Corporate Benefits Without Corporate Taxation: Limited Liability Company and Limited Partnership Solutions to the Choice of Entity Dilemma

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Many businesses confront a common dilemma in selecting a proper entity for the conduct of their business—the desire to incorporate for state law purposes, but to avoid the more onerous taxation imposed on corporate income. The options for dealing with this dilemma have changed significantly in recent years. One solution, the S corporation, has become less attractive. On the other hand, limited partnerships and limited liability companies may now permit new businesses to enjoy the best of both worlds—to have corporate benefits without corporate taxation.

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INTRODUCTION

New businesses faced with the task of selecting the most appropriate form of business organization are often presented with a dilemma. Corporations have served the needs of business very successfully for the past century and are generally the preferred form of organization for business purposes. However, the use of a corporate form subjects the income earned by the business to double taxation. Thus, the dilemma is whether to satisfy the business goals through incorporation[1] or reduce taxation through the use of a noncorporate form.[2]

There is a simple and obvious solution to this choice of entity dilemma. Subchapter S of the Internal Revenue Code (Code) permits a business to incorporate and elect to have its income passed through to the shareholders in a fashion resembling the taxation of income earned through a partnership.[3] Unfortunately, not all businesses can or should rely on subchapter S for several reasons. First, the right to make an S election is narrowly limited.[4] Second, while taxation of the income earned through an S corporation resembles the taxation of income earned through a partnership, it differs in ways that could cause a materially greater tax liability to be imposed on the shareholders of an S corporation than would be incurred by partners in like circumstances.[5]

Businesses unable to resolve the choice of entity dilemma by means of the subchapter S election have two alternatives: either they incorporate and take steps to ameliorate the more onerous tax burden imposed on corporate income or they organize as a partnership and endeavor to address state law issues as best they can without incorporation.

The incorporation alternative has probably been the most common solution for taxpayers not able to resort to the S election, and much time and attention has been devoted to developing techniques for reducing the tax burden. This approach is, at best, an accommodation

1. *See infra* text accompanying notes 25-72.
2. *See infra* text accompanying notes 73-98.
3. I.R.C. §§ 1361-78 (1986).
4. I.R.C. §§ 1361(a), (b) (1986). *See also infra* text accompanying notes 99-103.
5. *See infra* text accompanying notes 104-67.

to the competing concerns.[6]

The use of a noncorporate form to avoid double taxation while endeavoring to otherwise adequately address state law issues has been more problematic. The difficulty in using noncorporate forms has two sources. First, there has been reason to question whether a truly corporate-like relationship could be created in a noncorporate form of organization. In particular, concerns have existed as to whether owners who were active in the management and control of the business could shield themselves from personal liability.[7] Second, even if taxpayers could find a means to create corporate-like relationships without incorporation, it is incumbent on them not to be too successful in this effort. The Code imposes corporate income taxation not only on corporations, but also on any other unincorporated associations in which the relationships too closely resemble those typically present in a corporation.[8]

The ability to use noncorporate forms to achieve corporate-like relationships without also incurring corporate taxation has changed dramatically in recent years. The ability under state law to create noncorporate relationships closely resembling those typical of the corporate form has been greatly enhanced by a significant legislative trend in the states to limit the potential for owner liability.[9] In addition, in 1988 the Treasury finally completed a long period of study regarding the tax rules for entity characterization and announced its conclusion that these rules should not be modified. In particular, the Treasury also confirmed that arrangements providing owners with limited liability would not, for that reason alone, be subject to corporate income taxation.[10] This conclusion was immediately reflected in Revenue Ruling 88-76,[11] which held that a Wyoming "limited liability company" would be treated as a partnership for federal income tax purposes notwithstanding the fact that the owners were statutorily protected from personal liability.[12]

This Article examines some of the history of business organizations and the changes affecting choice of entity summarized above. It concludes that the recent changes affecting noncorporate forms have created significant new opportunities to fully solve the choice of

6. *See infra* text accompanying notes 168-74.

7. *See infra* text accompanying notes 264-78.

8. *See* I.R.C. §§ 7701(a)(2), (3) (1986). *See also infra* text accompanying notes 176-263.

9. *See infra* text accompanying notes 279-94.

