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Tax Considerations in the Formation and Operation of Limited Liability Companies

Blake D. Rubin
Howard T. Widra

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TAX CONSIDERATIONS IN THE FORMATION AND
OPERATION OF LIMITED LIABILITY COMPANIES

By
Blake D. Rubin and Howard T. Widra
Steptoe & Johnson, Washington, D.C.

June 15, 1995
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TAX CONSIDERATIONS IN THE FORMATION AND OPERATION OF LIMITED LIABILITY COMPANIES

By
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I. INTRODUCTION

A. What is a Limited Liability Company? -- A limited liability company ("LLC") is a new form of business organization which has, in recent years, been created under the respective laws of almost every state. An LLC, when structured correctly, is a hybrid entity which enjoys limited liability under state law, but may be treated as a partnership for federal tax purposes. S corporations and limited partnerships are currently the favored form of business for achieving pass-through taxation combined with no liability for the owners. However, an LLC may permit more flexibility than these commonly-used vehicles. Therefore, LLCs have received a great deal of attention as a potentially better form of organization for conducting a business.

B. Historical Development

1. State Law -- The first LLC statute enacted in the United States was enacted by Wyoming in 1977. In recent years, as it became clear that the Internal Revenue Service (the "Service") will view certain LLCs as partnerships for federal tax purposes, almost every other state has enacted some type of limited liability company act. As of January 1, 1995, all states except Massachusetts, Vermont, and Hawaii had LLC statutes.

2. Federal Tax Treatment

a. In proposed regulations, the Service initially took the view that if there was no personal liability for the debts of an entity, then the entity must be treated as a corporation for federal tax purposes. In

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light of criticism from practitioners, however, the Service quickly withdrew these regulations and instituted a study of the classification rules with "special focus on the significance of the characteristic of limited liability."³

b. In 1988, the Service announced that it had concluded its study and would not change the classification regulations relating to the significance of limited liability.⁴ At the same time, the Service released Rev. Rul. 88-76, 1988-2 C.B. 360, which stated that an LLC formed pursuant to the Wyoming LLC statute that possessed limited liability and centralized management would be considered a partnership for federal tax purposes. This ruling and Announcement 88-118 resolved the question of whether limited liability would be a "superfactor" which, by itself, would cause an LLC to be taxable as a corporation.

c. Subsequent to Rev. Rul. 88-76, the Service issued a number of other rulings which addressed the treatment of entities under the various states' LLC statutes. The statutes under which these rulings are issued can be divided into two categories:

(1) "Bullet-Proof" Statutes -- Many of the state statutes are designed to assure partnership tax treatment by requiring LLCs formed under them to meet the conditions described in Rev. Rul. 88-76. The Service has issued revenue rulings recognizing partnership treatment for all LLCs created under these statutes.⁵ The statutes addressed in these rulings have become known as "bullet-proof."

(2) "Flexible" Statutes -- Some state statutes allow more flexibility than is allowed under the "bullet-proof" statutes. As to these statutes, the

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Service has issued rulings which state that an LLC formed under these "flexible" statutes may, depending on its structure, be treated as a partnership or a corporation for federal tax purposes.\(^6\)

d. Because there continued to be a substantial amount of uncertainty concerning how the Service would apply the section 7701\(^7\) classification regulations to LLCs formed under "flexible" statutes, the Service recently issued Rev. Proc. 95-10, 1995-3 I.R.B. 20. The stated purpose of Rev. Proc. 95-10 is to specify conditions under which the Service will consider a ruling request that relates to classification of a domestic or foreign LLC as a partnership for federal tax purposes. In practical effect, Rev. Proc. 95-10 provides a comprehensive "safe harbor" as to what requirements are necessary for an LLC to qualify as a partnership for tax purposes.\(^8\)

C. Terminology -- LLCs are creatures of state law and, thus, the terminology applicable to LLCs varies from state to state. However, certain terms or concepts, many of which are also used in state partnership or corporate law, are similar in most of the states.

1. Articles -- A document containing basic information, required to be filed with the Secretary of State, usually referred to as the "Articles of Organization." A copy of this document must be included with the ruling request in order to receive a ruling from the Service that the LLC will be taxed as a partnership.

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\(^7\) Except as otherwise indicated, all section references herein refer to the Internal revenue Code of 1986, as amended.

\(^8\) Rev. Proc. 95-10 is discussed in detail below.
2. **Interest** -- An "interest" is the ownership right a "member" holds in an LLC. It is analogous to the "interest" a partner holds in a partnership.

3. **Limited Liability** -- A provision in LLC statutes that provide that no member or manager is liable for the debts of the LLC.

4. **Managers** -- Persons designated by the members to manage the LLC. There can be one or more managers, or no managers at all. Managers need not be members.

5. **Members** -- The owners of the LLC. In order to receive a favorable ruling from the Service on classification as a partnership, there must be at least two members. There is no upper limit on the number or type of members. Members may also be involved in the management of the LLC.

6. **Member-Manager** -- A member of an LLC who is also a manager.

7. **Operating Agreement** -- An agreement entered into by the members which provides extensive rules regarding operation of the company and the relationship of the members to each other. A copy of this document must also be included with the ruling request in order to receive a ruling from the Service that the LLC will be taxed as a partnership.

D. **Unsettled Issues** -- Because LLCs are a relatively new form of business entity, there are a number of unsettled issues relating to them. First, there is little state case law concerning LLCs and, thus, in some respects, the treatment LLCs will receive under state law is not clear. Second, there have been some indications that congressional staffers are concerned that LLCs will cause a revenue drain on the federal government. Thus, some practitioners are concerned that partnership treatment under the federal tax law will be eliminated by Congress.

II. **TAX CLASSIFICATION OF LLCS**

A. **The Issue** -- In order for an LLC to be useful for most taxpayers, it must have limited liability under state law and have pass-through taxation under federal tax law. Limited liability of LLCs is provided by statute

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9 This requirement is discussed more fully below in section II.D. of this outline.
under state law. In order for an LLC to receive pass-through taxation, it must be classified as a partnership, as opposed to an association taxable as a corporation, under Treas. Reg. § 301.7701-2(a)(1).

