Formation and Operation of the Limited Liability Company: Substantive Tax Issues

Allan G. Donn
FORMATION AND OPERATION
OF THE LIMITED LIABILITY COMPANY

SUBSTANTIVE AND TAX ISSUES

By

Allan G. Donn
Willcox & Savage, P.C.
Norfolk, Virginia

William & Mary Tax Conference
December 3, 1993
TABLE OF CONTENTS

I. Introduction .................................................. 1
   A. General ................................................. 1
   B. Definitions .......................................... 2
   C. Structure of statute ................................... 4
   D. Advantages of an LLC compared with other business entities ... 7
   E. Disadvantages and Risks ................................ 8

II. Features ...................................................... 9
   A. Name .................................................... 9
   B. Duration ............................................... 10
   C. Minimum number of members ............................ 10
   D. Purposes ............................................... 10
   E. Powers .................................................. 13

III. Organization ................................................ 14
   A. Selection of state of organization .................... 14
   B. Formation ............................................. 14
   C. Conversion of partnership to LLC ..................... 15
   D. Forms .................................................. 18
   E. Contents of the Articles of Organization ............ 19

IV. Relationship of LLC and its Members to Third Parties .... 21
   A. Agency power of members and managers ............... 21
   B. Liability to third parties ............................ 22
   C. Parties to actions ..................................... 23
   D. LLC property .......................................... 23

V. Capital Contributions ....................................... 23
   A. Form of contributions ................................ 23
   B. Default remedies ...................................... 24

VI. Allocations of Profits and Losses .......................... 25

VII. Distributions ............................................... 26
    A. Sharing ratio ........................................ 26
    B. Interim distributions ................................ 26
    C. Distribution upon event of dissociation ............ 26
    D. Distribution upon winding up ....................... 27
    E. Distribution in kind ................................ 27
    F. Restrictions on distributions ....................... 27
    G. Right to distribution ................................ 28

VIII. Relationship of Members to Each Other .................. 28
   A. Operating Agreement .................................. 28
<table>
<thead>
<tr>
<th>Section</th>
<th>Title</th>
<th>Pages</th>
</tr>
</thead>
<tbody>
<tr>
<td>B.</td>
<td>Management</td>
<td>30</td>
</tr>
<tr>
<td>C.</td>
<td>Voting</td>
<td>30</td>
</tr>
<tr>
<td>D.</td>
<td>Decision making</td>
<td>31</td>
</tr>
<tr>
<td>E.</td>
<td>Management by managers</td>
<td>32</td>
</tr>
<tr>
<td>F.</td>
<td>Standards of conduct for members and managers</td>
<td>33</td>
</tr>
<tr>
<td>G.</td>
<td>Limitation of liability of members and managers</td>
<td>34</td>
</tr>
<tr>
<td>H.</td>
<td>Business transactions of members and managers with LLC</td>
<td>36</td>
</tr>
<tr>
<td>IX.</td>
<td>Members and LLC Interests</td>
<td></td>
</tr>
<tr>
<td>A.</td>
<td>Nature of interest in LLC</td>
<td>36</td>
</tr>
<tr>
<td>B.</td>
<td>Admission of members</td>
<td>37</td>
</tr>
<tr>
<td>C.</td>
<td>Assignment of interest</td>
<td>38</td>
</tr>
<tr>
<td>D.</td>
<td>Right of assignee to become a member</td>
<td>39</td>
</tr>
<tr>
<td>E.</td>
<td>Dissociation</td>
<td>40</td>
</tr>
<tr>
<td>F.</td>
<td>Withdrawal or resignation</td>
<td>40</td>
</tr>
<tr>
<td>G.</td>
<td>Rights of creditors</td>
<td>41</td>
</tr>
<tr>
<td>X.</td>
<td>Dissolution</td>
<td></td>
</tr>
<tr>
<td>A.</td>
<td>Non-judicial dissolution</td>
<td>41</td>
</tr>
<tr>
<td>B.</td>
<td>Judicial dissolution</td>
<td>43</td>
</tr>
<tr>
<td>C.</td>
<td>Winding up</td>
<td>43</td>
</tr>
<tr>
<td>D.</td>
<td>Authority to act for dissolved LLC</td>
<td>43</td>
</tr>
<tr>
<td>E.</td>
<td>Distribution of assets upon dissolution</td>
<td>43</td>
</tr>
<tr>
<td>F.</td>
<td>Certificates of termination</td>
<td>44</td>
</tr>
<tr>
<td>XI.</td>
<td>Mergers</td>
<td></td>
</tr>
<tr>
<td>A.</td>
<td>Merger with LLCs only</td>
<td>44</td>
</tr>
<tr>
<td>B.</td>
<td>Merger with LLCs and other business entities</td>
<td>44</td>
</tr>
<tr>
<td>C.</td>
<td>Law governing mergers of foreign LLCs</td>
<td>45</td>
</tr>
<tr>
<td>XII.</td>
<td>Foreign Limited Liability Companies</td>
<td></td>
</tr>
<tr>
<td>A.</td>
<td>Law governing</td>
<td>45</td>
</tr>
<tr>
<td>B.</td>
<td>Registration</td>
<td>45</td>
</tr>
<tr>
<td>C.</td>
<td>Transaction of business without registration</td>
<td>45</td>
</tr>
<tr>
<td>D.</td>
<td>Activities that do not constitute transacting business</td>
<td>46</td>
</tr>
<tr>
<td>XIII.</td>
<td>Transacting Business in Other States</td>
<td></td>
</tr>
<tr>
<td>A.</td>
<td>Liability of members in state in which foreign LLC transacts business</td>
<td>46</td>
</tr>
<tr>
<td>B.</td>
<td>Liability of member in state in which foreign LLC not transacting business</td>
<td>47</td>
</tr>
<tr>
<td>C.</td>
<td>Title to real estate in foreign entity</td>
<td>47</td>
</tr>
<tr>
<td>XIV.</td>
<td>Securities Law Issues</td>
<td>47</td>
</tr>
</tbody>
</table>

72028.1
October 25, 1993
XV. Bankruptcy Law ................................................. 49

XVI. Banking ......................................................... 49

XVII. Federal Taxation .............................................. 49
    A. Classification ............................................. 49
    B. Application of partnership tax principles ............... 62

XVIII. State Taxation ............................................ 76
    A. Taxation of the entity .................................... 76
    B. Taxation of members ...................................... 78
    C. Miscellaneous Taxes ..................................... 78
I. Introduction

A. General

This outline is intended to provide an introduction to the principal issues that are encountered with the organization and operation of a limited liability company ("LLC"), but does not purport to be an exhaustive survey of the law in every state**.


NOTE: This outline was generally completed on October 15, 1993. This outline was derived from an outline prepared with Donald J. Hess, Pillsbury Madison & Sutro, and Brian L. Schorr, Paul, Weiss, Rifkind, Wharton & Garrison, prepared for programs presented by Prentice Hall Law & Business and Fordham University School of Law in the fall of 1993.

The following states have enacted LLC legislation:***

<table>
<thead>
<tr>
<th>State</th>
<th>Year</th>
</tr>
</thead>
<tbody>
<tr>
<td>Alabama</td>
<td>1993</td>
</tr>
<tr>
<td>Arkansas</td>
<td>1993</td>
</tr>
<tr>
<td>Arizona</td>
<td></td>
</tr>
<tr>
<td>Colorado</td>
<td></td>
</tr>
<tr>
<td>Connecticut</td>
<td>1993</td>
</tr>
<tr>
<td>Delaware</td>
<td></td>
</tr>
<tr>
<td>Florida</td>
<td></td>
</tr>
<tr>
<td>Georgia</td>
<td>1993</td>
</tr>
<tr>
<td>Idaho</td>
<td>1993</td>
</tr>
<tr>
<td>Illinois</td>
<td></td>
</tr>
<tr>
<td>Indiana</td>
<td>1993</td>
</tr>
<tr>
<td>Iowa</td>
<td></td>
</tr>
<tr>
<td>Kansas</td>
<td></td>
</tr>
<tr>
<td>Louisiana</td>
<td></td>
</tr>
<tr>
<td>Maryland</td>
<td></td>
</tr>
<tr>
<td>Michigan</td>
<td>1993</td>
</tr>
<tr>
<td>Minnesota</td>
<td></td>
</tr>
<tr>
<td>Missouri</td>
<td>1993</td>
</tr>
<tr>
<td>Montana</td>
<td>1993</td>
</tr>
<tr>
<td>Nebraska</td>
<td>1993</td>
</tr>
<tr>
<td>Nevada</td>
<td></td>
</tr>
<tr>
<td>New Hampshire</td>
<td></td>
</tr>
<tr>
<td>New Jersey</td>
<td></td>
</tr>
<tr>
<td>New Mexico</td>
<td>1993</td>
</tr>
<tr>
<td>North Carolina</td>
<td></td>
</tr>
<tr>
<td>North Dakota</td>
<td>1993</td>
</tr>
<tr>
<td>Oklahoma</td>
<td></td>
</tr>
<tr>
<td>Oregon</td>
<td>1993</td>
</tr>
<tr>
<td>Rhode Island</td>
<td></td>
</tr>
<tr>
<td>South Dakota</td>
<td>1993</td>
</tr>
<tr>
<td>Texas</td>
<td></td>
</tr>
<tr>
<td>Utah</td>
<td></td>
</tr>
<tr>
<td>Virginia</td>
<td></td>
</tr>
<tr>
<td>West Virginia</td>
<td></td>
</tr>
<tr>
<td>Wyoming</td>
<td></td>
</tr>
</tbody>
</table>

B. Definitions

1. Limited liability company

**Virginia.** An entity that is an unincorporated association, without perpetual duration, having two or more members that is organized and existing under [the Virginia Act]. Va. Code §13.1-1002.

**Delaware.** A limited liability company formed under the laws of the State of Delaware and having 2 or more members. Del. Code §18-101(5).

**New York.** An unincorporated organization of one or more persons having limited liability for the contractual and other liabilities of the business, other than a partnership or trust. N.Y. Bill §102(m).

*** Ribstein and Keatinge, supra; and 8 State Limited Partnership Laws; Limited Liability Company Statutes (Michael A. Bamberger and Joseph J. Basile, Jr., eds. 1993) contain the complete text of the state LLC acts.
a. Entity

In view of its numerous partnership attributes, the drafters of several statutes thought it desirable to include a specific statement that an LLC is an entity. Va. Code §13.1-1002; Del. Code §18-201(b).

b. Unincorporated


2. Articles of Organization ("Articles")


In Delaware the document filed to organize an LLC is called a "certificate of formation." Del. Code §18-101(2).

3. Manager

Person designated by members to manage the LLC. Va. Code §13.1-1002; Del. Code §18-101(9); N.Y. Bill §102(p).

4. Member

Person who is admitted as a member and who has not ceased to be a member. Va. Code §13.1-1002; Del. Code §18-101(10).

A person who owns an interest in an LLC is not necessarily a member.


5. Membership Interest

Member's share of the profits and losses and right to receive distributions of assets. Va. Code §13.1-1002.


Compare N.Y. Bill §102(r) and Calif. Bill §17001(y), which also include right to vote and participate in management within the meaning of "membership interest". Note also the
distinction between "membership interest" and "economic interest" in the California bill. The definition of "limited liability company interest" in Del. Code §18-101(7) is similar to the definition of "economic interest" in §17001(n) the California bill.

6. Operating Agreement ("operating agreement")

An agreement among the members as to the management of the affairs of the LLC and the conduct of its business.


Some states require an operating agreement to be in writing; others expressly permit oral operating agreements; while others are silent on the issue. Va. Code §13.1-1002; N.Y. Bill §102(u) (requiring written agreement).

Delaware and New York require the operating agreement to be in writing. In the proposed California legislation, an operating agreement may be written or oral, unless it effects a change in certain fundamental rights of members, in which case it must be in writing. Calif. Bill §17005(c).

C. Structure of statute

1. "Bulletproof" or "Flexible"

The terms "bulletproof" or "flexible", and their variants, are often used to describe LLC statutes in terms of the extent to which they satisfy the requirements for partnership classification for federal income tax purposes.

a. "Bulletproof" statute

(i) Contains nonwaivable unanimous consent provisions that comply with Rev. Rul. 88-76 on free transferability of interests and continuity of life.

(ii) States which have bulletproof statutes: Colorado, Nevada, Virginia, West Virginia and Wyoming.

(iii) Because of IRS liberalization, the more recently adopted acts are more flexible.
b. "Flexible-bulletproof" default statute

Contains default rules that result in classification of the LLC as a partnership, but those rules can be varied by agreement. Unless the members otherwise agree, unanimous consent is required for the admission of an assignee as a member, and unanimous consent of remaining members is required to avoid dissolution after specified events, unless otherwise provided in the Articles or a [written] operating agreement. E.g., Del. Code §18-704; Calif. Bill §§17301, 17303, 17350(d); Ga. Code §14-11-308(b)(1) and (4); Prototype Limited Liability Company Act §706 (Proposed Draft A.B.A. Nov. 19, 1992).

c. Pure flexible statutes

Contain default rules that do not necessarily result in partnership classification under the issued revenue rulings or even the more liberal private letter rulings. E.g., Uniform Ltd. Liab. Co. Act §504(b)(2) (Proposed Draft 1993) provides as the default rule majority of the members determined on a per capita basis (ULLCA §101(11)).

2. Sources and Analogues of LLC Acts

a. Partnership classification regulations and ruling.

b. LLC Acts in many jurisdictions have been drawn principally from the limited partnership act of the applicable jurisdiction, which is often substantially the Revised Uniform Limited Partnership Act ("RULPA"). As a result, courts may examine the body of law interpreting the analogue statute in order to analyze the LLC statute. See A.B.A. Prototype p. iii. Corporate statutes also have been drawn on for certain concepts contained in LLC statutes.

c. The Subcommittee on Limited Liability Companies of the ABA Business Law Section Partnership Committee has prepared a Prototype LLC Act dated November 19, 1992 ("Prototype"). With the publication of the Prototype, state legislatures may be expected to look to that model at least until adoption of ULLCA. E.g., Montana and Idaho.

d. The National Conference of Commissioners on Uniform State Laws had a first reading of the Uniform Limited Liability Company Act on August 5, 1993 ("ULLCA"). Unless otherwise indicated, references in this outline to

72028.1
October 25, 1993

-5-
ULLCA will be to the July 1993 draft. Substantial portions of ULLCA were derived from the Revised Uniform Partnership Act ("RUPA").