10. I.R.S. ANN. 88-118, 1988-38 I.R.B. 25. *See also infra* text accompanying notes 295-306.

11. Rev. Rul. 88-76, 1988-2 C.B. 360. Limited liability companies are hereafter referred to as "LLCs."

12. *See infra* text accompanying notes 296-306.

entity dilemma. Either a limited liability company or a limited partnership with a corporate general partner can now be utilized to provide owners with all of the principal benefits of incorporation without subjecting the income of the business to corporate income taxation.[13]

Given that corporate-like relationships can now be established for all practical purposes without subjecting businesses to corporate income taxation, this Article further concludes that corporate income taxation must now be viewed as an entirely voluntary and elective regime for all new nonpublic businesses. In light of this conclusion, the interests of certainty, uniformity, fairness, and efficiency demand that Congress act quickly either to make the election expressly available under the Code or to impose a business tax in a nonelective fashion.[14]

I. HISTORICAL PERSPECTIVE

The corporate form emerged during the nineteenth century in order to meet the changing needs of business after economic activity had shifted from small proprietorships, guilds, and agriculture into that of the industrialized era.[15] The need of business enterprises to organize efficiently and retain capital and labor created significant pressures to develop a form of business organization that would permit investors to provide capital without risking their entire personal wealth, that vested management in representatives knowledgeable about the business, that assured that the capital, once organized, would continue to be productive notwithstanding changes in ownership, and that allowed investors the opportunity to realize the benefit of their investment without causing dissolution and liquidation of the organization.

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13. *See infra* text accompanying notes 312-98.
14. *See infra* text accompanying notes 399-401.
15. For a brief history of the emergence of general corporation laws in the nineteenth century, including some of the turmoil that attended their early development, see LAWRENCE M. FRIEDMAN, A HISTORY OF AMERICAN LAW 446-63 (1973). Professor Friedman notes that while pre-twentieth century law is often thought of as "unfolding in slow patterns . . . nothing could be more startling than the difference one century made in the law of the business corporation. In 1800, corporation law mostly dealt with municipalities, charities, and churches. . . . By 1870 corporations had a commanding position in the economy." *Id.* at 446. During its early history, the corporate form was fraught with many uncertainties and provided the unscrupulous with many opportunities for fraud. Thus, legislators and the courts alike devoted considerable attention to corporate issues, ranging from antitrust laws to securities laws to fiduciary duties. As a result, by the end of the nineteenth century, the law of business corporations was well-developed, accessible, and rather generally understood.

The corporate form was not the only entity competing to meet the needs of business. The historical roots of the modern corporation lay in the franchises and monopolies available only through special charter from the sovereign authority,[16] and the need to obtain this special charter continued into the nineteenth century. Thus, businesses endeavored to establish the needed relationships not only by seeking corporate charters from the sovereign, but also by endeavoring to adapt trusts, partnerships, and other forms to the same ends.[17]

Early on it could not have been certain that the corporate form would emerge as the common form of business organization. However, over time the ability to obtain a special charter in the United States from the various state legislatures came to be fairly routine. This process finally led by the mid- to late-nineteenth century to recognition of the need to eliminate the requirement of obtaining the consent of the state to incorporate, lest the state legislatures be overwhelmed. The devised solution was to replace the special charter system with general corporation laws under which a charter would be automatically granted to any person satisfying the statutory requirements.

Once general corporation laws had become widely adopted and well understood, it is hard to discern why a business permitted to incorporate would have chosen any other form of organization. Absent tax considerations, it remains difficult today to posit a situation in which a person permitted to incorporate would be led to choose any other form of organization. Indeed, absent tax considerations, other business forms may well have developed into highly specialized vehicles, if not mere footnotes of legal history.

As interesting as it may be to speculate about life without income taxation, the reality is that income tax considerations loom very large. The twentieth century expansion of income taxation is perhaps as significant to business as the nineteenth century's acceptance of the corporation. Since 1909, the use of the corporate form has entailed an additional income tax burden that is not necessarily imposed on other forms of organization.[18] As a result, taxpayers

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16. *See generally* WILLIAM F. WALSH, A HISTORY OF ANGLO-AMERICAN LAW 377-80 (2d ed. 1932).

17. Alternatives that competed with the corporate form in an effort to meet the needs of business included joint stock companies, business trusts, limited partnerships, and partnership associations. For an early twentieth century overview of the alternatives to incorporation, see generally EDWARD H. WARREN, CORPORATE ADVANTAGES WITHOUT INCORPORATION (1929).

