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COMMENTS

The Wyoming Limited Liability Company: a Viable Alternative to the S Corporation and the Limited Partnership?

The passive loss rule promulgated in the Tax Reform Act of 1986[1] materially alters the relative tax advantage offered by various Wyoming business structures including the limited liability company (LLC). The impact of this new rule raises the question whether the LLC now provides adequate advantage over some of these other business forms, particularly the S corporation and the limited partnership, to justify its increased use by Wyoming businessmen.

This comment explores that question and discusses how the application of the new rule, combined with limited liability, may result in some tangible advantages to the LLC under certain circumstances.

BACKGROUND

In 1977, the Wyoming state legislature enacted the Wyoming Limited Liability Act (Act) thereby creating a new and discrete business entity known as a limited liability company (LLC).[2] In simplest terms, the LLC can be described as a business form much like a partnership, complete with partnership tax advantages, yet providing liability protection for its members similar to that provided by a corporation.

The new business form has not yet been widely accepted by the business community.[3] Only twenty-six Wyoming LLCs existed in 1988.[4]

The Wyoming legislature created the LLC in response to a perceived need for an entity bearing less tax burden than the C corporation[5] yet

1. Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (1986).
2. Wyoming Limited Liability Company Act, 1977 Wyo. Sess. Laws ch. 158, § 1 (codified at WYO. STAT. §§ 17-15-101 to -136 (1977, Rev. 1987)).
3. In 1982, Florida legislators followed Wyoming's lead and created a similar type of limited liability company. Florida Limited Liability Company Act, FLA. STAT. ch. 608.401-471 (Supp. 1987). Their purpose in doing so was to promote a belief that the LLC would attract foreign business and capital to the state by providing a format similar to the South and Central American Limitada. In theory, South and Central American businessmen would flock to the new structure. Preliminary studies and committee reports had indicated a favorable climate for the entity. However, despite these projections, the limited liability company has not been particularly well received in that state either. Only two limited liability companies were actually formed within the first year after the enabling legislation was passed. Comment, *The Limited Liability Company Act*, 11 FLA. ST. U.L. REV. 387, 387-88 (1983).

A similar type of limited liability company was proposed in Alaska but failed to be passed into law. *Id.* at 387.

4. Telephone conversation with the Wyoming Secretary of State on February 22, 1988.
5. In reference to a corporation, the terms S or C pertain to its tax status. The S corporation avoids C corporation double taxation by qualifying as a "small business corporation". I.R.C. § 1361,1366 (1982).

providing more liability protection than a limited partnership.[6] The S corporation now meets this need. However, the S corporation was fairly limited before enactment of the Subchapter S Revision Act of 1982.[7] Consequently, it was not particularly attractive to many Wyoming investors and businessmen at the time. Thus, it was logical to seek a new form such as the LLC. However, the 1982 Revision Act has revised the S corporation into a much more useful entity.[8] To justify wider use, the LLC must compare favorably to the current S corporation as well as maintain a favorable comparison to the limited partnership.

THE WYOMING LIMITED LIABILITY COMPANY

The LLC is a three part hybrid exhibiting some corporate characteristics, some limited partnership characteristics, and some characteristics peculiar to itself. Despite the borrowed characteristics, however, the LLC was not intended to be simply another type of corporation or partnership. It is a truly discrete business form. The LLC is a pass-through tax entity, much like a partnership,[9] that offers limited liability[10] in the same fashion as a corporation. In these respects, it is aptly compared to the S corporation.

Like the S corporation and unlike the limited partnership, the LLC is a business entity complete unto itself. It is legally separate from its

6. The "limited partnership" is distinguished from the straight partnership in that it provides for a class of partner, the limited partner, that is not personally liable for partnership debts. WYO. STAT. § 17-14-403 (1977, Rev. 1987).

7. Subchapter S Revision Act of 1982, Pub. L. No. 97-354, 96 Stat. 1669 (1982).

8. Prior to 1982, the IRS allowed the S corporation a maximum of 25 shareholders. Shareholder participation exceeding this maximum caused termination of S corporation status. SENATE COMM. ON FINANCE, SUBCHAPTER S REVISION ACT OF 1982, S. Rep. No. 640, 97th Cong., 2d Sess. 9, *reprinted in* U.S. CODE, CONG. & ADMIN. NEWS 3259 [hereinafter S. Rep. No. 640]. Passage of the Subchapter S Revision Act of 1982 increased shareholder participation limits to 35. *Id.*

Before the Act, a difference in voting rights among shareholders also terminated Subchapter S status. *Id.* at 3260. The Act now provides for a difference in voting rights among shareholders. *Id.*

Direct shareholder loans to the S corporation also terminated the S corporation election if the IRS determined such loans were actually capital contributions. The Act created a "safe debt harbor" whereby qualifying loans would not be considered stock. *Id.* at 3259-60.