3. Default Agreement

Except in the case of transferability and dissolution in bulletproof statutes, the LLC acts generally adopt the approach of the Uniform Partnership Act ("UPA"), which has been described as "to a large extent, a standard form of agreement that can be varied by the parties." 2 Alan R. Bromberg and Larry E. Ribstein, Bromberg and Ribstein on Partnership §7.01(c), at 7:7 (1991).

The Delaware and Georgia acts state that the policy of the state with regard to LLCs is to give maximum effect to the principle of freedom of contract and to the enforceability of LLC agreements. Del. Code §18-1101(b); Ga. Code §14-11-1107(b).

Generally members may "otherwise provide" in the Articles or the operating agreement. E.g., management vested in members. Va. Code §13.1-1022B; N.Y. Bill §206(6). Delaware Act permits members to "otherwise provide" in the limited liability company agreement. E.g., Del. Code §18-301(b)(1).

ULLCA §103(b), derived from RUPA §103(b) provides that certain fundamental rights may not be varied, unreasonably restricted (access to books and records), eliminated (duty of loyalty and obligation of good faith), or unreasonably reduced (duty of care).

4. Virginia Conforming Amendments to Other Laws.

a. The original Virginia Act did not include specific conforming amendments to other provisions of the Virginia Code. There was only the global provision that wherever the term "person" is defined to include both "corporation" and "partnership," it shall be deemed to include "limited liability company." Va. Code §13.1-1069.

b. The Virginia Professional LLC Act provides that for purposes of the Code, when "professional corporation" is used, that term is deemed to include a professional LLC, and wherever "shareholder," "employee," "officer," or "agent" are used, those terms are deemed to include as appropriate, "member," "manager," "employee," and "agent." Va. Code §13.1-1123.

c. Subsequent conforming amendments
(i) LLC added to list of entities that may not plead usury defense. Va. Code §6.1-330.76.

(ii) Professional LLC added to definition of "health care provider" against whom no action may be brought for malpractice unless statutory notice given. Va. Code §8.01-581.1.

D. Advantages of an LLC compared with other business entities

1. S Corporation

   a. LLC avoids the restrictions and consequent tax traps of an S corporation, such as limits on number of owners and types of eligible owners, 80% limit on ownership of stock of a corporation, and one class of stock rule.

   b. Provides the tax advantages that partnerships have over corporations:

      (i) May include entity debt in basis.

      (ii) More liberal requirements for nonrecognition of gain on contribution of appreciated property to entity in exchange for an interest.


The Subcommittee on Select Revenue Measures of the House Committee on Ways and Means held hearings in June 1993 on miscellaneous tax proposals including several proposals for liberalization of the S corporation rules. See Joint Committee on Taxation Staff, 103rd Cong., 1st Sess., Description of Miscellaneous Tax Proposals 30-39 (June 16, 1993). The Administration did not support the proposals, stating that there should be a consideration of how any changes would interact with the other current forms of business organizations such as limited partnerships and LLCs. Statement of Leslie B. Samuels, Assistant Secretary (Tax Policy), Before the Subcommittee on Select Revenue Measures of the House Committee on Ways and Means, 29 Tax Analysts' Daily Tax Highlights & Documents 4273, 4275-76 (June 23, 1993).
c. For securities law purposes, an LLC interest is not necessarily a "security". See Section XIV below.

d. LLC may be subject to more favorable state taxation. See Section XVIII below.

2. Limited Partnership

a. Right of all members to participate in management of the business without risk of the liability to which a limited partner may be subject under similar circumstances. Not pertinent in Georgia because Ga. Code §14-9-303 provides that a limited partner does not become liable for obligations of the limited partnership by participating in the management or control of the business.

b. No requirement that any member be personally liable for entity debt.

c. Presumably a corporate member-manager is not required to qualify to do business in every state in which the LLC is qualified to do business as is frequently the case for general partners of limited partnerships.

3. General Partnership

a. Limited liability of all members.

b. Greater durability. Under UPA, general partnership is dissolved upon dissociation of a member even where partners have otherwise agreed.

c. Member does not have power to withdraw when he has agreed not to do so.

d. If LLC is treated as a "corporation" under the Bankruptcy Code, a single member may not file an involuntary bankruptcy petition against the LLC.

e. Consider state taxation of LLC when comparing with partnership or corporations.

E. Disadvantages and Risks

1. Uncertainty as to tax status until ruling by IRS.

2. Uncertainty as to the limited liability status of members in states that have not enacted LLC legislation.
3. Absence of experience and developed body of case law.

4. State taxation.

II. Features

A. Name

1. The name must contain:

a. "Limited company" or "limited liability company" or the abbreviation "L.C.", "L.L.C.", "LC", or "LLC." Va. Code §13.1012A.

b. "Limited Liability Company" or "L.L.C.". Del. Code §18-102(1); N.Y. Bill §204(a).

NOTE: (1) Check compatibility of name requirement if intending to qualify in another state. E.g., until 1993 amendment, in Wyoming "limited liability company" had to be the last words of the LLC's name. Wyo. Stat. §17-15-105(a). Thus, "L.L.C." was not acceptable. Nevada still requires that the words "limited-liability company" be the last words of the LLC's name. NRS §86.171(1). The trend in more recent statutes is to make a broad choice available.

(2) In some states, failure to include the words "limited liability company" (or variants) in the name may result in personal liability of members. E.g., Wyoming, W.S. §17-15-105(b); Nevada, NRS §86.171(2).

2. Distinguishable

a. Distinguishable upon records of Secretary of State from name of any corporation, limited partnership or LLC. Del. Code §18-102(3) (or business trust).

b. Distinguishable only from name of other LLC. Va. Code §13.1-1012C; N.Y. Bill §204(b).

3. In some states, the name may not contain words that are required to be included in the name of a corporation or limited partnership. E.g., Va. Code §13.1-1012B.
B. Duration

The Wyoming LLC Act that was the subject of Rev. Rul. 88-76 contained a 30-year limit. Some of the other early acts followed that model. However, now that the IRS has indicated that the 30-year limit is not a requisite to partnership classification, the more recent acts have tended to omit it, and many of those that included it are being amended to delete it. For example, in 1993, Wyoming, Florida and Minnesota have deleted the 30-year requirement. Priv. Ltr. Rul. 9331010 held that an LLC with a 75 year term lacked continuity of life.


C. Minimum number of members

Most LLC statutes require at least two members. E.g., Va. Code §3.1-1002; Del. Code §18-101(5).

ULLCA §201, Prototype LLCA §201, Arkansas, Texas, Montana and Idaho also permit a single member LLC, as does the proposed New York statute, N.Y. Bill §203(c).

NOTE: It is unclear whether a single member LLC will be classified as a sole proprietorship or corporation for tax purposes.

D. Purposes

1. General


2. For Profit

a. By incorporating reference to business that may be conducted by LLCs, some states appear to have an implied "for profit" requirement. E.g., Ga. Code §14-11-201(b).

b. Other states do not have that requirement and appear to permit not-for-profit LLCs. E.g., Va. Code §13.1-1008; N.Y. Bill §201.

3. Professional services

a. Statutory provisions

(i) Express authorization

Az. Code Ann. §§29-841 to -847
Conn. Ltd. Liab. Co. Act, Pub. Act No. 93-267, §8(b)
Fla. Stat. §621.01
Ga. Code §14-11-201(b)
Idaho Code §53-615
Ind. Code §23-18-2-2(15)
Iowa Code §490A.1501 to -1519
Mich. LLCA §901(1)
Minn. Stat. §319A.03
Montana Ltd. Liab. Co. Act, §72
North Carolina. 1993 N.C. Sess. Laws §57C-2-01(c)
Tex. tit. 32, art. 1528n Part II, Art. 1528n
Utah Code Ann. §§48-2b-104, -111
Wyoming Stat. §17-15-103(b)

N.Y. Bill §§1201-1216
Calif. Bill §17400

NOTE: Check to see who may be members of professional LLC. For example, under the 1992 version of New York bill (S. 8180-C) only individuals could be members, which would have precluded converting a partnership with professional corporation members into an LLC. By contrast, the 1993 version of the New York bill permits individuals or professional service corporations, except professional engineers, architects, landscape architects, or
land surveyors to form an LLC: N.Y. §§1201(e), 1203; and the Virginia statute permits individuals and business entities authorized to practice the profession to form an LLC.

(ii) Within general purpose provision

Delaware
Illinois
Louisiana
Maryland (effective 10/1/93)
Minnesota
Oklahoma

(iii) Prohibited


b. Regulatory requirements

Even though professional practice may be authorized by statute, additional requirements are generally imposed by state agencies regulating particular professions.

c. Specific professions

(i) Accounting

(a) AICPA Ethics Rule 505, which had limited members to practicing in proprietorships, partnerships, or professional corporations, has been broadened to allow them to practice in any form permitted by state law or regulation whose characteristics conform to resolutions of Council. See AICPA Code of Professional Conduct Rules as Amended by Membership Ballot, 173 J. Accountancy, June, 1992, at 143 for amended rule and Council resolution. The definition of "firm" has been correspondingly revised by the AICPA's professional ethics executive committee. Ethics Definition, 173 J. Accountancy, July 1992, at 139.

(b) Virginia State Board of Accountancy has issued regulations governing registration as a PLLC practicing public accountancy. VR 105-01-2, 9
(ii) Law

Rules of the Virginia Supreme Court Part 6, Section IV, Paragraph 14, provides for issuance of Certificate of Registration to a professional law corporation or professional LLC.


d. Multistate Professional Practice

(i) Check state in which intend to do business to determine whether foreign PLLC may have members who are not licensed by that state to render the professional service.

(ii) Foreign PLLC may obtain a certificate of authority to render professional services in Virginia. Only members, managers, employees, and agents licensed or otherwise legally qualified by Virginia may perform the professional service in Virginia, but its members or managers who do not practice in Virginia need not be licensed in Virginia. Va. Code §13.1-1105(A)(2). However, an anomalous provision requires that all members of a Virginia LLC be licensed in Virginia. Va. Code §13.1-1102(A) (definition of "professional limited liability company").

E. Powers


2. Delaware: All powers and privileges granted by the Act or any other law or LLC agreement, together with any incidental powers so far as necessary or convenient to conduct, promote, or attain the business, purpose or activity of the LLC. Del. Code §18-106(b).
III. Organization

A. Selection of state of organization

1. Principal place of business ("Home") State. Advantage is familiarity with the statute and case law.

2. Virginia, Colorado, Nevada, West Virginia or Wyoming. For the comfort provided by the only LLC acts for which the IRS has issued unqualified revenue rulings. Qualify as foreign LLC in Home state.

3. Delaware, Florida, Illinois or other flexible act state (where private letter ruling to be obtained or reliance on advice of counsel as to partnership classification acceptable) to avoid inflexibility of bulletproof act. Qualify as foreign LLC in Home state.

4. Statute shopping for particular provisions. E.g.:
   a. Delaware Act expressly permits members to agree upon forfeiture of an interest as the remedy for failure to meet capital contribution obligation. Del. Code §18-502(c). If the LLC then qualifies as a foreign LLC in Home state, the latter state statute will likely provide that laws of state under which foreign LLC is formed govern its internal affairs. E.g., Va. Code §13.1-1051.

5. Foreign LLC act where Home state does not have LLC act. Georgia and Indiana (before LLC acts become effective). Mississippi does not have LLC act but provides for qualification of foreign LLCs.

6. Foreign LLC act for "neutral court."

B. Formation

1. Organizer
   a. One or more persons may form an LLC by signing Articles and filing with designated state official. Va. Code §13.1-1010; Del. Code §18-201(a); N.Y. Bill §203(a).

NOTE: While one person may perform the formal act of forming the LLC, by definition an LLC in most jurisdictions must have at least two members. Virginia and Delaware expressly so require.

2. When formed

Virginia: An LLC is created on the date that the State Corporation Commission ("SCC") issues the certificate of organization. Va. Code §13.1-1004(B). A certificate will be issued when the SCC finds that the Articles comply with the Act and required fees have been paid. Va. Code §13.1-1004(A). Like a corporation, LLC existence begins when the SCC issues the certificate; unlike a limited partnership, which is formed at the time of filing the certificate of limited partnership with the SCC. Va. Code §50-73.11(B).

Delaware and New York: Formed at time of filing initial certificate of formation with Secretary of State or later date specified in the certificate of formation. Del. Code §18-201(b); N.Y. Bill §203(d).

C. Conversion of partnership to LLC

1. Statutory Conversion

a. Virginia: (Derived from ULLCA §902)

   (i) Procedure

   (a) A general partnership or limited partnership may convert to an LLC by filing Articles including the name of the former partnership and the date and place of filing the certificate of the former partnership. Va. Code §13.1-1010.1(A).

   (b) The terms and conditions of a conversion shall be approved by the partners in the manner provided in the partnership agreement for amendments or if there is no such provision, by all partners. Va. Code §13.1-1010.1(B).
(ii) Pre-conversion partnership liabilities.

General partner who becomes a member on conversion remains liable for pre-conversion partnership obligations. Va. Code §13.1-1010.1(C) (effective July 1, 1993, but that must have been result before the provision was added.)

(iii) Post-conversion liabilities.


(iv) Effect of conversion.

(a) The converted partnership is "deemed for all purposes the same entity that existed before the conversion." Va. Code §13.1-1010.2(A).


The State Corporation Commission will issue a certificate of conversion to be recorded in the local title records to maintain continuity of title records. Va. Code §13.1-1067(A).

(c) All partnership obligations continue as obligations of the converted entity. Va. Code §13.1-1010.2(B)(2).

(d) An action or proceeding pending against the partnership may be continued as if the conversion had not occurred. Va. Code §13.1-1010.2(B)(3).
b. **Georgia:**

(i) **Procedure**

Corporation, limited partnership, or general partnership may "elect to become" an LLC. Ga. Code §14-11-212(a).