18. A corporate income tax has been imposed on corporations continuously since the adoption of the Payne-Aldrich Tariff Act of 1909. *See generally* BORIS I. BITTKER & JAMES S. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 1.01 (5th ed. 1987). *See also generally* EDWIN R.A. SELIGMAN, THE INCOME TAX: A STUDY OF THE HISTORY, THEORY, AND PRACTICE OF INCOME TAXATION AT HOME AND ABROAD (1914) (providing a history of income taxation in the United States through the

desiring to avoid more onerous taxation have continued to seek alternative means of relieving those very pressures that led to the adoption of general corporation laws, but to do so in a fashion that does not give rise to the corporate taxation.

Most of the alternative forms of organization that had competed with the corporate form did not long survive the renewed effort to create a hospitable form of business organization for the simple reason that those alternative forms so closely resembled corporations that corporate income taxation was imposed.[19]

The partnership has survived as the principal alternative to incorporation for the simple reason that it is the only alternative form of business organization recognized under the Code.[20] As a result, the partnership form has come to be utilized in surprising situations that would astound a nineteenth century lawyer.[21] Indeed, in the early

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adoption of the Sixteenth Amendment).

19. Joint stock companies have been expressly included within the definition of a corporation for income tax purposes since 1909. *See* Corporation Tax Law of 1909, 36 Stat. 112 (1909). Similarly, it was probably the partnership association that originally prompted the inclusion of "associations" in the definition of a corporation. *But cf.* Eliot v. Freeman, 220 U.S. 178, 187 (1911) (holding that the corporate tax was intended to apply to organizations created by statute or which "derive from that source some quality, or benefit not existing at the common law"). However, the use of so-called business trusts successfully avoided corporate taxation in the early part of this century. *Id. See also* Crocker v. Malley, 249 U.S. 223 (1919). The success was short lived and corporate taxation was extended to such business trusts in 1924. *See* Hecht v. Malley, 265 U.S. 144 (1924) (applying corporate income tax to the same trust which had escaped taxation in *Crocker*). *See also* Burk-Waggoner Oil Ass'n v. Hopkins, 269 U.S. 110 (1925) (approving the imposition of corporate income taxation on a Texas organization in which the capital was represented by transferable interests, the assets were vested in trustees having no authority to bind the individual beneficial owners, and which was apparently a partnership under the laws of the state of Texas). Morrissey v. Commissioner, 296 U.S. 344 (1935), is regarded as having first articulated the test currently applicable in determining whether any particular organization is an association taxable as a corporation. *See* Treas. Reg. § 301.7701-2(a)(1) (as amended in 1983). Generally, the test is based on whether the arrangement provides the benefits typical of incorporation. See *infra* text accompanying notes 176-252 for a more detailed discussion of the corporate resemblance test.

20. *See* I.R.C. §§ 7701(a)(2), (3) (1986). The combination of these definitions is to treat any organization engaged in the conduct of a business for the purpose of generating a joint profit as either a corporation or a partnership. *See also* Treas. Reg. §§ 301.7701-2 (as amended in 1983), 301.7701-4 (as amended in 1986). It is not clear precisely why limited partnerships escaped corporate taxation under early authorities. In *Eliot v. Freeman*, 220 U.S. 178 (1911), the inclusion of associations in the definition of corporations was held to contemplate any organization arising from statute or deriving a benefit from statute that did not exist at common law. This formulation would certainly seem to comprehend limited partnerships that are entirely a creature of statutory creation unknown to the common law.

21. Notwithstanding that limited partnership statutes had been widely adopted throughout the United States by 1929, Professor Warren noted that "[t]he lurking danger that a special partner might be exposed to unlimited liability has seriously restricted

1980s the partnership form reached its zenith when a significant number of partnerships had interests traded on the New York Stock Exchange.[22] While the utility of using the partnership form for publicly traded businesses was eliminated in 1987 by legislation imposing corporate taxation on most publicly traded organizations,[23] efforts of nonpublic companies to find a means by which corporate benefits can be obtained without corporate taxation continue.[24]

II. The Choice of Entity Dilemma

A. *The Goal of Pass-Through Taxation*

1. *The Benefits of Pass-Through Taxation*

The income of most businesses to which capital is a contributing factor would be subject to a lower tax burden by use of an entity that permits income to be passed through to its owners rather than to be subject to corporate income taxation.[25] This assertion stems from the simple fact that the single level of tax on income earned through a partnership or an S corporation, imposed at the partner or shareholder level, should be lower than the double taxation imposed on income earned through a corporation.[26] This conclusion is further supported by the fact that since 1986 the maximum rate of tax imposed on the income of individuals has been lower than that imposed

the use of the limited partnership statutes." WARREN, *supra* note 17, at 306.