9. Corporate income is taxed prior to distribution to shareholders. I.R.C. § 11 (West Supp. 1987). Shareholders then pay individual taxes on this same income as it is distributed in the form of dividends. I.R.C. § 61(a)(7) (West Supp. 1987). By passing profits directly to the business owners, this double taxation is avoided. Such a pass-through tax scheme is utilized with the partnership and sole proprietorship. I.R.C. § 701(a) (1982). Thus, there is a tax advantage to IRS classification as a partnership and not a corporation.

However, the corporate tax structure may be preferable under some circumstances. These circumstances hinge upon the total amount of corporate income. The approximate tax rate is 20% on corporate incomes of $75,000 or less. I.R.C. § 11(b) (West Supp. 1987). Personal tax rates on the same amounts would be approximately 28%. I.R.C. § 1(c) (West Supp. 1987). Therefore, assuming the corporation does not distribute accumulated earnings and assuming the corporation is not subject to the undistributed earnings tax, it is sometimes preferable for the taxpayer to leave profits with the corporation as a sort of untaxed savings plan. Generally, a corporation is allowed to accumulate up to $250,000 in earnings before the undistributed earnings penalty applies. I.R.C. § 535(c)(2)(A) (1982).

10. WYO. STAT. § 17-15-113 (1977, Rev. 1987).

members.[11] The LLC may be sued but individual members, unless the statutory "veil of protection" is "pierced",[12] will not be named in the suit.[13]

Like both the Wyoming limited partnership and the S corporation, the LLC may be formed for any lawful purpose other than banking or insurance.[14]

LLC statutory powers are similar to those of the Wyoming corporation. The LLC may sue or be sued in its own name.[15] It may purchase, hold, and convey both real and personal property, also in its own name,[16] as well as lend money to or otherwise assist its members.[17] The LLC may purchase, hold, and use ownership interests of other business entities in the same capacity as that of an individual or corporation.[18] It may also enter into contracts or incur various other liabilities as well as invest and reinvest its funds.[19] Furthermore, the Act authorizes the LLC to conduct its business and carry on its activities in any state, territory, district or possession of the United States as well as in any foreign country.[20]

Liabilities incurred while exercising these authorized powers are not charged to the individual members.[21] The member risks only his remaining contribution. This limitation applies to tort liabilities as well as contractual obligations.[22] This protection, combined with its intended tax advantages, is the limited liability company's most enticing feature.

Unlike the S corporation, which has a potentially infinite existence, the LLC is limited to a thirty year lifespan.[23] However, membership participation is unlimited in the LLC. The Act places no restrictions on either the types, kinds, or quantities of members.[24]

Like both the Wyoming corporation and limited partnership, the LLC must maintain a registered office and agent within the state.[25] Changes in status must be filed with the Secretary of State.[26] Failure to do so results in the entity being considered defunct. All protections granted then cease to exist.[27]

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11. *Id.*
12. The issue of "piercing the LLC veil" has not yet been litigated. Thoughtful speculation, however, suggests that the possibility of such action exists and that the "LLC veil" is likely to be treated much like the "corporate veil" is treated.
13. WYO. STAT. § 17-15-114(a) (1977, Rev. 1987).
14. WYO. STAT. § 17-15-103 (1977, Rev. 1987).
15. WYO. STAT. § 17-15-104(a)(i) (1977, Rev. 1987).
16. WYO. STAT. § 17-15-104(a)(ii) (1977, Rev. 1987).
17. WYO. STAT. § 17-15-104(a)(iv) (1977, Rev. 1987).
18. WYO. STAT. § 17-15-104(a)(v) (1977, Rev. 1987).
19. WYO. STAT. § 17-15-104(a)(vi)-(vii) (1977, Rev. 1987).
20. WYO. STAT. § 17-15-104(a)(v) (1977, Rev. 1987).
21. WYO. STAT. § 17-15-113 (1977, Rev. 1987).
22. *Id.*
23. WYO. STAT. § 17-15-107(a)(ii) (1977, Rev. 1987).
24. WYO. STAT. § 17-15-106 (1977, Rev. 1987).
25. WYO. STAT. § 17-15-110 (1977, Rev. 1987).
26. WYO. STAT. § 17-15-111 (1977, Rev. 1987).
27. WYO. STAT. § 17-15-112 (1977, Rev. 1987).

Unlike S corporation or partnership management, LLC management vests proportionally to each individual member's capital contribution unless provided otherwise in the Articles of Organization.[28] Essentially, this statutory provision implies non-centralized management. However, the Act further provides that management authority may be vested in a single manager or group of managers instead of the members.[29] If this option is chosen, management becomes centralized. The Act thus provides for a choice of either centralized or non-centralized management. Other than the requirements that they be elected annually and hold office in accordance with the mandates of the members, the Act places no restrictions on the managers.[30] Therefore, the LLC management structure may parallel the corporate board of directors,[31] at least in substance if not exactly in form, if the members desire this format.

