthwhile remembering the distinction between allocations and distributions. Allocation refers to the allocating of income or losses directly to members for tax purposes, even though legally the income and losses are earned or incurred by the business entity. No actual payment or distribution has to occur from the business entity to the member. The related term distribution refers to the actual payment or transfer of assets (including money) to members from the business entity.

The types of allocation and distributions made by a business entity largely reflect the potential contributions to them. Relevant concepts to distributions are the notions of splitting and streaming. The notion of income splitting refers to the ability to split income amongst a number of members, especially those subject to separate marginal tax rates. By splitting the income among several members, the overall tax impost can be lower compared to if just one member received the entire amount. Streaming refers to the practice of directing particular types of income to particular selected members. For example, a capital gain may be allocated just to one member, while the other members

193. Residual assets are those assets left after the entity satisfies its obligations to creditors. Equity holders share in an entity's residual assets, but the equity holders may agree that some investors will have priority over other investors. For instance, some investors may receive their capital contribution and a preferred return on their contributions before other investors receive any distributions. The type or timing of contributions may affect how equity holders agree to share an entity's residual assets; freedom to contract allows equity holders to choose how they will share residual assets. Thus, various factors affect whether an entity has an allocation—dependent equity structure, a distribution-dependent equity structure, or hybrid structure (which would actually be a distribution-dependent structure).

are allocated business income. Streaming can be done according to the different tax profiles of members, which may mean that it is preferable that a member receives a particular type of income.

Most tax pass-through entities' distribution structures fall within one of four general types: (1) distributions in proportion to contributions, (2) distributions based upon contributions and allocations, (3) distributions based upon periodic member negotiation, and (4) distributions based upon pre-determined distribution formulas.[194] The type of distribution structure that is most suited for a particular entity generally depends upon the type of entity and the characteristics of its members. Members of an entity may adopt a particular structure for one reason but modify it to adapt to particular circumstances that may warrant modifications. Member contributions also typically affect the distribution structure that an entity adopts. Considering each type of distribution in turn illustrates their unique characteristics, matches them with structures that favour each type, and lays the foundation for considering how modifications may serve various purposes.

The types of distributions that potentially can be made by a tax pass-through entity include money, property, use of property, services, tax preferences, and losses. In addition, there could be membership interest adjustments as part of a distribution. While not strictly equity distributions, member compensation, such as wages to active members and lease payments for the use of the member's assets, are other mechanisms that can be used to provide some flexibility in distributions.

Clearly, a distribution of money involves the distribution of cash by the tax pass-through entity to members. Also, property can be distributed in specie by the entity to the members. Additionally, distributions could be facilitated via services or the use of the entity's property by members. It is possible that such distributions can be taxable for the tax pass-through entity or the receiving member, but whether a distribution is taxable will depend on the tax rules of the relevant jurisdictions. For example, when an LLC distributes property to a member, generally neither the LLC nor the member recognises a gain or loss at that time.[195] Instead, the member receiving the property generally inherits the LLC's inside cost basis for the property,

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194. *See* BORDEN, *supra* note 119, § 9.02.

195. I.R.C. § 731(a)–(b). The so-called "hot asset" rules may, however, require taxation of the LLC, the distributees, and even the other members. I.R.C. § 751(b).

and the membership cost basis is reduced.[196] Typically, there is no gain recognised by the LLC member, regardless of whether the value of the distributed property exceeds their membership cost basis,[197] as any gain by the LLC member is not assessed until the property received is later disposed of.[198] In contrast, when an S Corporation distributes appreciated property to a member, the entity acknowledgment means that the S Corporation must recognise a gain as though it sold the property at its fair market value.[199] This recognised gain is then allocated pro rata to all S Corporation members. In addition to the allocated gain, the S Corporation member receiving the appreciated property will have tax consequences for the receipt of a distribution.[200]

In the United Kingdom, an LLP member receiving property will not be regarded as disposing of its fractional share in the asset,[201] and the non-receiving members will be treated as having disposed of their fractional interests in the asset. The asset is treated as having been disposed of at its current market value, with the gain allocated to the members not receiving the asset.[202] The member receiving the asset is not

196. I.R.C. §§ 732(a)(1), 733(2). It should be recalled that the inside cost basis is the LLC's cost basis in the property. The inherited inside cost basis cannot exceed the amount of the membership cost basis of the membership interest immediately before the distribution. I.R.C. § 732(a)(2).

197. I.R.C. § 731(a)(1).

198. Gain may, however, be recognized on a distribution if the distributing entity holds property with built-in ordinary income. *See* I.R.C. § 751. In addition, if a distribution of money exceeds the member's outside basis, gain will be required to be recognized. I.R.C. § 731(a)(1).

199. I.R.C. §§ 311(b), 1371(a). Such a gain would be allocated and assessable to all members in proportion of their membership interests. I.R.C. § 1366. Such an allocation would increase the membership cost basis. I.R.C. § 1367.

200. For the S Corporation member receiving the distributed property, this would decrease their membership cost basis, and if their membership cost basis was exhausted, the excess would likely be a capital gain. I.R.C. § 1368. If an S Corporation repurchased a membership interest in exchange for appreciated property, then the member would also be taxed on the gain realised on the redemption of his or her membership interest. I.R.C. § 302.

201. HM Rev. & Customs, *supra* note 131, § 3.1.

202. Taxation of Chargeable Gains Act 1992, c. 12, § 59A; HM Rev. & Customs, *supra* note 131, § 2. The gain is then allocated in the ratio of the members' fractional share in the asset surplus at the time of disposal. *Id.*

assessed allocated gain, although the capital gain tax cost of the asset, reduced by the member's allocated gain, is carried forward at the market value of the asset at the date of distribution. Similar principles would apply when a depreciated asset disposal results in a loss being allocated to members.[203]

The law applying to UK LLPs demonstrates that an aggregate approach can result in tax being imposed on the transfer of assets between the tax pass-through entity and members. The complexity that inheres in this tax treatment of asset holdings manifests in the fact that every member has fractional interests in each of the LLP assets, with possibly different acquisition dates and cost bases. This compliance maze is compounded when disposals of fractional interests occur through changes in membership or changes in the profit and asset sharing ratios.

Furthermore, this complexity can increase with greater asset holdings or membership changes. While the United Kingdom's Revenue and Customs submits that its Practice Statement saves on valuation costs and makes for simpler computation,[204] this conclusion is questionable, especially when there are large numbers of members or significant capital assets. To reduce this complexity, LLPs implement a number of mechanisms, such as holding capital assets separately in non-partnership entities.[205] It is argued that such techniques are cumbersome and impose additional costs and unnecessary complexity.

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203. HM Rev. & Customs, *supra* note 131, § 2. In calculating gains or losses, the proceeds of disposal are allocated between the members "in the ratio of their share in asset surpluses at the time of disposal." *Id.* § 2.1. "Where this is not specifically laid down, the allocation will follow the actual destination of the surplus as shown in the [LLP] accounts; regard will [also] . . . be paid to any agreement outside the accounts." *Id.*

204. HM Rev. & Customs, Capital Gains Manual, Partnerships CG27217 (archival version), https://webarchive.nationalarchives.gov.uk/20070910041159/http://www.hmrc.gov.uk/manuals/CG1manual/CG27217.htm.

205. It is understood that large professional firms do not hold many capital gains tax assets directly apart from goodwill. Instead, other capital gains tax assets are held in a separate entity. In relation to goodwill, professional firms argue that members do not own a stake in this goodwill as it remains with the firm on members exiting the firm. Such an argument means that there this is no 'fractional' disposal of goodwill on the entry and exit of members from large professional firms. That is, members do not pay for goodwill on entry to the large professional firms, nor did they get anything

1. Losses

If the tax pass-through entity generates a tax loss, the losses flow through to the members. To maintain the integrity of their tax systems, jurisdictions have implemented a range of loss restriction rules. There are broadly four categories of loss restrictions rules: the membership cost basis rules, risk rules, passivity rules, and streaming rules. The first restrictions involve the notion that members are able to utilise allocated losses only to the extent of the member's equity investment in the tax pass-through entity (membership cost basis). The second restriction considers the level of a member's risk exposure in terms of their equity investment in the tax pass-through entity or in terms of being exposed to movements in value of their membership interest. The third restriction considers the extent of a member's involvement in the tax pass-through entity's business. The final restriction deals with the ability of a tax pass-through entity to stream losses to some members in preference to others.[206]

2. Further Membership Interests

Entities may also issue additional membership interests as part of distributions or even as compensation to key employees. Employees who receive equity compensation typically become members of the entity,[207] after which any wages or salary they receive will be member compensation.[208]

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when they exit. The Australian Tax Office has provided an administrative guideline about 'no' goodwill partnerships. *See* Austl. Tax. Office, *Administrative Treatment: Acquisitions and Disposals of Interests in 'No Goodwill' Professional Partnerships, Trusts and Incorporated Practices*, https://www.ato.gov.au/Business/Income-and-deductions-for-business/In-detail/Professional-firms/Administrative-treatment—acquisitions-and-disposals-of-interests-in—no-goodwill—professional-partnerships,-trusts-and-incorporated-practices/ (last updated June 25, 2018).