B. Treas. Reg. § 301.7701-2(a)(1)

1. Treas. Reg. § 301.7701-2(a)(1) prescribes six factors relevant to the classification of an unincorporated business organization as a corporation: These six factors are:

   a. Associates;
   b. An objective to carry on business and divide the gains therefrom;
   c. Continuity of life;
   d. Centralization of management;
   e. Liability for corporate debts limited to corporate property; and
   f. Free transferability of interest.

2. The regulations provide that both associations taxable as corporations and partnerships have (1) associates and (2) an objective to carry on a business and divide the gains therefrom. Thus, these two factors are not relevant to the characterization of an entity. Therefore, the remaining four factors are controlling.

3. The regulations provide that an unincorporated organization shall not be classified as an association unless such organization has more corporate characteristics than non-corporate characteristics. Thus, in the context of LLCs, if an LLC is found to lack two (or more) of the relevant factors, it will be taxable as a partnership. In performing this analysis, each factor receives equal weight.

C. The Service’s Historical Analysis of the Four Factors

Prior to the issuance of Rev. Proc. 95-10, the analysis of how the four factor test under Treas. Reg. § 301.7701-2 would apply to LLCs relied mostly on extrapolation from revenue rulings and private letter rulings applicable to limited partnerships. Specifically, much reliance was placed on Rev. Proc. 89-12 which sets forth standards for a ruling that a business organization will be treated as a partnership for federal tax purposes. Although the language of Rev. Proc. 89-12 is broad enough to nominally apply to
LLCs.\textsuperscript{10} the rules outlined in the body of that procedure refer solely to limited partners and general partners as opposed to members, managers, and member-managers. Despite this lack of direct applicability, many of the LLC private letter rulings relied on the standards announced in Rev. Proc. 89-12. However, unanswered questions abounded.

\textbf{D. The Service’s Current Analysis of the Four Factors Under Rev. Proc. 95-10} -- Rev. Proc. 95-10 answered most of the previously unanswered questions by applying the four factors under Treas. Reg. § 301.7701-2 to LLCs. In some cases, the four factors apply to LLCs differently than they do to limited partnerships, and it is extremely important for practitioners to appreciate these differences.

\textbf{1. Purpose and Background}

\textbf{a.} Rev. Proc. 95-10 provides conditions under which the Service will consider a ruling request that relates to classification of a domestic or foreign LLC as a partnership for federal tax purposes.

\textbf{b.} Rev. Proc. 95-10 applies to all organizations that are formed as LLCs under the laws of the United States or of any State or the District of Columbia. It also applies to all organizations formed under a law other than domestic law, where the foreign law or foreign statute provides for or allows limited liability to any of the organization’s members (whether or not the foreign organization is "incorporated" under a foreign statute). However, it does not apply to a publicly traded LLC treated as a corporation under section 7704 of the Code.

\textbf{c.} Rev. Proc. 95-10 explicitly provides that Rev. Proc. 89-12 no longer applies to LLCs.

\textbf{2. General Provisions}

\textbf{a.} An LLC can only receive a ruling that it will be classified as a partnership for federal

\textsuperscript{10} Rev. Proc. 89-12 states that "[o]rganizations covered by this revenue procedure include both those formed as partnerships and other organizations seeking partnership classification."
tax purposes if it has two or more members.\textsuperscript{11}

b. If an LLC is issued a ruling under Rev. Proc. 95-10 that it is classified as a partnership and the LLC subsequently has only one member, the ruling ceases to be effective because the LLC’s status as a partnership for federal tax purposes terminates as of the relevant date specified in section 708 and section 736.

3. The Specific Corporate Characteristics

a. Continuity of Life

(1) Treas. Reg. § 301.7701-2 states that continuity of life does not exist if the death, insanity, bankruptcy, retirement, resignation or expulsion of any member will cause the organization to dissolve. In this context, dissolution means a change in the relationship of its members as determined under local law, not the complete termination of the business. This language has been interpreted to mean that continuity of life will be lacking if any one of the events occurring with respect to any one of the members will cause a dissolution of the organization.\textsuperscript{12} Consistent with this reading, in the context of limited partnerships, it is generally accepted that any of the listed events with respect to any of the general partners is sufficient to satisfy this requirement. Further, in the limited partnership context, a provision which allows the partnership to continue upon the vote of a majority in interest of the limited partners will not jeopardize

\textsuperscript{11} Certain state LLC statutes allow for the formation of LLCs with only one member. See, e.g., Colorado Rev. Stat. Ann., § 7-80-203. It is unclear whether a one-member LLC should be treated as an association or should receive pass-through treatment as, in effect, a sole proprietorship or branch.

a partnership's lack of continuity of life.\textsuperscript{13}

(2) Dissolution events relating solely to member-managers

(a) Section 5.01(1) of Rev. Proc. 95-10 states that the Service will generally rule that the LLC lacks continuity of life if (1) the members of the LLC designate or elect one or more members as managers, and (2) under the controlling statute, or an operating agreement pursuant to the controlling statute, the death, insanity, bankruptcy, retirement, resignation, or expulsion of any member-manager causes a dissolution of the LLC without further action of the members. Section 5.01 of the Rev. Proc. explicitly states that all member-managers must be subject to the specified dissolution events as opposed to just one of the members.

(b) Further, under Section 5.01(4), the Service states that it will rule that an LLC lacks continuity of life if it is provided that less than all of the dissolution events listed above with respect to the member-managers dissolves the LLC, but only if the taxpayer clearly establishes that the event or events so provided produce a meaningful possibility of dissolution.\textsuperscript{14}

(c) The Service will not rule that an LLC lacks continuity of life based on dissolution events that relate

\textsuperscript{13} Treas. Reg. § 301 7701-2(b)(1); see also Rev. Proc 89-12, Sec. 4.05.

