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PARTNERSHIP TAXATION & THE LIMITED LIABILITY COMPANY: Check Out the Check-the-Box Entity Classification[1]

I. INTRODUCTION

On December 18, 1996, the Internal Revenue Service (Service) published the "check-the-box" entity classification regulations[2] which became effective January 1, 1997.[3] Commentators, tax planners and practitioners enthusiastically support these regulations.[4] The check-the-box regulations replaced the traditional Kintner regulations,[5] which spanned four decades of confusion, inconsistencies, and frustration. The new regulations allow eligible entities to elect their classification status for federal tax purposes,

1. The authors would like to acknowledge the invaluable assistance and guidance of Jeffrey Anthony, Esq., C.P.A.

2. The Internal Revenue Code prescribes certain categories into which various organizations fall for purposes of taxation in Treas. Reg. § 301.7701-1(b) (as amended by 61 Fed. Reg. 66,584 (1996)). These categories, or classes, include associations (which are taxable as corporations), partnerships, and trusts. The tests, or standards, which are to be applied in determining the classification in which an organization belongs (whether it is an association, a partnership, a trust, or other taxable entity) are determined under the Internal Revenue Code. Sections 301.7701-2 to 4 of the Treasury Regulations set forth these tests, or standards, which are to be applied in determining whether an organization is (1) an association (*see id.* § 301.7701-2), (2) a partnership (*see id.* § 301.7701-3), or (3) a trust (*see id.* § 301.7701-4).

3. Treas. Reg. § 301.7701 (as amended by 61 Fed. Reg. 66,584 (1996)).

4. William D. Bagley, *The IRS Steps Back: Entity-Classification Rules Are Relaxed*, BUS. LAW TODAY, Jan.- Feb. 1997, at 41; Evan S. Blanco and Richard C. Doernberg, *What One Hand Giveth, the Other Taketh Away: The Proposed Check-The-Box Regulations and the Proposed Section 1441 Regulations*, 96 TNI 16-11, (1996); Marc M. Levy and Richard D. Teigan, *International Implications of 'Check-the-Box,'* 85 J. TAX'N 261 (1996); Gary M. Harden, *Attorney Praises 'Check-the-Box' Entity Classification Proposal*, 95 TNI 109-15, June 7, 1995; American Bar Association Section of Taxation, *ABA Tax Lawyers Embrace 'Check-the-Box' Proposal and Say Extended It to Foreign Organizations*, 95 TNI 144-4, July 27, 1995; Sheryl Stratton, *Commendations and Concerns Cited At Check-the-Box Hearing*, 96 TNI 165-7, Aug. 23, 1996; and Mark L. Harmon, *Federal Income Tax Considerations Related to Limited Liability Companies Including Check-the-Box*, 388 PLI/TAX 1145 (1996).

5. The decision in United States v. Kintner, 216 F.2d 418 (9th Cir. 1954), resulted in the promulgation of the four-factor corporate resemblance test: (1) continuity of life, (2) centralization of management, (3) limited liability, and (4) free transferability of interest. *See infra* note 32 and accompanying text.

unless the entity is identified as a per se corporation.[6] The adoption of check-the-box regulations by the Service simplifies entity classification for federal tax purposes.[7]

This comment focuses on how the recently adopted check-the-box regulations directly affect Wyoming limited liability companies. It discusses the evolution of the traditional four-factor test and how the test deteriorated over the last forty years, leading to the adoption of the check-the-box regulations. Additionally, this comment analyzes the advantages and disadvantages of the check-the-box regulations and how the regulations affect existing limited liability statutes. The analysis provides recommendations to practitioners working with the check-the-box regulations. The final section discusses the recent amendment to the Wyoming Limited Liability Company Act in response to the check-the-box regulations and proposes additional amendments the Wyoming Legislature should consider.

II. BACKGROUND

Brief History of the Limited Liability Company

The business entity known as the limited liability company (LLC)[8] combines the benefits of limited liability with the more favorable income tax consequences of a partnership.[9] The number of limited liability com-

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6. Treas. Reg. § 301.7701-2 (as amended by 61 Fed. Reg. 66,584 (1996)) defines "corporations," for federal tax purposes, to include corporations denominated as such under applicable law, as well as associations, joint-stock companies, insurance companies, organizations that conduct certain banking activities, organizations wholly-owned by a state, organizations that are taxable as corporations under provisions of the Code other than section 7701(a)(3), and certain organizations formed under the laws of a foreign jurisdiction.

7. The new regulations apply to all entities regardless of classification rules promulgated by individual states. For example, even though a single member limited liability company is not allowed by many state statutes, the Service now specifically provides that the entity will be disregarded for federal tax purposes unless a single-member entity elects corporate classification. Treas. Reg. § 301.7701 (as amended by 61 Fed. Reg. 66,584 (1996)). *See, e.g.*, Limited Liability Company Act Amendments of 1997, H. Enrolled Act 99, 54th Leg. (Wyo. 1997) (to be codified as amended at WYO. STAT. ANN. § 17-15-144(d)). Thus, there could be inconsistencies in the tax treatment of the entity by individual states and by the Service.

8. *See generally* WILLIAM D. BAGLEY & PHILIP P. WHYNOTT, THE BETTER ALTERNATIVE: THE LIMITED LIABILITY COMPANY (1991) (explaining the LLC); LARRY E. RIBSTEIN & ROBERT R. KEATINGE, RIBSTEIN AND KEATINGE ON LIMITED LIABILITY COMPANIES (1996) (introducing LLCs and the state statutes); JEROME P. FRIEDLANDER, II THE LIMITED LIABILITY COMPANY (1994) (explaining the LLC); Allan G. Donn et al., *Organization and Operation of the Limited Liability Company: Substantive Issues*, PRAC. L. INST. 149 (1996) (explaining the LLC); J. WILLIAM CALLISON AND MAUREEN A. SULLIVAN, LIMITED LIABILITY COMPANIES: A STATE-BY-STATE GUIDE TO LAW AND PRACTICE (1994) (introducing LLCs and the state statutes); Jerome P. Friedlander, II, *A Limited Liability Company Checklist*, 42 FED. LAW. 29 (1995) (discussing LLC issues); Carol Mayo Cochran, *Key LLC Issues & Answers*, 1996 WL 9338497 (1996) (discussing LLC issues).

9. The advantage of partnership income tax treatment is the pass-through system from the

panies has increased dramatically since 1988.[10] This growth is due to the proffered advantages of limited liability, with minimal formalistic procedural requirements, combined with partnership tax treatment.[11] Although the LLC is not the best choice for every type of business, it should be considered whenever an entity is being formed.[12]

Although a similar entity had existed in other countries since the nineteenth century, the LLC did not exist in the United States until 1977, when Wyoming adopted an LLC act at the request of an oil and gas exploration company.[13] The company was familiar with Panamanian law and was looking for a state that would adopt a similar statute, providing limited liability and more flexibility within the entity while retaining partnership tax benefits. The company approached Wyoming with model legislation, which the legislature adopted in 1977.[14] After Wyoming's adoption of the LLC statute (WLLCA), the company formed the first

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entity to the owners. The partnership is not taxed on its income, rather, the partners are taxed on the income they receive. The corporation is taxed on its income and then the shareholders are taxed on any dividends received without the corporation receiving a deduction, a system known as double taxation. *See infra* note 29 and accompanying text.

10. In 1988, there were approximately thirty LLCs formed in Wyoming, whereas in 1997, there are more than one-hundred formed every month. Telephone Interview with Jeanne Sawyer, Deputy Secretary of State, Wyoming Secretary of State's Office (Feb. 19, 1997).

11. The LLC is similar to the S Corporation without the additional rigorous federal regulations. For example, the S Corporation, which establishes a maximum of 70 shareholders on the company, requires shareholders to be a person and limits the company to one type of stock. The rules and regulations regarding S Corporations can be found at I.R.C. §§ 1361-1399 (West 1997). *See generally* Mark P. Altieri, *Considerations in Determining Whether to Elect S Corporation or LLC Status*, Tax Adviser Sept. 1996 at 547 (discussing the advantages and disadvantages of each type of entity); Stuart Levine et al., *Tax Aspects of Limited Liability Companies, Limited Liability Partnerships, and Other Novel Entities*, Q249 A.L.I.-A.B.A. 45 (1996) (comparing the various entities' tax attributes).

12. Due to the current statutory limitations on transferability and continuity of life, universal use of LLCs for larger businesses is precluded. *See* Kathleen King Parker, *The Limited Liability Company: An Introduction*, 39 BOSTON B.J. 8 (1995); Dennis S. Karjala, *Planning Problems in the Limited Liability Company*, 73 WASH. U. L.Q. 455 (1995); Altieri, *supra* note 11, at 547.