Ownership interests in the LLC are considered personalty.[32] They may be transferred or disposed of only as provided in the Articles of Organization or the regulations adopted by the members.[33] Consequently, transfer rights are inherently restricted. Upon transferral, the transferee does not necessarily gain the same rights, especially concerning management, as were held by the transferor. To participate in management, the transferee must have the unanimous written consent of all remaining members. The only statutory rights granted a transferee without this approval are the right to receive a proportionate share of profits and the right to a return of any contributions to which the transferring member would be entitled.[34]

Like with the corporation, capital contributions may be cash or property but not services.[35] They may not be withdrawn until all LLC liabilities are either settled or satisfactorily provided for.[36] In addition, all members must consent before withdrawal can be permitted.[37] However, this requirement may be waived if such waiver is specifically provided in the Articles of Organization.[38] Under some circumstances, a member may gain a return of his contribution by petitioning the courts for a dissolution of the company.[39]

Formation of a Wyoming LLC is quite simple. All that is necessary is to file Articles of Organization with the Secretary of State[40] and pay the required fees.[41] The procedure is similar to filing Articles of Incorpo-

28. WYO. STAT. § 17-15-116 (1977, Rev. 1987).
29. *Id.*
30. *Id.*
31. WYO. STAT. § 17-1-133(a) (1977, Rev. 1987).
32. WYO. STAT. § 17-15-122 (1977, Rev. 1987).
33. *Id.*
34. *Id.*
35. WYO. STAT. § 17-15-115 (1977, Rev. 1987).
36. WYO. STAT. § 17-15-120(a)(i) (1977, Rev. 1987).
37. WYO. STAT. § 17-15-120(a)(ii) (1977, Rev. 1987).
38. WYO. STAT. § 17-15-120(a)(iii) (1977, Rev. 1987).
39. WYO. STAT. § 17-15-120(d) (1977, Rev. 1987).
40. WYO. STAT. § 17-15-108 (1977, Rev. 1987).
41. Fees are set at $50.00 if starting capital is less than $50,000.00. $100.00 is charged if start up capital is between $50,001.00 and $100,000.00. For start up capital in excess of $100,000.00, fees are $100.00 plus $.50 per each additional $1000.00. WYO. STAT. § 17-15-132(a)(i) (1977, Rev. 1987).

ration.[42] Most other corporate type formalities are either dispensed with or greatly simplified.[43] This simplicity factor provides a major advantage to businesses either unwilling or unable to comply with rigid corporate formalities and other requirements.

THE S CORPORATION

As noted previously, the LLC can be readily compared to an Internal Revenue Code Subchapter S corporation.[44] While each have unique advantages and disadvantages, they are essentially negative images of each other. An S corporation is a corporation that has been granted the pass-through taxation characteristic of a partnership,[45] while the LLC can be described as a partnership granted corporate limited liability for its members. The most important points of similarity are that both enjoy limited liability for its participants as well as pass-through tax advantages.

Although widely used, the S corporation has several disadvantages. One is that shareholders may not exceed a maximum of thirty-five.[46] Another is that the corporation loses Subchapter S status if nonresident aliens, other corporations, partnerships, or most trusts are allowed to hold its shares.[47] For some businesses, a further disadvantage is that only one class of stock is permitted.[48] Rigid corporate formalities required to maintain Subchapter S status may also pose problems for smaller businesses. However, these drawbacks are not likely to be detrimental to most businesses that would seek Subchapter S status.

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42. WYO. STAT. § 17-1-203 (1977, Rev. 1987).

43. Corporate formalities entail shareholder meetings, minutes, voting, and legal separation between shareholders and directors. WYO. STAT. §§ 17-1-125-133 (1977, Rev. 1987). Small businesses often feel overburdened and uncomfortable with these formalities.

44. The S corporation is defined in I.R.C. §§ 1361-1375 (1982 & Supp. III 1985).

45. Congressional rationale for establishing the S corporation includes a belief that a business should be able to select its most appropriate form without consideration of tax consequences. Fulk & Needham v. United States, 288 F.Supp. 39, 46 (D.C. 1968), *aff'd*, 411 F.2d 1404 (4th Cir. 1968). I.R.C. § 1366(a)-(b) (1982) (pass-through taxation).

46. I.R.C. § 1361(b)(1)(A) (1982). A husband and wife holding stock together in an S corporation count as one shareholder. I.R.C. § 1361(c)(1) (1982). *But see* Hicks Nurseries, Inc. v. Commissioner, 517 F.2d 437, 440 (2d Cir. 1975) (when a husband and wife each hold stock separately and not as co-owners, they count as two shareholders).