\textsuperscript{14} There has been no guidance as to what will constitute a "meaningful possibility of dissolution" in the context of LLCs. The Service has indicated informally that bankruptcy of a corporate member-manager is a meaningful possibility even if the corporation is "bankruptcy remote." See Tax Analysts Highlight and Documents, March 10, 1995 at 3836.
solely to member-managers unless the member-managers in the aggregate own, pursuant to the express terms of the operating agreement, at least a 1 percent interest in each material item of the LLC’s income, gain, loss, deduction, or credit during the entire existence of the LLC. For LLCs with total capital contributions between $50 and $250 million, the 1 percent requirement "phases down" to .2 percent. In addition, the member-managers of the LLC must maintain, in the aggregate, throughout the entire existence of the LLC, a minimum capital account balance equal to the lesser of 1 percent of total positive capital account balances or $500,000.

(3) **Dissolution events relating to members:**
Section 5.01(2) of Rev. Proc. 95-10 states that the Service generally will rule that the LLC lacks continuity of life if (1) the members of the LLC do not designate or elect one or more members as managers (or if the LLC requests a ruling under this provision despite the presence of member-managers) and (2) the controlling statute, or the operating agreement pursuant to the controlling statute, provides that the death, insanity, bankruptcy, retirement, resignation, or expulsion of any member dissolves the LLC without further action of the members. Once again, unlike the requirements applicable to limited partnerships, the dissolution events must be applicable to all members and, if less than all of the dissolution events cause dissolution of the LLC, there must be a "meaningful possibility of dissolution."

(4) Rev. Proc. 95-10 further provides that, upon the occurrence of one of the dissolution events, an LLC will be considered to lack continuity of life notwithstanding that not less than a "majority in interest" of the remaining members may consent to the continuation of the LLC.
(a) Previously, it was uncertain whether such a decision to continue the LLC had to be unanimous. By only requiring that a "majority in interest" of the members vote to continue the LLC, Rev. Proc. 95-10 removes a potentially burdensome requirement (especially for an LLC with many members).

(b) The Service has taken the position that a "pre-agreement" to continue the LLC upon the occurrence of a specified dissolution event will cause the organization to possess continuity of life. See PLR 8937010 (holding that an LLC lacked continuity of life because there was no pre-agreement to continue in the articles of organization).

(5) "Majority in interest" for purposes of applying section 5.01(1) and (2) of Rev. Proc. 95-10 is defined by reference to Rev. Proc. 94-46, 1994-28 I.R.B. 129. That Revenue Procedure defines "majority in interest" for purposes of Rev. Proc. 89-12. Specifically, Rev. Proc. 94-46 states that a "majority in interest" will exist if a "majority of the profits interests and a majority of the capital interests owned by all the remaining partners agree to continue the partnership." For this purpose, "profits are determined and allocated based on any reasonable estimate of profits from the date of the dissolution event to the projected termination of the partnership" and "capital is determined as of the date of the dissolution event." Further, "[i]f. capital accounts are determined and maintained through the date of the dissolution event in accordance with the capital accounting rules of § 1.704-1(b)(2)(iv) of the

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15 Compare PLR 9010027 (holding that an LLC possessed continuity of life because its articles enabled only a majority of members to approve continuation of the LLC upon the occurrence of a dissolution event) and Rev. Rul. 93-91 (supporting the proposition that majority consent to continue is acceptable in the context of LLCs. See also T.D. 8475, 1993-1 C.B. 236 amending Treas. Reg. § 301.7701-2(b)(1).
Income Tax Regulations, then capital determined as of the date of the dissolution event represents the capital account balances determined on that date." Query: Is a rule equating an interest in capital with capital account balances meaningful when some or all members have negative capital accounts?

(6) The Service has recently noted that "the presence or absence of separate interests is not relevant to the determination of whether an entity possesses continuity of life." Thus, the "meaningful possibility of dissolution" requirement does not extend to the consideration of whether it is virtually assured that a "majority in interest" will vote to continue the LLC (e.g., as may be the case in an LLC consisting of related parties. Rev. Rul. 93-4, 1993-1 C.B. 225.

b. Free Transferability of Interests

(1) Treas. Reg. § 301.7701-2 states that an organization possesses the corporate characteristic of free transferability if a member, without the consent of other members, is able to substitute another person for him/herself. In order for free transferability to exist, the member must be able to confer upon the substitute all the attributes of the interest in the organization.

(2) In the limited partnership context, if it is desirable to lack free transferability, a possible restriction is a provision in the partnership agreement that permits free assignment of limited partnership interests but that requires the consent of the general partner for an assignee to become a substitute limited partner. An assignee succeeds to all the economic rights and obligations of the assignor limited partner and is treated as a partner for federal income tax purposes. Nevertheless, free transferability is lacking because

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only a substitute limited partner succeeds to all of the rights of a limited partner (e.g., the right to vote on major partnership decisions). Only a substitute limited partner succeeds to all of the rights of a limited partner (e.g., the right to vote on major partnership decisions).

Several state LLC statutes specifically permit the assignment of economic rights in order to allow members of LLCs to take advantage of this rule.

(3) Consent to transfer solely by member-managers

(a) Section 5.02(1) of Rev. Proc. 95-10 provides that the Service will generally rule that an LLC lacks free transferability of interests if (1) the members of the LLC designate one or more members as managers and (2) it is provided that each member, or those members owning more than 20 percent of all interests in the LLC's capital, income, gain, loss, deduction, and credit, do not have the power to confer upon a nonmember all the attributes of the member's interests in the LLC without the consent of not less than a majority of the non-transferring members.

(b) As is the case with respect to continuity of life, if a taxpayer requests a ruling that an LLC lacks the corporate characteristic of free transferability of interests, the member-managers of the LLC are generally required to, in the aggregate, own, pursuant to the express terms of the operating agreement, at least a 1 percent interest in each material item of the LLC's income, gain, loss, deduction, or credit during the entire existence of the LLC. Similarly, the member-managers of the LLC generally must maintain, in the aggregate, throughout the entire existence of the LLC, a minimum capital account balance equal to the lesser of 1 percent of

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17 See Treas. Reg. § 301.7701-3(b)(2), Example 1.
total positive capital account balances or $500,000. See Section II.D.3(c), above.