13. The origin of the LLC is attributed to German law. It was established in 1892, and was known as Gesellschäft mit beshcrankter Haftung. WILLIAM D. BAGLEY & PHILIP P. WHYNOTT, THE BETTER ALTERNATIVE: THE LIMITED LIABILITY COMPANY 1.500 (1991). Other countries used the German Act to adopt their own limited liability laws. The first United States LLC law was a mixture of German and Panamanian laws. *Id.* at 1.451.

14. Wyoming Limited Liability Company Act (WLLCA), WYO. STAT. ANN. §§ 17-15-101 to -144 (Michie 1977 & Supp. 1996). Along with limited liability, the Wyoming LLC has four other mechanical characteristics: (1) use of the word limited in the entity's name, (2) granting of full juristic personality, (3) control of admission of new members to the LLC, and (4) dissolution upon the death of a member. BAGLEY, *supra* note 13. Although the benefits of the LLC were numerous, its popularity was diminished by the degree of formality required to organize under the Wyoming Act. Subsequently, the Wyoming Legislature amended the Act to provide for election of more flexible requirements than the default LLC allow. The current WLLCA provides for a flexible LLC to be elected. WYO. STAT. ANN. § 17-15-144 (Michie Supp. 1996). *See* note 128 and accompanying text.

American LLC and requested a ruling on tax treatment by the Service.[15] In 1980, the Service issued a ruling granting the company partnership treatment, but the next day the Service issued proposed regulations that generally taxed *all* entities with limited liability as associations.[16] Thus, the Service's tax treatment of the LLC limited its effectiveness as a business organization since its major attraction was limited liability with *partnership* tax treatment.

Wyoming continued its pursuit of a favorable tax ruling for its LLC entity. In 1988, the Service issued Revenue Ruling 88-76, granting partnership treatment to Wyoming LLCs for federal income tax purposes.[17] The ruling made LLCs a more effective choice for those wanting to form a business entity.[18] No longer did each company have to receive an individual Service ruling granting partnership treatment. Instead, an LLC properly formed under the Wyoming Limited Liability Company Act (WLLCA) automatically received partnership tax treatment by the Service.[19]

Soon after Revenue Ruling 88-76, other states began enacting LLC statutes. Ultimately, every state adopted LLC acts.[20] Each state's statute has unique features, creating fifty ways to form an LLC in the United States.[21] Due to concerns regarding this diversity and the increase in multi-state transactions, the National Conference of Commissioners on Uniform State Laws appointed a drafting committee to promulgate a uniform act in late 1991.[22] In 1994, the Uniform Limited Liability Company Act (ULLCA) was approved by the National Conference of Commissioners.[23] The ULLCA is a flexible act[24] with a

15. BAGLEY, *supra* note 13.

16. *Id.* The company never took advantage of the entity it formed for this ruling, because of the proposed regulations. Under I.R.C. § 7701(3) (West 1997) an association is taxed as a corporation.

17. Rev. Rul. 88-76, 1988-2 C.B. 360.

18. *See generally* Joseph P. Fonfara and Corey R. McCool, *The Wyoming Limited Liability Company: A Viable Alternative to the S Corporation and the Limited Partnership*, 23 LAND & WATER L. REV. 523 (1988) (discussing the benefits of the Wyoming LLC).

19. The automatic treatment was the result of the WLLCA having "bulletproof" structure. Thus, following the facts set out in Rev. Rul. 88-76, 1988-2 C.B. 360, an LLC would receive partnership tax treatment.

20. *See* App., State LLC Statutes.

21. For example, an LLC formed in Delaware may have only one member, whereas an LLC formed in Connecticut must have two or more members. *See* CONN. GEN. STAT. § 34-101(9) (1996) and DEL. CODE ANN. tit. 6, § 18-101(6) (1996).

22. UNIFORM LIMITED LIABILITY COMPANY ACT, 6A U.L.A. 425, 427 (1995) (hereinafter "U.L.L.C.A."). *But see* Larry E. Ribstein, *A Critique of the Uniform Limited Liability Company Act*, 25 STETSON L. REV. 311 (1995) (criticizing the ULLCA and disputing the need for a uniform act). Multi-state transactions occur when companies do business in states other than the state of organization.

23. U.L.L.C.A., *supra* note 22, at 427.

comprehensive set of default rules used in creating an LLC operating agreement.[25] Although most states had previously adopted LLC statutes, the Commission felt that the wide degree of variance among state provisions and the ensuing need for uniformity would encourage states to adopt the ULLCA.[26] To help states with pre-existing LLC statutes, the ULLCA provided for extensive transition rules from existing state law to the ULLCA.[27] Regardless of what act an LLC is formed under (whether the WLLCA or the ULLCA), the primary goal of an LLC is to protect the members with limited liability without the harsh double taxation of a corporation.[28]

Tax Treatment of the Corporation Versus a Partnership

Under the old regulations, federal income tax classification was a primary concern in business planning due to the different tax consequences associated with corporations and partnerships. The classification of an entity determined whether the entity received partnership pass-through tax treatment or whether the entity received corporate double taxation treatment. Classification regulations came into existence because entities were acting like corporations, but claiming partnership status to avoid double

24. Allan G. Donn et al., *Organization and Operation of the Limited Liability Company: Substantive Issues*, PRAC. L. INST., 149, 159-60 (1996). The words "bulletproof" and "flexible" are used to define the extent to which the statute satisfies the Service's four-part entity classification rules. *Id.* A bulletproof statute requires that the organizing LLC complies with the limitations on continuity of life and free transferability of interests. *Id.* Therefore, an LLC organized pursuant to a bulletproof statute would be classified as a partnership for federal income tax purposes. The flexible statute allows for more choice in the LLC agreement, but will still result in partnership treatment. *Id.* Traditionally, the flexible statute requires more caution by the organizing entity to ensure that the LLC will in fact receive partnership tax treatment.

A recent addition to the WLLCA is a provision that allows for a company to elect to be a flexible limited liability company. The flexible LLC election allows the entity (to change in the operating agreement) choices with: (1) the transfer of a member's interest, (2) the continuity of life, and (3) the minimum number of members. The single-member amendment to this section allows for the existence of a single-member LLC if elected in the articles and established in the operating agreement. WYO. STAT. ANN. § 17-15-144 (Supp. 1996) & Limited Liability Company Act Amendments of 1997, H. Enrolled Act 99, 54th Leg. (Wyo. 1997) (to be codified as amended at WYO. STAT. ANN. § 17-15-144 (d) and (e)).

25. Donn, *supra* note 24.

26. *See* Carter G. Bishop, *The Uniform Limited Liability Company Act: Summary & Analysis*, 51 BUS. LAW. 15 (1995).

27. U.L.L.C.A. § 1205. The framework of § 1205 and comment provides that LLCs organized prior to the effective date of the ULLCA provisions will be governed by the prior act unless the LLC elects to be treated under the ULLCA provisions. *Id.* The section also provides for the amendment of the operating agreement to comply with the ULLCA provisions. *Id.* LLCs organized after the adoption of the ULLCA provisions are governed under those provisions. *Id.*

28. Although an S Corporation election eliminates the harsh tax treatment, it fails to alleviate the restrictions and formalities of the corporation.

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tax treatment.[29] Due to the significant differences in the tax treatment of an entity, the classification rules evolved in order to aid in determining whether an entity should be classified as a corporation regardless of form.

Development of the Kintner Regulations

The old entity classification regulations,[30] known as the Kintner regulations, were a codification of a United States Supreme Court decision, *Morrissey v. Commissioner,*[31] and a United States Ninth Circuit Court of Appeals opinion, *United States v. Kintner.*[32] In *Morrissey,* the Court formulated a corporate "resemblance test" to determine whether an entity should be classified as an association.[33] The corporate resemblance test consisted of six "salient features" of an association: (1) created and maintained with the objective of carrying on a business enterprise and sharing in the profits; (2) corporation members operate as associates; (3) opportunity for centralized management; (4) continuity of life; (5) free transferability of interests; and (6) limited liability of members.[34] The Court in *Morrissey* applied these principles and held that a twenty-five year trust created to construct, develop, own and operate golf courses was taxable as a corporation for federal tax purposes.[35] The Court held that the trust possessed three corporate characteristics: limited liability, transferability of interests, and continuity of life.[36] More generally, these six

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29. William D. Bagley, *The IRS Steps Back: Entity-Classification Rules Are Relaxed,* BUS. LAW TODAY Jan.-Feb. 1997, at 41. According to I.R.C § 11(a) and § 61(a)(7) (West 1997), generally a tax is imposed on the income of the corporation and a tax is imposed on dividends distributed as ordinary income to the shareholders. Furthermore, shareholders are not liable for losses of the corporation, and the corporation is entitled to deduct its own losses subject to carryback and carryforward rules. *Id.* Additionally, the corporation does not receive a deduction for dividends distributed. I.R.C. § 701 (West 1997) states: "A partnership shall not be subject to the income tax imposed by this chapter. Persons carrying on business as partners shall be liable for income tax only in their separate or individual capacities." *Id.* In contrast to the corporate tax scheme, the income of a partnership is passed-through to the partners based on their pro rata share of the partnership's income. I.R.C. §702(a) (1997). Thus, the partnership itself is not subject to any tax liability as the tax implications pass-through to the respective partners. Any losses proportionate to the partners' shares pass-through to the partners and generally are deductible by the individual partners, unlike the shareholders of a corporation who are not individually responsible. *Id.* Furthermore, the implication of tax treatment of corporations led to the proliferation of limited liability companies. Bagley, *supra,* at 42.

