Principal Differences in Application of Classification Rules to Limited Liability Companies Compared to Limited Partnerships

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PRINCIPAL DIFFERENCES IN APPLICATION OF CLASSIFICATION RULES TO LIMITED LIABILITY COMPANIES COMPARED TO LIMITED PARTNERSHIPS

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I. Continuity of Life

A. Regulation

"If the death, insanity, bankruptcy, retirement, resignation or expulsion of any member will cause a dissolution of the organization, continuity of life does not exist. If the death insanity, bankruptcy, retirement, resignation, expulsion or other event of withdrawal of a general partner of a limited partnership causes a dissolution of the partnership, continuity of life does not exist; furthermore, continuity of life does not exist notwithstanding the fact that a dissolution of the limited partnership may be avoided, upon such an event of withdrawal of a general partner, by the remaining general partners agreeing to continue the partnership or by at least a majority in interest of the remaining partners agreeing to continue the partnership." Treas. Reg. § 301.7701-2(b)(1).

B. Limited Partnerships

Under the above regulation, if a limited partnership has multiple general partners, the partnership does not have to dissolve until an event of dissolution occurs with respect to the last general partner. Even then, a majority of the remaining partners may elect to continue.

C. Limited Liability Companies

1. Designated Managers - All member-managers must be subject to the specified dissolution events. Rev. Proc. 95-10, § 5.01(1).

2. No Designated Managers - All members must be subject to the specified dissolution events. Rev. Proc. 95-10, § 5.01(2).
3. If less than all the specified dissolution events cause dissolution, the taxpayer must clearly establish that the selected event(s) create a meaningful possibility of dissolution. (A similar rule is probably also applicable in the limited partnership context).

II. Free Transferability

A. Regulation

"An organization has the corporate characteristic of free transferability of interests if each of its members or those members owning substantially all of the interests in the organization have the power, without the consent of other members, to substitute for themselves in the same organization a person who is not a member of the organization." Treas. Reg. § 301.7701-(2)(e)(1).

B. Limited Partnerships

1. Under the above regulation, if any unrelated partner has an unrestricted right to refuse to consent to transfer of an interest, that interest is not freely transferable.

2. If a valid restriction applies with respect to "the transferability of partnership interests representing more than 20 percent of all interests", the Service will rule that free transferability is lacking. Rev. Proc. 92-33, 1992-1 C.B. 782. It appears that the more than 20 percent requirement may be met by restricting a portion of a partners' interest.

C. Limited Liability Companies

1. Designated Managers - A restriction based on a requirement of consent of other members must require the consent of a majority of non-transferring member-managers (based on profits, capital, or per capita). Rev. Proc. 95-10, § 5.02(1).

2. No Designated Managers - A restriction based on a requirement of consent of other members must require the consent of a majority of non-transferring members (based on profits, capital or per capita). Rev. Proc. 95-10, § 5.02(2).
3. The restriction must apply to "those members owning more than 20 percent of all interests in the LLC's capital, income, gain, loss, deduction and credit." Rev. Proc. 95-10, § 5.02(1) and (2). Can this be met by restricting a portion of a member's interest?

4. The power to withhold consent to the transfer must constitute a "meaningful restriction" on transfer. The power to withhold consent is not meaningful if it may not be unreasonably withheld. Rev. Proc. 95-10, § 5.02(4). (A similar rule is probably applicable in the limited partnership context; see Larson, 66 T.C. 159 (1976)(acq.).

III. Centralization of Management

A. Regulation

"An organization has centralized management if any person (or group of persons which does not include all members) has continuing exclusive authority to make management decisions necessary to the conduct of the business for which the organization was formed." Treas. Reg. § 301.7701-2(c)(1).

B. Limited Partnerships

"Limited partner interests, excluding those held by general partners, may not exceed 80 percent of the total interests in the partnership, or the Service will not rule that the partnership lacks centralized management." Rev. Proc. 89-12, 1989- C.B. 798, § 4.06.

B. Limited Liability Companies

1. Designated Managers

a. The Service will not rule that the LLC lacks centralized management unless the member-managers in the aggregate own at least 20 percent of the interests in the LLC. However, even if the 20 percent test is satisfied, the Service will consider all facts and circumstances, including, particularly, member control of the member-managers (whether direct or indirect), in determining whether the LLC lacks centralized management. Rev. Proc. 95-10, § 5.03(2). (Similar rules apply in the limited partnership context).
b. If member-managers are subject to periodic elections or non-managing members have a substantially unrestricted right to remove member-managers, the Service will not rule that centralized management is lacking. Rev. Proc. 95-10, § 5.03(3).

2. **No Designated Managers** - If the controlling statute or operating agreement pursuant to the controlling statute provides that the LLC is managed by the members exclusively in their membership capacity, the Service will rule that centralized management is lacking. Rev. Proc. 95-10, § 5.03(1).

IV. **Limited Liability**

A. **Regulation**

"An organization has the corporate characteristic of limited liability if under local law there is no member who is personally liable for the debts of or claims against the organization... In the case of an organization formed as a limited partnership, personal liability does not exist, for purposes of this paragraph, with respect to a general when he has no substantial assets (other than his interest in the partnership) which could be reached by a creditor of the organization and when he is merely a 'dummy' acting as the agent of the limited partners." Treas. Reg. § 301.7701-2(d).

B. **Limited Partnerships**

If the net worth of corporate general partners equals at least 10 percent of the total contributions to the limited partnership and is expected to continue to equal at least 10 percent of the total contributions to the limited partnership throughout the life of the partnership, the Service will generally issue a favorable advance ruling. Rev. Proc. 89-12, § 4.07.

C. **Limited liability Companies**

The Service will not rule that an LLC lacks limited liability unless at least one assuming member validly assumes personal liability for all (but not less than all) obligations of the LLC, pursuant to express authority granted in the controlling statute. A similar 10 percent net worth test as applies to limited partnerships is also applicable. Rev. Proc. 95-10, § 5.04.