22. It is reported that the first publicly traded limited partnership appeared in 1981 and that there were between 100 and 125 such partnerships in existence by 1988. *See* Willard B. Taylor, *Master Limited Partnerships*, 46 INST. ON FED. TAX'N § 28.01, at 28-2 (1988).

23. Revenue Act of 1987, Pub. L. No. 100-203, § 10211, 101 Stat. 1330-403. This legislative change was in direct response to the fear that the growth of publicly traded limited partnerships would jeopardize the corporate tax base. *See* H.R. REP. No. 100-391, 100th Cong., 1st Sess. 1063 (1987).

24. A report to Congress of a joint study conducted by the Treasury and the Internal Revenue Service (Service) with respect to the tax treatment of large partnerships did not recommend extending corporate taxation to such organizations. TREAS. DEP'T, WIDELY HELD PARTNERSHIPS: COMPLIANCE AND ADMINISTRATION ISSUES, REPORT SUBMITTED TO CONGRESS (March 30, 1990), *reprinted in* [Mar.-Apr.] Daily Tax Rep. (BNA) No. 64, at L-1 (Apr. 3, 1990). Recommendations have been made in the past to treat partnerships with more than a certain number of partners as corporations for tax purposes. *See, e.g.*, JOINT COMM. ON INT. REV. TAX., 95TH CONG., 2D SESS., SUMMARY OF THE PRESIDENT'S 1978 TAX REDUCTION AND REFORM PROPOSALS 6 (1978). Apparently sentiments about large partnerships have changed. *See* H.R. 4287, 102d Cong., 2d Sess. 4301-05 (1992) (providing "simplified" rules for flow-through, audit, and compliance of partnerships with more than 250 partners or, at the election of the partnership, 100 partners).

25. This conclusion should not be applicable to a business in which the income is attributable to services simply because deductible salaries should be able to eliminate virtually all corporate taxable income.

26. *See* I.R.C. §§ 701, 1363(a) (1986) (exempting partnerships and S corporations from entity level taxation). Compare these sections with I.R.C. § 11 (1986).

on the income of corporations.[27] Thus, even before taking into account the impact of the second tax, the initial tax on business profits will often be reduced under a pass-through tax regime. When the impact of the second tax is added, even if the second tax is deferred through accumulations of corporate income, the tax burden of incorporation increases.[28]

2. *Exception for Income Splitting Situations*

As with most other generalizations about taxation, there are situations in which the presumptive benefit of pass-through taxation will not exist. One such exception may involve small businesses owned by persons who are individually subject to the maximum tax rate. A tax benefit could result from incorporation of such a business because of the graduated tax rates imposed on the first $75,000 of corporate income.[29] Setting aside for the moment the impact of the second tax, business income passed through to the owners will be subject to a thirty-one percent maximum federal tax.[30] With the graduated rates imposed on the first $75,000 of corporate income, the corporate tax liability will not exceed 31% of taxable income until the income reaches approximately $210,000.[31]

Whether there is a significant tax savings possible from the use of

27. *Compare* I.R.C. § 1 *with* § 11 (1986). The imposition of a higher rate of tax on the income of corporations than on the income of individuals had not previously existed at any time since the individual income tax was first imposed under the Sixteenth Amendment.

28. The second level of taxation on income earned through a corporation will be imposed when the shareholders realize the benefit of the income earned by the corporation either in the form of dividends or as gain from the sale or other disposition of the stock.

Into the 1980s, the so-called *General Utilities* doctrine allowed the corporate level tax on the appreciation in the value of property to be avoided by the distribution of the asset in kind (*see* I.R.C. §§ 311(a), 333, 336 (1954)), or when the gain was realized by a sale incident to a 12-month plan of complete liquidation (*see* I.R.C. § 337 (1954)). *See* General Utilities & Operating Co. v. Helvering, 296 U.S. 200 (1935), which gave its name to the non-recognition rules even though the Court had refused to rule on the issue of corporate gain recognition. The *General Utilities* doctrine, which had begun to erode years earlier, was finally eliminated by legislation in 1986. Tax Reform Act of 1986, Pub. L. No. 99-514, § 331, 100 Stat. 2085 (1986). The repeal of the *General Utilities* doctrine has removed all possibilities for avoiding the imposition of tax on corporate level gains.