30. Treas. Reg. § 301.7701-2 (1960).

31. 296 U.S. 344 (1935).

32. 216 F.2d 418 (9th Cir. 1954).

33. *Morrissey,* 296 U.S. at 349 (stating that the term "corporation" includes associations, joint-stock companies, and insurance companies). The Court stated that an "'association' implies associates. It implies the entering into of a joint enterprise, and, as the applicable regulations imports, an enterprise for the transaction of business." *Id.*

34. *Id.* at 359.

35. *Id.*

36. *Id.* at 360. The Court applied the corporate resemblance test to determine that the trust constituted an association, stating that, "those who took a beneficial interest became shareholders in

factors provided the foundation for the four-factor test which the Service promulgated and continued to use prior to the adoption of the check-the-box regulations.[37]

The *Kintner* court refined the *Morrissey* holding. The issue in *Kintner* was whether an entity should be treated as a corporation.[38] Unlike *Morrissey*, the taxpayer in *Kintner* wanted the entity to be classified as a corporation,[39] whereas the Service attempted to classify the entity as a partnership.[40] Applying the *Morrissey* factors, the Ninth Circuit Court of Appeals determined that the organization had more corporate characteristics than non-corporate characteristics and held that the entity was an association with corporate tax status.[41] The Service's defeat resulted in the promulgation of the Kintner Regulations for entity classification in 1960.[42]

Nature of the Kintner Regulations

The promulgation of the Kintner regulations indicated that the Service's position had shifted, allowing for more flexibility in classifying an entity as a partnership rather than a corporation.[43] The Kintner regulations incorporated the *Morrissey* corporate "resemblance test,"[44] but promulgated its own four-factor test.[45] The regulations reduced the six "salient factors" to four because the Service recognized that the "associates" factor and the "objective to carry on business and divide the gains" factor were essential characteristics of all organizations engaged in businesses for profit.[46] The remaining four factors included: continuity of

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the common undertaking to be conducted for their profit," "the arrangement vested the management and control in the trustees," "essentially a business enterprise," and that the "arrangement provided for centralized control, continuity, and limited liability, and the analogy to corporate organization was carried further by the provision for the issue of transferable certificates." *Id.*

37. Treas. Reg. § 301.7701-2(a)(1) (1960).

38. *Kintner*, 216 F.2d at 421.

39. *Id.* at 420-21. The entity was an organization formed by eight physicians who wanted corporate tax treatment in order to maintain larger pensions and profit sharing deductions. *Id.*

40. *Id.* The Service contended that the entity should be a partnership because the practice of medicine is personal, and that a corporation cannot engage in such practice. The court stated that, as a general rule, a corporation cannot practice medicine. *Id.*

41. *Id.* at 422.

42. Stephen B. Scallen, *Federal Income Taxation of Professional Associations and Corporations*, 48 MINN. L. REV. 603, 671 (1965). A more appropriate label would be "anti-Kintner Regulations," since the Service promulgated the regulations in opposition to the holding in the *Kintner* case.

43. Susan Pace Hammill, *The Taxation of Domestic Limited Liability Companies and Limited Partnerships: A Case for Eliminating the Partnership Classification Regulations*, 73 WASH. U. L.Q. 497, 572 (1995). The regulations provided more favorable treatment of partnerships because they only required three of the four factors to be classified as a corporation, whereas less than three resulted in partnership treatment. Thus, this resulted in more partnership classifications. *Id.*

44. *See supra* notes 33-34 and accompanying text.

45. Treas. Reg. § 301.7701-2 (1960).

46. Treas. Regs. § 301.7701-2(a)(2) (1960).

life, centralization of management, limited liability, and free transferability of interests.[47] Furthermore, the regulations formulated a rigid test for determining whether an entity would be classified an association:

> An unincorporated organization shall not be classified as an association unless such organization has more corporate characteristics than noncorporate characteristics. In determining whether an organization has more corporate characteristics than noncorporate characteristics, all characteristics common to both types of organizations shall not be considered.[48]

Therefore, weighting each factor equally, if the entity lacked two of the four characteristics it would be classified as a partnership and given pass-through tax treatment. If the entity had three of the four characteristics, it would be classified as an association and given double taxation treatment.[49] Thus, because the number of corporate characteristics was the determining factor, the Kintner regulations apparently valued form over substance.

> Since associates and an objective to carry on business for joint profit are essential characteristics of all organizations engaged in business for profit (other than the so-called one-man corporation and the sole proprietorship), the absence of either of these essential characteristics will cause an arrangement among co-owners of property for the development of such property for the separate profit of each not to be classified as an association . . . On the other hand, since associates and an objective to carry on business and divide the gains therefrom are generally common to both corporations and partnerships, the determination of whether an organization which has such characteristics is to be treated for tax purposes as a partnership or an association depends on whether there exists centralization of management, continuity of life, free transferability of interests, and limited liability.

Id.

47. Treas. Reg. § 301.7701-2(a)(1) (1960).

> The term "association" refers to an organization whose characteristics require it to be classified for purposes of taxation as a corporation rather than as another type of organization such as a partnership or a trust. There are a number of major characteristics ordinarily found in a pure corporation which, taken together, distinguish it from other organizations. These are: (i) associates, (ii) an objective to carry on business and divide the gains therefrom, (iii) continuity of life, (iv) centralization of management, (v) liability for corporate debt limited to corporate property, and (vi) free transferability of interests. Whether a particular organization is to be classified as an association must be determined by taking into account the presence or absence of each of these corporate characteristics . . . . An organization will be treated as an association if the corporate characteristics are such that the organization more nearly resembles a corporation than a partnership or trust.

Id.

48. Treas. Reg. § 301.7701-2(a)(3) (1960).

49. An LLC always possesses limited liability. Therefore an LLC had to lack at least two of the remaining three corporate resemblance factors in order to be classified as a partnership. Prior to the check-the-box regulations, business planners focused their attention and energy on avoiding corporate characteristics. *See supra* notes 47 and accompanying text.

The Traditional Four-Factor Test and LLC's

According to the Kintner regulations, if an LLC satisfied three of the four factors, it would be taxed as an association.[50] Conversely, if the LLC satisfied less than three factors it would be taxed as a partnership.[51] Because of the pass-through taxation of a partnership, most entities preferred partnership classification.[52] The Service released Revenue Procedure 95-10 in December of 1994, to provide its interpretation of how the classification rules should apply to LLCs.[53]

Continuity of Life

For tax planning purposes, the operating agreement or articles of organization of an LLC needed to include a provision which lacked continuity of life. According to the Service's Kintner regulations:

> An organization has continuity of life if the death, insanity, bankruptcy, retirement, resignation, or expulsion of any member will not cause a dissolution of the organization. On the other hand, if the death, insanity, bankruptcy, retirement, resignation, or expulsion of any member will cause a dissolution of the organization, continuity of life does not exist . . . .[54]

The regulation stated that any alteration in the identity of an organization which changed the relationship between its members constituted a dissolution under the regulations.[55] Additionally, under Revenue Procedure 95-

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50. Treas. Reg. § 301.7701-2(a)(3). "An unincorporated organization shall not be classified as an association unless such organization has more corporate characteristics than noncorporate characteristics. In determining whether an organization has more corporate characteristics than noncorporate characteristics, all characteristics common to both types of organization shall not be considered. For example, if a limited partnership has centralized management and free transferability of interests but lacks continuity of life and limited liability, and if the limited partnership has no other characteristics which are significant in determining its classification, the limited partnership is not classified as an association." *Id.*

51. *Id.*

52. Some entities with an abundance of revenue will want to shield personal taxation by retaining earnings within a corporate structure, instead of having the revenue pass-through.

53. Rev. Proc. 95-10, 1995-1 C.B. 501 (stating that member-managers are treated as general partners for purposes of entity classification). *See also* Susan Pace Hammill, *The Taxation of Domestic Limited Liability Companies and Limited Partnerships: A Case for Eliminating the Partnership Classification Regulations*, 73 WASH. U. L.Q. 497, 588 (1995) .