(ii) **Effect of election on conversion**

(a) Corporation or partnership "shall become" an LLC. Ga. Code §14-11-212(c)(1).

(b) Title to all property of the corporation, limited partnership or general partnership becomes vested in the LLC by such election without further act or deed. Ga. Code §14-11-212(c)(5).

c. **West Virginia:**

(i) **Procedure**


(ii) **Effect of conversion**

Title to all assets transferred by operation of law; title to West Virginia real estate in the LLC shall be evidenced by confirmatory deed. W.Va. Code §31-1A-47(b).

d. **Missouri:**


2. **Statutory Merger**


b. In a number of states with cross-entity merger statutes, an "other business entity" includes a general partnership. E.g., Del. Code. §18-209(a).
Conversion of a general partnership is not an option available in Virginia because the cross-entity merger statute does not apply to general partnerships. Va. Code §13.1-1070A.

3. Nonstatutory Conversion
   a. Partners contribute partnership interests.

   Partners contribute their partnership interests to LLC in exchange for interests in LLC; partnership dissolves because only one partner remains; the dissolved partnership distributes its assets to the LLC. Priv. Ltr. Rul. 9226035 (March 26, 1992).

   b. Partnership contributes assets.

   The partnership contributes its assets to LLC in exchange for LLC membership interests; the partnership then distributes LLC interests to its partners in liquidation. E.g., Priv. Ltr. Rul. 9321047 (Feb. 25, 1993). (Pursuant to assignment and assumption agreement, partnership contributes its assets to LLC in exchange for membership interests and assumption of partnership's liabilities.)

   c. Partnership distributes assets. Partnership distributes its assets in kind to its partners who contribute them to LLC.

4. Title insurance
   a. ALTA title insurance policy defines the "insured" as the named person and any successor by operation of law, including the survivor in a corporate merger.

   b. name change endorsement

   c. "Fairway" endorsement

   d. permitted transactions endorsement

D. Forms

1. Delaware. Secretary of State has not issued forms.

2. Virginia. SCC has published forms for organization, conversion, and other purposes. However, they are optional and any document that includes the required information may be used.
a. Form LLC-1011. Articles of Organization.


E. Contents of the Articles of Organization

1. Required information.


   c. Duration


      Delaware and New York: If LLC is to have specific date of dissolution, Articles must set forth latest date on which it is to dissolve. Del. Code §18-201(a)(3); N.Y. Bill §206(a)(3). If no date so specified in limited liability company agreement, then 30 years. Del. Code §18-801(1). New York does not have the 30 year default.

   d. Principal office


   e. Management

      New York and California require a statement in the Articles as to whether the LLC is to be managed by members or managers, N.Y. Bill §206(a)(6), Calif. Bill §17151(b).

2. Information not required:

b. Purposes of the LLC, which may be limited by Articles. A few states require purpose. E.g., Missouri, Mo. Rev. Stat. §359.718(2).


3. Other matters permitted

Since Articles and any amendment must be filed with state, it is generally preferable to "otherwise provide" in the operating agreement.

4. Constructive notice of limitation on authority. See 1 Ribstein and Keatinge, supra, §4.09, at 4-10.

a. Yes

(i) **Georgia**: Limitations on authority set forth in Articles effective against grantee or person claiming through the grantee, with respect to LLC real property if Articles are filed in the county in which the property is located. Ga. Code §14-11-302.

(ii) **Louisiana**: Authorizes inclusion in Articles of statement regarding restrictions on authority of managers or that such restrictions are contained in a written operating agreement. La. Rev. Stat. Ann. §12:1305(C)(3). Third party is deemed to have knowledge of restrictions if Articles contain statement that the restrictions exist. La. Rev. Stat. Ann. §12:1317(B).

b. No

(i) **Virginia**: Virginia Act is silent on whether a limitation on authority set forth in the Articles will constitute constructive notice of that limitation. Although the Act does not have a provision like Revised Uniform Limited Partnership Act §208 (amended 1985) ("RULPA"), the result should be the same, that is, not constructive notice. However, it may give actual knowledge to person who has read the articles. See ULLC Act §202 (Committee's comment).

(ii) **Delaware**: Filed certificate is notice that entity is LLC and of all other facts required to be set forth. Del. Code §18-207.
5. Certain statutory rules may be changed only by the Articles.

Virginia:


IV. Relationship of LLC and its Members to Third Parties

A. Agency power of members and managers

1. General Rule. Unless management is vested in managers, every member is an agent of the LLC. Ga. Code §14-11-301(a); Calif. Bill §17157(a).

   Apparently, if the delegation is not set forth in the Articles, the members have apparent authority as to third parties. Ga. Code §14-11-301.

   Compare ULLCA §301, Prototype §301 and N.Y. Bill §412.

   If the Articles provide that management is vested in managers, then no member is an agent and every manager is an agent. Ga. Code §14-11-301(b); Calif. Bill §17157(b).

   As in the case of a general partner, the member-agent or manager-agent (as the case may be) can bind the LLC by any act for apparently carrying on in the usual way the business and affairs of the LLC, unless the person so acting has, in fact, no authority to act for the LLC in the particular matter and the third person with whom he is dealing has "knowledge" of the lack of authority. Ga. Code §14-11-301(a); Calif. Bill §17157(c).

   Act of manager or member not apparently for carrying on in the usual way the LLC's business or affairs does not bind the LLC. Ga. Code §14-11-301(c) if authorized by written operating agreement.

   No act in contravention of a restriction on authority binds the LLC to persons having knowledge of the restriction. Ga. Code §14-11-301(d); Calif. Bill §17157(c).
2. The Virginia and Delaware Acts are silent on the authority of a member or manager to incur a liability on behalf of an LLC. These acts do not confer authority upon members or managers to bind an LLC merely by virtue of being a member or manager. In the absence of a specific grant of authority, general agency principles should apply. Ribstein and Keatinge state, "In the absence of clear statutory provisions, the courts will apply general partnership rules regarding members' authority." 1 Ribstein and Keatinge, supra, §8.05, at 8-14. It is not apparent why every member should be deemed an agent of the LLC even in a member-managed LLC. Vesting of management in members does not without more mean vesting of agency power in each member.

B. Liability to third parties

1. General rule

   a. No member or manager of an LLC will have any personal obligation for any liabilities of an LLC, whether arising in contract, tort or otherwise, solely by reason of being a member or manager of the LLC. Va. Code §13.1-1019; Del. Code §18-303; N.Y. Bill §609.

   b. The "solely by reason of" phrase is to make clear that, while members do not have the vicarious liability of partners, they are responsible for their own acts or omissions and for obligations undertaken by agreement, such as the guaranty by a member of a loan to an LLC.

2. Exceptions

   a. Other law

      Virginia: "Except as otherwise provided by this Code . . ." Va. Code §13.1-1019. That phrase was added in response to a concern expressed by the Office of the Virginia Attorney General that the section might be deemed to override sections imposing liability on "responsible persons" for certain unpaid taxes. However, Va. Code §58.1-1813, imposing personal liability for taxes on any "corporate or partnership officer" has not yet been extended to managers of an LLC.

      Delaware: "Except as otherwise provided by this chapter . . . ." Del. Code §18-303.

b. Otherwise provided in Articles


e. Piercing the entity veil doctrine as in the corporate context may be applicable. Ga. Code §14-11-314 (act does not alter "any law with respect to disregarding legal entities.")

C. Parties to actions

A member is not a proper party to a proceeding by or against an LLC, except:

1. Where the object is to enforce the member’s right against or liability to the LLC. Va. Code §13.1-1020; N.Y. Bill §610; or


D. LLC property

Any estate or interest in property may be acquired in the name of an LLC, and title to any estate or interest so acquired vests in the LLC. Va. Code §13.1-1021.

V. Capital Contributions

A. Form of contributions

1. Contributions may be in cash, property or services rendered or a promissory note or other obligation to contribute cash or property or to perform services. Va. Code §13.1-1027(A); Del. Code §18-501.

Delaware Act provides that a person may be admitted as a member without a capital contribution. Del. Code §18-301(c).
2. Except as otherwise provided in the operating agreement, a member is obligated to contribute cash or property or perform services, even if he is unable to perform because of death, disability or other reason. If he does not contribute the property or services, the LLC has the option to require him to contribute cash equal to the value, as stated in the records required to be maintained, of the contribution that has not been made. Va. Code §13.1-1027(B); Del. Code §18-502(a); N.Y. Bill §502(a). Delaware and New York further provide that the cash option is in addition to, and not in lieu of, any other rights of the LLC, including the right to specific performance.

3. Unless otherwise provided in the Articles or operating agreement (in some states required to be in writing), the obligation of a member to contribute capital or property may be reduced or eliminated only by consent of all members. Va. Code §13.1-1027(C).

Notwithstanding the compromise, a creditor who extends credit or otherwise acts in reliance on the original obligation may enforce the original obligation. Va. Code §13.1-1027(C); Del. Code §18-502(b); Va. Code §13.1-1027(C); N.Y. Bill §502(b).

4. No promise by a member to contribute is enforceable unless set out in Articles or operating agreement (in many states required to be in writing) or other writing signed by the member. Va. Code §13.1-1027(B) (writing signed by the member); Ga. Code §14-11-402(a). New York and Delaware do not expressly so provide, but their acts require the operating agreement to be in writing. N.Y. Bill §102(u); Del. Code §18-101(6).

B. Default remedies

1. An operating agreement may provide that the interest of a member who fails to make an obligated contribution will be subject to specified penalties for, or specified consequences of, such failure. Ga. Code §14-11-402(c); Del. Code §18-502(c); N.Y. Bill §502(c).

2. Penalty or consequence "may take the form of":

   a. Reducing or eliminating the defaulting member’s proportionate interest;

   b. Subordinating his interest to that of nondefaulting members;

   c. Forced sale of his interest;
d. Forfeiture of his interest;

   [NOTE: This is an important provision because some courts will not enforce a forfeiture provision. E.g., Hill v. Hearron, 249 P.2d 54 (Cal. Dist. Ct. App. 1952) held that although a partnership agreement clearly provided for a forfeiture on breach, that the failure to perform was a material breach, and that the breach was willful, as a matter of public policy the forfeiture provision would not be enforced without regard to the damages actually caused by the breach. Distinguished by Feiger v. Winchell, v. Gram, 22 Cal Rep. 901 (Cal.Ct.App. 1962), which enforced a partnership agreement provision for a 20% reduction of profit share for each failure to contribute capital.]

   e. Lending to other members of amount necessary to meet his commitment;

   f. Fixing value of his interest by appraisal or formula and redemption or sale of his interest at that value; or

   g. Other penalty or consequence.


NOTE: Presumably, even if the operating agreement does not expressly so provide, the LLC may sue for money judgment or specific performance as applicable under Del. Code §18-502(a).

The N.Y. Bill bill provides that the consequences "may include, but are not limited to . . . ." N.Y. Bill §502(c); but it does not include in its list "forfeiture of his interest" as found in the Delaware Act. Query: Is the introductory language sufficiently broad to permit forfeiture?

VI. Allocations of Profits and Losses


    Delaware and New York: On the basis of agreed value of the contributions made by each member (as stated in the LLC records) to the extent received by the LLC and not returned. Del. Code §18-503; N.Y. Bill §503.

NOTE: Delaware Act does not require that records be maintained; but presumably the LLC's tax return is included in the LLC
records on which the calculation may be made. **Query:** What distributions are deemed return of contributions?

**Georgia:** If not otherwise provided, profits and losses are allocated equally among the members. Ga. Code §14-11-403.

**VII. Distributions**

**A. Sharing ratio**

**Virginia:** If not otherwise provided, then distributions are shared on the basis of the value of the contributions made by each member.

**Delaware and New York:** If not otherwise provided, then on the basis of the agreed value of the contribution made by each member (as stated in the LLC records) to the extent received by the LLC and not returned. Del. Code §18-504; N.Y. Bill §504; Va. Code §13.1-1029 (allocated on basis of value of contributions).

**Georgia:** If not otherwise provided, shared equally among members. Ga. Code §14-11-403.

**B. Interim distributions**

Except as provided in the Act, a member is entitled to receive distributions before resignation from the LLC and before dissolution and winding up to the extent and at the times or upon the happening of events specified in the Articles or operating agreement. Va. Code §13.1-1031; Del. Code §18-601; Ga. Code §14-11-404. Thus, if operating agreement does not require distributions, they may not be compelled.

**C. Distribution upon event of dissociation**

Except as otherwise provided, and subject to limitation on distributions, a resigning member is entitled to receive, within a reasonable time after the event, the fair value of his membership interest as of the date of the event. Va. Code §13.1-1033 provides for payment of the fair value of his membership interest based upon his right to share in distributions. Compare with provision for withdrawn limited partner which is "the fair value of his interest based upon his right to share in distributions . . . ." Va. Code §50-73.39.
D. Distribution upon winding up

See Dissolution, Section X Subsection E below.

E. Distribution in kind

Except as provided in the operating agreement:

1. A member, regardless of the nature of his contribution, has no right to demand and receive any distribution in any form other than cash; and


F. Restrictions on distributions

1. No distribution may be made if, after the distribution:

   Virginia:
   
   a. The LLC would not be able to pay its debts as they become due; or

   b. The LLC’s total assets would be less than the sum of its total liabilities plus, unless the Articles or written operating agreement otherwise permit, the amount that would be needed to satisfy preferential rights of other members upon dissolution whose preferential rights are superior to the rights of members receiving the distribution. Va. Code §13.1-1035(A).

   Delaware; New York: No distribution to a member if it results in liabilities to third parties, other than those for which recourse is limited to specified property, exceeding fair value of assets, but fair value of property securing nonrecourse liability in excess of the liability is included in assets. Del. Code §607(a); N.Y. Bill §508(a).

   c. The LLC may base a determination that a distribution is not prohibited on:

      (i) Financial statements prepared on the basis of accounting practices and principles that are reasonable in the circumstances; or

d. The effect of a distribution is measured as follows:

**Virginia:**

(i) The date the distribution is authorized if payment is made within 120 days after date of authorization; or

(ii) The date payment is made if made more than 120 days after the date of authorization.