(4) Consent to transfer by members: Section 5.02(2) of Rev. Proc. 95-10 provides that the Service will generally rule that an LLC lacks free transferability of interests if (1) the members of the LLC do not designate or elect one or more members as managers (or if the LLC requests a ruling under section 5.02(2) despite the presence of member-managers), and (2) it is provided that each member, or those members owning more than 20 percent of all interests in the LLC’s capital, income, gain, loss, deduction, and credit, do not have the power to confer upon a non-member all the attributes of the member’s interests in the LLC without the consent of not less than a majority of the non-transferring members.

(5) Under both of the options described above, "consent of a majority" is defined as a majority in interest (see discussion above regarding continuity of life), a majority of either the capital or profits interests in the LLC, or a majority determined on a per capita basis. In the limited partnership context, the right of any one partner (unrelated to the transferring partner) to restrict the sale of a partnership interest is adequate to ensure that the partnership lacks free transferability of interests. See, e.g., PLR 9426039 (ruling that a limited partnership lacks free transferability where the sole general partner must give prior written consent to any assignment of any interest in the partnership). Thus, the "consent of the majority" requirement applicable to LLCs creates a more stringent requirement than is applicable to limited partnerships.

(6) The requirement that the restriction on transfer apply with respect to "those members owning more than 20 percent of all interests in the LLC’s capital, income, gain, loss, deduction, and credit" derives from Rev. Proc. 92-33,
1992-1 C.B. 782 (which is cited in section 5.02 of Rev. Proc. 95-10). In the limited partnership context, Rev. Proc. 92-33 states that the Service will rule that free transferability is lacking if "the partnership agreement expressly restricts . . . the transferability of partnership interests representing more than 20 percent of all interests . . . ." Thus, restricting 21 percentage points of the interest owned by a 99 percent limited partner appears to be a sufficient restriction on transferability. However, Rev. Proc. 95-10 can be read to require that all members who own more than 20 percent of the LLC must have their entire interest restricted. Thus, it is unclear whether a 21 percent restriction on all partners (or a 99 percent partner) will be adequate under Rev. Proc. 95-10.

(7) Section 5.02(4) of Rev. Proc. 95-10 states that the Service will not rule that an LLC lacks free transferability of interests unless the power to withhold consent to the transfer constitutes a "meaningful restriction on the transfer of the interests." Moreover, the Revenue Procedure states that "a power to withhold consent to a transfer is not a meaningful restriction if the consent may not be unreasonably withheld." See also Larson v. Com'r., 66 T.C. 159 (1976), acq. 1979-1 C.B. 1. Another example of a restriction on transfer that would likely not be meaningful arises if one person is ultimately in control of all the interests in the LLC and, thus, is the only party capable of restricting a transfer of its own interest. See PLR 9433008 (free transferability found to exist in LLC where members were an S corporation and its sole shareholder because consent to transfer provision was not meaningful). However, a complete prohibition on the transfer of interests apparently is considered meaningful, even if all parties are under common control. See Rev. Rul. 93-4; see also PLR 9409014 (holding that an LLC lacks free transferability when the operating agreement prohibits transfer.
and provides for dissolution upon "the attempted assignment of a member's interest").

c. Centralization of Management

(1) Treas. Reg. § 301.7701-2 provides that an organization has centralized management if any person (or any group of persons which does not include all the members) has continuing exclusive authority to make the management decisions necessary to conduct the business for which the organization was formed. The regulation further provides that "centralized management ordinarily does exist in . . . a limited partnership if substantially all the interests in the partnership are owned by limited partners." There is limited guidance regarding the quantum of ownership by general partners necessary to avoid a finding of centralized management. Treas. Reg. § 301.7701-3(b)(2) contains examples in which centralized management exists where the general partners own 5.7 percent and 2.9 percent of the aggregate interests of a limited partnership. In Rev. Proc. 89-12, the Service has indicated that it will not rule that a limited partnership lack centralized management if the limited partners own in the aggregate more than 80 percent of the interests in the partnership.

(2) Management of LLC by All Members

If it is provided in the controlling statute or in the operating agreement that the LLC is managed exclusively by the members in their membership capacity, the Service generally will rule that the LLC lacks centralized management under section 5.03(1) of Rev. Proc. 95-10.

(3) Management of LLC by member-managers

(a) In the alternative, under section 5.03(2) of Rev. Proc. 95-10, if the members of an LLC designate or elect one or more members as managers of the LLC, the Service
will not rule that the LLC lacks centralized management unless the member-managers in the aggregate own at least 20 percent of the total interests in the LLC.

(b) In addition, the Service will not rule that the LLC lacks centralized management if the member-managers are subject to periodic elections by the members, or, alternatively, the non-managing members have a substantially non-restricted power to remove the member-managers. This result was foreshadowed in Rev. Rul. 93-6, 1993-1 C.B. 229, which held that an LLC managed by its five members in their capacity as managers possessed centralized management because their authority to make management decisions was a result of their role as elected managers rather than as members.

(c) Further, even if the other requirements are satisfied, the Service will consider all the relevant facts and circumstances, including, particularly, member control of the member-managers (whether direct or indirect), in determining whether the LLC lacks centralized management.

(4) As discussed below, the ability of a member in an LLC to limit its liability while participating in management may create a significant advantage over limited partnerships. In general, limited partners who take part in the management of the limited partnership are subject to liability as general partners. Therefore, typically, members which indicate control must be disclosed.

Rev. Proc. 95-10 requires that any relationships between limited partners who participate in management is only liable to third parties for the obligations of the partnership when such third parties reasonably believes, based on the limited partner's conduct, that the limited partner is a general partner. See also GA Code § 14-9-303 (stating that a limited partner does not become
only general partners manage limited partnerships and limited partnerships do not lack centralization of management unless the general partners own a "substantial interest." See section II.D.3.c.(1), supra. In contrast, as described above, an LLC can more easily lack centralization of management, thus permitting the LLC the flexibility to possess another of the four corporate characteristics without jeopardizing its status as a partnership for federal tax purposes.

d. Limited Liability

(1) Treas. Reg. § 301.7701-2 provides that 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 limited partnerships, the regulations provide that a limited partnership will not possess the characteristic of limited liability unless the general partner has no substantial assets (other than its interest in the partnership) that can be reached by partnership creditors and is a "dummy" acting as an agent of the limited partners. The courts and the Service apply this test conjunctively and required both an absence of substantial assets and that the general partner be a "dummy" in order for limited liability to exist. 20

(2) In almost every case, a major reason the LLC form is chosen is the limitation of

liable for the obligations of the limited partnership "by participating in the management or control of the business").