54. Treas. Reg. § 301.7701-2(b)(1) (1960).

55. Treas. Reg. § 301.7701-2(b)(2) (1960).

10, "dissolution events" were events which triggered a dissolution (e.g. death, insanity, bankruptcy, retirement, resignation, or expulsion).[56]

Since the entity classification regulations did not mention application to LLCs, Revenue Procedure 95-10 attempted to clarify the application of the regulations with respect to LLCs. The Service identified two circumstances when it would rule that an LLC lacked continuity of life. If an LLC's operating agreement or articles of organization provided for dissolution according to the dissolution events by any (1) member-manager of the LLC or (2) by any member; without further action of the members, unless the LLC was continued by the consent of not less than a majority in interest of the remaining members, then generally the LLC lacked continuity of life.[57] Under the Kintner regulations, an operating agreement needed to provide that a dissolution event was applicable to all the member managers and not to just one named manager.[58] Likewise, if the agreement was applicable to any member it had to apply to all members of the LLC.[59] Additionally, the LLC would lack continuity of life if the operating agreement or articles of organization selected less than all of the dissolution events, or chose only one of the events, as long as members clearly established in the ruling request that the events, or event, selected provided for a meaningful possibility of dissolution.[60]

Centralization of Management

Centralized management under the Kintner regulations existed when "any person (or any group of persons which does not include all the members) had continuing exclusive authority to make the management decisions necessary to the conduct of the business for which the organization was formed."[61] Furthermore, according to the regulations the manager may or may not have been a member of the organization who was elected, appointed by proxy, or by other means of concentrating management authority to make decisions.[62] It was essential that the person or group had continuing exclusive authority to make independent business decisions on behalf of the entity without the required ratification of any of the members.[63] The regulations specifically stated that, "there is not centralized management when the centralized

56. Rev. Proc. 95-10 § 5.01(1), 1995-1 C.B. 501.
57. Rev. Proc. 95-10 § 5.01(1)-(2), 1995-1 C.B. 501.
58. *Id.* § 5.01(1), 1995-1 C.B. 501.
59. *Id.* § 5.01(2), 1995-1 C.B. 501.
60. *Id.* § 5.01(4), 1995-1 C.B. 501.
61. Treas. Reg. § 301.7701-2(c)(1) (1960).
62. *Id.* § 301.7701-2(c)(2) (1960).
63. *Id.* § 301.7701-2(c)(3) (1960).

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authority is merely to perform ministerial acts as an agent at the direction of the principal."[64]

According to Revenue Procedure 95-10, if an LLC left the management responsibilities exclusively to members without designating managers, the Service generally would rule that the LLC lacked centralized management.[65] Conversely, where designated or elected managers performed management responsibilities, the Service would not rule that the LLC lacked centralized management "unless the member-managers in the aggregate own[ed] at least 20 percent of the total interests in the LLC."[66] However, this was not a hard and fast rule. If the entity satisfied the twenty percent requirement, the Service would look at the facts and circumstances surrounding the members' control over the member-managers and make a determination based on the evidence in determining whether the LLC lacked centralized management.[67]

In summary, LLCs run by managers elected by the members generally possessed the corporate characteristic of centralized management. However, the Service would scrutinize the facts and circumstances in determining whether an LLC possessed centralized management when unelected managers were also members. Thus, prior to the check-the-box regulations, if the LLC wanted to avoid the centralized management characteristic, the operating agreement had to provide for exclusive member management.

Limited Liability

In general, LLCs always possess the corporate characteristic of limited liability.[68] Limited liability is the primary consideration in forming an LLC in order to shelter partners from liability of debts and obligations incurred by the entity. The Kintner entity classification regulations provided that:

> An organization has the corporate characteristic of limited liability if under local law there is no member who is personally liable for the debts of or claims against the organization. Personal liability means that a creditor of an organization may seek personal satisfaction from a member of the organization to the extent that the

64. *Id.*
65. Rev. Proc. 95-10 § 5.03(1), 1995-1 C.B. 501.
66. *Id.* § 5.03(2), 1995-1 C.B. 501.
67. *Id.*
68. *Id.* § 5.04, 1995-1 C.B. 501.

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assets of such organization are insufficient to satisfy the creditor's claim.[69]

According to Revenue Procedure 95-10, an LLC lacked the characteristic of limited liability if one member assumed personal liability for all obligations of the LLC.[70] However, the Service scrutinized such an agreement very closely, requiring that the assuming member(s) have an aggregate of at least ten percent of the total contributions to the LLC, which was expected to continue throughout the life of the LLC.[71]

Free Transferability of Interests

The Kintner regulations provided that an entity had the corporate characteristic of "free-transferability of interest" if:

> [E]ach of its members or those members owning substantially all of the interests in the organization have the power, without the consent of other members, to substitute for themselves in the same organization a person who is not a member of the organization . . . . Thus, the characteristic of free transferability of interests does not exist in a case in which each member can, without the consent of the other members, assign only his right to share in profits but cannot so assign his rights to participate in the management of the organization.[72]

If any member or member-manager owned more than twenty percent of the total interest in the LLC, that member could not transfer his interest to any non-member, without the consent of the majority of the LLC members.[73] Under the Kintner regulations, if an LLC operating agreement strictly prohibited free transferability by any member or member-manager, this characteristic would be avoided.[74]

The four-factor test defined in the Kintner regulations was eliminated by the adoption of the check-the-box regulations. Pursuant to the check-

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69. Treas. Reg. § 301.7701-2(d)(1) (1960).
70. Rev. Proc. 95-10 § 5.04, 1995-1 C.B. 501.
71. *Id.*
72. Treas. Reg. § 301.7701-2(e)(1) (1960).
73. Rev. Proc. 95-10 § 5.02(1)-(2), 1995-1 C.B. 501.
74. *Id.* § 5.02(4), 1995-1 C.B. 501. Provided there was meaningful consent, "the Service will not rule that the LLC lacks free transferability of interests unless the power to withhold consent to the transfer constitutes a meaningful restriction on the transfer of the interests. For example, a power to withhold consent to a transfer is not a meaningful restriction if the consent may not be unreasonably withheld." *Id.*

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the-box regulations, an entity can possess all four of the factors and still be afforded partnership treatment. The adoption of the check-the-box regulations eliminates the need for a business planner to manipulate the factors. The new regulations allow the taxpayer to choose an entity tax status regardless of the characteristics provided in the structure of the entity.[75]

Check-the-Box Regulations

In 1995, the Service issued Notice 95-14,[76] stating that it was considering a simplification of the entity classification rules under Section 7701. After much debate and discussion between practitioners and the Service, the Service issued Proposed Regulations and subsequently finalized them in December of 1996,[77] effective January 1, 1997.[78] The new regulations replaced the four-factor test with either a default or elective classification system known as "check-the-box." These regulations simplify entity classification, allowing the entity to elect its tax treatment.

The adoption of the new regulations will notably simplify tax and business planning regarding classification of business.[79] However, there are two issues facing LLC practitioners with the adoption of the check-the-box regulations.[80] The first issue is the effect the new regulations will have on existing LLCs. The second issue is the consequences of the check-the-box regulations for the formation of new LLCs.

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75. It is extremely important to note that if an entity classified as a corporation were to elect partnership tax treatment, it will be treated as a liquidation under the tax code, subject to all taxes associated with that event. *See infra* note 133 and accompanying text. Thus, if an LLC was previously classified as a corporation, electing partnership treatment would require considerable deliberation. *Id.*

76. I.R.S. Notice 95-14, 1995-1 C.B. 297.

77. Treas. Reg. § 301.7701 (as amended by 61 Fed. Reg. 66,584 (1996)). The debate primarily revolved around three issues: the single-member LLC, definition of "limited liability" and the extension of the check-the-box scheme to foreign entities. *See* Public Comments on Proposed Regulations, Notice 95-14, 1995-14 I.R.B. 7; Sheryl Stratton, *Commendations and Concerns Cited at Check-the-Box Hearing*, 96 TNI 165-7 (1996).

78. Treas. Reg. § 301.7701 Prefatory Note (as amended by 61 Fed. Reg. 66,584 (1996)).

79. Although the regulations significantly simplify the classification for new entities, they also ease the classification of an existing entity inasmuch as the Service will not be analyzing the continued classification of a company. *See* Treas. Reg. § 301.7701-3 (as amended by 61 Fed. Reg. 66,584 (1996)).

80. This comment focuses on the regulations as they pertain to domestic LLCs, assuming the LLC is an eligible entity. Issues regarding non-eligible entities or foreign entities are not discussed. *See generally* Marc M. Levey & Richard D. Teigen, *International Implications of 'Check-the-Box,'* 85 J. TAX'N 261 (1996) (explaining the effect of the check-the-box regulations on foreign entities); Roger F. Pillow et al., *Check-the-Box Proposed Regs. Simplify the Entity Classification Process*, 85 J. TAX'N 72 (1996) (clarifying the check-the-box regulations and some of the unanswered planning issues).