2. Liability for excess distribution

**Virginia:** If a member has received a distribution in violation of the Articles or operating agreement or in violation of Va. Code §13.1-1035, then he is liable to the LLC for six years thereafter for the amount of the wrongful distribution. Va. Code §13.1-1036.

**Delaware and New York:** Member is liable only if he knew at the time of distribution that it was wrongful. Del. Code §18-607(b); N.Y. Bill §508(b). Unless otherwise agreed, three year statute of limitations. Del. Code §607(c); N.Y. Bill §508(c).

G. **Right to distribution**

When a member becomes entitled to a distribution, he has the status of, and is entitled to all remedies available to, a creditor with respect to the distribution. Va. Code §13.1-1037; Del. Code §18-606; N.Y. Bill §506.

VIII. **Relationship of Members to Each Other**

A. **Operating Agreement**

1. The members are authorized to enter into an operating agreement to regulate or establish the affairs of the LLC, the conduct of its business, and the relations of its members. Va. Code §13.1-1023(A); Del. Code §18-101(6); N.Y. Bill §417 ("shall adopt").
2. Form


Delaware and New York: Must be written. Del. Code §18-101(6); N.Y. Bill §§102(u), 417(a).

3. Adoption and Amendment


b. If the operating agreement does not provide a method for its amendment, then all members must agree to amendment. Va. Code §13.1-1023(B)(2).

4. The operating agreement may contain any provisions regarding management of the affairs of the LLC and the conduct of its business to the extent not inconsistent with law or the Articles. Va. Code §13.1-1023(A).

5. As a matter of good practice, a written operating agreement should be adopted.

a. To vary the statutory "default" rules. E.g., management, voting, profit sharing and distributions.

b. To address matters as to which there is no default rule. The acts contain no provision comparable to RULPA §1105 to fill gaps in the statute.

However, in any case not provided for, some statutes provide that the principles of law and equity supplement the provisions of the acts. Va. Code §13.1-1001.1; Del. Code §18-1104.

c. Since LLCs are taxable under I.R.C. Subchapter K, compliance with Section 704(b) regulations is important. E.g., maintenance of capital accounts, minimum gain chargeback, and qualified income offset.
d. Freed of one class of stock limitation applicable to S corporation, members have great flexibility in provisions for allocations and distributions.

e. To define duty of care and any other fiduciary duties.


6. Certain statutory rules may not be changed even by agreement in Virginia.


b. Requirement for unanimous consent to avoid dissolution on termination of membership. Va. Code §13.1-1046(3). However, operating agreement should address continuity of business of LLC where unanimous consent to avoid dissolution cannot be obtained.

B. Management

Except to the extent that the operating agreement provides for management by managers, management is vested in the members. Va. Code §13.1-1022(A); Del. Code §18-402; N.Y. Bill §401. Management may be vested in managers in whole or in part.

C. Voting

1. Members

Virginia: Unless otherwise provided in the Articles or operating agreement, members vote in proportion to their contributions to the LLC, as adjusted from time to time to reflect additional contributions or withdrawals. Va. Code §13.1-1022(B). This requirement may have an unintended result where capital accounts have been adjusted to reflect a revaluation of partnership property under Treas. Reg. §1.704(b)(2)(iv)(f).

Delaware and New York: Unless otherwise agreed, members vote in proportion to the then current percentage or other interest share in profits. Del. Code §18-402; N.Y. Bill §402(a). That share is based on unreturned contributions. Del. Code §18-503; N.Y. Bill §402.
2. Managers

Virginia: Unless otherwise provided by Articles or operating agreement, one vote per manager. Va. Code §13.1-1024.G.

D. Decision making
1. Members

Virginia: Unless otherwise provided in the Act, Articles or operating agreement, members act by approval of members having a majority share of voting power of all members. Va. Code §13.1-1022(C).

Delaware: Decisions by members owning more than 50% of the current interest in profits. Del. Code §18-402.

New York:

a. Unless otherwise required or specified by [Act], Articles, or operating agreement, majority in interest vote required. N.Y. Bill §402(f).

b. Unless operating agreement otherwise provides, even if managers are designated, majority in interest vote required for specified matters (e.g., admission of member, incurrence of extraordinary debt, adoption, amendment or revocation of the Articles). N.Y. Bill §402(c).

c. Unless Agreement otherwise provides, even if managers are designated, two-thirds in interest vote required for specified matters (e.g., dissolution, sale or exchange of substantially all LLC assets, merger). N.Y. Bill §402(d).

2. Managers

Virginia and New York: Unless otherwise provided in the Articles or the operating agreement, any action required and permitted to be taken by managers may be taken upon a majority vote of the managers. Va. Code §13.1-1024(G); N.Y. Bill §408(b).

Delaware: Voting may be on per capita, number, financial interest, class, group, or any other basis. Del. Code §18-404(b). No default rule specified.

E. Management by managers
1. Full or partial responsibility for management may be delegated to or among one or more managers. Va. Code §13.1-1024(A) (Articles or operating agreement); Ga. Code §14-11-304(a) (Articles or written operating agreement); Del. Code §18-402 (operating agreement); N.Y. Bill §408(a)(Articles).

2. Managers need not be members of the LLC unless the Articles or operating agreement so require. Va. Code §13.1-1024(B); Ga. Code §14-11-304(b)(2); N.Y. Bill §410. The Delaware Act is silent; and since no qualifications for managers are imposed, presumably the result is the same as in Virginia.

3. Manager need not be a natural person. Virginia repealed original requirement.


5. The Articles or operating agreement may prescribe qualifications for managers. Va. Code §13.1-1024(B); N.Y. Bill §410(b)(operating agreement).

6. The number of managers is to be fixed by or in the manner provided in the Articles or operating agreement, and may be increased or decreased by amendment. Va. Code §13.1-1024(C); N.Y. Bill §413(d).

7. Managers are to be elected by the members. Va. Code §13.1-1024(D); Del. Code §18-402; N.Y. Bill §413. Unlike the Wyoming Act, there is no requirement for annual election in the manner of corporate officers.

8. Unless otherwise provided in the Articles or operating agreement, any vacancy in the office of manager is to be filled by vote of more than one half of members, Ga. Code §14-11-304(b)(1). By vote of majority in interest of the members. Va. Code §13.1-1024(E); N.Y. Bill §416(a).

9. Managers may be removed, with or without cause, by a majority vote of members, unless the Articles or operating agreement otherwise provide. Va. Code §13.1-1024(F); N.Y. Bill §414. Delaware Act does not contain a "default" removal provision.

October 25, 1993
F. Standards of conduct for members and managers

1. Fiduciary Duties

a. General fiduciary duties arise out of agency relationship.

"The agreement to act on behalf of the principal causes the agent to be a fiduciary, that is, a person having a duty, created by his undertaking, to act primarily for the benefit of another in matters connected with his undertaking." Restatement, (Second) of Agency, §13 cmt. a (1958).

b. Partnerships

   (i) UPA §21 "Partner Accountable as Fiduciary"

   (ii) Every partner is an agent of the partnership. UPA §9(1).

   (iii) The law relative to principals and agents supplements the UPA. UPA §4(3).

c. LLCs

   (i) While the acts generally have not included an analogue of UPA §21, most of them have included provisions that members are agents of the LLC in member-managed LLCs and managers are agents of the LLC in manager-managed LLCs. E.g., Ga. Code §14-11-301(a).

   (ii) Some acts assume the existence of fiduciary duties and attempt to circumscribe them by specifying "the only fiduciary duties" a member owes. E.g., ULLCA §411(a). This approach was derived from Revised Uniform Partnership Act §404 (1992) ("RUPA"). However, ULLCA §103(b) limits the extent to which fiduciary duties may be varied, reduced, or eliminated.
2. Corporate law analogue for standards of conduct

**Virginia:** Act sets forth the general standard of conduct for managers comparable to those of corporate directors, derived from Virginia Stock Corporation Act.

**Delaware:** Imposes no express standard of conduct on managers or members. It authorizes the operating agreement to provide that a member or manager who fails to comply with the operating agreement shall be subject to specified penalties or consequences. Del. Code §§18-306, -405.

**New York:** A manager must perform his or her duties in good faith and with the degree of care that an ordinarily prudent person in the same condition would use under similar circumstances. N.Y. Bill §409(a).

A manager is to discharge his duties as a manager in accordance with his good faith business judgment of the best interests of the LLC. Va. Code §13.1-1024.1(A).

**NOTE:** Derived from the Virginia Stock Corporation Act, which omits duty of ordinary care in the RMBCA §8.30(a).


G. Limitation of liability of members and managers

**Virginia:** Act incorporates Virginia Stock Corporation Act provisions.

1. In a proceeding by or on behalf of an LLC or its members, the damages assessed against a manager or member arising out of a single transaction, occurrence, or course of conduct cannot exceed the lesser of:

   a. The monetary amount, including the elimination of liability, specified in the Articles or in writing in the operating agreement as a limitation on or elimination of the liability of the manager or member; or

   b. The greater of (A) $100,000 or (B) the amount of cash compensation received by the manager or member from the LLC during the preceding 12 months. Va. Code §13.1-1025(A)(1)-(2).
2. The foregoing limitation of liability does not apply if the manager or member engaged in willful misconduct or a knowing violation of a criminal law, or to the extent otherwise provided in the Articles or in writing in the operating agreement. Va. Code §13.1-1025(B).


Delaware: To the extent that, at law or equity, member or manager has duties (including fiduciary duties) and liabilities relating thereto to LLC or another member or manager:

1. Member or manager acting under the limited liability company agreement is not liable for good faith reliance on the agreement; and

2. Member’s or manager’s duties and liabilities may be "expanded or restricted" by limited liability company agreement. Del. Code §18-1101(c).

Georgia:

To extent that, pursuant to Ga. Code §14-11-305(1) or otherwise at law or in equity, a member or manager has duties (including fiduciary duties) and liabilities relating thereto to LLC or another member or manager:

Member’s or manager’s duties and liabilities may be "expanded, restricted, or eliminated" by Articles or written operating agreement, except that no provision may eliminate or limit liability:

1. for intentional misconduct or knowing violation of law; or

2. for any transaction for which the person received a personal benefit in violation or breach of written operating agreement. Ga. Code §14-11-305(4)(A).

While Georgia and Delaware Acts impose no statutory fiduciary duties, Ga. Code §14-11-305(4) and Del. Code §18-1101(c) are an acknowledgment that common law duties may be imposed. Therefore, it is advisable to address in the operating agreement the subjects of standard of care and duty of loyalty. For example, it is typical to provide that a manager is liable only for gross negligence. Also, it is typical to nullify or curtail duty not to compete, business opportunities, and certain
self-dealing transactions (e.g., manager permitted to engage affiliate for property management).

**New York: Operating agreement may contain a provision "eliminating or limiting" the personal liability of manager to LLC or members for damages for breach of duty in that capacity, but it may not eliminate or limit:**

1. Liability if judicial determination that acts or omissions were in bad faith or involved intentional misconduct or knowing violation of law or that the manager gained a financial profit or other advantage to which he was not legally entitled, or that the manager failed to meet requirements in use of excess distribution; N.Y. Bill §417(a)(1); or

2. Liability for act or omission before provision adopted. N.Y. Bill §417(a)(2).

**H. Business transactions of members and managers with LLC**

**Virginia, Delaware:** Except as provided in the operating agreement, any member or manager may lend money to and transact other business with the LLC and, subject to other applicable law, have the same rights and obligations with respect thereto as a person who is not a member or manager. Del. Code §18-107; Va. Code §13.1-1026. See also N.Y. Bill §611.

**New York:** Prescribes procedures for transactions between LLC and "interested managers." N.Y. Bill §411.

Presumably, as in the case of RULPA §107, from which source the provision is derived, transactions between a member and the LLC remain subject to the general fraudulent conveyance statute, and other doctrines developed under bankruptcy and insolvency laws. See RULPA §107 cmt. See Retzke v. Larson, 803 P.2d 439 (Ariz. Ct. Apps. 1990) (Applying analogous provisions of Arizona RULPA, held that "other applicable law" included RULPA §608 and the Arizona Uniform Fraudulent Conveyance Act.)

**IX. Members and LLC Interests**

**A. Nature of interest in LLC**


2. Member has no direct ownership interest in specific LLC assets. Del. Code §18-701; Ga. Code §14-11-501(a); N.Y.
Bill §601; Calif. Bill §17300. Virginia Act does not expressly so provide, but the result is the same.

3. LLC interest as general intangible under U.C.C. §9-106 (1990). See N.Y. Bill §603(b) and ULLCA §501 cmt. 4.

B. Admission of members

Virginia:

1. Acquisition from LLC. A person acquiring an interest directly from the LLC may become a member by compliance with the operating agreement or if it does not so provide, upon consent of all members. Va. Code §13.1-1038.1(A)(1).

2. Assignee. An assignee of an interest (that is, a person acquiring an interest from a person other than directly from the LLC) may become a member by compliance with the specific rules governing admission of assignees. Va. Code §13.1-1038.1(A)(2).

Delaware:

1. In connection with formation of LLC, a person acquiring a limited liability company interest is admitted as a member on the later to occur of (1) formation of the LLC, or (2) the time provided in and upon compliance with the limited liability company agreement or, if no provision is made, when the person's admission is reflected in the LLC's records. Del. Code §18-301(a).

2. After formation of the LLC, a person acquiring a limited liability company interest is admitted as a member:

   a. if the interest is acquired directly from the LLC, at the time provided in and upon compliance with the limited liability company agreement or, if no provision is made, upon the consent of all members and when the person's admission is reflected in the records of the LLC; and

   b. in the case of an assignee of an interest, in compliance with the limited liability agreement and upon the approval of all members of the LLC other than the assignor; or compliance with any procedure provided for in the limited liability company agreement. If the limited liability agreement does not so provide, when the assignee's admission is reflected in the records of the LLC. Del. Code §§18-301(b), 18-704(a).
New York:

1. A person becomes a member of an LLC on the later of either the effective date of the Articles, or the date that this person becomes a member under the statute or operating agreement; but, if this date is not ascertainable, the person becomes a member on the date stated in the LLC's records. N.Y. Bill §602(a)(1)-(2).