206. These four rules are discussed in more detail in Part IV *infra*.

207. As discussed below, however, an entity may structure compensation to allow employees to share in profits without admitting them as members of the entity. *See* BORDEN, *supra* note 119, ¶¶ 1.01, 4.05[D].

208. *See id.*, ¶ 3.07[F] ("Entities may decide to grant employees equity compensation for a number of reasons. Equity compensation may help align the interests of employees and owners, reducing agency costs. Entities

E. Capital Protection

By their very nature, there will be some practical restrictions on distributions, especially as tax pass-through entities can provide liability protection to members. Distributions to members can be affected by rules to protect creditors, so that distributions can only be made if there is sufficient liquidity in the business entity.

When a business entity provides members with liability protection, it is perceived as necessary to ensure that the business is not utilised as a mechanism to defraud creditors. To this end, rules have been introduced to ensure that capital is maintained[209] and that insolvent trading is avoided.

A particular issue arising for tax pass-through entities is the appropriate treatment of unpaid allocations to members as the tax laws can influence the underlying governance regime. Unpaid allocations refer to the tax pass-through entity allocating profit to the member who has been assessed for income tax purposes, but the profit remains within the tax pass-through entity. The issue is whether such unpaid allocations represent further equity contributions or debt owing to the members (member loan).[210]

This distinction is of central importance because, if considered as a further equity contribution, an unpaid allocation can then be subject to capital protection rules that (in turn) restrict the ability for the

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that are short on cash, such as start-up companies, may decide to use equity instead of cash to compensate employees to reduce capital requirements. Equity compensation also provides employees the opportunity to participate in an entity's upside, so it may be more effective than cash compensation at attracting and retaining talent. Equity received as compensation typically differs from other forms of equity in one significant way—the recipients of equity compensation often do not contribute capital to the entity; they typically only contribute their services to the entity. Thus, the recipients of equity compensation participate in profits based upon some factor other than capital contributions.").

209. For example, dividends are to be only paid out of profits. *Corporations Act 2001* (Cth) s 254T (Austl.).

210. Refer to the discussion *supra* Part I and Freudenberg, *supra* note 11, regarding the potential influence of unpaid allocations on members' ability to utilise allocated losses.

amount to be subsequently withdrawn without obstruction.[211] The distinction is also important because it has the potential to impact the comparative ranking of creditors. For example, if an unpaid allocation is considered equity, then the member will have only a residual claim after secured and unsecured creditors have been satisfied. In comparison, if it is regarded as an unsecured member loan, then it can rank equally with other unsecured creditors. Determining the status of unpaid allocations is critical for closely held businesses, insofar as members may not demand the full payment of income allocations, in an endeavour to assist with the financing of the tax pass-through entity's operations.[212] Also, in terms of being able to utilise allocated losses, there could be a desire for members to have unpaid allocations treated as equity contributions to increase the membership cost basis and thereby the amount of allocated losses able to be utilised.[213]

If it is determined that an unpaid allocation is a member loan, then the governing constitution of the tax pass-through entity would need to recognise and appropriately deal with the loan as a debt in its accounting books. Furthermore, managers of the tax pass-through entity would need to ensure that this debt was properly provisioned; otherwise, general director duties and the associated obligations to avoid insolvent trading could be infringed by the incurring of this (or future) debts.[214]

In terms of insolvent trading, the protection of creditors is provided for in a U.S. LLC by having mandatory rules that no distribution may be made if (after the distribution) the LLC would not be able to pay its debts as they become due in the usual course of business,[215] or if

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211. Consider, for example, the Australian share buy-back and reduction in capital rules. *Corporations Act 2001* (Cth) pt 2J.1 (Austl.).

212. Equity finance from active members can be an essential source of financing, especially in the early years of operation. In these years, the business may not have the "track record" to satisfy creditors, nor have tangible assets which can stand as security for the loans. Freudenberg, *supra* note 17, at 127–30.

213. Refer to the discussion of the loss utilisation rules in Freudenberg, *supra* note 11.

214. Alternatively, members may prefer that the right to receive the allocation is stapled to the obligation to be paid from the unpaid allocation of the tax pass-through entity's profit. Failure do this may cause systematic insolvency of the members.

215. RULLCA, *supra* note 27, §§ 405, 406.

its total assets would be less than the sum of its total liabilities and the satisfaction of members' preferential rights upon dissolution.[216]

A member of a member-managed LLC or a manager of a manager-managed LLC who consents to an excess distribution is personally liable for the excess violation amount.[217] Accordingly, such provisions can prejudice a member's limited liability protection via the tax pass-through entity and could affect the ability to make a distribution to a member to satisfy a prior unpaid allocation.

In the United Kingdom, members of an LLP have potential liability exposure through actions for misfeasance,[218] fraudulent trading,[219] wrongful trading,[220] and adjustment of withdrawals.[221] Furthermore,

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216. *Id.*

217. *Id.* § 406. An action must be commenced within two years of the improper distribution. *Id.* § 406(e). The Delaware code provides for a similar rule with a three-year time limit. DEL. CODE ANN. tit. 6, § 18-607 (2019).

218. Insolvency Act 1986 c. 45, § 212. The provision provides that if a person has taken part in the management of a LLP and "has misapplied or retained, or become accountable for, any money or other property of the [LLP], or been guilty of any misfeasance or breach of any fiduciary or other duty in relation to the" LLP, then the court may, on application of the receiver/liquidator or creditor, compel the offender to repay, restore, or account for the money/property, with interest. *Id.*

219. *Id.* § 213. The provision provides that if in the course of winding-up it appears that an LLP's business was carried on with intent to defraud the LLP's creditors or other creditors, then the court may, on application by the liquidator, require a person to make contributions. *Id.* § 212(1), (3).

220. *Id.* § 214. The "wrongful trading" liability provides that if an LLP has become insolvent, and before commencement of winding-up the members "knew or ought to have concluded that there was no reasonable prospect" to avoid insolvency, then the court can order that members personally pay some contribution towards paying off the LLP's debts to its creditors. *Id.* It is a defence to wrongful trading if the members "took every step with a view to minimising the potential loss" to the LLP's creditors. *Id.* § 214(3). The wrongful trading provisions include both a subjective and an objective judgement when considering directors' duties. *Id.* § 214(4).

221. *Id.* § 214A (added by Limited Liability Partnerships Regulations 2001, SI 2001/1090, sched. 3); *see also* Limited Liability Partnerships Act 2000, c. 12, § 14. Members may have to contribute on a winding up if they withdrew property from the LLP over the two years preceding winding up at a time when they knew or had reasonable grounds for believing that the LLP

the liability protection offered by the LLP to members is not certain.[222] The adjustment of withdrawals—unlike other obligations—does not apply to corporations, thereby leading some commentators to state that LLP members "are slightly more exposed than directors/shareholders of a company."[223] The rule on adjustment of withdrawals was considered a necessary imposition as LLPs can distribute their profits "without let or hindrance."[224] The adjustment of withdrawals can result in a court ordering a past or present LLP member to make a contribution to the LLP's assets if, in the prior two years,[225] they withdrew LLP property or had any other withdrawal.[226] In this context, the term "withdrawal" is defined widely and extends beyond a profit distribution to include salary, principal, and interest payments to a member.[227] It has been argued this can mean that payments of allocations recognised as debt to members could be subject to this withholding adjustment even though they would not increase a member's ability to utilise allocated losses.[228] Also, concerns have been expressed about the lack of defences for withholding adjustment to LLPs that are available under other insolvent trading provisions.[229]

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was or would thereby become unable to pay its debts. However, others have argued that creditor's protection may be weakened by LLP members pleading ignorance of the LLP's financial circumstances and consequently could not be said to have reasonable grounds for believing the LLP's insolvency. SELECT COMM. ON TRADE & INDUS, *supra* note 4, ¶¶ 48–51; Vanessa Finch & Judith Freedman, *The Limited Liability Partnership: Pick and Mix or Mix-Up?*, 2002 J. BUS. L. 475, 508–09 (2002).