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The regulations that pertain to domestic LLCs are rather straightforward. First, the LLC must be a separate taxable entity.[81] If the organization is not a separate taxable entity, then the regulations do not apply.[82] Considered next is whether the organization is a business entity or a trust.[83] If the organization is considered a business entity, the regulations apply to determine the tax treatment.[84] Finally, whether the entity is an eligible for partnership tax treatment is considered.[85] Final resolution is determined by whether the entity existed prior to the effective date of the check-the-box regulations.[86]

Pre-existing LLCs

If an LLC was a domestic, eligible entity previously classified under the Kintner regulations as a partnership, then the LLC would automatically retain its partnership status for federal income tax purposes.[87] If the LLC desires to be taxed as an association, then it can elect association status by checking the box on the classification form. Thus, unless an LLC would like to be taxed as a corporation, no action is necessary to retain its partnership classification.[88]

81. Treas. Reg. § 301.7701-1 (as amended by 61 Fed. Reg. 66,584 (1996)). The regulation provides that "[w]hether an organization is an entity separate from its owners for federal tax purposes is a matter of federal tax law and does not depend on whether the organization is recognized as an entity under local law." *Id.* at (a)(1).

82. *Id.* at (a)(2). The regulations explain that joint undertakings without a goal of carrying on a trade, business, financial operation or a venture to divide the profits will not be considered an entity separate from the owners. *Id.* Also, entities wholly-owned by the state and Indian tribes do not qualify. *Id.* at (a)(3).

83. The regulations restate the traditional distinction between trusts and business entities: trusts generally do not have associates or an objective to carry on business for profit and therefore would not be considered a business entity. *Id.* at (b).

84. Since a trust is not considered a business entity, it would not be classified as either a partnership or an association. Rather, regulation of trusts is established in Treas. Reg. § 301.7701-4 (as amended by 61 Fed. Reg. 66,584 (1996)).

85. An eligible entity is one that is not required to be treated as a corporation for federal tax purposes and can elect its classification. Treas. Reg. § 301.7701-3(a) (as amended by 61 Fed. Reg. 66,584 (1996)). Generally, an LLC would be an eligible entity. *Id.*

86. The effective date for the regulations is January 1, 1997. Treas. Reg. § 301.7701 (as amended by 61 Fed. Reg. 66,584 (1996)).

87. Treas. Reg. § 301.7701-3(b)(3)(i) (as amended by 61 Fed. Reg. 66,584 (1996)) maintains the classification for entities in existence prior to the effective date of the check-the-box regulations. The classification of existing entities will be respected if: (1) the entity had a reasonable basis for its classification, (2) the entity and members recognized the tax consequences of any changes in classification and (3) the entity and members did not receive notice that it was under examination for its classification. Treas. Reg. § 301.7701-3(f)(2) (as amended by 61 Fed. Reg. 66,584) (1996).

88. Practitioners should cautiously make an election. The idea that an election should be made to ensure the default classification, known as a protective election, is dangerous because once an election is made another one cannot be made for sixty months. Thus, practitioners need to trust the default classification. *See infra* notes 90 and 91 and accompanying text.

LLC's Created After Effective Date

If an LLC is a domestic, eligible entity created after January 1, 1997, the issue becomes whether it wants association or partnership status.[89] The default rules allow LLCs to be treated as partnerships.[90] Thus, it is very simple for a Wyoming LLC to receive partnership treatment for federal tax purposes.[91]

The regulations provide for a single-member LLC to be disregarded for tax purposes and treated as a sole proprietorship.[92] Prior to the adoption of these regulations, the tax treatment of single-member LLCs was uncertain.[93] Practitioners did not know whether the single-member entity would be classified as a sole proprietorship or as an association, thus receiving corporate tax treatment. Due to the severity in the outcome, many companies could not take the chance. The company does not have to pay income taxes as a separate entity, since the check-the-box regulations articulate the treatment of single-member entities as a disregarded entity.

Checking the Box: The Procedure for Electing Classification

Entities that are not per se corporations are defaulted into partnership tax treatment if they have more than one member.[94] The regulations provide that an eligible entity may elect classification as an entity other than the default or may change its classification by filing Form 8832, Entity Classification Election, with the proper Service center at any time.[95] If the entity files a federal tax return for the year that it makes the

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89. Treas. Reg. § 301.7701-3(b)(3) (as amended by 61 Fed. Reg. 66,584 (1996)) provides an exception: if an eligible entity with a single owner claimed partnership status under the regulations, the entity will be disregarded as an entity separate from its owner. This provision makes it possible for a single-member LLC to be taxed as a sole proprietor rather than an association. *See infra* notes 93 and 94 and accompanying text. There is a chance for states to amend their statutes to allow for one-member LLCs. If they were to do this the one-member LLC would be disregarded under the default rule, unless it elects association status. *Id.*

90. Treas. Reg. § 301.7701-3(b) (as amended by 61 Fed. Reg. 66,584 (1996)). Any eligible entity that is not a per se corporation under the regulations receives default partnership tax treatment. *Id.*

91. An LLC organized under the Wyoming Limited Liability Company Act meets the criteria for an eligible entity and as long as it has two or more members it will receive default partnership tax treatment. *See* Treas. Reg. § 301.7701-1 (as amended by 61 Fed. Reg. 66,584 (1996)).

92. Treas. Reg. § 301.7701-2(a) (as amended by 61 Fed. Reg. 66,584 (1996)).

93. The corporate resemblance test also limited the use of single-member LLCs. It was generally too difficult for the single-member to not meet at least three of the four criteria.

94. Treas. Reg. § 301.7701-3(b) (as amended by 61 Fed. Reg. 66,584 (1996)).

95. *Id.* § 301.7701-3(c)(1). Form 8832 is available through the Service Home Page on the Internet (http://www.irs.ustreas.gov.), by calling 1-800-TAX-FORM, or by modem via 703-321-8020. New Form 8832, Entity Classification Election, Now Available, 1997-3 I.R.B. 15.

election, then a copy of Form 8832 must be attached to the return.[96] If the entity is not required to file a return, a copy of Form 8832 should be attached to the return of any owner.[97] The effective date of the election will be either the date specified on the election form or, if no date is specified, the date the form is filed.[98] An entity cannot make more than one election to change its classification status within a sixty-month time period.[99] The election must be signed by each member-owner at the time of the election or by any authorized agent, member or manager.[100]

Validity of the IRS's Adoption of Check-the-Box Regulations

Some question the Treasury's authority for adopting the check-the-box regulations, arguing that an executive agency lacks the power to adopt these regulations.[101] The argument relies on principles of administrative law and questions the legislative nature of regulations coming from an executive agency.[102]

Under administrative law principles, there is a two-part process for evaluating agency interpretation of statutes.[103]

> First, as always, is the question whether Congress has directly spoken to the precise question at issue. If the intent of Congress is clear, that is the end of the matter; for the court, as well as the agency, must give effect to the unambiguously expressed intent of Congress. If, however, the court determines Congress has not directly addressed the precise question at issue, the court does not simply impose its own construction on the statute, as would be

96. Treas. Reg. § 301.7701-3(c)(1)(ii) (as amended by 61 Fed. Reg. 66,584 (1996)).

97. *Id.* The owner can be either direct or indirect.

98. Treas. Reg. § 301.7701-3(c)(1)(iii) (as amended by 61 Fed. Reg. 66,584 (1996)). If an effective date is specified on the form it cannot be more than seventy-five days before or one year after the date the form is filed. *Id.* "If an election specifies an effective date more than 75 days prior to the date on which the election is filed, it will be effective 75 days prior to the date it was filed. If an election specifies an effective date more than 12 months from the date on which the election was filed, it will be effective 12 months after the date it was filed." *Id. See also* Michael J. Grace & Jonathan E. Becker, *Check-the-Box "Top 40,"* 12 TAX MGMT. REAL EST. J. 330 (1996).

99. Treas. Reg. § 301.7701-3(c)(iv) (as amended by 61 Fed. Reg. 66,584 (1996)). There is an exception if the ownership interest in the entity has changed by at least 50 percent since the last election. *Id.*

100. *Id.* For planning purposes, practitioners may want to explicitly provide for election authority in an LLC's operating agreement.

101. Corey E. Fleming, *LLCs Are Easier to Set Up,* LAW WKLY., Jan. 13, 1997, at 1.

102. *See* Victor E. Fleischer, *"If It Looks Like a Duck": Corporate Resemblance and Check-the-Box Elective Tax Classification,* 96 COLUM. L. REV. 518, 532-38 (1996).

103. Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc., 467 U.S. 837, 842-44 (1984).