2. After formation, a person may become a member of the LLC:

   a. where a person acquires a membership interest directly from the LLC, by complying with the operating agreement or, if the agreement is silent, by the vote or written consent of at least a majority of the members.

   b. where a person is an assignee of a member who has the power under the agreement to grant an assignee the right to become a member, by exercising that power and complying with any limitations on the power. N.Y. Bill §602(b)(1)-(2).

C. Assignment of interest

1. "LLC interest" is a member's share of the profits and losses of the LLC and the right to receive distributions; it does not necessarily include any right to participate in management. Va. Code §13.1-1002; Del. Code §18-101(7). New York definition includes "right to vote and participate in the management . . . ." N.Y. Bill §102(r).

2. Unless otherwise provided, a membership interest is assignable in whole or in part. Va. Code §13.1-1039; Del. Code §18-702(a); N.Y. Bill §603(a)(1).

3. Circumstances under which anti-assignment agreement may be ineffective.


   b. Judgement creditor may reach the interest by a charging order. E.g., Tupper v. Kroc, 88 Nev. 146, .

   c. Under §541(c) of the Bankruptcy Code, a debtor's bankruptcy estate automatically succeeds to the debtor's property.
4. Grant of security interest in LLC interest is not an assignment. Ga. Code §14-11-502(7). Compare §17301(c) of the California bill, which provides only that the granting of a pledge of or security interest in a membership interest does not cause member to cease to be a member nor grant to anyone else the power to exercise any rights of a member.


   NOTE: However, if the assignor ceases to be a member, then the dissolution provisions will be implicated.

6. An assignment does not entitle the assignee to participate in the management and affairs of the LLC or to become or to exercise any rights of a member. Va. Code §13.1-1039; Del. Code §18-702(a); N.Y. Bill §603(a)(2).

   The assignment entitles the assignee to receive, to the extent assigned, only any share of profits and losses and distributions to which the assignor would be entitled. Va. Code §13.1-1039; Del. Code §18-702(b)(1); N.Y. Bill §603(a)(3).

7. An assignee of an interest who has not become a substituted member will be treayed as a substituted member for federal tax purposes. Rev. Rul. 77-137, 1977-1 C.B. 178.

D. Right of assignee to become a member

1. Procedure

   Virginia: An assignee of an interest in an LLC may become a member only if the other members unanimously consent. Va. Code §13.1-1040(A).

   Delaware: Approval of all members other than the assigning member; or compliance with procedure specified in the LLC agreement. Del. Code §18-704(a).

   Consider tiered-ownership structure to minimize impact of statutory restrictions. For example, if a member is a limited partnership, interests in that entity would not have to be subject to the same restrictions.

2. An assignee who has become a member has, to the extent assigned, the rights and powers, and is subject to the restrictions and liabilities, of a member under the Articles, operating agreement and the Act. Va. Code §13.1-1040(B); Del. Code §18-704(b); N.Y. Bill §604(b).
3. Liability upon assignment.

**Virginia:** An assignee who becomes a member is liable for any obligations of his assignor to make and return contributions as provided in Articles 5 and 6 of the Act; except that an assignee who becomes a member is not obligated for liabilities of the assignor unknown to him at the time he became a member. Va. Code §13.1-1040(B).

**Delaware and New York:** Unless operating agreement otherwise provides, substituted member is liable for obligations of assignor to make contributions, but not to return distributions. Del. Code §18-704(b); N.Y. Bill §604(b).

4. If an assignee becomes a member, the assignor is not released from his liability to make contributions and to return wrongful distributions. Va. Code §13.1-1040(C); N.Y. Bill §605. Under the New York provision, an assignor also is not released from liability for a false statement in the LLC's Articles or other certificate, liability that conceivably could run to third parties.

**E. Dissociation**

Except as provided in the operating agreement, a member ceases to be a member upon assignment of his entire membership interest. Del. Code §18-702(b)(2); Va. Code §13.1-1039; N.Y. Bill §603(a)(4).

Unless otherwise agreed, granting a security interest in an LLC interest does not cause a member to cease to be a member. Del. Code §18-702(b)(2); N.Y. Bill §603(a)(4).

Person ceases to be a member upon "events of bankruptcy." Del. Code §18-304.

**F. Withdrawal or resignation**

1. Member may resign or withdraw ("resign") at the time or upon events specified in operating agreement. Va. Code §13.1-1032; Del. Code §18-603; N.Y. Bill §606.

2. If operating agreement or [Articles - Virginia] does not specify time or events upon the happening of which a member may resign or definite time for dissolution and winding up, member may resign on not less than six months' prior written notice. Va. Code §13.1-1032; Del. Code §18-603.
3. **Distribution:** Unless otherwise provided, on withdrawal, a member is entitled to be paid, within a reasonable time, the fair value of his interest. Va. Code §13.1-1033; Del. Code §18-604; N.Y. Bill §509.

G. **Rights of creditors**

1. Member has no direct ownership interest in the assets of an LLC that may be reached by his creditors.

2. Member's creditors may reach his interest in the LLC. A judgment creditor of a member may apply to court to charge the interest of a member or assignee with payment of the unsatisfied amount of the judgment with interest. To the extent so charged, the judgment creditor has only the rights of an assignee of the interest. Va. Code §13.1-1041; Del. Code §18-703; Ga. Code §14-11-504(a); N.Y. Bill §607(a). A member's creditor cannot obtain possession of, or otherwise exercise legal or equitable remedies against the property of the limited liability company. N.Y. Bill §607(b).

3. In Georgia, a charging order is not the exclusive remedy, and garnishment is available. Ga. Code §14-11-504(b). However, presumably, principles that have evolved in partnership context will be applicable, so that generally the charging order will be the exclusive remedy. 2 Alan R. Bromberg and Larry E. Ribstein, *Bromberg and Ribstein on Partnerships*, §3.05 at 3:70.

X. **Dissolution**

A. **Non-judicial dissolution**

An LLC is dissolved and its affairs are to be wound up upon the happening of the first to occur of the following events:

1. At the time specified in the Articles or operating agreement. Va. Code §13.1-1046(1); N.Y. Bill §701(a), (b). At the time specified in the operating agreement. Del. Code §18-801(1); N.Y. Bill §701(a). In Delaware, if no time specified, then 30 years from formation. Del. Code §18-801(1).

2. Upon the happening of events specified in Articles or operating agreement. Va. Code §13.1-1046(1); Del. Code §18-801(2); N.Y. Bill §701(b).

3. Upon unanimous written consent of the members. Va. Code §13.1-1046(2); Del. Code §18-801(3); unless operating
agreement otherwise provides, upon written consent of two-thirds in interest. N.Y. Bill §701(c).

4. Upon the event that terminates the continued membership of any member (N.Y.: only the member, class or group specified in the operating agreement) in the LLC, unless the LLC is continued:


a. Unanimity requirement is not subject to contrary agreement by members.

b. Advance consent not contemplated; consent must follow event that terminates membership.

c. While unanimous consent is required to avoid dissolution, the members may agree, as in the case of a partnership, that the business of the LLC may be continued without liquidation of its assets by less than unanimous vote. For purposes of tax classification regulations, so long as dissolution results under local law, continuation of the business does not create continuity of life. Treas. Reg. §301.7701-2(b)(2). Presumably, a successor LLC will have to be formed.

Delaware: Either by consent of all remaining members within 90 days after the event; or pursuant to right to continue stated in the operating agreement. Del. Code §18-801(4).

New York: Within 180 days after such event, by vote or written consent of the percentage of members, classes or groups stated in the operating agreement, or if no such percentage is specified in the operating agreement, by vote or written consent of a majority in interest of all of the remaining members, or pursuant to a right to continue stated in the operating agreement. N.Y. Bill §701(d).


B. Judicial dissolution

On application by or for a member, court may decree dissolution of LLC if it is not reasonably practicable to carry on the business in conformity with the Articles or operating

See RULPA §802.

Delaware has a special rule for LLC that is publicly traded and is taxable as a corporation for federal tax purposes. Del. Code §18-802(b).

C. Winding up

**Virginia** and **New York**: On cause shown, court may wind up the LLC's affairs on application of any member, and his legal representative, or his assignee. Va. Code §13.1-1048; N.Y. Bill §703(a). Since the Act contains no provision for dissolution in violation of the operating agreement, "wrongful dissolution" of an LLC must refer to wrongful conduct resulting in judicial dissolution. In Virginia alone, unless otherwise provided in the Articles or operating agreement, the members who have not wrongfully dissolved an LLC may wind up the LLC's affairs. Va. Code §13.1-1048.

**Delaware**: Manager who has not wrongfully dissolved. Del. Code §18-803.

D. Authority to act for dissolved LLC

Virginia Act does not expressly address the subject.

E. Distribution of assets upon dissolution

Upon winding up of LLC, its assets are to be distributed as follows:

1. To creditors, including members who are creditors, to the extent permitted by law, in satisfaction of liabilities of the LLC other than for distributions to members under the Act. Va. Code §13.1-1049(1); Del. Code §18-804(a)(1); N.Y. Bill §704(a).


3. Unless otherwise provided, to members first for the return of their contributions and second with respect to their interest in the LLC, in the proportions in which the members

F. Certificates of termination

1. Some states require filing of notice of dissolution. E.g., California, Calif. Bill §17356(a)(1) (certificate of dissolution); but Virginia does not.

2. Upon completion of winding up of the LLC, a certificate of cancellation is to be filed. Va. Code §13.1-1050(A); Del. Code §18-203; N.Y. Bill §705 (articles of dissolution).

3. Winding up is completed when all debts, liabilities, and obligations of the LLC have been paid and discharged or a reasonably adequate provision therefor has been made, and all of the remaining property and assets of the LLC have been distributed to the members. Va. Code §13.1-1050(A).

4. Unless otherwise provided in the Act or in the certificate, a certificate of cancellation (or judicial decree of cancellation) is effective when accepted for filing. Va. Code §13.1-1050(B).

XI. Mergers

A. Merger with LLCs only

<table>
<thead>
<tr>
<th>State</th>
<th>State Law</th>
</tr>
</thead>
<tbody>
<tr>
<td>Connecticut</td>
<td>Conn. LLCA §64(a)</td>
</tr>
<tr>
<td>Indiana</td>
<td>Ind. Code §28-18-7-1, -6</td>
</tr>
<tr>
<td>Montana</td>
<td>Montana LLCA §71(1)</td>
</tr>
<tr>
<td>Oregon</td>
<td>Or. Ltd. Liab. Co. Act, ch. 173, §90</td>
</tr>
<tr>
<td>Utah</td>
<td>Utah Code Ann. §48-2b-149(1)</td>
</tr>
</tbody>
</table>

B. Merger with LLCs and other business entities

Merger of LLC with other business entities but not all permit merger with all other entities.
<table>
<thead>
<tr>
<th>State</th>
<th>Code Reference</th>
</tr>
</thead>
<tbody>
<tr>
<td>Arizona</td>
<td>Az. Code §29-751 et. seq.</td>
</tr>
<tr>
<td>Delaware</td>
<td>Del. Code §18-209</td>
</tr>
<tr>
<td>Georgia</td>
<td>Ga. Code §14-11-901(a)</td>
</tr>
<tr>
<td>Missouri</td>
<td>Mo. Rev. St. §359.902</td>
</tr>
<tr>
<td>Wyoming</td>
<td>W.S. §17-15-139</td>
</tr>
<tr>
<td>New York</td>
<td>N.Y. Bill §1001 et seq.</td>
</tr>
<tr>
<td>California</td>
<td>Calif. Bill §17550 et seq.</td>
</tr>
</tbody>
</table>

**C. Law governing mergers of foreign LLCs**

1. If a foreign LLC owning assets in Virginia is a party to a merger in which a foreign corporation, foreign limited partnership or foreign LLC is a successor, the transfer of those assets to the successor is governed by the laws of the place that governed the merger. Va. Code §13.1-1060.

2. Certificate to be issued by SCC upon request and may be admitted in local clerk's office to maintain continuity of title records. Va. Code §13.1-1067(B).

**XII. Foreign Limited Liability Companies**

**A. Law governing**


**B. Registration**


**C. Transaction of business without registration**

1. A foreign LLC transacting business may not maintain any action, suit or proceeding until it has registered. Va. Code §13.1-1057(A); N.Y. Bill §808(a).

2. The failure of a foreign LLC to register does not impair the validity of any contract or act of the foreign LLC or prevent it from defending any proceeding in a court. Va. Code §13.1-1057(B); N.Y. Bill §808(b).
3. If a foreign LLC transacts business in Virginia without the requisite certificate, each member, manager or employee of the LLC who does any such business knowing that a certificate is required and has not been obtained is liable for a penalty. Va. Code §13.1-1057(C).

4. A member, manager, or agent of a foreign LLC is not liable for the contractual or other liabilities of the foreign LLC solely by reason of the LLC's doing or having done business in New York or California without the requisite certificate. The Virginia Act is silent on this point.


D. Activities that do not constitute transacting business

1. List of activities, which is not exhaustive, that do not constitute transacting business. Va. Code §§13.1-1059(A) and (C); N.Y. Bill §803.


XIII. Transacting Business in Other States

A. Liability of members in state in which foreign LLC transacts business

1. States With LLC Acts

States with LLC acts generally provide that the liability of the members and managers of a foreign LLC is governed by the law of the jurisdiction of organization. E.g., Va. Code §13.1-1051(ii); Del. Code §18-901; N.Y. Bill §801(a).

2. States Without LLC Acts That Recognize Foreign LLCs

Before adoption of Indiana LLC Act, Indiana provided for registration of foreign LLCs, but was silent as to recognition of limited liability. Presumably it did recognize it. Ind. Code Ann. §23-16-10.1-1 to 10.1-4 (repealed 1993).

Georgia provides for registration of foreign LLCs and that the law of the jurisdiction of organization governs the liability of its managers, members and other owners. Ga. Code
§14-11-1, -2. (Repealed upon effective date, March 1, 1994, of Georgia LLC Act, which contains foreign LLC registration provision.)