222. Freudenberg, *supra* note 18, at 217.

223. *Structuring a Business as a Limited Liability Partnership (LLP)*, MACFARLANES 1 (July 2014), https://www.macfarlanes.com/media/1723/structuring-a-business-as-a-limited-liability-partnership_july-14.pdf.

224. SELECT COMM. ON TRADE & INDUS, *supra* note 4, ¶ 48 (referencing evidence provided by the Dep't of Trade & Indus.).

225. More precisely, "within the period of two years ending with the commencement of the winding up." Insolvency Act 1986 c. 45, § 214A (added by Limited Liability Partnerships Regulations 2001, SI 2001/1090, sched. 3).

226. *Id.*

227. *Id.*

228. Freudenberg, *supra* note 11.

229. For example, the defence in wrongful trading of "minimising the potential loss to the company's creditors" does not appear in withdrawal

F. Compensation: Non-Equity Distributions

Another flexibility factor is how active members are recognised for additional work they contribute to the business. Rather than granting an additional profit percentage, the active member may be remunerated as an employee. Alternatively, a member could lease an asset to the entity or loan money as debt rather than as an equity contribution. Collectively referred to as compensation, these non-equity contributions mean that (potentially) any payments made by the entity to the member for items such as wages for services, lease payments, or interest would be deductible for the entity (compare to the non-deductible nature of equity returns). Consequently, the tax treatment of this compensation can vary.

There are a number of reasons for these non-equity contributions by members. For example, wages provide a guaranteed return for active members, compared to allocations that are dependent on profit.[230] Another reason can be to separate assets from the business for asset protection, to provide extra liquidity to the business with the use of funds, but also to guarantee return of interest that is not dependent on profit.

These non-equity contributions may not fall squarely within the concept of equity, but paying members through compensation or fee arrangements is another way to grant them rights to a tax pass-through entity's resources. An entity typically treats such payment arrangements

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adjustments. *Compare* Insolvency Act 1986 c. 45, § 214(3), *with id.* § 214A (added by Limited Liability Partnerships Regulations 2001, SI 2001/1090, sched. 3). This concern is exacerbated as there is no need to prove lack of good faith in carrying on business with a withdrawal action, with such a defence available against undervalued transactions proceedings. *Id.* § 238(4)–(5); Phillips v. Brewin Dolphin Bell Lawrie Ltd. [2001] UKHL 2, [2001] BCC 864; *Re* Barton Manufacturing Co. [1998] BCC 827 (appeal taken from Eng.); *Re* Lewis's of Leicester Ltd. [1995] BCC 514; *Re* MC Bacon Ltd. [1990] BCC 78; *see also* Finch & Freedman, *supra* note 221, at 503.

230. Member wages are not unusual in many types of entities. For instance, in addition to receiving a carry, fund managers often receive a management fee. Entities typically treat management fees in the same manner that they treat other expenses of the entity, so they pay management fees before making distributions and deduct them in computing net income and profits. Entities with allocation-dependent equity structures may also agree to compensate managers who provide services. The type of entity should not affect the ability to pay member compensation to members who participate in management. *See* BORDEN, *supra* note 119, ¶ 9.02.

to members as other expenses, so it deducts the payment from revenue in computing the entity's income and profits. Nonetheless, the payment of wages to a member transfers resources from the entity to the member, so, in that regard, member wages are similar to a distribution. Often, choosing to accept wages or other non-equity distributions requires accepting a smaller share of residual assets. Such a choice can have significant economic consequences, either in favour of the person receiving wages or in favour of the other parties, depending upon the entity's financial performance.

A potential concern for revenue authorities with this flexible arrangement is that their tax systems could treat such compensation differently from equity distributions with the equity being subject to more or less tax impost. Also, the valuation of such compensation could be contestable.

For example, an LLC member usually does not qualify as an employee of the LLC for tax purposes. Instead, more of an aggregate approach is utilised, with an LLC member treated as self-employed.[231] That is, the LLC is not recognised as a separate taxpayer from its active member, and consequently, a member cannot then be employed by him or herself. This has the resultant consequence that the entire allocation of income to an LLC member (including guarantee amounts)[232] is likely to be regarded as self-employment income and consequently be subject to employment taxes.[233] Thus, in effect, this means that the entire LLC allocation could be subject to employment taxes in addition to income taxes. Contrast this situation with that pertaining to an S Corporation where, for the active member, only the reasonable wages paid to him or her are subject to employment taxes.[234] Of course, what constitutes reasonable wages can be subject to valuation queries.

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231. *See* WILLIAM H. HOFFMAN, JR., ET AL., CORPORATIONS, PARTNERSHIPS, ESTATES & TRUSTS, chs. 10–11 (2007).

232. A guaranteed payment is a payment for services performed by the members or for the use of the member's capital, usually expressed as a fixed dollar amount. Guaranteed payments would be assessable income to the member and an allowable deduction for the LLC (assuming general requirements for deductibility are met). I.R.C. § 707(c).

233. In I.R.C. § 1402(a), self-employment income includes the distributive share (whether or not distributed) of income or loss from any trade or business carried on by a partnership of which the individual is a member.

234. Some commentators argue that allocations to LLC members as a "limited partner" should not be subject to employment taxes. This has

The U.S. Government is aware of the discrepancies in relation to the application of employment taxes between S Corporations and LLCs.[235] Research concludes that S Corporations might be a "multi-billion dollar employment tax shelter"[236] that is worth an estimated $39 billion in lost tax revenue in 2001.[237] Hence, there are current proposals on the political agenda designed to treat members as self-employed if the S Corporation conducts a service business. For such service businesses, all allocations from an S Corporation would be subject to employment taxes like LLC members, although these are yet to be implemented.[238] Despite proposals and commentary regarding this issue, to date, no significant momentum has built to close this so-called tax shelter.

The application of employment taxes in the United Kingdom can influence the level of tax imposed on a corporation, compared to that of an LLP. In terms of non-active members, the United Kingdom's corporate form could be quite instrumentally advantageous or beneficial compared to the LLP. LLP members are treated as self-employed, and, in addition to the imposition of income tax, they are also subject to a National Insurance Contribution (NIC) liability, which, in turn,

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resulted in planning strategies, including the imposition of an additional LLC between the active member and the LLC conducting the business. The efficacy of these strategies is by no means certain as they have not been subjected to judicial scrutiny. I.R.C. § 1402(a)(13); Friedman, *supra* note 107, at 53–54.

235. It was reported that prior Vice Presidential candidate John Edwards (running partner with Al Gore) appreciated the difference between allocations and wages, prompting him to use an S Corporation, rather than an entity subject to Subchapter K for the conduct of his law business to minimise self-employment taxes. Janet Novack, *Get Me John Edwards*, FORBES (Mar. 14, 2005), https://www.forbes.com/forbes/2005/0314/046a.html#417e7a3b2155.

236. TREAS. INSPECTOR GEN. FOR TAX ADMIN., ACTIONS ARE NEEDED TO ELIMINATE INEQUITIES IN THE EMPLOYMENT TAX LIABILITIES OF SOLE PROPRIETORSHIPS AND SINGLE-SHAREHOLDER S CORPORATIONS 2 (2005).

237. JOINT COMM. ON TAX'N, ADDITIONAL OPTIONS TO IMPROVE TAX COMPLIANCE 29 (2006).

238. *Id.* at 31 "For this purpose, a service partnership is a partnership (including an LLC or other entity that is treated as a partnership for Federal income tax purposes), substantially all of whose activities involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting." *Id.* at 29.

increases their overall tax burden.[239] However, this can be advantageous compared to active members using a corporation. This is because when an active member is present in the corporation, the latter entity should be paying reasonable wages, with a resultant NIC obligation imposed for both employer and employee. The overall rates of NIC that are applicable to a corporation are greater than those applicable to an LLP self-employed situation.

In terms of a corporation that employs its members, an overall NIC rate of up to 23.8% could indeed be payable, with some by the corporation as employer and the remainder paid by the employee-member.[240] Of course, reasonable remuneration and the NIC will be deductible for the corporation.[241] The impact of NIC in a closely held corporation can be mitigated if an employee-member takes payments out of the corporation by way of dividend instead of remuneration,[242] as dividends are not subject to NIC and carry the benefit of a tax credit.

In contrast, when the LLP form is utilised, an LLP member would be regarded as self-employed rather than as an employee, and thus subject to a lower NIC rate. The maximum NIC rate applicable to those who are self-employed is approximately 9%.[243] As previously noted, an LLP member would be subject to a 9% overall NIC rate on allocated income compared with the up to 23.8% applicable to an employee-member in a corporation.[244] As a result, the LLP may be preferable to a corporation if the members actively engage in the business.[245]

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239. *See supra* note 73 and accompanying discussion.