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> necessary in the absence of an administrative interpretation. Rather, if the statute is silent or ambiguous with respect to the specific issue, the question for the court is whether the agency's answer is based on a permissible construction of the statute. . . . If Congress has explicitly left a gap for the agency to fill, there is an express delegation of authority to the agency to elucidate a specific provision of the statute by regulations. Such legislative regulations are given controlling weight unless they are arbitrary, capricious, or manifestly contrary to the statute.[104]

Congress has not directly addressed the issue of the definition of "association."[105] The validity of the check-the-box regulations depends on whether its definition of association is based on a permissible construction of the statute. Due to Congress's deference to the Treasury's interpretation in the area of taxation, it is argued that the check-the-box regulations are within the Treasury's administrative functions.[106]

Congress substantiated critics' concern by questioning the legitimacy of the check-the-box regulations. Prior to the adoption of the regulations, Congress' Joint Committee on Taxation considered the validity of the regulations and whether Congress should act to overturn the check-the-box regulations.[107] The Committee did not release any statements or opinions regarding the check-the-box regulations. However, most practitioners feel safe using the check-the-box regulations since: (1) Congress did not act prior to the adoption of the final check-the-box regulations, and (2) the technical nature of the regulations.[108]

III. ANALYSIS

Improvement of New Regulations

The adoption of the simplified entity classification regulations are long overdue. The dramatic increase in the formation of LLCs made the Kintner regulations an exercise in futility. Prior to the check-the-box regulations, articles of organizations and operating agreements were stra-

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104. *Id.*

105. I.R.C. § 7701(a)(3) (West 1997) defines corporation as including "associations, joint-stock companies, and insurance companies." Section 7701(a)(2) defines partnership as including "a syndicate, group, pool, joint venture, or other unincorporated organization . . . which is not . . . a trust or estate or a corporation."

106. Fleischer, *supra* note 102, at 535-36.

107. Corey E. Fleming, *LLCs Are Easier to Set Up*, LAW. WKLY., Jan. 13, 1997, at 1.

108. *Id.* Practitioners apparently feel that Congress has deferred to the Treasury on this matter.

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tegically drafted to intentionally avoid being classified as associations. An inordinate amount of time, energy, and resources were used in attempting to draft articles of organization which lacked two of the four corporate resemblance factors. Not only were the Kintner regulations eroded by individual rulings, but the classification of entities became a game of skirting the four-factor corporate resemblance test. The Kintner regulations allowed the issue of entity-level taxation to be determined by whether an entity possessed "easily manipulatable corporate characteristics,"[109] which resulted in most entities being classified as partnerships. The check-the-box regulations essentially overrule *Morrissey*. The analysis provided in Revenue Procedure 95-10 concerning corporate versus noncorporate attributes is no longer applicable. Thus, there will be virtually no change in the number of entities given association treatment because the entity can now elect its respective tax treatment instead of manipulating the articles of organizations in order to achieve the same result. By adopting the check-the-box regulations, the Service and the Treasury simply conceded the cumbersome nature and increasingly ineffective use of the Kintner regulations and the corporate "resemblance test."

The administrative costs of creating LLCs using flexible statutes is reduced significantly since the corporate resemblance test is so difficult to apply and so fact-intensive.[110] Not only will the LLC reduce organizational costs and increase efficiency, but the Service will significantly cut down the administrative cost of reviewing and monitoring the formation of new entities, which will increase its efficiency. There should be little concern about the corporate revenue base diminishing as a result of the check-the-box regulations.[111] The amount of taxable revenue generated should not be materially affected.[112] The regulations still provide for per se corporations, and publicly traded entities are taxed as corporations.[113] Thus, if an entity wants to be traded on the secondary markets, it will be

109. Daniel S. Goldberg, *The Tax Treatment of Limited Liability Companies: Law in Search of Policy*, 50 BUS. LAW 995, 1006 (1995).

110. Administrative costs could include attorney, accountant and filing fees. The resources and energy used in the formation of the LLC can now be put to better use in the planning and drafting of the articles and operating agreement. The cost to the government is also lessened since the fact-intensive analysis is no longer necessary. The Service will also benefit by reallocating the corporate resemblance resources to other areas.

111. The opportunity for the Service to police other areas of federal tax with the resources previously allocated to the four-factor test should minimize any anticipated decrease in revenue caused by the check-the-box system. *See* Fleischer, *supra* note 102, at 549-51.

112. *Id.*

113. I.R.C. § 7704 (West 1997) governs publicly traded partnerships: (a) a publicly traded partnership shall be treated as a corporation; (b) "publicly traded partnership" means any partnership if (1) interests in such partnership are traded on an established securities market, or (2) interests in such partnership are readily tradable on a secondary market.

classified as a corporation and responsible for such taxes.[114] Additionally, the Kintner regulations did not effectively protect the revenue base, and entities were obtaining the same result by drafting agreements that lacked corporate resemblance in form.

The simplification of classification with the check-the-box regulations will virtually eliminate the frequent inconsistencies and overall confusion surrounding entity classification. Allowing taxpayers to elect their tax status does not jeopardize the integrity of the Service. Rather, the Service has eliminated an ineffective method of classification and created more time to regulate and police other areas. These new regulations are taxpayer-favorable and will increase stability and predictability, which strengthens the overall scheme and application of the Internal Revenue Code. The entity can be absolutely certain of its tax treatment by the federal government and direct its energy and resources toward the ultimate goal of profit maximization.

Effect of Check-the-Box on the Wyoming Limited Liability Company Act

The adoption of the check-the-box regulations is an opportunity for Wyoming to once again get ahead in the LLC game by enacting a flexible and contemporary LLC Act. Since the new regulations reject the four-factor test that was the basis of the Wyoming Act, we suggest the legislature amend the act to provide the most effective LLC available under the new classification regime. This can be accomplished by reevaluating the current WLLCA. If the legislature is able to act quickly, it might allow Wyoming to attract companies to organize and file under the Wyoming LLC Act. This would, in turn, increase revenue and notoriety for the State.[115] If the legislature fails to act on the new regulations, it may decrease the competitiveness of the WLLCA and create severe inconsistencies between what is available in the Wyoming Act compared to other LLC Acts.[116]

114. *See* Fleischer, *supra* note 102, at 549-56, where Fleischer argues that the corporate revenue base will not be affected since, "[t]he publicly traded partnership rules, not the four-factor test, protect the corporate revenue base; the very need to enact Section 7704 in 1987 demonstrated the inefficacy of the four-factor test as a proxy for corporate resemblance . . . Section 7704 is the real line of defense against the disincorporation of America. As one Treasury official noted, Check-the-Box does not mean the end of corporations because '[i]f an LLC goes gangbusters and becomes public, section 7704 will kick in.'"

115. An increase in filings under the WLLCA would increase the amount of filing fees and annual taxes received by the state from LLCs.

116. On January 20, 1997, the Virginia House of Representatives introduced a bill that would amend the Virginia Limited Liability Act to change the default voting requirements regarding the admission of new members and the continuation of the LLC after an event of dissolution. 1996 VA H.B. 2474 (SN). Available on Westlaw® in BILLTRK.

However, there are drawbacks to amending the Act to allow for complete flexibility. Although an LLC Act with complete flexibility would attract additional companies, other problems may arise. The State has an interest in protecting its residents from the negative effects of limited liability. To protect third parties, the State should limit the latitude it gives to organizing entities. Thus, a balance between flexibility and formality must be achieved. If LLCs are allowed to exist without any substantive requirements, the costs of insurance, litigation, and consumer protection may significantly increase. Thus, making the Act too "pro-entity" would hurt the economy in the long-run, whereas making the Act too "pro-third-party" detracts from the desire to organize in Wyoming. The Wyoming legislature should minimize the importance that the traditional four factors play in organizing an LLC. Although it may not want to create a corporation in LLC clothing, it is no longer necessary to retain rigid requirements paralleling the four-factor test. Therefore, the legislature should amend the Act to allow for more flexibility in organizing an LLC.[117] However, it could go a step further by making the default provisions more flexible by allowing for continuity of life and transferability of interest.

Another way to increase flexibility is to lessen the rigid limitations on continuity of life. The current Act requires dissolution of the LLC upon the;

> death, retirement, resignation, expulsion, bankruptcy, dissolution of a member or occurrence of any other event which terminates the continued membership of a member in the LLC, unless the business of the limited liability company is continued by the consent of all the remaining members under a right to do so stated in the articles of organization of the limited liability company.[118]

This requirement is superfluous because the members merely dissolve and reorganize. By creating a continuation default, members who prefer limits on continuity may provide for this in the operating agreement. This would alleviate the aimless requirement for automatic dissolution of the LLC

117. The legislature needs some consistency in its amendments. The drafting of the Act should be different depending on the goals of the legislature. If the goal is to facilitate those who cannot or do not want legal assistance in organizing, then the Act should be a coherent, unambiguous, and include an easy-to-follow checklist of how to organize without much significance placed on the operating agreement. If the goal is to facilitate the sophisticated businessperson who will most likely retain legal assistance, the Act can be more barren and depend on an effective operating agreement.

118. WYO. STAT. ANN. §§ 17-15-123(a)(i)-(iii) (Michie 1977).

when the members could simply reorganize. This amendment will make the LLC more attractive to companies with short term investors, since they would be able to become a member of the LLC without dissolution.