See Zuckerman v. United States, 524 F.2d 729, 741 (Ct. Cl. 1975); Larson v. Commissioner, 66 T.C. 159, 180 (1976), acq. 1979-1 C.B. 1. See also Rev. Proc. 39-12 (stating that it must be demonstrated "either that a general partner has (or the general partners collectively have) substantial assets (other than a partner's interest in the partnership) that could be reached by a creditor of the partnership or that the general partners individually and collectively will act independently of the limited partners").
liability. Therefore, it will be very rare for a taxpayer to request a ruling that an LLC lacks the corporate characteristic of limited liability.

(3) Section 5.04 of Rev. Proc. 95-10 provides that the Service generally will not rule that an LLC lacks limited liability unless (1) at least one assuming member validly assumes personal liability for all obligations of the LLC, pursuant to express authority granted in the controlling statute and (2) the assuming members have an aggregate net worth that, at the time of the ruling request, equals at least 10 percent of the total contributions to the LLC and is expected to continue to equal at least 10 percent of total contributions to the LLC throughout the life of the LLC.

(4) If the assuming members do not satisfy the 10 percent requirement described above, the Service will pay close scrutiny to determine whether the LLC lacks limited liability. Specifically, it must be demonstrated that an assuming member has (or the assuming members collectively have) substantial assets (other than the member's interest in the LLC) that could be reached by a creditor of the LLC. The Service states that in determining the net worth of the assuming member (or assuming members), the principles contained in section 4.03 of Rev. Proc. 92-88, 1992-2 C.B. 496, will be applied.

III. OTHER TAX ISSUES RELATING TO LLCs

Assuming an LLC qualifies as a partnership for federal tax purposes, the LLC will be subject to all tax rules relating to partnerships. However, the precise manner of application of many Code provisions to LLCs remains uncertain, particularly where the provision draws a distinction between limited and general partners.

A. Liabilities of the LLC

1. Absent a guarantee or a loan by a member of the LLC, it appears that debt of the LLC should be treated as a nonrecourse liability for purposes of
section 752 and section 704(b). The debt should be treated as nonrecourse even if recourse is not limited to specific assets and the lender has the right to look to the general assets of the LLC to satisfy the debt.  

2. An unsecured nonrecourse liability of an LLC is equivalent to an "exculpatory liability" in the partnership context. In the preamble accompanying the current version of the section 704(b) regulations, T.D. 8385, 1992-1 C.B. 1992, the Treasury stated that a liability of a partnership that is not secured by any assets and is recourse to the partnership as an entity, but is explicitly not recourse to any partner is a nonrecourse liability. Application of the rules of Treas. Reg. § 1.704-2 requires the computation of "minimum gain," i.e., the excess (if any) of partnership nonrecourse debt over the basis (or "book value") of property securing such debt. In the case of exculpatory liabilities, it is unclear how to compute "minimum gain," and, according to the preamble, "taxpayers, therefore, are left to treat allocations attributable to these liabilities in a manner that reasonably reflects the principles of section 704(b)."

B. Cancellation of Indebtedness Income

1. The insolvency exception to cancellation of indebtedness income under section 108 applies at the member level, not at the LLC level. This treatment is consistent with partnership status as opposed to S corporation status. Compare sections 108(d)(6) and (d)(7).

2. The treatment of recourse but unguaranteed liabilities of an LLC under section 61(a)(12) and 1001 is uncertain. As noted in section III.A.2, these liabilities are like "exculpatory liabilities" of a partnership.

Example: LLC owns property with an unencumbered value of $100, subject to a recourse but unguaranteed debt of $120. The adjusted basis of the property is $70. The property is foreclosed upon. If the debt is treated as recourse for purposes of section 1001, then the LLC recognizes $30 of sale or exchange gain and $20 of cancellation of indebtedness.

See Treas. Reg. § 1.752-1(a).
income. See Treas. Reg. § 1.1001-2(c)

Example 8. On the other hand, if the debt is treated as nonrecourse for purposes of section 1001, then the LLC recognizes $50 of sale or exchange gain. Note that although the liability is a "nonrecourse liability" under section 752, this may not be determinative for purposes of section 1001.

c. Passive Loss Rules

1. Generally, under section 469(c), a passive activity is any trade or business in which the taxpayer does not materially participate.

2. Under section 469(h), except as provided in regulations, no interest in a limited partnership as a limited partner is treated as an interest with respect to which the taxpayer materially participates.

3. Under the regulations, an individual limited partner will be deemed to materially participate only if:

   a. The taxpayer participates more than 500 hours during the year;

   b. the taxpayer materially participated in the activity for any five tax years during the ten preceding tax years; or

   c. the activity is a personal service activity that the taxpayer materially participated in for any three preceding tax years. Temp. Treas. Reg. § 1.469-5T(e)(2).

4. In contrast, other taxpayers (including general partners), will be deemed to materially participate if they meet any of the above three tests or any of the following four tests:

   a. The taxpayer's participation in the activity for the year constitutes substantially all of the participation in the activity of all individuals (including individuals who are not owners of interests in the activity) for the year;

   b. The taxpayer participates in the activity for more than 100 hours during the tax year, and such participation is not less than the participation in the activity of any other
individual (including individuals who are not owners of interests in the activity) for such year;

c. The activity is a significant participation activity for the tax year (all business activities in which an individual participates for over 100 hours) and the individual's aggregate participation in all significant participation activities during the year exceeds 500 hours; or

d. Based on all of the facts and circumstances, the individual participates in the activity on a regular, continuous and substantial basis. See Temp. Treas. Reg. § 1.469-5T-(a)

5. Arguably, the treatment applicable to limited partners should not apply to LLC members because LLCs permit members to participate in the management of the business without exposing themselves to liability, and, thus, most LLC members, unlike limited partners, are not merely passive investors. For this purpose, LLC members should be treated like S corporation shareholders rather than limited partners, and thus should have less stringent material participation requirements.