240. *See supra* note 74 and accompanying discussion.

241. Crawford & Freedman, *supra* note 75, at 2; J. Freedman & J. Ward, *Taxation of Small and Medium-Sized Enterprises*, EUR. TAX'N, May 2000, at 158, 166 ("[If it] is unreasonable in amount, it may be partially disallowed under the 'wholly and exclusively' rule."). Alternatively, profits could be retained in the corporation and then realized as capital gain on sale or liquidation.

242. However, this would not be unrestricted as the employee-member would be entitled to a reasonable remuneration. Although, what is reasonable is debatable.

243. *See supra* note 74 and accompanying discussion.

244. Freudenberg, *supra* note 17, at 149–50.

245. *See supra* note 75 and accompanying discussion. The test for classifying self-employed income turns on whether the income is "incurred wholly and exclusively" for the purpose of trade. Income Tax (Trading and Other Income) Act 2005, c. 5, § 34 (Eng.).

G. Calculation of Distributions

In terms of equity distributions, it is important how these are calculated, which can generally be detailed in the Operating Agreement governing the tax pass-through entity. Such calculations could be based on (1) proportion of contributions, (2) adjusted to reflect further contributions and allocations, (3) a pre-determined distribution formula, or (4) be subject to periodic member negotiation. Such flexibility again allows (potentially) the recognition of different contributions at different times, as well as adjustments for allocations.

The simplest type of distribution structure is one that requires all contributions and distributions be made in the same proportions. With such arrangements, the tax pass-through entity should also allocate tax items to the members in the same proportions. Thus, the entity does not have to engage in additional study to determine how to allocate tax items. It would be apparent that such allocations should be the simplest and potentially reduce compliance costs.

Given that S Corporations have one class of membership interest, they are required to allocate items of income and make distributions in proportion to the members' contributions.[246] This ensures that the accounting for such entities remains simple (assuming ownership of the S Corporation remains static) compared to the accounting required for some pass-through structures.[247]

Traditionally, many tax pass-through entities based members' rights to distributions on the members' contributions and allocations. If the entity allocated items to the members in proportion to their contributions, then the distributions would be in proportion to contributions, but freedom of contract allows allocations of items to differ from the proportion of contributions. Tax pass-through entities that adopt this

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246. With an S Corporation, each item of income, loss, deduction, and credit is allocated pro rata on a per membership interest per day basis. I.R.C. § 1377(a)(1).

247. It should be acknowledged that S corporations can still provide some flexibility with payments, as wages (compensation) paid to members do not have to be paid in proportion to their contributions; however, it must be paid for services provided to the entity. The S Corporation will be able to deduct wages paid (and pass the deduction to its members on a pro rata basis), unlike distributions, with the service-providing member assessable on the wage income payment, which would be taxed at the service-providing member's ordinary tax rate.

type of distribution structure typically use capital accounts to determine members' rights to distributions. Such entities credit capital accounts for contributions and allocations of income and debits them to account for distributions and allocations of losses.

Rights to distributions can also be based upon contributions but be adjusted to reflect further contributions and allocations. For instance, an LLC agreement may provide for capital calls and adjust rights to distributions based upon whether the members fulfil their obligations to make such additional contributions. Some such adjustments may be intended to be punitive, diluting a non-contributing member's rights to distributions by amounts that exceed the percentage of failed additional contribution.

Some LLC agreements adopt a pre-determined distribution formula, such as a distribution waterfall. Such distribution structures are common with arrangements between a property developer or manager and passive investors. With such arrangements, distribution waterfalls typically provide a preferred return of contributed capital, a return of contributed capital, and then a sharing of any residual equity based upon some percentage, giving the manager a share of the residual equity that significantly exceeds the manager's proportionate share of the contributed capital.

Finally, members of an LLC may agree that distributions will be subject to periodic member negotiation. For instance, a law firm may form as an LLC (typically a professional LLC) and provide that the members will determine distributions at the end of the year based upon their relative performances and ability to convince each other that they are entitled to the respective distributions.

Consequently, there are many reasons for the desire for flexibility when it comes to contributions, allocations, and distributions, and this feature is an important part of the story of the popularity of tax pass-through entities. The next Part considers, however, what some of the consequences of this flexibility may be.

IV. The Effect of Flexibility

A. Tax Integrity Rules About Contributions and Distributions

The tax authorities have generally seen flexibility as a potential risk to revenue, as this flexibility can be abused, and there can be an over-utilisation of tax preferences and concessions, as they are directed to particular types of taxpayers who are best positioned to use them. Also,

it is suggested that there can be a misunderstanding of what is occurring commercially. Furthermore, sometimes these tax differences highlight inconsistent treatment in the tax system, which may be hard to justify or rationalise.

Some of the issues that face revenue authorities about tax pass-through entities include, with respect to timing and calculation, (1) how to tax contributions (if at all); (2) how contributions relate to membership cost basis; (3) how to tax allocations and subsequent distributions (if at all), including distribution of losses and tax preferences; and (4) how allocations and distributions relate to membership cost basis.

Consequently, governments have introduced integrity rules to try to protect revenue, especially with a business entity that provides some form of liability protection for members. To this extent, some of the rules try to align (take account of) members' equity contributions as proxies to their risk exposure. Some of the tax integrity rules that can apply to tax pass-through entities are in relation to eligibility;[248] distributed assets; revenue assets;[249] allocation of loss rules, which can include membership cost basis; risk rules; passivity; and streaming. Of particular relevance to the notion of flexibility is how the loss integrity rules apply to tax pass-through entities. An initial notion about this is the measurement of the cost basis.

For both S Corporations and LLCs, membership cost basis equals the initial contribution for membership interest,[250] the additional capital contributions,[251] and the allocated income,[252] less both allocated

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248. Even though the eligibility rules for an LLC to receive tax pass-through treatment are lax, the requirement that the entity not be publicly traded (as defined in I.R.C. § 7704) reduces the flexibility in terms of the possible number of members.

249. I.R.C. § 751. These revenue assets are commonly referred to as "hot assets" and include unrealized receivables and inventory (but only substantially appreciated inventory in the case of distributions). The primary purpose of this rule is to prevent a member from converting ordinary income into capital gain through the sale of a membership interest. *See* Karen C Burke, *Taxing Hot Asset Shifts*, 8 FLA. TAX REV. 327 (2007).

250. I.R.C. § 358 (S Corporations), § 722 (LLCs). Further capital contributions made by a member would increase their outside cost basis. Such contributions could be money, property, and/or future services. RULLCA, *supra* note 27, § 402; Rev. Rul. 64–56, 1964–1 C.B. 131.

251. *See* I.R.C. § 722.

252. I.R.C. §§ 1366, 1367.

deductions and actual distributions.[253] This raises the important point that allocation of income or losses immediately adjusts the membership cost basis.

It appears that members of the United States' LLC can increase their membership cost basis by outside loans to the LLC.[254] This appears to occur because LLCs are granted transparency through the general partnership tax provisions that cater to a business entity where traditionally members would have joint and several liability for debts.[255] For the other tax pass-through entities studied, S Corporations and the United Kingdom's LLPs, outside loans do not increase the membership cost basis.

An actual distribution (whether cash or property) to a member made by an S Corporation or an LLC will normally decrease the membership cost basis.[256] For Trade LLPs in the United Kingdom, even though the membership interest does not exist as a separate tax asset,[257] the application of the notion of contributed capital for the loss restriction rules effectively mean that a membership cost basis has to be

253. I.R.C. §§ 705, 1367(a)(1).

254. Nonrecourse loans (which will predominate in an LLC because members will not have personal liability) are generally shared among members pursuant to their profit sharing ratios. Reg. § 1.752–3(a)(3). Recourse loans are generally shared according to each member's economic risk of loss. Reg. § 1.752–2.

255. However, given the business reform in the United States over the last 20 years, the list of entities eligible for general partnership tax treatment has expanded to include LLCs, LLPs, and LLLPs.

256. For members of S Corporations, their respective cost basis in their membership interest must be reduced by the amount of actual distributions. I.R.C. §§ 1368(b)(1), 1367(a)(2)(A). The adjustments to the cost basis of a membership interest because of allocations of current year S Corporation income or losses must occur prior to determining the tax treatment of actual distributions to members. I.R.C. §§ 1368(d)(1), 1366(d)(1), 1367(a)(1); Reg. § 1.1368–1(e)(1). However, when an S Corporation makes a distribution in a loss year, the distribution reduces the cost basis of the member's interest before the S Corporation's loss is allocated to the members. I.R.C. §§ 1366(d)(1)(A), 1368(d). The amount of any distribution to a member is equal to the amount of cash plus the fair market value of any property distributed.