Mississippi provides for registration of foreign LLCs (H.B. No. 743, Sect. 5) and that law of the jurisdiction of organization governs the liability of its members and managers (Sect. 4(1)).

3. States Without LLC Legislation

It is unclear whether states that have not adopted LLC legislation will recognize the limited liability of members and managers or will treat an LLC as a partnership. See Means v. Limpia Royalties, 115 S.W. 2d 468 (Tex. Civ. App. 1938). For discussion of Restatement (Second) Conflict of Laws §6(2), comity, and Full Faith and Credit Clause, 1 Ribstein and Keatinge, supra, §§13.04-.05, at 13-8 to -18.

B. Liability of member in state in which foreign LLC not transacting business

Suit against resident of non-LLC state in that state for claim arising out of act or omission by foreign LLC in another state.

C. Title to real estate in foreign entity

How will non-LLC state treat title to real estate in that state that is in name of foreign LLC?

XIV. Securities Law Issues

A. "Security"


2. Since "partnership interests" are not explicitly enumerated as "securities," the issue is whether they are included within that definition as "investment contracts." Holden v. Hagopian, 978 F.2d 1115, 1118 (9th Cir. 1992). The same issue arises in the case of a limited liability company interest.

3. "Investment contract" exists when a person (1) invests his money (2) in a common enterprise and (3) is led to expect profits solely from the efforts of others.

B. Partnership interest

1. Generally a limited partner's interest is a "security" and that of a general partner is not. 2 Louis Loss and Joel Seligman, Securities Regulation 958-63 (3d ed. 1989).

2. General partnership cases.

Rivanna Trawlers Unlimited v. Thompson Trawlers, Inc., 840 F.2d 236 (4th Cir. 1988), held that a general partnership interest was not a security where the partnership agreement allowed the general partners, when acting in concert with a group of other partners, to control major actions and to remove the managing general partner.

Williamson v. Tucker, 645 F.2d 404, 424 (5th Cir. 1981), cert. denied, 454 U.S. 897 (1981). "A general partnership or joint venture interest can be designated a security if the investor can establish, for example, that (1) an agreement among the parties leaves so little power in the hands of the partner or venturer that the arrangement in fact distributes power as would a limited partnership; or (2) the partner or venturer is so inexperienced and unknowledgeable in business affairs that he is incapable of intelligently exercising his partnership or venture powers; or (3) the partner or venturer is so dependent on some unique entrepreneurial or managerial ability of the promoter or manager that he cannot replace the manager of the enterprise or otherwise exercise meaningful partnership or venture powers."

Gordon v. Terry, 684 F.2d 736, 741 (11th Cir. 1982) reh'g denied, 690 F.2d 907 (11th Cir. 1982), cert. denied, 459 U.S. 1203 (1983), held that a general partnership interest was not a security where the investors were granted control over the significant decisions that affect the success of the enterprise, except where an investor may be incapable of exercising the power given to him by the agreement as a result of his dependency on another's specialized expertise.

Koch v. Hankins, 928 F.2d 1471 (9th Cir. 1991) applied all three Williamson factors in evaluating whether investors expected profits produced by efforts of others so as to satisfy the third element of Howey.
Interest in a general partnership was held to be a security by the Georgia Securities Division in In the Matter of Atlanta Investment Services, Inc. Blue Sky L. Rep. CCH ¶ 72, 367, at 71,666 (1985).

C. LLC interest


XV. Bankruptcy Law

See 1 Ribstein and Keating, supra, §14.04, at 14-11 for discussion of application of Bankruptcy Code to LLCs.

XVI. Banking


XVII. Federal Taxation

A. Classification

1. Classification Principles

   a. I.R.C. §7701(a)(2) provides that "partnership" includes an unincorporated organization, through or by means of which any business' financial operation or venture is carried on, and which is not a trust, estate or corporation.

   b. (i) The regulations set forth the following major characteristics of a corporation:

      (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 interests.

      Treas. Reg. §301.7701-2(a)(1).
(ii) The first two characteristics are common to both partnerships and corporations and are to be disregarded. Treas. Reg. §301.7701-2(a)(2).

(iii) If an unincorporated organization lacks two of the remaining four characteristics, it will be classified as a partnership. Treas. Reg. §301.7701-2(a)(3). Equal weight will be given to each characteristic. Rev. Rul. 93-5, 1993-3 I.R.B. 6.

2. Bulletproof Act States

Revenue Rulings:

Colorado: Rev. Rul. 93-6, 1993-3 I.R.B. 8

The five cited revenue rulings held that an LLC formed under the subject bulletproof LLC acts will be classified as a partnership for federal tax purposes.

Each revenue ruling was based upon the conclusion that the LLC lacked free transferability of interests and continuity of life. In all cases the statutes required unanimous consent.

3. Flexible Act States

a. Revenue Rulings


Held: Since the Delaware Act provisions that affect the pertinent characteristics can be modified by agreement, a Delaware LLC will be classified as a corporation or partnership depending upon the terms of the agreement.

Rev. Rul. 93-38 was the first revenue ruling on a non-bulletproof act. It was important in holding that a flexible act LLC may be classified as a partnership, but the two examples used in the ruling did not contribute to clarification of provisions short of unanimous consent that will be acceptable for partnership classification.
Example 1.

(a) Under the Act, members not liable for LLC debt.
(b) Agreement vested management in all 25 members.
(c) Unanimous consent required for admission of assignee as a member.
(d) Unanimous consent required to avoid dissolution.

Held: Partnership.

Example 2.

(a) Members not personally liable for LLC debt.
(b) Agreement vested management in 3 of 25 members elected managers.
(c) Consent of other members not required for admission of assignee as member.
(d) LLC will continue under all circumstances without consent of any member or manager.

Held: corporation.

LLC lacked free transferability of interests and continuity of life because in both events the LLC agreement had a unanimity requirement.

LLC lacked free transferability of interests and continuity of life because in both events the LLC agreement had a unanimity requirement.

b. Private letter rulings for states without revenue rulings

Arizona E.g., Priv. Ltr. Rul. 9321047 (Feb. 25, 1993)
Kansas E.g., Priv. Ltr. Rul. 9119029 (Feb. 7, 1991)
Texas E.g., Priv. Ltr. Rul. 9242025 (July 22, 1992)
Utah E.g., Priv. Ltr. Rul. 9321070 (March 3, 1993)
c. Determination of Characteristics

(i) **Limited Liability**

Organization has "limited liability" if under local law no member is personally liable for debts of, or claims against, the organization. Personal liability means a creditor may seek personal satisfaction from a member to the extent that the organization's assets are insufficient. Even if another person assumes a liability or agrees to indemnify the member for the liability, if under local law the member remains liable to the creditor, there exists personal liability with respect to the member. Treas. Reg. §301.7701-2(d)(1).

Generally, no LLC member has any personal liability for any liabilities of the LLC solely by reason of being a member.

Are these circumstances under which an LLC could be found to lack "limited liability"?

(a) Waiver as provided in the Articles or operating agreement? E.g., Va. Code §13.1-1019.

(b) Retained personal liability for professional services? Ga. Code §14-11-314. This seems no different from a corporate shareholder's being liable for his own acts or omissions.

(c) Retained vicarious liability of a professional member for negligence of other members? E.g., First Bank & Trust Co. v. Zagoria, 302 S.E.2d 674 (Ga. 1983); Nelson v. Patrick, 326 S.E.2d 45 (N.C.Ct.App. 1985) (holding shareholders of professional corporation jointly and severally liable).

(ii) **Centralized Management**

Centralized management exists if any person (or group not including all members) has continuing exclusive authority to make management decisions. Those persons resemble a corporate board in powers and functions. Treas. Reg. §301-7701-2(c)(1).
Persons with management authority need not be members and method of selection is not controlling. Treas. Reg. §301-7701-2(c)(2).

Centralized authority merely to perform ministerial acts as an agent at the direction of a principal is not "centralized management." Treas. Reg. §301-7701-2(c)(3).

There is no centralization of continuing exclusive authority to make management decisions unless managers have sole authority to make management decisions. In a corporation, concentration of powers in the board effectively prevents stockholder, simply because he is a stockholder, from binding the corporation by his acts. However, because of the mutual agency relationship between general partners under the UPA, a general partnership cannot achieve effective concentration of management powers. Usually, the act of any partner within the scope of the partnership business binds all partners; and even if partners agree to vest management in a selected few, a third party without notice is not bound. Treas. Reg. §301.7701-2(c)(4).

Limited partnerships generally do not have centralized management unless substantially all the interests in the partnership are owned by limited partners. If all or group of limited partners may remove a general partner, then facts and circumstances test applies, except "substantially restricted right," i.e., for cause. Treas. Reg. §301.7701-2(c)(4).

In Glensder Textile Co. v. Commissioner, 46 B.T.A. 176, 185 (1942), the general partners of a limited partnership owned five-twelfths of the partnership. The court said that there was centralized control by the general partners, but that fact did not make them analogous to corporate directors. They were acting in their own interest, being five-twelfths, and not merely in a representative capacity for a body or persons having a limited investment and a limited liability. Nor were the limited partners able to remove the general partners and control them as agents, as stockholders may control directors. Therefore, the partnership lacked centralized management.
Examples in the regulations:

(1) three general partners and thirty limited partners, with former contributing less than 6% of the capital. Held: the organization had centralized management since substantially all of the interests were owned by limited partners;

(2) three general partners and nine hundred limited partners with former contributing less than 3% of the capital. Held: centralized management since substantially all the interests were owned by limited partners. Treas. Reg. §301.7701-3(b)(2).

Unless limited partner interests, excluding those held by general partners, do not exceed 80% of the total interests in the partnership, the IRS will not rule that the partnership lacks centralized management. Rev. Proc. 89-12, 1989-1 C.B. 798, §4.06.

In the case of organizations other than those formed as partnerships under local law, "general partner" refers to those members with significant management authority relative to the other members. Rev. Proc. 89-12, 1989-1 C.B. 798, §1.02

If managers with powers comparable to general partners own at least 20% of the total membership interests, centralized management should be lacking. Kenneth L. Harris and Francis J. Wirtz, Corporate Governance, Limited Liability Companies and the IRS's View of Centralized Management, 71 Taxes 225, 228 (1993).

However, thus far, the IRS has not ruled that an LLC with managers, regardless of the membership interest owned, lacks centralized management. Rev. Rul. 93-6, 1993-3 I.R.B. 8 addressed the Colorado LLC Act. That Act provides that management of the LLC's business and affairs is vested in managers. The LLC in the ruling had five members, each of whom was elected as a manager. If Section 4.06 of Rev. Proc. 89-12 were applicable, the LLC would lack
centralized management. However, the ruling held that since members, by sole virtue of being members, do not possess managerial authority, even though all the members were elected managers, the LLC possessed centralized management.

Priv. Ltr. Rul. 9321070 (March 3, 1993) - Utah Act provides that, unless provided in the Articles, management is vested in the members; and if so, then any member has authority to bind the LLC, unless the Articles otherwise provide. Articles of the LLC provided that management was vested in the members, and any member has authority to bind the LLC. Held: LLC lacked centralized management.

Priv. Ltr. Rul. 9325048. Utah LLC in which day to day operations were to be handled by one member pursuant to a separate management agreement. Held, since management was generally vested in members and any member had the authority to bind the LLC, no centralized management.

(iii) **Free transferability of interests.**

An organization has the corporate characteristic of free transferability of interests if each member or those owning substantially all the interests in the organization have the power, without the consent of other members, to substitute for themselves and confer all the attributes of the member's interest upon the substitute, a person who is not a member. The right to assign without the consent of the other members, only the right to share in profits but not the right to participate in management, is not deemed to constitute free transferability. Treas. Reg. §301.7701-2(a)(1).

Under the bulletproof acts, the assignee or transferee of a member does not become a substitute member and acquire all the attributes of a member's interest unless all the remaining members approve the assignment or transfer; therefore a bulletproof act LLC lacks free transferability of interests.

**Less than unanimous consent.** Rev. Proc. 92-33, 1992-17 I.R.B. 28. IRS will rule that a
partnership lacks free transferability of interests if, throughout the life of the partnership, the agreement expressly restricts the transferability of partnership interests representing more than 20% of all interests in partnership capital, income, gain, loss, deduction and credit.

Rev. Proc. 92-33 was expressly applied to an LLC in Priv. Ltr. Rul. 9306008 (Nov. 10, 1992). That was a foreign LLC, but Rev. Rul. 88-8 held that a foreign entity is classified for federal tax purposes on the basis of the characteristics in Treas. Reg. §301-7701-2.

Under the governing instrument in that private letter ruling generally membership interests could be disposed of only with the consent of other members, but there was an exception for one member as to which there was a representation that that member would always have less than an 80% interest.

LLCs requiring less than unanimous consent held to lack free transferability:


(b) Priv. Ltr. Rul. 9218078 (Jan. 31, 1992). Consent of manager (who must be member) or members owning at least two-thirds of nontransferred units.

(c) Priv. Ltr. Rul. 9210019 (Dec. 6, 1991). Consent to transfer requires consent of manager; alternatively, if the manager is not a member, or if the manager is making a disposition, transfer requires consent of a majority in interest of members.

Also, no consent is required for transfer if transfer occurs by reason of death, dissolution, divorce, liquidation, merger or termination of transferor and if transferee is a permitted transferee as defined.
(iv) Continuity of life

If the (1) death, (2) insanity, (3) bankruptcy, (4) retirement, (5) resignation, or (6) expulsion of any member will cause a dissolution of the organization, continuity of life does not exist. Treas. Reg. §301.7701-2(b)(1).

The Wyoming LLC Act that was the subject of the first revenue ruling included not only the six dissolution events specified in the regulation, but added all other events of dissolution. The other bulletproof acts followed Wyoming.

(a) Rev. Proc. 92-35, 1992-18 I.R.B. 21. The IRS will not take the position that a limited partnership has continuity of life if local law and the partnership agreement provide that the bankruptcy or removal of a general partner of a limited partnership causes a dissolution unless the remaining general partners, or at least a majority in interest of all remaining partners, agree to continue the partnership.