29. *See* I.R.C. § 11(b) (1986). Such a situation is often created by splitting the income between the owners and the corporation.

30. I.R.C. § 1 (West 1992).

31. Once corporate income has exceeded $100,000, an additional 5% tax is imposed until the benefit of the progressive rates has been eliminated. I.R.C. § 11(b)(West 1992). The higher corporate rate on income over $75,000, combined with the 5% surcharge, will result in a blended corporate rate in excess of 31% when the taxable

the progressive corporate rate structure by small businesses is somewhat speculative. The eventual second tax must be balanced against the immediate tax savings possible under the graduated corporate rate structure. The current tax savings achieved by having access to graduated corporate tax rates on small amounts of income will have to exceed the present value of the deferred second tax. To illustrate, with income of $100,000, the tax on the corporation will be $22,250.[32] Had the income passed through to individual owners taxable at the maximum individual rate, the tax on the individual owners would have been $31,000.[33] The use of the corporation thus produces an initial tax savings of $8,750. However, there also exists a deferred tax liability of at least $21,770.[34] The use of the corporation is beneficial if this future tax liability is, in present value terms, less than the current $8,750 tax savings. Even at a ten percent per annum discount, the deferral would have to continue for nearly ten years to offset the effect of the second tax.[35]

In evaluating the benefit of utilizing the progressive corporate rate structure, it must be held in mind that unlimited accumulations of corporate income are not permitted under the Code. Rather, an onerous surcharge is imposed on income accumulated in excess of the reasonable needs of the business.[36] To avoid this surcharge, distributions of excess funds must be made and such distributions will result in imposition of the second tax. Further, even where accumulations can be justified by the reasonable needs of the business, the business must typically be one that is expanding. With an expanding business, the income could quickly reach the level at which the effective corporate tax rate is not sufficiently less than the individual tax rate to justify the second tax regardless of the length of time the second tax may be deferred, and, at some point, the initial tax on business

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income reaches slightly under $210,000. The combined rate of tax will reach 34% overall at $335,000 of taxable income and the tax rate will thereafter be a flat 34%.

32. *See* I.R.C. § 11(b)(1) (West 1992).

33. *See* I.R.C. § 1 (West 1992). This illustration disregards the impact of state income taxation, which simplifies the illustration at the expense of ignoring some of the real economic significance of the choice.

34. The net after-tax income of the corporation is $77,750 and presumably increases the value of the corporation by a like amount. If this increase in value is recognized in the form of a long-term capital gain at the time the stock is sold, the federal income tax at 28% would be $21,770. If the income is distributed and taxed as a dividend, the applicable tax rate would be 31% and produce a larger deferred tax liability.

35. This comparison also fails to take into account the more restricted use of any excess funds necessitated by retention within the corporation and the double taxation imposed on the income derived from the use of the funds within the corporation during the period of the deferral.

36. I.R.C. §§ 531-37 (1986). Generally, corporations will be able to accumulate up to $250,000 of income without any independent showing that the income accumulated is needed in the business. *See* I.R.C. § 535(c)(2)(A) (1986). Accumulations in excess of this amount will be subject to the accumulated earnings tax unless the business can establish the business need for further accumulations.

profits will become more onerous for having adopted the corporate form. The second tax, whenever incurred, will merely add to the cost of having incorporated.

It is often suggested that the double taxation of corporate income will be avoided by the retention of the stock until the death of the owner.[37] At death, all property of the decedent, including stock, will pass to the heirs or legatees with a basis equal to fair market value and thus will permit the avoidance of the second tax by means of a sale of the shares or liquidation of the corporation.[38]

The fair market value basis arising on death of the shareholder will permit the deceased shareholder's successor to avoid the second tax on accumulated income through a sale of the stock, but it does not necessarily eliminate the tax cost of having incorporated. The date of death basis step-up will not avoid the double tax on future income if the business is continued. Further, if the business continues to operate and there is a desire to remove excess cash from the business through distributions, the date of death basis step-up will not efficiently eliminate the second tax because the stepped-up basis does not eliminate the corporate earnings and profits.[39] Finally, incorporation will significantly diminish the benefit of the stepped-up basis on death if the business has any built-in gain.[40] The basis step-up applies only to the stock, not to the basis of the corporate assets. The built-in gain in a corporation is subject to a potential double tax, and the basis step-up will eliminate only the shareholder level tax on the built-in gain. The other level of tax, the corporate tax, is not avoided.[41]

In contrast, the date of death basis step-up in the partnership context applies not only to the basis of the decedent's partnership interest, but may also result in an increase in the basis of the assets to the partnership.[42] Thus, in a partnership, there is only a single level of

37. *See* WILLIAM S. MCKEE ET AL., FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS 2-8 (2d ed. 1990).