6. Despite the logical strength of this argument, regulations under section 469 issued before the surge in popularity of LLC's indicate that LLC members are treated like limited partners for passive activity purposes. Specifically, Treas. Reg. § 1.469-5T(e)(3) states that a partnership interest will be treated as a limited partnership interest if the holder of such interest has liability limited under state law. This language is broad enough to apply to LLC members with limited liability.

7. Note also that Treas. Reg. § 1.469-4, defining "activity," treats limited partners and "limited entrepreneurs" the same and then provides that LLC members are "limited entrepreneurs." See Treas. Reg. § 1.469-4(d)(3)(ii).

D. **Tax Matters Partner** -- An LLC that is classified as a partnership for federal tax purposes is subject to federal audit procedures applicable to partnerships and, thus, must have a Tax Matters Partner ("TMP"). Section 6231(a)(7) states that the TMP is the general
partner designated by the partnership or the general partner with the largest profits interest, failing such designation. However, if no general partner is designated by the partnership and the Secretary of the Treasury determines that it is impracticable to apply the "largest interest" rule, the TMP is selected by the Secretary of the Treasury. An LLC has no general partner, so the TMP of an LLC is technically selected by the Secretary. It seems likely, however, that the selection of a TMP by the LLC will be respected by the Secretary.

E. Method of Accounting

1. Sections 448(a) and 461(i)(3) provide that a "syndicate" cannot use the cash method of accounting, but, rather, must use the accrual method. Under section 1256(e)(3)(B), a "syndicate" is defined as any partnership or other entity (other than a C corporation) in which more than 35 percent of the losses are allocable to limited partners or limited entrepreneurs. A limited entrepreneur is a person who "(A) has an interest in an enterprise other than as a limited partner, and (B) does not actively participate in the management of such enterprise." See section 464(e).

2. The Service has apparently concluded that members of an LLC are not limited partners but may be "limited entrepreneurs." Thus, if it can be established that the members of the LLC are actively participating in the management of the business, the LLC would not be a "syndicate" and the cash method would be an option. See PLR 9434027 (holding that an LLC will not be prohibited from using the cash method where the LLC was not a "syndicate" because of participation in management of members).

3. Where many members do not participate in management and the LLC is a "syndicate," the Service has indicated that the cash method can be used until the LLC has losses. See PLR 9415005 (holding that the cash method is acceptable for an LLC because the LLC had no losses). Thus, for professional service LLCs without losses, the cash method may be a viable option even if many members do not participate in management.
F. Self-Employment Tax

1. Section 1402(a) provides that an individual's net income for purposes of calculating the self-employment tax includes "the gross income derived by an individual from any trade or business carried on by such individual, . . . plus his distributive share (whether or not distributed) of income and loss described in section 702(a)(8) from any trade or business carried on by a partnership of which he is a member." However, section 1402(a)(13) provides that a limited partner's distributive share of partnership income, other than a guaranteed payment, is excludible from income for self-employment tax purposes. Thus, a general partner's income from a limited partnership is includible in income for self-employment tax purposes while a limited partner's income is excludible.

2. The exclusion of a limited partner's income for self-employment tax purposes enables the limited partner to avoid paying FICA and FUTA taxes. On the other hand, the exclusion from a limited partner's income from self-employment income could reduce the amount of income an individual is eligible to defer from income tax. Specifically, under section 415(c), the deferral available to a self-employed individual is sometimes limited to 25 percent of his "earned income." If a limited partner's income is not self-employment income under section 1402(a) than it is not "earned income." See I.R.C. § 401(c). Thus, in some cases, the exclusion of limited partner's income for self-employment purposes will reduce the amount of income eligible for tax deferral.

3. In PLR 9432018, the Service dismissed the argument that the distributive shares of the LLC members at issue were to be excluded from income for self-employment tax purposes by summarily stating that LLC members are partners whose distributive shares are not covered by section 1402(a)(13) and that "classification of the LLC as a partnership under section 7701 means that the members of the LLC will be partners for SECA purposes." In PLR 9452024, the Service once again held that an LLC member's income for self-employment tax purposes included his distributive share from the LLC. In reaching this decision, the Service, instead of focusing on the fact that the LLC was classified as a partnership under section 7701, focused on the fact that the LLC members at issue would
"engage in daily activities" of the LLC. Thus, the Service, in PLR 9452024 changed the focus of the analysis to the economic relationship between the members and the LLC.

4. The Service has recently issued proposed regulations addressing this issue. Prop. Reg. § 1.1402(a)-18 states that, as a general rule, a member of an LLC will have his earnings from that LLC included in income for self-employment tax purposes. However, the proposed regulations allow limited partner treatment for an LLC member when (i) the member is not a manager of the LLC, (ii) the LLC could have been formed as a limited partnership rather than an LLC in the same jurisdiction, (iii) the member could have qualified as a limited partner in that limited partnership under applicable law.

G. Liquidation Payments

1. Prior to 1993, under section 736(b) LLCs (like other tax partnerships) were permitted to deduct payments made to retiring or deceased partners in exchange for goodwill or unrealized receivables.

2. Under a 1993 Tax Act amendment to section 736(b), however, the ability to deduct such payments was restricted to payments to general partners in a partnership in which capital is not a material income-producing factor. According to the legislative history, the change restricts deductibility to businesses in which "substantially all the gross income of the business consists of fees, commissions, or other compensation for personal services performed by an individual." See House Explanation of 1993 Revenue Reconciliation Act, P.L. 103-66. Doctors, dentists, lawyers, architects, and accountants will still be permitted to deduct these payments even if such professionals "have a substantial investment in professional equipment or in the physical plant constituting the office from which such individual conducts his or her practice so long as such capital investment is merely incidental to such professional practice." Id.