(b) 1993 amendment to Treas. Reg. §301.7701-2(b)(1), third sentence, permits dissolution to be avoided by agreement of remaining general partners or at least a majority in interest of the remaining general and limited partners combined (effective 6/14/93, but taxpayers may apply to earlier years.)

That amendment also "clarified" the third sentence that the regulations apply not only to retirement, death, or insanity of a general partner, but also to all other events of withdrawal of a general partner. The first sentence which lists six specific events was not similarly modified.

According to the Explanation of Provisions and Comments section of T.D. 8475, containing the final amendment to the continuity regulation, commentators had requested a number of clarifications to the proposed amendment, none of which were adopted:
(1) Specify that regulations apply to any unincorporated organization, not simply to limited partnerships.

(2) Include a reference to LLCs.

(3) Provide that the regulation applies to any one or more events of withdrawal of a member; if only one event of withdrawal causes dissolution, e.g., bankruptcy, the limited partnership will lack continuity.

(4) Provide that an organization will lack continuity if dissolution occurs upon an event of withdrawal of any member, and that "any" does not mean "each."

While acknowledging that the requested clarifications "may have merit," the IRS stated that "their concerns have been addressed to a significant degree in other published guidance or will be considered for future public guidance," citing Rev. Proc. 92-35.

(c) LLCs requiring less than unanimous consent held to lack continuity:

(1) Priv. Ltr. Rul. 9325039 (March 26, 1993). (Illinois) Continuity held lacking where dissolution could be avoided on event of dissociation with "approval by all the remaining owners," which was defined to mean two-thirds in number of owners. Ruling was revoked, presumably because consent was based on number, not interests, of remaining members.

But Priv. Ltr. Rul. 9333032, (Illinois) "All remaining owners" was defined to mean two-thirds in number, which also had to constitute a majority in interest.

(2) Priv. Ltr. Rul. 9308027 (Nov. 27, 1992). Continuity lacking when consent of majority of managing directors and majority in interest and number of remaining members required.

requirements of consent of all remaining managers and majority of the members in number and voting interest.

(d) Number of dissolution events.

Does LLC lack continuity where consent required to avoid dissolution for some but not all of the specified events of dissociation? The "or" of the regulations "could be read either way." William B. Brannan, Lingering Partnership Classification Issues, 1 Fla. Tax Rev. 197, 236 (1993). Bob Keatinge has said that the "or" is not a "grammatical imperative."

Preamble to 1993 amendment declined to address the issue; however, Rev. Proc. 92-35 specified only bankruptcy or removal.


(e) Does LLC lack continuity if dissolution occurs upon dissociation of a specified member or members, rather than each?

Preamble to 1993 amendment declined to address the issue.

Priv. Ltr. Rul. 9210019. Continuity lacking where unanimous consent required on dissolution or bankruptcy of manager.

4. Related Members

a. Husband and wife as sole members

b. Commonly controlled subsidiaries as sole members.

(i) Rev. Rul. 75-19, 1975-1 C.B. 382, held that partnership of four domestic subsidiary corporations of same corporate parent formed under UPA lacks corporate characteristics of continuity of life, centralization of management, and limited liability.


Under German law, GmbH had limited liability and centralization of management. It would be taxable as an association if it possessed either continuity of life or free transferability of interests.

(a) Continuity of life

GmbH's memorandum of association provided that it was dissolved on death, insanity or bankruptcy of any member.

Rev. Rul. 77-214, 1977-1 C.B. 408 had stated that the dissolution event had significance in establishing continuity only if there exist separate interests that could compel a dissolution.

Held: Presence or absence of separate interests not relevant to continuity. Because memorandum requires dissolution on bankruptcy of either member, without further action, continuity lacking.

(b) Free transferability.

While memorandum required consent to transfer an interest, because two wholly owned domestic subsidiaries own 100% of interests, controlling parent can make all transfer decisions for its own wholly owned subsidiaries.

To lack free transferability, possibility of impediment to transfer must exist;
and because all members are commonly controlled, consent to transfer not meaningful.

If memorandum had either prohibited transfer of an interest or provided for dissolution on transfer, it would have lacked free transferability.


5. Single Member LLC

Gen. Couns. Mem. 39,395 (August 5, 1985) classified a single beneficiary New York business trust "as an arrangement along the lines of a sole proprietorship that conducts business through an agent (the trustee)."

6. Procedure for private letter rulings

a. While the Service is considering revenue rulings on other LLC acts, it will accept and act upon requests for private letter rulings.

b. Rev. Proc. 89-12, 1989-1 C.B. 798, specifies the conditions under which the IRS will consider a ruling request on classification as a partnership.

The IRS has acknowledged that Rev. Proc. 89-12 does not fit an LLC very well. Nevertheless, it appears that an attempt to comply with Rev. Proc. 89-12 will be required until further notice. LLC private rulings continue to contain the following statement: "This ruling is subject to the requirements set forth in Rev. Proc. 89-12 . . . to the extent applicable. If the requirements of Rev. Proc. 89-12, to the extent applicable fail to be met at any time, this ruling will have no force or effect. E.g., Priv. Ltr. Rul. 9308039 (Dec. 2, 1992).

The IRS 1993 Business Plan includes the publication of a revenue procedure providing advance ruling guidelines for LLCs. I.R.S. News Release NB-2142, partnerships, item 6 (Jan. 5, 1993).
The IRS has stated that Section 4.07 of Rev. Proc. 89-12, dealing with the corporate characteristic of limited liability does not apply to LLCs. Gen. Couns. Mem. 39,798 n.3 (October 18, 1989).

c. Rev. Proc. 91-13, 1991-1 C.B. 477, amplifies Rev. Proc. 89-12 by providing a checklist of necessary documents and representations that must accompany a request for a private letter ruling on limited partnership classification. Although Rev. Proc. 89-12 states that "limited partnership" includes any other organization that limits the liability of any member for the organization's debts, the IRS has indicated that Rev. Proc. 91-13 is not applicable to a request on LLC classification.

d. LLC Tax Force of the ABA Section of Taxation has prepared for submission to IRS a proposed Revenue Procedure for LLCs analogous to Rev. Proc. 89-12 and a checklist for LLCs analogous to that in Rev. Proc. 91-13.

e. Rev. Proc. 92-87, 1992-42 I.R.B. 38, sets forth guidelines under which a limited partnership will be treated as lacking continuity of life and limited liability. It applies only to limited partnerships formed under a state limited partnership act that the IRS has determined in a published revenue ruling is a statute that corresponds to RULPA. Thus, it does not apply to LLCs.

B. Application of partnership tax principles

1. Organization

a. No gain or loss recognized to LLC or any member on the contribution of property to the LLC in exchange for an interest in the LLC. I.R.C. §721(a), except as provided in I.R.C. §752. Priv. Ltr. Rul. 9313009 (Dec. 17, 1992).

b. Basis of property contributed to LLC by a member equals the adjusted basis of such property to the contributing member. I.R.C. §723.

c. Basis of member's interest in LLC.

(i) Member's basis in his LLC interest is the amount of money and adjusted basis of property contributed. I.R.C. §§705, 722. For that purpose an increase in the member's share of liabilities of the LLC is treated as a contribution of money and a
decrease in the member's share is treated as a
distribution of money. I.R.C. §§752(a) and (b).

(ii) A member's share of LLC liabilities is
determined under the Section 752 regulations, with
different rules applicable to recourse liabilities and
nonrecourse liabilities.

(iii) Recourse liability. A member or related
person bears the "economic risk of loss" for that

(iv) Nonrecourse liability. No member or
related person bears the economic risk of loss for that

(v) As in the case of the allocation rules,
absent a member guarantee, all LLC debt should be
treated as nonrecourse debt.

2. Conversion

a. Partnership to LLC

(i) Rev. Rul. 84-52, 1984-1 C.B. 157
prescribed federal income tax consequences of
conversion of general partnership into limited
partnership and limited partnership into general
partnership.

(a) Exchange of interest in general
partnership for interest in limited partnership
will be treated as an exchange under I.R.C.
section 721, so that no gain or loss will be
recognized by partners under §§741 or 1001 except
under section 731.

(b) If business of converted entity will
continue after the conversion, then because under
Treas. Regs. §1.708-1(b)(1)(ii) a transaction
governed by I.R.C. section 721 is not a sale or
exchange under I.R.C. section 708, the converted
entity is not terminated.

Therefore, it should not be neces-
sary to obtain a new tax identification number for
the LLC, to remake various elections under
subchapter K, or file a short year tax return.
(c) If there is no change in partners' shares of liabilities under I.R.C. section 752, there will be no change to the adjusted basis of their interests in the entity.

(d) If there is a change in the partners' shares of liabilities and the change causes a deemed contribution of money or a deemed distribution of money, basis will be adjusted and gain may be recognized under I.R.C. section 731.

Since persons who were general partners will remain liable for obligations of the converted partnership, there should be no change in their share of the liabilities solely as a result of the conversion. Cf. Weiss v. Commissioner, 956 F.2d 242 (11th Cir. 1992). As the partnership liabilities are satisfied and new obligations

the partnership then distributes LLC interests to its partners in liquidation. E.g., Priv. Ltr. Rul. 9321047 (Feb. 25, 1993) (Pursuant to assignment and assumption agreement partnership contributes its assets to LLC in exchange for membership interests and assumption of partnership's liabilities.)

b. Corporation to LLC

(i) C corporation

Will be treated as a liquidation of the corporation.

(a) Gain or loss recognized to corporation on distribution of property as if property were sold to distributee at fair market value. I.R.C. §336(a).

On conversion of professional corporation to professional LLC, there may be a deemed distribution of "practice goodwill," as distinguished from "professional or personal goodwill." Christhart S. Schilbach v. Commissioner, 62 T.C.M. (CCH) 1201 (1991).

(b) Gain or loss recognized to shareholders. I.R.C. §331.

(ii) S corporation

(a) Corporate tax imposed on net recognized built-in gain. I.R.C. §1374(a).

(b) Gain or loss recognized to corporation on distribution of property as if property were sold to distributee at market value. I.R.C. §336(a).
I.R.C. §368(a)(1) is not applicable. “Party to a reorganization” includes only corporations. I.R.C. §368(b).

3. Pass-through rules

a. LLC is not subject to tax. I.R.C. §701

b. Members are liable for income tax in their individual capacities, each taking into account his distributive share of partnership items. I.R.C. §§701, 702(a).

c. Loss allowed only to extent of adjusted basis of partner’s interest in the partnership. I.R.C. §704(d).

4. Allocations

a. Under the I.R.C. section 704(b) regulations, generally allocations of income, gain, loss, deduction, or credit (or item thereof) will be respected if the allocation has substantial economic effect taking into account all facts and circumstances, is in accordance with the partner’s interest in the partnership, or is deemed to be in accordance with the partner’s interest in the partnership pursuant to one of the special rules. Treas. Reg. §1.704-1(b)(1)(i).

b. An allocation of an item of loss, deduction, or section 705(a)(2)(B) expenditure attributable to non-recourse liabilities (“nonrecourse deductions”) of the partnership cannot have economic effect and must be allocated in accordance with the partners’ interest in the partnership. Treas. Reg. §1.704-2(b)(1).

c. Regulations provide a test under which certain allocations of nonrecourse deductions will be deemed to be in accordance with the partners’ interest in the partnership. Treas. Reg. §1.704-2(e).

d. Nonrecourse liability of a partnership is a liability of the partnership (or portion thereof) for which no partner bears the economic risk of loss. Reg. §§1.704-2(d)(3), 1.752-1(a)(2).

e. Absent a guarantee by a member of an LLC obligation, or a member or related member as lender, all debt of the LLC should be treated as nonrecourse debt because no member will bear the economic risk of loss with
respect to the debt. That should include debt to which the general assets of the LLC are liable, such as trade debt, which is not ordinarily thought of as nonrecourse.

Debt that is recourse to a partnership as an entity but "explicitly not recourse to any partner" is referred to as "exculpatory liability." See preamble, Section V.A to the nonrecourse debt regulations, Treas. Reg. §1.704-2.

The preamble points out that the application of the nonrecourse debt rules, specifically the calculation of minimum gain, may be difficult in the case of exculpatory liability because the liability is not secured by specific property and the basis of the assets that can be reached by the creditor may fluctuate greatly. The regulations do not prescribe precise rules addressing the allocation of income and loss attributable to those liabilities, and they leave the taxpayer to treat allocations attributable to those liabilities in a manner that reasonably reflects the principles of I.R.C. section 704(b).

5. At Risk Rules

a. Generally, under I.R.C. section 465 in the case of individuals and certain closely held C corporations, a loss from activity subject to the section is allocable only to the extent of the aggregate amount with respect to which the taxpayer is at risk. I.R.C. §465(a)(1).

b. Except in the case of "qualified nonrecourse financing," a taxpayer is at risk with respect to amounts borrowed for use in an activity only to the extent that he is personally liable for repayment of such amounts, or has pledged property as security for the debt. I.R.C. §465(b)(2).

c. If a taxpayer guarantees repayment of an amount borrowed by another person for use in an activity, the guarantee does not increase the taxpayer's amount at risk. Even if the guarantor pays the debt, the amount at risk is not increased until the taxpayer has no remaining legal rights against the primary obligor. Prop. Treas. Reg. §1.465-6(d).

d. Exception for qualified nonrecourse financing.

(i) A taxpayer is considered at risk with respect to his share of any qualified nonrecourse
financing that is secured by real property used in the activity. I.R.C. §465(b)(6).

(ii) Qualified nonrecourse financing is debt with respect to which no person is personally liable for repayment. I.R.C. §465(b)(6)(B)(iii).

(iii) A partner’s share of qualified nonrecourse financing is determined on the basis of that partner’s share of partnership liabilities increased in connection with the financing within the meaning of Section 752. I.R.C. §465(b)(6)(C).