47. I.R.C. § 1361(b)(1) (1982). Essentially, only individuals and estates may continually hold shares in an S corporation. An estate may hold shares only for a limited time. If this period is exceeded, the IRS considers the estate a testamentary trust and terminates the Subchapter S election. Old Virginia Brick Co. v. Commissioner, 367 F.2d 276, 280 (4th Cir. 1966). The only trusts allowed to hold shares in an S corporation continually are those with a sole present beneficiary. Prop. Treas. Reg. § 1.1361-1(A)(h)(i); 51 Fed. Reg. 35661-63 (1986). Many corporations are also ineligible for Subchapter S election. Those ineligible are primarily banks and insurance companies. I.R.C. § 1361(b)(2)(B)-(C) (1982).

48. I.R.C. § 1361(b)(1)(D) (1982). Rights to profits and assets must be identical for all shareholders. S. Rep. No. 640 *supra* note 8, at 3260. Consequently, with a few exceptions, the IRS permits only one class of stock. The major exceptions are the straight debt safe harbor and the fact that voting rights may be differentiated. A straight debt safe harbor allows the shareholder to loan money to the S corporation and not have the loan considered a capital contribution. I.R.C. § 1361(c)(5)(B) (1982).

These S corporation disadvantages are not inherent to the LLC. Membership is unlimited, both as to quantity and to type.[49] Stock limitations are inapplicable because the LLC does not issue stock. Ownership rights associated with the LLC may vary according to contractual arrangement. Also, formation and continuation of the LLC is a much simpler procedure than that required for the S corporation. As noted previously, most formalities are dispensed with.[50] Other than this simplicity factor, however, these disadvantages are not major considerations for most businesses. Nonetheless, circumstances exist where they may make an LLC significantly more attractive than the S corporation.

THE LIMITED PARTNERSHIP

The LLC may also be compared to the limited partnership, especially the limited partnership with a corporate general partner. Both entities enjoy pass-through tax advantages. However, significant differences exist between the two forms.

Liability protection in a limited partnership varies depending on whether the member is a limited or general partner. Limited partners are liable only to the extent of their capital contributions, while general partners are virtually unprotected from liability.[51] In contrast, all LLC members are protected equally regardless of status or any other differences.[52]

If the general partner in a limited partnership is a corporation, its individual shareholders are afforded the same protections granted shareholders of any corporation. As a separate legal entity, the corporation itself may be found liable but the shareholders are insulated and therefore protected.[53] This particular arrangement thus extends limited liability to all individual participants in the limited partnership. However, this particular arrangement is also self defeating in the sense that individual shareholders of the corporate general partner do not completely enjoy the tax advantages of a pass-through entity.[54] Profits accruing to the general partner are double taxed to the shareholder. Nonetheless, a limited partnership with a corporate general partner is the partnership most similar to the LLC.[55]

Another difference between the two forms is that management rights are more restricted in a limited partnership than in an LLC. If limited partners participate in management, they are considered general partners

49. Formation of a LLC requires two or more "persons". Wyo. Stat. § 17-15-106 (1977, Rev. 1987). "[Person] includes individuals, general partnerships, limited partnerships, limited liability companies, corporations, trusts, business trusts, real estate investment trusts, estates, and other associations." WYO. STAT. § 17-15-102(a)(iv) (1977, Rev. 1987).

50. *See generally, supra* note 43.

51. WYO. STAT. § 17-14-503(a) (1977, Rev. 1987).

52. WYO. STAT. § 17-15-113 (1977, Rev. 1987).

53. WYO. STAT. § 17-1-122 (1977, Rev. 1987).

54. *See generally, supra* note 9. However, if the general partner's profit share is insignificant, the actual evil caused by this tax becomes minimal.

55. Corporate general partners are subject to a minimum capitalization requirement. Rev. Proc. 72-13, 1972-1 C.B. 735. The IRS has announced that similar regulations may eventually apply to the LLC. I.R.S. Ann. 83-4, 1983-2 C.B. 31.

and risk losing liability protection.[56] In contrast, all LLC members may participate in management and still maintain limited liability. The only restriction is that such rights must be proportional to their individual contributions unless provided otherwise in the Articles of Organization.[57] Simply stated, protection from liability in the LLC is not predicated upon the degree of management undertaken by the member as it is in the limited partnership. This factor provides an advantage to the LLC in the event the investor chooses to involve himself in management.

THE PASSIVE LOSS RULE AS PROMULGATED WITH THE TAX REFORM ACT OF 1986

The new advantage to the LLC lies in its application to the passive loss rule now promulgated in the 1986 Tax Reform Act.[58] This rule is one of the Act's most significant provisions. It was primarily drafted to eliminate certain tax shelters.[59] These shelters employ losses from heavy paper deduction businesses to offset gains and income from more productive enterprises as well as salaries and wages. Their purpose is to keep the taxpayer's current income within an acceptable bracket and amount. The passive loss rule now makes it more difficult to employ this technique by separating passive from active income and allowing passive losses to be deducted only from passive income.[60]

In explanation, a passive gain is simply any gain which is not active. An active gain is a gain derived from an activity in which the taxpayer materially participates.[61] Material participation is participation which is regular, continuous, and substantial.[62] Factors relevant to determining what are regular, continuous, and substantial activities include whether the activity is the taxpayer's principal business, whether the location of the business is proximate to his residence, and whether the activity is within the taxpayer's particular area of expertise.[63]

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56. If the limited partner participates in "control" of the limited partnership, he becomes personally liable for the obligations of the limited partnership. WYO. STAT. § 1714-403(a) (1977, Rev. 1987). This is the trade-off for protection from liability. However, the limited partner may be employed by the limited partnership, and may advise the general partner. WYO. STAT. § 17-14-403(b)(i),(ii) (1977, Rev. 1987).