257. This is even though the UK LLP Act envisages that a member of an LLP has a "share" and "interests" in the LLP. *See* Limited Liability Partnerships Act 2000, c. 12, §§ 7, 10.

established and monitored. Furthermore, it is possible for an LLP to fail to be eligible for transparency; if this happens, the membership interest will then be recognised as a separate tax asset, which will involve a historical reconstruction.[258]

In the United Kingdom, Trade LLP members' allocated losses cannot exceed the amount of each member's contribution to the LLP at the end of the year in which the loss is sustained, less the total of all losses previously utilised by the member from the same trade.[259] A Trade LLP member's contribution at any time is the amount that the individual has contributed as capital less certain amounts, such as amounts previously drawn out or received back, plus the member's liability on a winding-up of the LLP.[260] It is argued in this context that the term "contribution to the LLP" is equivalent to, and synonymous with, the "membership cost basis." The amount contributed includes contributions of capital to the LLP,[261] less any previously withdrawn or repaid capital (directly or indirectly),[262] any withdrawal that was undertaken in the following five years,[263] any amounts the member is entitled to withdraw

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258. Due to this potential recognition, it is prudent for LLP members to monitor their membership cost basis as a separate tax asset because if the LLP does go into liquidation, or otherwise ceases to be eligible for tax transparent treatment, then each membership cost base will need to be determined. This cost base will be determined by historical capital contributions made as if the LLP had never been tax transparent, rather than the market value of the membership interest at the time when transparency ceases. HM REV. & CUSTOMS, *supra* note 134, CG27050. This would require detailed records to be maintained throughout the existence of the LLP, or it would require those records to be constructed later. Also, at cessation of tax transparency, previous chargeable gains rolled over as a result of the acquisition of a fractional interest in an LLP asset would crystallise for the member. Taxation of Chargeable Gains Act 1992, c. 12, § 156A (Eng.).

259. Income Tax Act 2007, c. 3, § 107.

260. *Id.* § 108.

261. *Id.* § 108(2).

262. *Id.* § 108(6).

263. *Id.* § 108(5)(b). The five years beginning at the relevant time. The "draws out or receives back" five-year rule is stated to prevent a member from increasing their capital contributions temporarily to inflate the amount of trading losses that they can offset against their other income or gains. If the member withdraws any capital from the LLP within five years of the time that

(but has not actually withdrawn),[264] and any reimbursement amounts that the member may be entitled to require from another person.[265]

The United Kingdom has rules to exclude member contributions that have been financed through nonrecourse or limited recourse borrowings by the member.[266] These provisions were introduced because it was felt that investment businesses could be motivated to adopt an LLP structure for tax reasons, rather than to obtain limited liability.[267] This in turn led to the introduction of rules to prevent the use of nonrecourse and limited recourse borrowings[268] to increase capital contributed by a member of Trade LLPs used for investment[269] and property investment.[270]

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their contribution was calculated for loss relief purposes, the extent to which they can claim loss relief under Income Tax Act 2007, c. 3, § 108(5) is reduced.

264. *Id.* § 108(5)(c). E.A.L. Rowlands & I.P. Zieder, *supra* note 178, at 1714–16 (arguing that this is penal but acknowledging that the United Kingdom Revenue may have concerns that a limited partner could artificially increase this contribution at little cost—for example, by providing a letter of credit where the underlying intention was to create a loss, but not to draw on the limited member's money to the full extent).

265. Income Tax Act 2007, c. 3, § 108(5)(d).

266. Partnerships (Restrictions on Contributions to a Trade) Regulations 2005, SI 2005/2017.

267. HM Treasury, Pre-Budget Report: Opportunity for All: The Strength to Take the Long-Term Decisions for Britain § 5.90, at 109 (2004); Explanatory Memorandum to the Partnerships (Restrictions on Contributions to a Trade) Regulations 2005, ¶ 4, http://www.legislation.gov.uk/uksi/2005/2017/pdfs/uksiem_20052017_en.pdf; Antony Seely, *Tax Reliefs for Production of British Films, SN/BT/3927*, at 7–8, Libr. U.K. H. Commons (Mar. 16, 2007), http://researchbriefings.files.parliament.uk/documents/SN03927/SN03927.pdf.

268. HM Rev. & Customs, Partnership Manual PM202000, https://www.gov.uk/hmrc-internal-manuals/partnership-manual (last visited Dec. 30, 2019). The member is said not to be at-risk because with a limited recourse loan the borrower can be required to use only certain money, assets, or revenues identified in the loan document to repay the debt. With a nonrecourse debt the borrower is not personally liable for the repayment of the debt at all. *See id.* PM203000. In comparison, a recourse loan entitles the lender to require the borrower to use its own funds, assets, or revenues to pay a debt.

269. An "investment LLP" means a LLP whose business consists wholly or mainly in the making of investments and the principal part of whose income is derived therefrom. Income Tax Act 2007, c. 3, § 399(6).

270. *Id.* §§398–399B. A "property investment LLP" means a LLP whose business consists wholly or mainly in the making of investments in

Also excluded from capital contributions in the United Kingdom are liabilities incurred if the financial burden of meeting the liability is or may be borne, assumed, or released by someone else.[271] Failing this, there is a *de facto* test excluding finance procured if the member's loan repayment costs over any period of five years are less than they would be on arm's length commercial terms.[272]

However, in addition to calculating this cost basis, losses can be restricted to the notion of what the member has at risk in terms of their investment in the entity. This broadly considers the level of members' risk exposure in terms of their equity investment in the tax pass-through entity or in terms of being exposed to movements in value of their membership interests.

In the United States, the "at-risk rule" is a separate rule that applies in addition to the membership cost basis rule.[273] A member's at-risk amount generally equals the sum of the cash or the adjusted basis of non-cash property contributed to the business. In addition to this, it further includes most recourse borrowings by the business for which the member has personal liability or that is secured by property unconnected with the business.[274] The member's share of amounts borrowed for use

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land and the principal part of whose income is derived from investments in land. *Id.* § 1004.

271. HM REV. & CUSTOMS, *supra* note 268, PM203000.

272. *See* HM REV. & CUSTOMS, *supra* note 268, PM203000. This could cover the situation where arrangements are made so that the financial cost to the contributing member can be reimbursed by someone else. To ensure there is no "back-dating," the United Kingdom has an integrity measure that addresses when the contractual terms of the borrowing are altered from recourse to a nonrecourse nature. If a Trade LLP member has claimed loss relief and then borrowings terms are altered from recourse to nonrecourse, there will be a chargeable event triggering an amount of "miscellaneous income" for the member. Reg 4 Partnerships (Restrictions on Contributions to a Trade) Regulations 2005, SI 2005 No 2017. *See* HM REV. & CUSTOMS, BUSINESS INCOME MANUAL, MISCELLANEOUS INCOME: LOSSES BIM100190 (revised May 2, 2019), https://www.gov.uk/hmrc-internal-manuals/business-income-manual/bim100190.

273. I.R.C. § 465.

274. Most outside loans would be regarded as nonrecourse for both S Corporation and LLC members because third-party creditors would not have recourse to the assets held personally by members.

in the business that come within the definition of qualified nonrecourse financing,[275] and the member's share of allocated income items are also included in a member's at-risk amount.[276] The amount at risk should be *decreased* by actual distributions to the member, the member's share of allocated (and deducted) loss items, and the repayment of loans that had earlier increased the member's at-risk amount. Excluded from this calculation are nonrecourse financing and guarantees provided by members.[277] However, it should be pointed out that the real estate industry in the United States is given some concessional treatment due to the definition of qualified nonrecourse financing.[278]

Another way that flexibility may be impinged is the extent to which a member is active or not in the tax pass-through entity's business operations. If a member is not active in the business, then the losses can be regarded as passive and may only offset other passive income of the member. While these passivity rules do not eliminate the losses allocated, they restrict what income the losses can offset. The quarantining of losses in this manner may prevent a member from the timely utilisation of losses if there is not sufficient passive income.

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275. I.R.C. § 465(b)(6). Qualified nonrecourse financing is present if the business has nonrecourse debt collateralised with real property that it uses in its business. This is because real estate nonrecourse financing provided by a bank, retirement plan, or similar party or by a federal, state, or local government generally is deemed to be at-risk.