Additionally, the legislature could consider making the default in the transferability of interest requirement more flexible. The amendment could authorize the free transferability of interest without unanimous member approval. However, the legislature should amend with caution to avoid an interest in an LLC from being considered a security.[119] If the interest in the LLC could be construed as a security, the extra burden placed on the LLC regarding securities laws and possible corporate tax treatment could far outweigh any benefit.[120] It is imperative for members to realize that publicly-traded companies may not be treated as eligible entities for partnership treatment under the check-the-box regulations.[121]

Increased flexibility and the rights of third parties can be balanced by the legislature while amending the Act. The legislature could place a premium on limited liability by requiring some planning or procedure.[122] In exchange for more flexibility in the organization of the LLC, the statute could require more substantive procedures after formation.[123] This would minimize the number of companies that organize with limited liability but without genuine business interests.

Wyoming should amend its statute to define the duties of the managers and members of the LLC.[124] The duties surrounding an LLCs' members and managers are unclear and, therefore, the well-developed corpo-

119. SEC v. W.J. Howey Co., 328 U.S. 293 (1946), establishes the criteria for whether an interest can be considered an investment contract. If an interest is an investment contract then it is treated as a security under federal and state securities laws. The determination of whether an interest is an investment contract is made with a four-prong test: a contract, transaction or scheme whereby a person (1) invests money, (2) in a common enterprise, (3) led to expect profits, (4) solely from the efforts of others. *Id.* at 298-99.

120. *See* Elaine Welle, *Limited Liability Company Interests As Securities: Planning and Drafting Strategies Related to Securities Law Considerations*, 31 LAND & WATER L. REV. 153 (1996).

121. Treas. Reg. § 301.7701-2(b)(7) (as amended by 61 Fed. Reg. 66,584 (1996)) provides that a business entity taxable as a corporation, under a provision other than section 7701(a)(3), is a corporation for federal tax purposes. Publicly traded partnerships are taxable under section 7704 as corporations. *See* Fleischer, *supra* note 102, at 541; *See also* Michael L. Schler, *Initial Thoughts on the Proposed 'Check-the-Box' Regulations*, TNT, June 17, 1996, 118-79.

122. Unlike in the corporate context, the WLLCA does not provide for any fiduciary duties. *See* Wyoming Business Corporation Act, WYO. STAT. ANN. §§ 17-16-830, -841, -842 (Michie 1977). Consumers and creditors need protection from limited liability, since there are no express fiduciary duties specifically required for members or managers. Although creditors are protected to some extent by the six year contribution rule, the gift of limited liability may come at a cost to society.

123. For example, a requirement that the operating agreement be written will require some planning and forethought on the part of the organizers.

124. Examples of clear statutory statements of the duties of members and managers appear in the ULLCA and the Delaware Limited Liability Company Act. *See* Appendix.

rate principles are usually utilized. The generally-applicable duties of care and loyalty are not explicitly stated in the WLLCA and would apply only by analogy from corporate law.[125] Establishing duties that protect members and third parties from the egregious conduct of other members is necessary. An equitable doctrine that protects third parties from total limited liability is the "piercing the corporate veil" doctrine. Whether these same duties and equitable attacks exist with regard to LLCs is unanswered.[126] If explicit statutory language is adopted, third parties would have a weapon against limited liability and the foundation needed to pierce the veil.[127]

In 1997, the legislature amended the flexible LLC section which allows for the organization of a single-member LLC.[128] The check-the-box regulations validate the creation of single-member LLCs, by disregarding them as separate entities (as opposed to treating single-member LLCs as corporations). Under the check-the-box regulations, a single-member entity is disregarded for federal tax purposes.[129] Without the punitive double-taxation, single-member LLCs could be allowed and even encouraged. Thus, sole proprietors would have the option of limited liability without the punitive double taxation of corporations. This should attract small businesses that prefer limited liability over the sole proprietorship. Single-member LLCs are an excellent choice for the organization of an entity for both sole proprietors and businesses looking for a firewall with limited liability protection.[130] By amending the statute, the Wyoming Legislature creates a vehicle for single-member entities to organize in Wyoming. The State should reap the benefits of acting quickly and the consistency in treatment should entice smaller business to organize within

125. "The duty of loyalty is the duty of selflessness." Carter G. Bishop & Daniel S. Kleinberger, LIMITED LIABILITY COMPANIES, ¶10.01[1][b] (1994). The duty of care requires that a manager acts in good faith and with the care of an ordinarily prudent person in a similar situation. *Id.* ¶ 10.01[1][a].

126. For a discussion regarding the applicability of the piercing doctrine to LLCs *see* Fonfara, *supra* note 18, at 532; Eric Fox, *Piercing the Veil of Limited Liability Companies*, 62 GEO. WASH. L. REV. 1143 (1994).

127. The Wyoming Legislature should use the ULLCA in drafting new statutes. The ULLCA has some excellent provisions regarding the duties of members and managers. However, it too lacks some of the cognizance necessary to take the LLC after check-the-box. *See* ULLCA.

128. Limited Liability Company Act Amendments of 1997, HEA99 (1997) (to be codified as amended at WYO. STAT. ANN. § 17-15-144 (d) and (e)).

129. Treas. Reg. § 301.7701-2(a) (as amended by 61 Fed. Reg. 66,584 (1996)) provides that a business entity with two or more members is classified for federal tax purposes as either a corporation or a partnership. A business entity with only one owner is classified as a corporation or is disregarded; if the entity is disregarded, its activities are treated in the same manner as a sole proprietorship, branch, or division of the owner. *Id.*

130. Fleming, *supra* note 101, at 12. The firewall entity would be used to create protection between an unstable division of a business and a stable division. *Id.*

Wyoming. Since the primary business form in Wyoming is a small business, this amendment should be beneficial to the State.

Planning Considerations

The practitioner organizing an LLC still needs to make sure she is complying with state and federal law. Of course, with the adoption of the check-the-box regulations compliance with applicable federal law is much simpler. However, state tax classification issues still remain. Thus, practitioners need to comply with the state requirements and procedures.[131]

The practitioner should also be aware of the default provisions of the check-the-box regulations. As a default, an LLC is treated as a partnership for federal income tax purposes. Due to the drastic simplification, it might be tempting to ensure this treatment by making a protective election. However, any election is binding on an entity for five years.[132] Thus, any later preference for corporate tax treatment would be unavailable until the time limitation expired.

Another issue is the transition from corporate to partnership tax treatment as a taxable event. This causes a "paper liquidation" of the corporation resulting in the possibility of significant tax implications. Prior to electing partnership tax treatment the practitioner must seriously consider the costs and benefits before making a recommendation to clients.[133]

Disadvantages of Becoming an LLC

Although the LLC is fast becoming the entity of choice among organizing businesses, this business organization is not for everyone.[134]

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131. The tax requirements pursuant to the WLLCA are $100 annually. WYO. STAT. ANN. § 17-15-132(a)(vi) (Michie 1977 & Supp. 1996).

132. Treas. Reg. § 301.7701-3(c)(iv) (as amended by 61 Fed. Reg. 66,584 (1996)). *See supra*, note 99 and accompanying text.

133. It is advisable to consult with a certified public accountant regarding liquidation.

134. The resulting changes in the LLC Act could create a question as to why would anyone chose a partnership or a S Corporation. The only real advantage of the partnership over the LLC was the certainty of partnership tax treatment, therefore the advantage disappeared with the adoption of the check-the-box regulations.

The benefit of the S Corp is also limited after the new regulations. Since the new regulations provide for single-member LLCs, it is possible for one person to have limited liability without a corporate structure. However, the advantage of corporate tax treatment with regard to employment taxes is not available with LLCs. *See* Mary L. Harmon, *Federal Income Tax Considerations Related to Limited Liability Companies (Including Check-the-Box)*, 388 PLI/Tax 1145, 1148 (1996). Thus, shareholders who also receive a salary from the corporation are able to avoid the self-employment tax by organizing as an S Corporation. *See generally* BORIS I. BITTKER & JAMES S. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS, ¶¶6.01 to 6.1 (6th ed. 1994) (describing

There are some disadvantages to selecting the LLC. First, LLCs interested in publicly trading shares will lose default partnership income tax treatment and instead are classified as per se corporations. This prohibits raising capital through secondary markets and eliminates an optimal resource for outside investors. Thus, entities concerned about avenues for financial opportunities should consider this limitation on an entity with partnership tax classification.

Another disadvantage is the lack of case law pertaining to LLCs. There is a dearth of court decisions that concern substantive issues regarding LLCs, whereas the case law and precedent of corporations and partnerships is well-developed. Thus, practitioners can only surmise how courts will translate the established corporate principles into the area of LLCs, which results in speculation and uncertainty. With the benefits of an LLC entity comes the lack of precedent, structure and familiarity courts recognize with corporations.

The check-the-box regulations articulate that a conversion from a corporation to a partnership tax-treated entity (e.g. LLC) is a liquidation and therefore a taxable event.[135] The practitioner should consider the costs associated with converting to an LLC such as taxes, filing fees, and administrative costs.[136] The entity would be required to pay those costs the year it makes the election. Therefore, the attractiveness of converting a corporate entity to an LLC, after the check-the-box regulations, should be dismissed unless the corporation is willing to pay the substantial costs. The costs of conversion could far outweigh the benefits of an LLC.