38. I.R.C. § 1014 (1986). With a fair-market-value basis in the stock, there should be no gain or loss realized on the disposition of the shares. *See* I.R.C. § 1001 (1986).

39. *See* I.R.C. §§ 301, 316(a) (1986).

40. "Built-in gain" refers to the excess of the value of an asset at any particular time over the adjusted basis of that asset. Obviously, built-in gain can arise either from changes in value or adjustments to basis.

41. Prior to 1986 the *General Utilities* doctrine provided numerous opportunities under the Code for corporations to avoid the recognition of gain on appreciated assets, and thus made the inability to step-up the basis of the assets in the hands of the corporation less significant. All such provisions were eliminated in 1986. *See supra* note 28.

42. *See* I.R.C. §§ 743(b), 754 (1986).

tax and that tax is eliminated by the stepped-up basis at death.[43]

3. *Public Trading Exception*

With respect to publicly traded businesses, while pass-through taxation might still be preferable, it is not possible. The emergence of publicly traded limited partnerships in the early 1980s led to legislation in 1987 requiring all businesses with publicly traded interests to be taxed as corporations regardless of the form of organization employed.[44] It may also be true that any business desiring to become publicly traded will find little merit in pass-through taxation during the prepublic period.[45]

4. *Identity of Investors Exceptions*

The identity of investors may militate against pass-through taxation. Specifically, tax-exempt and nonresident alien investors may desire to avoid investment in a pass-through entity that is engaging in an active business.

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43. At one time it was thought that optional adjustments to the basis of partnership assets involved so much complexity as to make it an undesirable election. *See generally* McKEE ET AL., *supra* note 37, at ¶ 24.10[5] (stating that "continuing partners may well decide that the benefits of the election . . . [will be] more than outweighed by the potential long-term detriments to themselves, in the form of recordkeeping headaches and possible future basis decreases as to their interests"). The coming of the computer age hopefully has overcome most of the reluctance to make this election. Indeed, most of the publicly traded limited partnerships formed in the 1980s made the 754 election notwithstanding that the daily trading at differing prices made the administration of this election far more difficult than would be the case with a nonpublic company. *See* Taylor, *supra* note 22, § 28.07, at 28-24.

44. I.R.C. § 7704 (1987). For a discussion of the limited exceptions to the imposition of corporate taxation on publicly traded organizations, see McKEE, ET AL., *supra* note 37, at 3-85.

45. There is no necessity that businesses incorporate during their prepublic period. However, there is added complexity in explaining and in accounting for the prepublic period at the time of the public offering if a pass-through organization was employed. It is probable that businesses that desire to gain access to public markets would desire the simplicity of the corporate form. The tax consequences during a prepublic period are likely to be nominal in relation to the expected profitability that the prepublic shareholders expect to realize from going public.

If a significant capital gains preference were to return to the tax law, the situation might change. The ability to have ordinary losses pass through to owners, which will be deductible against ordinary income not later than the year in which the interest in the company is disposed of (*see* I.R.C. § 469(g) (1992)), and which will be recovered as capital gains on the sale of stock, could produce significant tax benefits. This may be particularly attractive given that it may be difficult for net operating losses in early years to survive repeated financing under I.R.C. § 382 (1992). See Richard L. Parker, *The Innocent Civilians in the War Against NOL Trafficking*, 9 VA. TAX REV. 625 (1990). Of course, the presence of tax-exempt and non-resident investors who would typically not be in a position to use any losses passed through to owners might militate against such a plan.

a. Tax-Exempt Investors

For tax-exempt investors, there will be a single level of tax regardless of whether the entity is a corporation or a partnership. If a corporation is used, the corporation will incur tax liability on all of its income. However, the tax-exempt investor will be exempt from taxation when it realizes the benefit of its share of the income, regardless of whether realized in the form of dividends or gain from a sale or exchange of the stock.[46] If the business had organized as a partnership, there would be no entity level taxation, but the tax-exempt investor would be treated as engaged in an unrelated trade or business[47] and would be taxed on its share of the business profits.[48] While there could be some benefit from being subject to pass-through taxation, either through reduced taxation[49] or increased cash flow,[50] the potential benefits generally have not been viewed as sufficient to overcome the increased administrative burden entailed in reporting and paying tax on unrelated business income.[51]