276. I.R.C. § 465(b)(1)–(2).

277. I.R.C. § 465(b)(4).

278. I.R.C. § 465(b)(6). The exclusion of the real estate industry may be better understood as resulting from lobbying, rather than formulaic tax policy. Indeed, this carve out means that it is possible for the LLC's assets to be borrowed against on a nonrecourse basis, which increases the membership cost basis, so that the borrowed funds can be distributed out to members tax free. Such a borrowing and distribution by an S Corporation would result in an assessable distribution to members, as S Corporation membership basis is not increased by borrowings of the S Corporation from third-party creditors. *See* Altieri & Cenker, *supra* note 107. Due to the carve out provided to the real estate industry in the United States, it may be the case that the tax system is funding poor economic investments. This can be further aggravated by the fact that if rollovers are utilised and the assets are held until death, then the inheritors can have a step up in value, resulting in little or no tax ever being paid. I.R.C. § 1014(a).

The United States applies passive loss rules to most taxpayers, including both S Corporation and LLC members.[279] These passivity rules are considered in addition to the membership cost basis and the at-risk rule. One way to determine if a member is active is if the member has worked 500 hours in the year with the business.[280]

In the United Kingdom, if a Trade LLP member is regarded as non-active in the first four years of operation,[281] then only the amounts actually contributed on a winding-up count towards the second cap in determining the utilisation of losses.[282] To be regarded as active, a Trade LLP member must devote a "significant amount of time" to the trade in a tax year.[283] This occurs when a member spends an average of at least 10 hours a week personally engaged in activities of the Trade LLP.[284]

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279. The passive activity loss rules apply to an individual, a corporation where five or fewer individuals own more than 50% of the membership interest, and a corporation in which the employee-owners substantially provide certain professional services and in which the employee-owners of the corporation each own more than 10% of the corporation. I.R.C. § 469(a)(2), (c)(7)(D).

280. In terms of the United States, for losses allocated from a tax pass-through entity to be regarded as active, the member must materially participate in the business on a regular, continual and substantial basis. There are several tests to determine whether the member materially participates, including a need to participate in the activity for more than 500 hours during the taxable year (approximately 10 hours per week for 50 weeks in a taxable year). Temp. Reg. § 1.469–5T(a).

281. Income Tax Act 2007, c. 3, § 112. The restriction applies to losses sustained in the tax year in which the member first carries on the trade and in any of the next three years. The Partnerships (Restrictions on Contributions to a Trade) Regulations 2005, SI 2005/2017 came into force on July 22, 2005. The non-active member restrictions apply to members of LLPs, and do so in priority to Income and Corporation Taxes Act 1988, c. 1, § 117, where both sets of restrictions would otherwise apply to the same loss (or interest). HM Rev. & Customs, *supra* note 268, PIM 194000.

282. Rule applies from 10 February 2004. Income Tax Act 2007, c. 3, § 110(2), (4).

283. *Id.* § 74C(2) defines "significant amount of time."

284. *Id.* For a part year calculation, if the basis period is less than six months because the tax year is the one in which the individual joined or left the partnership, the requirement must instead be met by reference to the six months beginning with his commencement date or ending with his cessation date. *Id.* § 74C(4). The Explanatory Notes to the 2004 Finance Act (which

This requirement for minimum activity is similar to the requirements that exist in the legislative counterpart of the United States. Accordingly, the United Kingdom uses passivity to restrict the quantum of losses to be utilised, whereas the United States use passivity to quarantine passive losses.

The streaming rules have the greatest ability to influence flexibility of allocations and distributions.[285] Another integrity measure that has been introduced in connection with tax pass-through entities are rules dealing with the ability to stream losses to some members in preference of others. In any year, the ability of members to utilise allocated losses (or other tax preferences) may vary due to members' specific tax profile. As stated earlier, the allocation of losses, or income, according to a member's tax profile is referred to as streaming.[286] Streaming may be seen as infringing the integrity of a tax system because it facilitates exploiting losses and tax preferences. An alternative view is that streaming enables the most effective utilisation of resources between members.

For LLCs in the United States, while their Operating Agreement[287] can allow for special allocations[288] of income, deductions,

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added Income and Corporation Taxes Act 1988, c. 1, §118ZH, the predecessor to the current rule) suggests that personal engagement in the activities of the trade "may for example include a management or service role such as personnel, accountancy or purchasing. It does not include time spent deciding whether or not to invest, and/or how much to invest, in the partnership or its trade." Finance Act 2004, c. 12, Explanatory Notes, cl. 119, ¶ 9.a.

285. It is arguable that streaming can be perceived as infringing upon the integrity of a tax system because it facilitates the exploitation of losses and tax preferences. An alternative view, however, is that streaming enables the most effective utilisation of resources between members, thereby promoting or facilitating the integrity of the tax system. Freudenberg, *supra* note 11, at 156.

286. There are a number of factors that could affect a member's ability to utilise allocated losses, such as their membership cost basis, their at risk amount, whether the member is active or passive in the business, and whether the member is a tax resident or not. For further examples of streaming, see POLICY ADVICE DIV. INLAND REV., OFFICIALS' REPORT ON PARTS 5 AND 6 OF THE LIMITED PARTNERSHIPS BILL: TAX ASPECTS 6 (2007) (N.Z.).

287. I.R.C. §§ 704(a), 761(c).

288. For example, special allocations could allow for capital gains or depreciation deductions to be allocated disproportionately to one member

losses, or tax credits to different members,[289] for them to be recognised for U.S. tax purposes they must satisfy the test for substantial economic effect or be in accordance with the members' interests in the entity.[290] This is a two-part test requiring the allocation to have economic effect and the economic effect of the allocation to be substantial. Essentially this rule requires that there be economic impact associated with the allocation.

The rules provide an economic effect safe harbor under which the IRS will not challenge the economic effect of allocations if (1) the entity maintains capital accounts according to the rules in the regulations; (2) the entity liquidates in accordance with positive capital account balances; and (3) the entity agreement requires partners to restore deficit capital account balances upon liquidation.[291] Adhering to these rules will impinge liability protection because if capital accounts go into a deficit, the member would be obliged to make additional contributions.[292]

The substantiality test requires a comparison of the after-tax economic results of the allocations in the entity agreement to the after-tax economic results of allocations made in accordance with the partners' interests in the partnership.[293] Allocations that are in accordance with partners' interests in the partnership should be respected. Thus, streaming allocations are possible if they come within these parameters.

The United Kingdom's LLPs have some ability to stream losses. The default rule is that LLP members share equally in the capital and

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whose tax profile results in a more effective utilisation of them. Friedman, *supra* note 107, at 23.

289. There are regulations to restrict "shifting tax consequence rule," which would also apply to foreign members. Reg. § 1.704–1(b)(2)(iii)(*b*).

290. I.R.C. § 704(b). "Substantial economic effect" is elaborately defined in the regulations. Reg. § 1.704–1(b)(2). If an allocation lacks substantial economic effect, then it is modified to conform to the economic arrangement. GEORGE K. YIN & DAVID J. SHAKOW, AM. LAW INST. FED. INCOME TAX PROJECT: TAXATION OF PRIVATE BUSINESS ENTERPRISES 80 (1999). The regulations interpret "substantial economic effect" as encompassing two requirements; the allocation must have an "economic effect" and must pass a "substantiality" test.

291. Reg. § 1.704–1(b)(2)(ii).

292. *See* Bradley T. Borden, *The Allure and Illusion of Partners' Interests in a Partnership*, 79 U. CIN. L. REV. 1077, 1100 (2011).

293. Reg. § 1.704–1(b)(2)(iii); *see* Borden, *supra* note 292, at 1101.

profits of the LLP;[294] however, this does not mean that they share equally for tax purposes.[295] Unfortunately, it is not entirely clear how to calculate each member's entitlement,[296] but it would be determined according to the interest of the member during the accounting period, with trading profits likely to be calculated on an accrual basis.[297]

Furthermore, in the United Kingdom, members may not assign their income rights to others,[298] nor can a member's current year allocation relate to a future profit sharing ratio.[299] However, at the same time, there is nothing prohibiting members from changing their profit sharing ratio for future allocations, and thereby allowing for special allocations.[300] This change in allocation rights can occur

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294. Limited Liability Partnerships Act 2000, c. 12, § 15(c); Limited Liability Partnerships Regulations 2001, SI 2001/1090, § 7(1).

295. INST. CHARTERED ACCT. ENG. & WALES, TECH 56/05 ACCOUNTING BY LIMITED LIABILITY PARTNERSHIPS app. 3, ¶¶ 3–4 (2005).

296. Michiel A. Hoozemans, *The Taxation of Income Derived by a Netherlands, German and US Investor Through a UK Limited Liability Partnership*, EUR. TAX'N, Feb. 2002, at 72, 73–74.