3. It seems logical that an LLC member should be considered a general partner for these purposes, and, thus, a liquidation payment to such member should be deductible to the LLC. However, this question has not been addressed.
H. International Transactions

1. LLCs are a widely-accepted form of business in many foreign countries and, therefore, may be ideal for forming a joint venture with a foreign partner (especially because the use of an S corporation is not an option).

2. A nonresident alien who conducts U.S. operations through an LLC avoids the branch profit tax and any dividend withholding which could result from conducting operations through a corporation. Of course, any LLC engaged in a U.S. trade or business has to file a U.S. income tax return and will be subject to withholding on all income connected with a U.S. trade or business.

I. State Tax Issues -- Most states follow the federal classification of LLCs. Thus, in those states, if an LLC qualifies as a partnership under Rev. Proc. 95-10 then it will be taxed as a partnership under state tax law.

IV. COMPARISON OF LLCs TO OTHER BUSINESS FORMS

A. LLCs v. S Corporations

1. Advantages of LLCs Compared to S Corporations

   a. Under section 1361, only individual United States residents, estates and certain trusts may be shareholders in S corporations. In contrast, there is no restriction on the type or character of members of an LLC. Thus, for example, nonresident aliens, partnerships, corporations, and pension plans may own interests in LLCs.

   b. Under section 1361(b), an S corporation may have no more than 35 owners. In contrast, there is no limit on the number of members of an LLC. (However, as stated above, Rev. Proc. 95-10 requires an LLC to have at least two members). 22

   c. An S corporation may have only one class of stock while an LLC may have many classes of

22 Although there is no upper limit on the number of members in an LLC, an LLC that is treated as a publicly traded partnership under section 7704 would be taxable as a corporation unless an exception under section 7704(c) applies.
membership interests. See section 1361(b)(1)(D).

d. Shareholders in S corporations cannot count any portion of the corporation's liabilities as part of their basis in the stock of the S corporation. See section 1367. In contrast, members in LLCs increase their basis for their share of the LLCs liabilities. See section 752.

e. An S corporation cannot make a section 754 election. In contrast, an LLC can make such an election. As a result, upon the sale of an interest, the death of a member, and certain distributions, a member in an LLC can have its share of "inside" basis adjusted upward (or downward).

f. S corporations cannot be members of affiliated groups. See section 1361(c)(2)(A). Thus, S corporations cannot own 80 percent or more of the stock of a subsidiary. Also, if an S corporation owns any stock of another corporation, the other corporation cannot qualify to elect S status. In contrast, LLCs can own and operate subsidiaries, which subsidiaries may themselves be LLCs (subject to the two-member requirement).

g. LLCs may be able to take advantage of the flexibility allowed under section 736 in cashing out deceased or retired LLC members. See section III.G, above.

h. LLCs can make special allocations under section 704(b). S corporations cannot make such allocations because they will run afoul of the requirement that they only have one class of stock.

i. S corporations, as opposed to LLCs, are required to file an election.

2. Disadvantages of LLCs Compared to S Corporations

a. LLCs must have two members while S corporations may have only one owner.

b. The boundaries of the limited liability protection of LLCs have not been ruled on by the courts of the various states. Thus, S corporations may be a safer alternative to limit liability until the scope of the
limited liability protection of LLCs is defined.

c. State laws or regulations may not have contemplated the existence of LLCs. For example, many state licensing statutes do not explicitly allow LLCs to obtain licenses. Thus, additional time and expense may be necessary when such laws or regulations are relevant.

d. The creation of an LLC is more time consuming and more costly than the formation of a corporation because properly forming an LLC requires the drafting of an operating agreement that reflects the business deal of the members and utilizes some of the flexibilities of the LLC.

B. LLCs v. Limited Partnerships

1. Advantages of LLCs Compared to Partnerships

a. In limited partnerships, the general partner has liability exposure. In contrast, no member of an LLC has liability exposure. This difference eliminates the need for a corporate general partner and, thus, eliminates the problems that go along with having a corporate general partner (e.g., additional complexity and adequate capitalization issues).

b. Limited partners in a limited partnership cannot participate in management without risking their limited liability status.\(^\text{23}\) In contrast, LLC members can participate in management of the LLC with no risk of liability.

c. The ability of members to participate in management without losing limited liability may enable LLC members to meet the material participation tests under the passive loss rules without losing limited liability. This is true even though the stringent material participation rules applicable to limited partnerships apply to LLCs.

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\(^{23}\) But see note 18, supra.
2. **Disadvantages of LLCs Compared to Partnerships**

   a. As stated above, the boundaries of the limited liability protection of LLCs have not been ruled on by the courts of the various states. Thus, currently a limited partnership may be a safer alternative to limit liability.

   b. State licensing and other laws and regulations may contemplate the existence of limited partnerships, but not LLCs.

   c. Limited partnerships are subject to less stringent requirements in order to lack continuity of life than are LLCs. Specifically, as described in section II.D.3.a, above, limited partnerships generally can lack continuity of life even though the partnership dissolves only upon the occurrence of a dissolution event with respect to the last general partner. LLCs must dissolve upon the occurrence of a dissolution event with respect to any member-manager (if there are managers) or any member (if there are not managers).

   d. Limited partnerships are also subject to less stringent requirements in order to lack free transferability of interests. Specifically, as described in section II.D.3, above, limited partnerships are deemed to have an adequate restriction on transferability if one member can prevent a transfer while LLCs must require at least a "majority in interest" of non-transferring parties to approve a transfer. In addition, as discussed above, it is possible that LLCs will not be able to rely on Rev. Proc. 92-33 for the conclusion that a restriction on transferability on 21 percent of the total interests is a sufficient restriction. Instead, LLCs may have to restrict the entire interest of every member owning more than 20 percent of the LLC.

C. **LLC v. C Corporation**

   1. Because the limited liability protection is the same, the comparison of an LLC and a C corporation revolves around the different tax treatment between the two entities.
a. Current corporate tax rates are lower than individual tax rates and, thus, if a C corporation makes no distributions it will provide more favorable tax treatment than an LLC.

b. As distributions are made by a C corporation, however, there is a shareholder-level tax. Thus, to the extent there are significant distributions to the owners, LLCs provide more favorable tax treatment than C corporations.