IV. CONCLUSION

After the long-awaited change in entity classification for federal tax purposes, check-the-box regulations are in effect today. The new regulations simplify the classification by defaulting eligible entities into partnership tax treatment. LLC's traditionally fall into the eligible entity

S Corporations); Larry E. Ribstein & Mark A. Sargent, *Check-the-Box and Beyond: The Future of Limited Liability Entities*, 52 BUS. LAW. 605 (1997) (discussing the implications of check-the-box and the viability of limited liability enities as separate business organizations).

135. I.R.C. §§ 336, 331 (West 1997), govern the liquidation of corporate property. A conversion from corporate tax classification to partnership tax classification will create taxes payable on a complete liquidation.

136. The practitioner should compare the annual state taxes and filing fees of the corporation and the LLC. The fees associated with an LLC are provided for in WYO. STAT. ANN. § 17-15-132 (Michie 1977 & Supp. 1996) and the fees associated with a corporation are provided for in WYO. STAT. ANN. § 17-16-1630 (Michie 1977 & Supp. 1996) and WYO. STAT. ANN. § 17-16-122 (Michie 1977).

classification and thus can receive partnership treatment without satisfying the corporate resemblance test.

The adoption of the check-the-box regulations provide states with an opportunity to make substantive changes to existing LLC statutes. If Wyoming takes advantage of the opportunity to amend its LLC Act to reflect the lower federal tax requirements, it will benefit businesses in the state. However, it cannot do a cursory job on the enactment of amended statutes. The legislature must look to other states and the ULLCA to determine what is best about these statutes and what is unnecessary after the regulations. The check-the-box regulations bring entity classification into the new millennium and will undoubtedly increase the popularity and effectiveness of limited liability companies for business planning.

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APPENDIX: State LLC Statutes

The state LLC Acts can be found at:

Alabama Limited Liability Company Act, ALA. CODE §§ 10-12-1 through 10-12-61 (1994)

Alaska Limited Liability Company Act, ALASKA STAT. §§ 10.50.010 through 10.50.995 (1996)

Arizona Limited Liability Company Act, ARIZ. REV. STAT. §§ 29-601 through 29-857 (1996)

Arkansas Small Business Entity Tax Pass Through Act, ARK. CODE ANN. §§ 4-32-101 through 4-32-1316 (Michie 1996)

California Beverly-Killea Limited Liability Company Act, CAL. CORP. CODE §§ 17000 through 17705 (West 1997)

Colorado Limited Liability Company Act, COLO. REV. STAT. §§ 7-80-101 through 7-80-1006 (West Supp. 1994)

Connecticut Limited Liability Company Act, CONN. GEN. STAT. ANN. §§ 34-100 through 34-242 (West 1996)

Delaware Limited Liability Company Act, DEL. CODE ANN. tit. 6 §§ 18-101 through 18-1109 (1993 & Supp. 1996)

Florida Limited Liability Company Act, FLA. STAT. ch. 608.401 through 608.514 (West 1993 & Supp. 1997)

Georgia Limited Liability Company Act, GA. CODE ANN. §§ 14-11-100 through 14-11-1109 (1994 & Supp. 1996)

Hawaii Uniform Limited Liability Company Act, HAW. REV. STAT. §§ 428-101 through 428-1302 (Supp. 1996)

Idaho Limited Liability Company Act, IDAHO CODE §§ 53-601 through 53- 672 (1994 & Supp. 1996)

Illinois Limited Liability Company Act, 805 ILL. COMP. STAT. ANN. 180/1- 1 through 180/60-1 (West 1996)

Indiana Business Flexibility Act, IND. CODE §§ 23-18-1-1 through 23-18-13-1 (1995 & Supp. 1996)

Iowa Limited Liability Company Act, IOWA CODE §§ 490A.100 through 490A.1601 (West Supp. 1996)

Kansas Limited Liability Company Act, KAN. STAT. ANN. §§ 17-7601 through 17-7652 (1995 & Supp. 1996)

https://scholarship.law.uwyo.edu/land_water/vol32/iss2/29

Kentucky Limited Liability Company Act, KY. REV. STAT. ANN. §§ 275.001 through 275.455 (Michie 1994 & Supp. 1996)

Louisiana Limited Liability Company Law, LA. REV. STAT. ANN. §§ 12:1301 through 1369 (West 1994)

Maine Limited Liability Company Act, ME. REV. STAT. ANN. tit. 31, §§ 601 through 762 (West 1995 & Supp. 1996)

Maryland Limited Liability Company Act, MD. CODE ANN., CORPS. & ASS'NS §§ 4A-101 through 4A-1103 (1993 & Supp. 1994)

Massachusetts Limited Liability Company Act, MASS. GEN. LAWS ch. 156C, §§ 1 through 68 (1996)

Michigan Limited Liability Company Act, MICH. COMP. LAWS §§ 450.4101 through 450.5200 (Supp. 1996)

Minnesota Limited Liability Company Act, MINN. STAT. ANN. §§ 322B.01 through 322B.960 (West Supp. 1997)

Mississippi Limited Liability Company Act, MISS. CODE ANN. §§ 79-29-101 through 79-29-1204 (1996)

Missouri Limited Liability Company Act, MO. REV. STAT §§ 347.010 through 347.740 (Vernon Supp. 1997)

Montana Limited Liability Company Act, MONT. CODE ANN. §§ 35-8-101 through 35-8-1307 (1996)

Nebraska Limited Liability Company Act, NEB. REV. STAT. §§ 21-2601 through 21-2653 (Supp. 1996)

Nevada Limited Liability Company Act, NEV. REV. STAT. §§ 86.010 through 86.571 (Michie 1994 & Supp. 1995)

New Hampshire Limited Liability Company Act, N.H. REV. STAT. ANN. §§ 304-C:1 through 304-D:20 (Supp. 1996)

New Jersey Limited Liability Company Act, N.J. STAT. ANN. §§ 42:2B-1 through 42:2B-70 (West Supp. 1996)

New Mexico Limited Liability Company Act, N.M. STAT. ANN. §§ 53-19-1 through 53-19-74 (Michie 1993 & Supp. 1996)

New York Limited Liability Company Act, N.Y. LIMITED LIABILITY COMPANY LAW §§ 101 through 1403 (McKinney Supp. 1997)

North Carolina Limited Liability Company Act, N.C. GEN. STAT. §§ 57C-1-101 through 57C-10-07 (1993 & Supp. 1996)

North Dakota Limited Liability Act, N.D. CENT. CODE §§ 10-32-01 through 10-32-155 (1995)

Ohio Limited Liability Company Act, OHIO REV. CODE ANN. §§ 1705.01 through 1705.58 (Baldwins Supp. 1997)

Oklahoma Limited Liability Company Act, OKLA. STAT. ANN. tit. 18 §§ 2000 through 2060 (West Supp. 1997)

Oregon Limited Liability Company Act, OR. REV. STAT. §§ 63.001 through 63.990 (Supp. 1996)

Pennsylvania Limited Liability Company Law, 15 PA. CONS. STAT. §§ 8901 through 8998 (1995)

Rhode Island Limited Liability Company Act, R.I. GEN. LAWS §§ 7-16-1 through 7-16-75 (1992 & Supp. 1996)

South Carolina Limited Liability Company Act, S.C. CODE ANN. §§ 33-43-101 through 33-43-1409 (Law Co-op Supp. 1996)

South Dakota Limited Liability Company Act, S.D. CODIFIED LAWS §§ 47-34-1 through 47-34-59 (Michie Supp. 1996)

Tennessee Limited Liability Company Act, TENN. CODE ANN. §§ 48-201-101 through 48-248-606 (1995)

Texas Limited Liability Company Act, TEX. REV. CIV. STAT. ANN. 1528n §§ 1.01 through 11.07 (West Supp. 1997)

Utah Limited Liability Company Act, UTAH CODE ANN. §§ 48-2b-101 through 48-2b-158 (1994 & Supp. 1996)

Vermont Limited Liability Company Act, VT. STAT. ANN. tit. 11, §§ 3001 through 3162 (1997)

Virginia Limited Liability Company Act, VA. CODE ANN. §§ 13.1-1000 through 13.1-1121 (Michie 1993 & Supp. 1996)

Washington Limited Liability Company Act, WASH. REV. CODE §§ 25.15.005 through 25.15.902 (Supp. 1997)

West Virginia Limited Liability Company Act, W. VA. CODE §§ 31B-1-101 through 31B-13-1306 (1996)

Wisconsin Limited Liability Company Act, WIS. STAT. §§ 183.0102 through 183.1305 (Supp. 1996)

Wyoming Limited Liability Company Act, WYO. STAT. ANN. §§ 17-15-101 through 17-15-144 (Michie 1977 & Supp. 1996)