57. WYO. STAT. § 17-15-116 (1977, Rev. 1987).

58. Tax Reform Act of 1986, Pub. L. No. 99-514, § 501, 100 Stat. 2085, 2233-44 (1986) (to be codified at I.R.C. § 469).

59. *Id.* at 2233.

60. I.R.C. § 469(a) (West Supp. 1987). If passive deductions exceed passive gains in any given year, the taxpayer may carry those deductions forward into future years. I.R.C. § 469(b) (West Supp. 1987). But still, those passive deductions carried forward may only be deducted from future passive gains. *Id.* However, the taxpayer may deduct carryover passive losses from active income if a complete disposal is made of the passive activity. I.R.C. § 469(g)(1)(A)(i)-(iii) (West Supp. 1987). The passive loss statute provides special rules for rental business activities as well as oil and gas interests. I.R.C. § 469(c)(1),(2) (West Supp. 1987).

61. *See* I.R.C. § 469(c)(1) (West Supp. 1987).

62. I.R.C. § 469(h)(1) (West Supp. 1987).

63. Passive Activities Loss Limitations, 5 Fed. Taxes (P-H) ¶ 20,649.71 (1988). An example of material participation is provided in the situation of an employee of an nonrelated business managing a ranch. Even though not performing day-to-day physical work, he makes management decisions concerning personnel, sales of livestock, etc. Such management decisions constitute adequate involvement to establish material participation. *Id.* at ¶ 20,746-Z.34.

Because most taxpayers derive their income from active sources, generally either wages or a salary, losses offsetting most income must now come from active investments. Thus, an investment vehicle is more advantageous to the average investor if it can be construed as active.[64] The trade-off, however, is that most active investments do not offer limited liability. The closely held C corporation shareholder, although enjoying limited liability, cannot take advantage of corporate losses without selling his interest in the entity.[65] This fact greatly diminishes any tax advantages provided by an investment in the closely held C corporation.

Interests belonging to the limited partner in a limited partnership are passive both by definition and by statute.[66] The passive loss rule applies and losses, even though passed through to the partner, cannot be deducted from active income. Therefore, for the average investor, there is no longer a tax advantage to the limited partnership. If the limited partner becomes active to avoid the rule, which usually entails management, he is construed to be a general partner and subject to full partnership liability.[67] In the limited partnership, the investor must trade liability protection for any potential tax advantage if the entity suffers a loss.

Under the passive loss rule, the LLC provides the best of both worlds. The taxpayer/investor may be classified as active by materially participating in management yet still maintain complete liability protection.[68] If a loss occurs, the LLC investor is able to deduct this loss from his active income. The 1986 Tax Reform Act passive loss rule provides a strong basis for a renewed interest in the LLC.

However, the investor in an S corporation also enjoys the best of both worlds because the Passive Activity Loss statute does not apply to this entity.[69] The IRS treats S corporation shareholders individually in passive/active determinations. The relevant test is whether the shareholder "materially participates".[70] If he "materially participates", the IRS construes the shareholder as active. Consequently, he will be allowed to deduct any pass-through losses from his active income yet still maintain corporate liability protection.

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64. Example: If the total salary income of an investor equals $100,000 and if this particular investor has two investments, one providing an active gain of $10,000 and the other a loss of $20,000, his tax liabilities will vary greatly under the 1986 Tax Act depending upon whether his loss is active or passive. If passive, his total tax liability is based upon an income of $110,000. ($100,000 + $10,000 − 0 = $110,000) The passive loss may not be deducted from active income. If the loss is active, his total tax liability is based upon an income of $90,000. ($100,000 + $10,000 − $20,000 = $90,000).

65. I.R.C. § 1001(c) (1982). Losses on such a sale can be deducted from active income because C corporation stock transactions are considered portfolio income and the passive loss rule does not apply to portfolio income. *See* I.R.C. § 469(a) (West Supp. 1987).

66. I.R.C. § 469(i)(6)(C) (West Supp. 1987).

67. WYO. STAT. § 17-14-403(a) (1977, Rev. 1987).

68. WYO. STAT. § 17-15-113 (1977, Rev. 1987).

69. I.R.C. § 469(a)(2) (West Supp. 1987).

70. I.R.C. § 469(a),(c)(1)(B) (West Supp. 1987).

ACCEPTANCE OF THE WYOMING LLC

With only 26 Wyoming LLCs currently existing, it is obvious that the new business form has not been widely accepted. While any number of reasons for this reluctance may exist, the most probable hinge upon uncertainties associated with the entity's most important advantages, limited liability and pass-through tax treatment.