297. *Id.* at 77. If the notional salary to a member causes some LLP members to have a loss, when previously the LLP was profitable then there can be adjustments. Where the LLP as a whole makes a profit (as adjusted for tax purposes), but, after the allocation of notional salaries the result is that an individual member makes a loss, the loss-making member cannot claim tax relief for the loss. Income Tax (Trading and Other Income) Act 2005, c.5, § 850B; HM REVENUE & CUSTOMS, *supra* note 268, PIM163060. Instead, the loss-making member is treated as making neither profit nor loss, and the loss is reallocated to the profit-making member in proportion to the profits already allocated to them.

298. *Compare Hadlee v. Comm'r Inland Rev.* [1993] STC 294 (N.Z.), *with Comm'r of Tax'n v. Everett* [1980] 143 CLR 440 (Austl.). *See also* DAVID SMAILES, TOLLEY'S INCOME TAX 2019–20, § 51.3 (Rebecca Benneyworth ed., 104th ed. 2019) ("The assignment by a partner of part of his share in the partnership was ineffective for the purpose of displacing his liability to income tax on that part of his share of partnership profits.").

299. DAVID COLLISON & JOHN TILEY, TILEY AND COLLISION UK TAX GUIDE 2005–06, at 449 (23d ed. 2005).

300. This is likely to depend upon the LLP Agreement.

> In deciding if a fractional share has changed, you need to keep these tests in mind. The three tests are: (a) is there any

without immediately realising a chargeable gain or loss even though the change could result in a part disposal of the members' fractional interests in the LLP's assets. This is because the change can be treated as taking place at a consideration that gives rise to neither a gain nor a loss.[301] However, a member whose profit share was reduced would carry forward a smaller fractional interest in the LLP's assets and thereby have a greater capital gain on any ultimate disposal.[302] If there is an adjustment through the LLP accounts prior to the change in sharing, such a deferral of gain or loss will not be possible.[303]

The eligibility requirement that S Corporations have only one class of membership interest is one way to address streaming concerns.[304] This is because all membership interests in these tax pass-through

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> written agreement which sets out how you allocate capital assets? (b) is there any written agreement which sets out how capital profits will be shared or any evidence showing how they are shared? (c) is there any written agreement which sets out how income profits will be shared or any evidence showing how they are shared? The final test, which applies in the absence of any of these three, allocates equal shares to all the members.

HM REV. & CUSTOMS, CAPITAL GAINS MANUAL, PARTNERSHIPS CG27181 (archival version), https://webarchive.nationalarchives.gov.uk/20040119020630/http://www.inlandrevenue.gov.uk/manuals/CG1manual/html/CG27000/17_0031_CG27181.htm.

301. HM Rev. & Customs, *supra* note 131, § 4. The disposal is treated as made for a consideration equal to the member's capital gains tax cost, and therefore there will be no chargeable gain or allowable loss at this point. *Id.*

302. *Id.* § 4.3. The normal rules for part disposal apportionments are not applied; instead a fractional basis is used. *Id.* § 4.4. A member whose share is increased carries forward a larger proportion of such costs. *Id.*

303. *Id.* § 6.2. Similarly the deferral will not be possible if payment is made outside the accounts; or if the transfer is between persons who are "connected persons" otherwise than through the LLP. *Id.* §§ 4, 7, 8. For example, by revaluing assets, coupled with a corresponding increase or decrease in the member's current or capital account at some date between the member's acquisition and the reduction in his or her share, recognition will not be deferred. HM REV. & CUSTOMS, *supra* note 134, CG27540. Such a revaluation could occur because LLPs have to comply with Generally Accepted Accounting Practice and Statement of Recommended Practice.

304. I.R.C. § 1361(b).

entities must carry the same entitlement to losses according to the percentage of interests.[305] However, it is argued that the requirement for one class of membership interest does not entirely eliminate the potential for streaming. For example, streaming could still occur by issuing more membership interests to members best able to utilise losses. For this strategy to be fully effective, the membership interests would have to be issued at the beginning of the loss year and not partway through or at the end of the year when it becomes apparent that a tax loss will be generated.[306] Additionally, the payment of reasonable wages and other deductible expenses to members could be used to manipulate the overall allocation of losses.[307]

In total, these integrity rules potentially restrict the flexibility of the tax pass-through entities and have the potential to increase the complexity of tax laws. Such increased complexity could then lead to compliance costs (and this could diminish the overall advantage of flexibility). It is argued that there is evidence to suggest that tax pass-through entities can increase complexity, and thereby compliance costs.

B. Complexity

Flexibility comes with a cost, in particular the likely increase in complexity and, thereby, compliance costs. For example, flexibility in governance rules may mean that there are reduced networking benefits

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305. Before the New Zealand LAQC regime was replaced by the "look-through company" (LTC) regime, commencing April 1, 2011 (*see supra* note 32), LAQC losses were allocated to members in the ratio of the number of shares held by all members during an income year on a per share, per day basis, known as their "effective interest." There was no option in relation to the treatment of an LAQC's losses, as any losses incurred while a corporation was an LAQC had to be directly allocated to its members. Income Tax Act 2007 (NZ), HA 20. Once allocated, the losses are no longer available to the corporation, and the LACQ cannot offset the losses to other group corporations prior to attributing them to its members. *Id.* HA 21–22.

306. This is because a member's allocation is calculated on a per day basis for the taxable year.

307. For example, if one member were paid wages or lease payments by the tax pass-through entity, this would effectively allocate more profit to this member, resulting in less profit in the tax pass-through entity to be allocated amongst members.

obtained[308] compared to if there are standard default rules. Additionally, the ability to have multiple classes of membership interests, which allow for the variations in contributions, allocations, and distributions, arguably increases complexity.

The requirement for one class of membership interest may in some ways ease tax compliance costs.[309] This is because, on a purely mathematical basis, allocations of income and losses to members are

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308. Easterbrook and Fischel have argued that in the absence of transaction costs the supply of clear and simple default rules will be regarded as value enhancing. *Compare* FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 14–15 (1991), *with* Larry E. Ribstein, *Efficiency, Regulation and Competition: A Comment on Easterbrook & Fischel's Economic Structure of Corporate Law*, 87 NW. U. L. REV. 254 (1992). Even though their work mainly concerned widely held corporations, similar principles arguably apply to closely held firms. An advantage of default rules is the ability to develop "network externality benefits," J. William Callison, *Venture Capital and Corporate Governance: Evolving the Limited Liability Company to Finance the Entrepreneurial Business*, 26 J. CORP. L. 97, 117 (2000), or in other words, benefit from the build-up of precedent and decisions. This refers to the idea that enacting laws to govern business entities can reduce transaction costs. That is, as case law considering the standard set of rules develops, there is understanding and improved certainty about how the provisions will be applied in the future. These networking benefits extend to third parties, such as trade creditors, dealing with the business entity as they have improved understanding about the governance of the business entity.

309. Note that a counterargument is that the requirement for one class of membership interest increases complexities. This is because to ascertain whether there is one class of membership interest requires all of the governing provisions of the S Corporation to be carefully considered. For example, this could involve reviewing the corporate charter, articles of incorporation, bylaws/constitution, applicable state law, members' agreements and binding agreements relating to distribution and liquidation proceeds. Reg. § 1.1361–1(l)(2). Also, it is important to consider whether "debt" could be regarded as a second class of membership interest. Due to difficulties in distinguishing between debt and equity investments, there are safe harbour rules in the United States providing for "straight" debt. I.R.C. § 1361(c)(5). In order to be within the safe harbour provisions, the debt must meet the following criteria: (1) there must be a written unconditional promise to pay on demand, or on a specified date, a sum certain in money; (2) the interest rate and payment dates must not be contingent on profits, the borrower's discretion, or similar factors; (3) the debt must not be convertible into membership interest; and (4)

made on a per day basis for each membership interest held.[310] Another reason is that one class restricts the potential for preferential streaming of income and losses and thus removes the need for certain tax integrity measures. In the United States, S Corporation members do not have to address complex rules requiring that allocations have substantial economic effect, whereas LLC members do.[311] These rules are described as among the most complex in all of U.S. tax law[312] and are accompanied by voluminous regulations.[313] Without the requirement for one class of stock, the finance provisions of LLC agreements can become complex, and complex rules are needed to govern the complex arrangements.

C. Compliance Costs

Tax pass-through entities with greater flexibility could have greater compliance cost and complexity (compared with pass-through structures with lower flexibility—such as those that only allow for one class of membership interest—S Corporations).