2. A C corporation is a better vehicle if the business will be publicly-held. As stated above, public trading would generally cause an LLC to lose its status as a partnership for tax purposes. Further, LLCs generally have the additional disadvantage of lacking perpetual life.

V. CONVERSION TO LLC FROM OTHER FORMS

A. From Corporation to LLC

1. There are no tax-free reorganizations from corporations to partnerships and, thus, there are no tax-free reorganizations from corporations (either "S" or "C") to LLCs. As a result, such a conversion, to the extent permitted by state law, would be viewed as:

a. A distribution of assets to the shareholders followed by their contribution to the LLC, or

b. A contribution of the assets from the corporation to the LLC in exchange for interests in the LLC and then distribution to the shareholders of those interests, or

c. A contribution of stock in the corporation to the LLC followed by a liquidation of the corporation.

2. The second characterization of the transaction apparently is the one currently embraced by the Service. See PLR 9404021, PLR 9409016.

3. The result of this treatment is that, under section 336, the corporation recognizes gain on the distribution of the property as if the corporation had sold the property and the shareholders must recognize gain to the extent the fair market value of the assets they receive exceed the basis in their stock. Thus, the conversion of a corpo-
ration to an LLC will be taxable at both the corporate and shareholder levels. This result will likely make any such conversion unappealing.

B. From Partnership to LLC

1. This type of conversion is treated under the rules applicable to partnership mergers. This conclusion is reached from the Service’s rulings that sections 708 and 721 apply to LLCs.

2. An example of the Service’s approach in this area is found in PLR 9226035. That ruling involved the partners in a partnership contributing their interests in the partnership to an LLC in exchange for all of the interests in he LLC. Thereafter, the partnership distributed all of its assets to the LLC and dissolved. The Service ruled that this transaction results in (1) no gain or loss recognized by the members, the LLC or the partnership upon the transfer of the interests in the partnership to the LLC and upon the liquidation of the partnership, except as provided in section 752, and (2) the LLC will be considered to be a continuation of the partnership and the conversion of the partnership into the LLC will not result in the termination of the partnership under section 708. See also PLR 9119029.

3. The conversion may trigger gain under sections 752(b) and 731 to the extent that partners in the partnership are relieved of liabilities as the result of the conversion. See Rev. Rul. 84-52, 1984-1 C.B. 157.

4. Some recently enacted state LLC statutes provide state law procedures for converting a partnership to an LLC. These procedures allow the conversion from a partnership to an LLC to occur simply by making a filing with the state. Thus, it is not necessary to take the intermediate steps of transferring interests and assets.

VI. PLANNING ISSUES: USING LLCs WHEN NOTHING ELSE WILL DO

A. An LLC may provide flexibility that a limited partnership cannot where the business deal of the parties involves management by all or a substantial portion of the owners. For example, assume a wealthy individual wishes to acquire and own leveraged real

estate. Because of the advantages of partnerships over S corporations, (see section IV.A above), one structure that may be considered is a "one-person" limited partnership consisting of the individual as a 99 percent limited partner and an S corporation wholly-owned by the individual as a 1 percent general partner.

1. There is a serious risk that this arrangement will fail to qualify as a partnership unless the S corporation has "substantial assets" which will be exposed to creditors.

2. Specifically, the limited partnership will lack continuity of life if it is formed pursuant to a statute that corresponds to the Uniform Limited Partnership Act. See Treas. Reg. 301.7701-2(b)(3). Because the general partner owns only a one percent interest, it will possess centralized management. Although an outright restriction or transfer may be respected, given the stakes involved in the classification issue, conservative tax planners may require that the S corporation possess substantial assets. See section II.D.3.b, above.

B. In contrast, a "one person" LLC consisting of an S corporation as a 1 percent member and the sole shareholder as a 99 percent member may qualify as a partnership even though the S corporation lacks substantial assets and there is restriction on transferability. Both members may participate in management because there will be no risk to limited liability. Thus, the LLC will lack centralized management. This lack of centralized management, combined with the lack of continuity of life, will qualify the LLC as a partnership. Thus, the LLC structure provides unfettered participation in management combined with limited liability for the participants and flexibility in transferring interests. Diagrams showing the "one person" limited partnership and "one person" LLC are attached at the end of the outline.

C. Similarly, the LLC structure may be preferable for a joint venture desiring to limit liability and not have an absolute restriction on transferability.

1. A joint venture between two sets of individuals could be organized as a limited partnership consisting of one set of individuals owning 49.5 percent of the interests as limited partners and their wholly-owned S corporation as a .5 percent general partner, and another set of individuals also owning 49.5 percent as limited partners and
their wholly-owned S corporation owning .5 percent as general partner.

2. In contrast, an LLC between two sets of individuals forming a joint venture may be formed simply by having each set of individuals own 50 percent of the LLC and providing that the LLC is managed by its members in their capacity as such.

3. For identical reasons as applied to the "one person" LLC, the LLC joint venture may qualify as a partnership without exposing "substantial assets" of a general partner to liability and without imposing any restriction on transferability. Specifically, both sets of individuals may participate in management directly, rather than through their controlled general partners, because there will be no centralized management. This lack of centralized management, combined with the lack of continuity of life, will qualify the LLC as a partnership.

4. In addition, the LLC structure is simpler because no S corporations need be organized.

5. Diagrams showing the joint venture limited partnership and the joint venture LLC are attached at the end of the outline.
"ONE PERSON"
LIMITED PARTNERSHIP

100% Shareholder

S Corp.

1% GP

Limited Pshp

Individ.

99% LP
"ONE PERSON" LLC

100% Shareholder

S Corp.

1%

Individ.

99%

LLC

→ Management by members
PARTNERSHIP

JOINT VENTURE

100% 100%

49.5% GP

Individs.  49.5% LP

S Corp.  S Corp.

.5% GP .5% GP

Limited Pshp
LLC JOINT VENTURE

Individs. 50%  Individs. 50%

LLC

Management by members