Legal precedent pertaining to these advantages is nonexistent. To date, neither the format, protections, nor tax status of the Wyoming LLC has been litigated. The investor must rely on his own interpretation of the statutes and regulations pertaining to the entity without the benefit of judicial guidance.

The largest gray area centers around LLC liability protection concerns. Will the Act be rigidly and literally upheld thus providing a strong shield for LLC members, or will the LLC "veil of protection" be "pierced" like that of the closely held corporation? Until this issue is tested in the courts, it remains to be seen whether the LLC provides either more or less protection than the limited partnership or the S corporation. Satisfactory resolution of this question is critical because much of the LLC's potential advantage is conditioned upon liability protection.

Corporate shareholders, like LLC members, are statutorily protected from personal liability.[71] However, based on public policy arguments, courts have been willing to "pierce the corporate veil" where equity demands it be done.[72] It is a logical assumption that they may do the same with the LLC. Without judicial precedent, however, the extent to which this common law doctrine may apply to the LLC is uncertain. Nevertheless, by analogizing the LLC to the corporation, some reasonable probabilities emerge.

Certain criteria must be firmly established to "pierce" the "corporate veil". These stem from the principle that shareholders should be personally liable for corporate obligations when the two entities have such a "unity of interest" that "separateness" has ceased and that it would be unjust to continue with the fiction of separate existence.[73] Such "unity of interest" is implied in the presence of one or all of the following four factors: inadequate capitalization,[74] a commingling of shareholder and corporate assets,[75]

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71. WYO. STAT. § 17-1-122 (1977, Rev. 1987).
72. AMFAC Mechanical Supply Co. v. Federer, 645 P.2d 73, 77 (Wyo. 1983).
73. *Id.* (quoting Arnold v. Brown, 27 Cal. App. 3d 386, 103 Cal. Rptr. 775, 781 (1972)).
74. A corporation is inadequately capitalized when its net assets are clearly insufficient to carry out its intended purposes. However, if a justifiable business reason for such inadequate capitalization exists, this factor does not indicate that the corporation is merely an alter ego for its shareholders. *AMFAC*, 645 P.2d at 79-80; Note, *A Prima Facia Case for Piercing the Corporate Veil*, 18 LAND & WATER L.REV. 823, 832 (1982).
75. A shareholder commingles corporate funds when he treats them as his own. *AMFAC*, 645 P.2d at 78 (quoting *Arnold* 103 Cal. Rptr. at 781-82). Generally, withdrawals of corporate assets must be properly approved, documented, and kept separate from the shareholders' private assets. *Id.* Commingling shows a disregard for the fiction of a separate entity as well as injures creditors who have justifiably relied on those corporate assets. *Id.*

a subordination of creditors' debts to those of shareholders,[76] and a disregard for corporate formalities.[77] Policy rationales underlying the first three factors may make them applicable to the LLC as well as to the corporation. However, the fourth factor, rigid adherence to corporate formalities, is not applicable because the LLC has statutorily dispensed with requirements for such formalities.[78]

While it is certain that the S corporation is subject to the "piercing of the corporate veil" doctrine and it is possible that the LLC may not be, the corporate shareholder has the advantage of certainty. He knows where he stands on this issue and can plan and act accordingly.

Even though the individual LLC member is clearly protected in Wyoming, at least within the parameters discussed above, it is questionable whether the same statutory protection will be upheld in other states. In choice of law problems, it is speculative whether a foreign jurisdiction will grant limited liability to members of an LLC if it neither recognizes nor uses the form.[79] The individual member is potentially liable virtually any time the LLC engages in interstate business because, currently, foreign jurisdictions include all other states but Florida.[80] As there is no precedent, it is not even certain that Florida will recognize the Wyoming LLC or protect its members.

An argument in favor of limited interstate liability is that the LLC complies closely enough to each jurisdiction's corporate structure to be classified there as a corporation for liability purposes. However, the predictable success of this argument is uncertain, as well as contradictory, because most arguments pertaining to the LLC speak of it as a discrete entity and not a corporation. It is possible, if not probable, that the foreign jurisdiction would accept these same arguments and classify the entity as non-corporate. The only sure way for the LLC and its members to avoid liability in foreign jurisdictions is to transact all business within the State of Wyoming. This practice is too restrictive and impractical for most businesses. Uncertainty surrounding this issue is likely be a major stumbling block to investors contemplating the Wyoming LLC.

Another reason investors may be unwilling to accept the LLC is the degree of uncertainty regarding its actual tax status. Without congressional action, the IRS cannot classify the LLC as a unique entity. Congress is not likely to address this issue. So far, even though it has the

76. Courts consider the subordination of general creditors to shareholder creditors to be an abuse of the corporate entity. *Id.* at 81.