A problem that has been highlighted by research is that when closely held businesses operations are small they have the least capacity to cope with the burden of regulations.[314] This can lead to the compliance costs for small businesses being regressive.[315] Even if not regressive, compliance costs can detract from the economic efficiency of a business entity, especially if there are insufficient benefits obtained from the compliance activity.[316] Also, compliance costs are not just

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the creditor must be an individual (other than a non-resident alien), an estate, or a trust that is otherwise permitted to hold shares of an S Corporation.

310. I.R.C. § 1377(a)(1).

311. I.R.C. § 704(b); *see supra* discussion accompanying note 290.

312. Stark & Zolt, *supra* note 125, at 332.

313. Reg. § 1.704–1(b)(2)(i).

314. SMALL BUS. DEREGULATION TASK FORCE, *supra* note 87, at 19.

315. CHRIS EVANS ET AL., A REPORT INTO TAXPAYER COSTS OF COMPLIANCE 77–82 (1997); Coleman & Evans, *supra* note 87, at 163–67; *see* Katherine Ritchie, *Tax Compliance Issues for Small Business in Australia*, *in* TAXATION COMPLIANCE COSTS: A FESTSCHRIFT FOR CEDRIC SANDFORD 297, 301–14 (Chris Evans et al. eds., 2001).

316. Francis Chittenden et al., *Regulatory Burdens of Small Business: A Literature Review* 10 (Manchester Bus. Sch. 2000), https://citeseerx.ist.psu.edu/viewdoc/download?doi=10.1.1.630.1697&rep=rep1&type=pdf.

purely financial, as non-financial costs can include stress and lost time.[317] However, these findings need to be balanced against arguments that small businesses may have greater noncompliance, which to an extent, may offset the regressive nature of compliance costs.[318]

Compliance costs are an issue for all businesses, and it appears that the choice of business entity can have some relationship with compliance costs.[319] Another concern with compliance costs for closely held businesses is that regulations are likely to be dealt with by the principal decision maker of the business, which can distract the person from the decision maker's core role.[320]

The higher complexity found in the United States and the potential link to LLCs is supported by the data in the study by DeLuca et al. This data demonstrated that general partnerships had the lowest overall tax compliance costs ($1,516) of all business entities, whereas LLCs had the highest ($2,611).[321] This is interesting as general partnerships and LLCs are both assessed pursuant to Subchapter K, and therefore this difference of 72% may be attributed to how the LLC's legal characteristics (particularly limited liability) interact with tax pass-through,[322] and the way they interact with tax integrity measures. Additionally,

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317. Bd. of Tax'n, Scoping Study of Small Business Tax Compliance Costs: A Report to the Treasurer 41, finding 6 (2007) (Austl.). Other costs can include psychological, temporal, opportunity, and transitional.

318. Joel Slemrod, *Small Business and the Tax System*, *in* Henry J. Aaron & Joel Slemrod, The Crisis in Tax Administration 69, 82–91 (2004).

319. Chris Evans et al., *supra* note 315, at 29–31; DeLuca et al., *supra* note 12, at 83.

320. Gary Banks, Chairman, Productivity Comm'n, Address to the Small Business Coalition, Brassey House, Canberra, Reducing the Business Costs of Regulation 5 (Mar. 20, 2003), https://www.pc.gov.au/news-media/speeches/cs20030320/cs20030320.pdf.

321. Note, sole proprietors were not included in the survey. It is not clear whether this data also includes time spent on the members' tax compliance, as technically it is the members of both S Corporations and LLCs who are assessed on the income or losses of the business.

322. In comparison, members of a general partnership do not have liability protection. Note that in the United States, some general partnerships provide for a separate legal entity with the adoption in 1997 of the *Revised Uniform Partnership Act*. *See Partnership Act*, Unif. L. Comm'n, https://www.uniformlaws.org/committees/community-home?CommunityKey=52456941-7883-47a5-91b6-d2f086d0bb44.

business owners may adopt LLCs for more complex arrangements that require more sophisticated and costly accounting, legal, and compliance services.

Accordingly, it is the application of particular tax rules to complex LLCs that could be a major contributing factor to the high complexity of partnership taxation in the United States. Another compounding factor is that LLCs may be used for more aggressive tax planning strategies and have more sophisticated business operations, joint ventures, and greater asset holdings. All of these factors are likely to lead to greater complexity. Also, the compliance cost differential may be due to the increased flexibility available with LLCs, particularly with distributions, which can lead to greater tax planning requiring professional advice, and therefore greater cost.[323]

This increased complexity of tax pass-through entities is supported by another study of the U.S. tax system. This study found that the most complex business entity's taxation is partnership taxation.[324] This initially may be surprising for those not familiar with the U.S. tax system because partnerships are generally regarded as a simple (more accessible) business entity in other jurisdictions.[325]

The reason for the complexity surrounding partnership taxation in the United States is because Subchapter K's partnership tax rules not only apply to general partnerships but also to business entities with liability protection, such as limited partnerships, LLCs, LLPs, and

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323. For example, losses allocated through an LLC have to satisfy the "substantial economic effect" rule, whereas S Corporation members with one class of membership interest do not. Refer to the analysis in Freudenberg, *supra* note 11, at 147.

324. Brett Freudenberg et al., *A Comparative Analysis of Tax Advisers' Perception of Small Business Tax Law Complexity: United States, Australia and New Zealand*, 27 AUSTL. TAX F. 677, 698 (2012).

325. In Australia, the "taxation of partnerships" ranked only 29th out of 35 items in Australia—being the easiest business entity surveyed. Note that sole traders were not directly surveyed in the Australian study. In Australia, this would tend to indicate that tax pass-through for this business entity is easier than trusts and corporations. The reasons for this could be that general partnerships in Australia do not provide liability protection for members; partnerships are used for simpler business operations; less aggressive tax planning strategies are available to this business entity; a simpler governance regime is employed; or that fewer tax integrity measures apply to this business entity. *Id.*

entities that qualify as partnerships under the check-the-box rules and are eligible for tax pass-through treatment.[326]

It appears that the greater flexibility available in a business entity–particularly when it provides liability protection for members–necessarily leads to greater tax complexity for advisors. While this may appear obvious, it needs to be clearly articulated as there continues to be calls for greater flexibility and choice in the United States.[327] Without judging the merits of such calls, it is prudent for those involved (and policy advisors) to be cognisant of how choice and flexibility appear to be positively correlated with greater complexity.[328]

V. Conclusion

For a business entity, the ability to source equity is a critical characteristic to facilitate commerce. Historically, business entities have done this by providing separate legal entity status and liability. However, an important part of this is also the flexibility in allowing for different rights and contributions by members, while then affecting allocations and distributions. It is this flexibility that has been part of the success story for new tax pass-through entities, such as LLCs in the United States and LLPs in the United Kingdom. However, such flexibility has led to concerns, especially by revenue authorities. Such concerns have seen the introduction of complex integrity rules, especially in relation to the allocation of tax losses. Such rules can adversely affect the initial flexibility achievable by tax pass-through entities.

This Article has outlined a brief history of LLCs and LLPs and their current utilisation, as well as how financing can be a problem for closely held businesses. The Article discussed how there can be different types of flexibility and provided examples of how flexibility can facilitate different equity contributions by members. Flexibility was then considered in terms of allocations as well as subsequent distributions.

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326. Reg. § 301.7701–2(b); *see* Jeffrey L. Kwall, The Federal Income Taxation of Corporations, Partnerships, Limited Partnerships, Limited Liability Companies, and Their Owners 189–91 (3d ed., 2005).

327. *See supra* note 175 and accompanying discussion.

328. *See* Andrew Reeson & Simon Dunstall, *Behavioural Economics and Complex Decision-Making: Implications for the Australian Tax and Transfer System* (CMIS Report Number 09/110, 2009), https://citeseerx.ist.psu.edu/viewdoc/download?doi=10.1.1.619.9530&rep=rep1&type=pdf.

The Article reflected on some of the effects of this flexibility, in particular tax integrity rules, which then can increase complexity and compliance costs.

It is important that advisors and government agencies are aware of the need for flexibility and how it assists closely held businesses in raising important equity to fund operations. However, it is also important that advisors and their clients are made aware of the complexity and the compliance cost that can rise with this flexibility. This involves considering whether the potential tax savings outweigh the increased compliance costs (monetary and psychological, as well as others). Flexibility is a desired business entity attribute, and it is critical for tax rules to strike the right balance between protecting tax revenue and allowing flexibility. Otherwise, the tax rules could adversely affect tax pass-through entities. As Yin warns, you do not want situations where the "tax law dictates how parties must carry on their economic affairs"; that is the tail wagging the dog.[329]

329. Yin, *supra* note 13.