(iv) If the Section 752 definition of nonrecourse applies, since recourse liability exists only to the extent that any partner or related person bears the economic risk of loss, then debt secured by LLC real property that is not restricted to the security would be qualified nonrecourse financing. However, the at-risk rule, in addition to referring to the Section 752 test to determine a partner’s share of qualified nonrecourse financing, describes it as financing with respect to which "no person" (not merely no member or related person) is personally liable for repayment. I.R.C. §465(b)(6)(B)(iii). Jordan and Kloepfer, supra, at 208.

6. Limitations on Passive Activity Losses

a. Section 469 disallows a deduction for the passive activity loss of an individual, trust, estate, personal service corporation, and closely held C corporation. I.R.C. §469(a)(1)(A).


c. Passive activity means any rental activity and any activity that involves the conduct of any trade or business and in which the taxpayer does not materially participate. I.R.C. §469(c)(1).

d. A natural person may deduct up to $25,000 of passive activity losses attributable to all real estate activities with respect to which that individual actively participated during the year. I.R.C. §469(i)(1), (2).
e. Material participation.

Generally an individual is treated as materially participating in an activity for a taxable year if he meets one of seven tests: Temp. Treas. Reg. §1.469-5T(a) (1993).

(i) The individual participates for more than 500 hours;

(ii) The individual's participation constitutes substantially all of the participation of all individuals;

(iii) The individual participates for more than 100 hours, and that participation is not less than that of any other individual;

(iv) The activity is a significant participation activity and the individual's aggregate participation in all significant participation activities exceeds 500 hours;

(v) The individual materially participated for any 5 taxable years during the 10 immediately preceding taxable years;

(vi) The activity is a personal service activity and the individual materially participated for any 3 preceding taxable years; or

(vii) Based on all facts and circumstances, the individual participates on a regular, continuous and substantial basis.

f. Limited partner material participation.

(i) A limited partner is deemed to materially participate only by qualifying under tests (1), (5) or (6). Temp. Treas. Reg. §1.469-5T(e)(2) (1993). By contrast an S corporation shareholder may satisfy any of the 7 tests.

(ii) "Limited partner" is an individual whose liability for obligations of the partnership is limited, under the law of the state in which the partnership is organized, to a determinable fixed amount, such as capital contributions and contractual

(iii) A membership interest falls within the definition of a limited partnership interest.

Commentators have argued that manager-members should not be treated as limited partners for purposes of the material participation tests. Jordan and Kloepfer, The Limited Liability Company: Beyond Classification, 69 Taxes 203, 210 (1991).

A partnership interest is not treated as a limited partnership interest if the individual holder is a general partner at all times during the year. Temp. Treas. Reg. §1.469-5T(e)(3)(B)(ii) (1993). In the absence of a definition of "general partner" in the Section 469 regulations, they look to the definition under Rev. Proc. 89-12, which states that for organizations other than partnerships "general partner" will mean the members "with significant management authority relative to the other members." If that definition applied, then the interests of member-managers would not be treated as limited partners.

While the argument in favor of such a position by IRS is reasonable, it would seem to require an amendment of the regulations to reach that result.

g. Limited Partner active participation

Except as provided in regulations, no interest as a limited partner in a limited partnership shall be treated as an interest in which the taxpayer actively participates. I.R.C. §469(i)(6)(C).

7. Tax Matters Partner

a. Only a general partner may be designated by the partners as the "tax matters partner" for purposes of partnership audits. I.R.C. §6231(a)(7).

b. If there is no general partner, the IRS is authorized to designate the tax matters partner. I.R.C. §6231(a)(7).
c. The Code does not define a general partner. If the term is deemed to mean a partner with personal liability for the organization's liabilities, then in an LLC there will be no one whom the partners may designate. See Transpac Drilling Venture v. United States, 26 Cl.Ct. 1245 (1992), in which court held that limited partners who were designated as general partners for the "limited purpose only" of being tax matters partners did not qualify.

Compare Rev. Proc. 89-12, which defines "general partner" to include a person with "significant management authority relative to the other members."

d. IRS 1993 Business Plan includes proposed regulations under Section 6231 on designation of TMP for LLC. I.R.S. News Release NB-2142, partnership, item 6 (Jan. 15, 1993).

8. Method of Accounting

a. Generally, a taxpayer may compute taxable income under any of specified "permissible methods" of accounting, including cash or accrual. I.R.C. §446(c).

b. However, a "tax shelter" may not use the cash method. I.R.C. §448(a)(3).

c. I.R.C. section 448(d)(3) refers to section 461(i)(3) for the definition of "tax shelter," which means:

   (i) an enterprise (other than a C corporation) if at any time interests have been offered for sale in an "offer required to be registered" with any federal or state agency;

   (ii) any "syndicate" (within the meaning of section 1256(e)(3)(B)); and

   (iii) any "tax shelter" (as defined in section 6662(d)(2)(C)(ii)).

d. "Enterprise"

   (i) Registration requirement

   Offering is "required to be registered" if, under applicable federal or state law, failure to file a notice of exemption from registration would result in violation of applicable federal or state law

Virginia exempts from registration any sale of securities by issuer or registered broker-dealer on behalf of the issuer, if, after the sale, the issuer has not more than 35 security holders and if its securities have not been offered to the general public by advertisement or solicitation. Va. Code §13.1-514(B)(7). What about a professional LLC with at least 35 members? Depends on whether LLC membership interest is a "security," that is, is it an "investment contract" under the Howey facts and circumstances test?

Compare position in California, due to proposed amendment to Section 25019 of Corporate Securities Law, which would include most LLC interests in definition of "security".

(ii) In Priv. Ltr. Rul. 9321047, law firm LLC represented that it has not ever and will not ever offer any interest in itself for sale to the general public. Based on that representation, the LLC was held not to be an enterprise. See also Priv. Ltr. Rul. 9328005.

e. "Syndicate" means any partnership or other entity other than a C corporation if more than 35% of the losses of the entity during the taxable year are allocable to limited partners or limited entrepreneurs (as defined in I.R.C. section 464(e)(2)). I.R.C. §1256 (e)(3)(B).

(i) Losses allocable:

(a) Losses. "Losses" - means the excess of the deductions allocable to the enterprise over the amount of income recognized by the enterprise under its tax method of accounting, excluding gains or losses from the sale of capital assets or section 1221(2) assets. Temp. Treas. Reg. §1.448-1T(a)(4) (1993).

(b) "Allocable" - Regulations use "allocated" rather than "allocable." Temp. Treas. Reg. §1.448-1T(a)(4). Consequently, in a year in which an LLC has no "losses," it should not be a syndicate regardless of how allocable.
Cf. Priv. Ltr. Rul. 8911011 (Dec. 14, 1988), held that with respect to profit years, a limited partnership will not be a "syndicate" within I.R.C. section 1256(e)(3)(B) because "there will be no losses allocable to partners" whether limited or otherwise.

Priv. Ltr. Rul. 9321047 used "allocated" rather than "allocable" in paraphrase of the statute, but made no ruling on that point. Also Priv. Ltr. Rul. 9328005.

(ii) Classification of members to whom losses allocable.

An interest in any entity is not treated as held by a limited partner or a limited entrepreneur in five situations, including any period during which the interest is held by an individual who actively participates at all times during the period in the management of the entity or if the interest is held by an individual who actively participated in the management of the entity for a period of not less than five years. However, note that the interests must be held by an individual. That could create a problem for a professional LLC converted from partnership including professional corporations. I.R.C. §1256(e)(3)(C)(i), (iii).

In Priv. Ltr. Rul. 9321047, although the operating agreement provided for members to elect five managers as the management committee with authority to conduct business for the firm, it further provided that all members would be required to vote in order for the firm to take certain actions, including the following: election of members to the management committee and compensation committee; removal of a member from either committee; admission of a member or provisional member; dismissal of a member; amendment of the operating agreement; dissolution of the firm; major decisions; and approval of compensation committee recommendations subject to prescribed procedures.

Based on the representation that the members would continue to engage in the practice of law and participate in the various described management activities, it was held that the LLC will meet the active participation requirements.
In Priv. Ltr. Rul. 9328005, an executive committee will manage the LLC, but vote of all members is required for the LLC to take certain actions: admit or expel a member; determine compensation of members; make expenditures in excess of a specified amount; borrow funds in excess of a specified amount; open or close a branch office; change the name of the LLC or the location of its principal office; sell or otherwise dispose of all or substantially all of the assets of the LLC; dissolve the LLC; amend the agreement under which the LLC is operated.

In addition, "each member will, in varying degrees, participate in the following management activities attributable to the Business": handling client relations; supervising services provided to clients; billing, collecting, and negotiating fees; participating in business and practice development activities; staffing projects, including the selection and use of specialists; and supervising, training, and evaluating LLC employees.

Participation in the "various management activities set forth above" was held to constitute active participation.

Therefore, an LLC will not be a "syndicate" if either it has no losses, so that there are none to be allocated, or at least 65% of any losses are allocated to persons who actively participate in management and are consequently not limited partners or limited entrepreneurs.

f. Tax shelter within I.R.C. section 6662(d)(2)(C)(ii). Any arrangement whose principal purpose is the avoidance or evasion of federal income tax.

In Priv. Ltr. Rul. 9321047, based on representation that members will participate in management, will be organized to practice law, and will not be organized for any federal income tax avoidance motive, the LLC was held not to be a tax shelter. Also Priv. Ltr. Rul. 9328005.

g. Cash method is also not available for a partnership that has a C corporation as a partner. I.R.C. §448(a)1). However, for purposes of that rule, a qualified personal service corporation is treated as an individual, not a C corporation.
That exception is important to a professional partnership, including C corporations, that converts to an LLC.

9. Self-Employment Tax

a. Distributive share of any item of income or loss of a limited partner, as such, other than guaranteed payments for services is excluded from "net earnings from self-employment." I.R.C. §1402(a)(13).

b. Under what circumstances will an LLC member be treated as a limited partner for that purpose? Priv. Ltr. Rul. 9110003 (Nov. 29, 1990), held that strict compliance with the state limited partnership act was required for an inactive member of a partnership with limited management rights to qualify as a "limited partner" for purposes of the §1402(a)(13) exclusion. However, the result in that case does not necessarily indicate how IRS will treat an LLC member.

If all members treated are general partners, then even those who are passive investors will be subject to self-employment tax. If all are treated as limited partners, then even those who perform services and participate in management, will not have self-employment income.

The correct result is that only those members who are like passive investors should not have self-employment income.

c. Qualified Retirement Plans

For purposes of qualified retirement plans under I.R.C. section 401, "employee" includes "self-employed individual." I.R.C. §401(c)(1)(A). "Self-employed individual" means an individual who has "earned income." I.R.C. §401(c)(1)(B). "Earned income" means net earnings from self-employment (as defined in section 1126 and section 1402(a). I.R.C. §401(c)(2)(A). Deduction for contributions for self-employed individuals is based upon earned income. I.R.C. §404(a)(8). Thus, if all LLC members are treated as limited partners for purposes of section 1402(a)(13), their distributive shares that were not guaranteed payments could not be taken into account for purposes of calculating their retirement plan contributions.

10. Liquidation Payments.
Before the 1993 tax act, payments made in liquidation of the interest of a retiring partner or deceased partner attributable to good will and unrealized receivables could be treated as a distributive share or guaranteed payment that could give rise to a deduction or its equivalent. That special treatment has been repealed except with respect to payments made to a general partner in a partnership in which capital is not a material income-producing factor. I.R.C. §736(b)(3). The House Committee report makes clear the special rule was intended to preserve the prior law treatment for personal service businesses. However, in order to benefit personal service LLCs, the retiring or deceased member would have to be treated as a "general partner." I.R.C. §736(b)(3)(B). "General partner" is not defined, so it is an open question as to whether an LLC member will be included.

XVIII. State Taxation

A. Taxation of the entity

1. State Tax Classification Based Upon Federal Classification.

   a. LLC Act States

      (i) General conformity provision

      Under the Virginia conformity statute an LLC that is classified as a partnership for federal income tax purposes should be similarly treated for Virginia income tax purposes. Va. Code §58.1-301(A). Confirmed by P.D. 92-181 (9/10/92).

      Partners are liable for Virginia income tax only in their separate or individual capacities. Va. Code §58.1-390.

      Virginia partnership or partnership having income from Virginia sources is not required to file a Virginia tax return. Va. Code §58.1-392.

      (ii) Specific conformity provision.

      Georgia. LLC is classified as a partnership for Georgia tax purposes unless otherwise classified for federal income tax purposes. Ga. Code §14-11-1104.

North Carolina. An LLC is classified for state income tax purposes in the same manner as it is classified for federal income tax purposes. 1993 N.C. Sess. Laws 57C-10-06.

b. Non-LLC Act States

California. Until California legislation or regulations specifically address the issue, if an LLC is classified as a partnership for federal tax purposes, it will be so classified for California tax purposes. FTB Notice 92-5 (8/21/92). Required to file partnership return.


Mississippi. Foreign LLC is classified for state income tax in same manner as for foreign income tax purposes.

2. State Tax Classification Independent of Federal Tax Classification

a. Taxed as a corporation


b. Taxed as a partnership


Arkansas taxes an LLC with at least two members as a partnership and taxes the sole member of an LLC as a proprietorship. House Bill 1419, §1313.

3. General partnership or limited partnership

See Scott D. Smith, LLCs: What Are They, and What Are Their Implications for State Taxation (Part I), 4 State Tax Notes 1289, 1296 (May 31, 1993).
B. Taxation of members

If LLC does business in California, or otherwise generates California source income, both resident and nonresident members must file California tax returns and are taxable for their share of California source income.

LLC required to withhold taxes from non-resident members. Ga. Code §48-7-128.

C. Miscellaneous Taxes

1. Real estate transfer taxes
   a. Virginia
      (i) Transfers to and from 50% owned LLCs, exempt from recordation tax as in the case of partnerships. Va. Code §58.1-811(A)(10), (11).

2. Intangibles Tax on Distributions

   Open question whether Michigan will impose intangibles tax on distributions, as it does on S corporations, or whether they will not be so taxed, as in the case of partnership distributions. Gregory A. Nowak, Limited Liability Company Act Enacted, 4 State Tax Notes 1087 (May 10, 1993).
TAX PLANNING FOR DISPOSITIONS
OF REAL ESTATE

by

Charles H. Egerton