77. *See generally, supra* note 43.

78. A rigid adherence to corporate formalities can be a double-edged sword. The businessman who faithfully abides by these requirements may be shielded because the court is then more apt to find the corporate entity truly separate. *AMFAC*, 645 P.2d at 79. But the businessman who fails to comply with these formalities risks having the court construe his corporation as an alter ego and, therefore, subject to "piercing the corporate veil". To the extent that corporate formalities are not germane to the LLC, that particular businessman may be better protected with the LLC.

79. Mertz v. Mertz, 271 N.Y. 466, 3 N.E.2d 597, 598 (1936).

80. Comment, *supra* note 3, at 387.

power to do so, the IRS has been unwilling to classify the LLC as a partnership.[81] This is critical because much of the LLC's potential advantage lies within its tax status. If the LLC is classified as either a corporation or an association,[82] it becomes subject to double taxation thereby losing one of its major advantages. Because the IRS has not ruled on the issue, the businessman/investor is left in limbo.

Congress contributes to this uncertainty by referring to the "corporation" in its statutes yet never precisely defining the term.[83] Although Wyoming statutorily defines the LLC as other than a corporation, the IRS is not precluded from reclassification since state classification is not determinative.[84] In fact, the state of Florida taxes its limited liability companies as corporations.[85] The IRS has refused to elevate form over substance and, short of Congressional action, makes its own classification and tax scheme decisions regardless of other statutory classifications.[86]

Currently, the Kintner regulations[87] provide the criteria used by the IRS in making corporate status determinations.[88] These regulations consist of six characteristics common to the corporation which serve to distinguish it from other business entities. Only four of these particular characteristics are relevant in distinguishing a corporation from a partnership. These four are the attributes of limited liability, free transferability of interests, a provision for central management, and continuity of life.[89] Presently, all characteristics are weighted equally.[90] Applying these regulations, the IRS will only classify an organization as an association or corporation if the organization has more corporate than non-corporate characteristics.[91]

Under the Kintner test, the LLC would be classified as a partnership, at least for tax purposes, because it does not have more corporate than non-corporate characteristics.[92] A change in the status of a member causes dissolution of the LLC.[93] Because of this provision and because it is limited to a lifespan of thirty years, it does not have continuity of life, a corporate characteristic.[94] Because a member may not transfer management

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81. LLCs have been taxed as partnerships. Priv. Ltr. Rul. 81-06-082 (Nov. 18, 1980) (LLC found to be a partnership). Private letter rulings, though, have no precedential value and the IRS is not prospectively bound. I.R.C. § 6110(j)(3) (1982).
82. Treas. Reg. § 301.7701-2 (as amended in 1983).
83. The term "corporation" includes associations, joint stock companies, and insurance companies. I.R.C. § 7701(a)(3) (1982).
84. Treas. Reg. § 301.7701-1(c) (as amended in 1977).
85. Comment, *supra* note 3, at 395.
86. Treas. Reg. § 301.7701-1(c) (as amended in 1977).
87. Treas. Reg. § 301.7701-2 (as amended in 1983).
88. *Id.*
89. *Id.*
90. Larson v. Commissioner, 66 T.C. 159, 185 (1976).
91. *Id.* at 172.
92. *Id* at 185.
93. WYO. STAT. § 17-15-123(a)(iii) (1977, Rev. 1987).
94. WYO. STAT. § 17-15-107(a)(ii) (1977, Rev. 1987). Dissolution as provided in WYO. STAT. § 17-15-123(a)(iii) (1977, Rev. 1987) satisfies the explicit language of Treas. Reg. § 301.7701-2(b)(1) (as amended in 1983).

rights without unanimous consent of the other members, he is not able to freely convey his entire interest in the LLC.[95] Consequently, ownership interests are not freely transferable, another corporate determinant.[96] However, by statute, LLC members may elect either central or non-central management.[97] The respective choice, therefore, may be either corporate or non-corporate.[98] But either choice does not affect LLC status under the Kintner regulations because even if combined with limited liability, the only remaining corporate characteristic, there can only be a maximum of two corporate characteristics. This number is insufficient to classify the LLC as a corporation.[99]

However, there is no absolute certainty that the IRS will follow the Kintner regulations even though they have been consistently applied since 1936.[100] Like most federal administrative agencies, the IRS has substantial discretion in the application and construction of its own regulations. Despite the longevity of these regulations, it could take a different approach. It may be argued that any other approach would be an abuse of discretion and that the IRS would not be likely to take it.[101] Notwithstanding this argument, the issue of tax status could be determined by some standard other than the Kintner regulations. This uncertainty, plus the fact that IRS regulations can be enforced retroactively,[102] causes tax planning problems for many businessmen considering the LLC.

APPLICATION

Despite uncertainties, the LLC is now the most advantageous Wyoming business structure for certain applications. The following hypothetical scenario demonstrates one such possible situation:

A wealthy Wyoming part-time investor, possibly a physician or other professional, decides that a wholly intrastate commuter bus service should be his next venture. The plan is to cater especially to skiers travelling to Jackson, Wyoming from various locations throughout the state. Our investor believes that, under his management, the enterprise will eventually show a profit but is likely to show a paper loss for the first few years because of depreciation on busses and other equipment. This loss aspect is considered important because of its potential to offset his already high income.

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95. WYO. STAT. § 17-15-122 (1977, Rev. 1987).

96. Restrictions of this kind on the free transferability of interests satisfies the explicit language of the treasury regulation. Treas. Reg. § 301.7701-2(e)(1) (as amended in 1983).

97. Wyo. Stat. § 17-15-116 (1977, Rev. 1987).

98. Treas. Reg. § 301.7701-2 (as amended 1983).

99. *Larson*, 66 T.C. at 185.

100. The distinguishing characteristics of a corporation were first set out by the *Morrissey* Court in 1935. Morrissey v. Commissioner, 296 U.S. 344, 352-60 (1935).

101. Helvering v. R.J. Reynolds Tobacco Co., 306 U.S. 110, 116 (1939) (The Court refused to give retroactive effect to a regulation disrupting settled law that had been implicitly approved by Congress and had been relied upon by the taxpayer).

102. I.R.C. § 7805(b) (1982) (IRS regulations may be given retroactive effect).

He proposes to raise initial capital through several different avenues. The first is to invest his own funds. The second is to solicit funds from an investment partnership to which he belongs. A third is to invest assets of a trust set up for his children. The last, and most necessary, is to attract outside investors. Fortunately, several have expressed an interest. One is a local corporation willing to provide both cash and advertising but demanding a disproportionate share of profits as well as management participation. Another is an unincorporated ski club consisting of thirty-six local skiers willing to make small individual investments just to see the project get off the ground. These skiers have no interest in management, but would like to receive reasonable returns on their investments.

Due to large capital requirements, our investor cannot afford to refuse any of these financial resources. However, ownership interests will need to be distinguished to accomodate these varying demands and conditions.

Additionally, our investor has some unique business needs himself. Because he is wealthy and wants to protect his personal assets, he needs liability protection. His requirements are even more stringent for this particular enterprise because he intends to manage. Also, as a physician or other professional, most of his personal income is derived from active participation in his business. Consequently, he needs an investment vehicle that can offset active income should the investment show a loss. Conversely, if the enterprise shows a profit, he wants to avoid double taxation. Thus, a pass-through tax entity is desirable.

To proceed, our investor needs a business structure that will be attractive and accomodating to these varying potential investors yet will fulfill his own needs adequately.

The C corporation is ill-suited to this enterprise because it is not a pass-through tax entity, one of our investor's primary requirements.

The limited partnership is also inappropriate for a number of reasons. Most importantly, our investor is not afforded liability protection because he will be involved in management. If he decides not to manage, he becomes a limited partner and unable to deduct anticipated early losses from his active income.

The S corporation structure, even though providing adequate liability protection and favorable tax consequences, is unavailable for this particular enterprise because a corporation, partnership, and a trust will be among those investing. Also, over thirty-five potential shareholders are involved. Moreover, the S corporation cannot distinguish ownership interests as demanded by these investors.

None of the above mentioned restrictions apply to the Wyoming LLC. The impact of inherent uncertainties is reduced as well. Choice of law problems are greatly diminished because the enterprise is conducted wholly intrastate. Potential problems concerning "piercing the veil" adhere to the S corporation and the limited partnership as well as to the LLC so the LLC member is not exclusively disadvantaged in this respect. These facts show the LLC to be especially well suited to a venture of this type.

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CONCLUSION

For the Wyoming businessman contemplating the LLC, the phrase "proceed at your own risk" takes on new meaning. Despite some attractive incentives, there are two major disincentives to the form. Those disincentives are uncertainty over the degree of liability protection actually provided by the LLC and uncertainty over its tax status. Until these issues are resolved, the average businessman is well advised to consider the limited partnership or the S corporation.

However, some Wyoming businessmen would find the LLC advantageous even prior to resolution of these uncertainties. For them, positive aspects of the entity overshadow possible detriments and inherent risks. Generally, these situations occur where the limitations of the S corporation or limited partnership make these structures either inappropriate or unavailable, and the investor feels that the risks of possible liability or unfavorable tax treatment are not severe enough to justify abandoning his enterprise.

Moreover, minus the LLC, the sole proprietorship and the straight partnership are the only options realistically available should the S corporation, the limited partnership, and the C corporation be either inappropriate or unavailable. The LLC is highly advantageous to these two remaining forms in that neither offer liability protection. Therefore, under circumstances similar to those in the above hypothetical, the Wyoming businessman is well advised to consider the Wyoming LLC. For him, the LLC is indeed a viable business form.

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