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46. I.R.C. § 501(a) (1986).
47. Treas. Reg. § 1.512(c)-1 (1960).
48. I.R.C. §§ 501(b), 511-14 (1986).
49. The potential tax savings could arise from the ability of the taxexempt to use the progressive tax rates with respect to its share of income. *See* I.R.C. §§ 511(a), 11(b) (1986). This will obviously not be meaningful to sizable tax-exempt investors. An additional tax savings is possible to the extent that the business, if incorporated, would accumulate income and generate passive income thereon in order to avoid the second tax that would otherwise be imposed on non-tax-exempt investors. When a corporation is used, the tax-exempt shareholder's share of the investment income attributable to the accumulation will be subject to the corporate-level tax. Similar investment income on accumulations in a partnership allocated to the tax-exempt investor would not be subject to tax as unrelated business income.

If there were numerous partnership investments in the tax-exempt organization's portfolio, some of which were producing losses, a tax savings would be possible from the ability of the losses from one organization to be used to offset the profits of another.

50. It seems evident that the use of the corporate form must result in greater accumulations than would otherwise be the case. If a business generates $100 of excess after-tax income, the shareholder will presumably desire to employ the funds in the most efficient manner possible. The choices are to leave the funds in the corporation, in which case the full $100 is available for investment, or to distribute the funds for individual investment. Because the distribution would result in a dividend and a tax of up to $31, only $69 would be left to invest. Obviously, the more efficient use of the funds is to retain them in the corporation. In effect, the benefit to the shareholder is an interest-free loan from the government conditioned on retention of the excess funds in the corporation. Given the incentive to accumulate income to defer the second tax, it must be reasoned that excess accumulations occur. *See* William S. McKee, *Master Limited Partnerships*, 45 INST. ON FED. TAX'N §§ 23.01, 23.03, at 23-9 (1987) (suggesting that this "lock-in effect" is one of the chief tax policy problems with the corporate income tax).
51. *See id.* at 23-9 to 23-10.

b. Nonresident Alien Investors

The situation of the nonresident alien investor is similar to that of the tax-exempt investor. For nonresident alien investors, their share of income earned through a corporation will be taxed at the corporate level. In addition, the nonresident alien will be taxed a second time, through withholding, on that income when the benefit of that income is realized in the form of a dividend.[52] The United States generally does not impose a second level of tax on the nonresident alien when the benefit of the income is realized in the form of gains from the sale of the stock.[53] Thus, double taxation may be at least partially avoided. However, the real economic impact of any United States tax is likely to be largely or entirely eliminated by the allowance of tax credits in the nonresident aliens country of residence.[54]

In contrast to income earned through corporations, the active business income which a nonresident alien earns through a partnership is treated as income effectively connected with the conduct of a United States trade or business[55] and is taxed to the nonresident alien in the same way such income would be taxed to any United States citizen or resident.[56] The income earned by a nonresident alien through a partnership is not subject to a second tax when distributed.[57] Again, any United States tax should be creditable against tax due in the country of residence.[58] Thus, there may be no economic impact to the nonresident alien from the choice of entity.

While the choice of entity may have little economic impact, a nonresident alien investing in an active business partnership will be required to file a return and otherwise comply with United States tax law. This is an obligation which nonresident aliens understandably are not anxious to accept.

52. I.R.C. § 871(a)(1)(A) (1986). The tax imposed on dividends paid to a nonresident alien is 30% under the Code, *id.*, but by treaty, it is widely reduced to as little as 5%. *See, e.g.*, Convention Modifying the Convention for the Avoidance of Double Taxation, Dec. 30, 1965, U.S.-Neth., art. 5, 17 U.S.T. 896, 900-01 (reducing the tax rate on dividends to 5% for large shareholders and 15% for all others).

53. *See* I.R.C. § 871(a)(2) (1986). United States-sourced capital gains of nonresident aliens which are not effectively connected to a United States trade or business are subject to United States taxation only if the nonresident is present in the United States for at least 183 days during the year in which the gains are realized. *Id.*

54. *See, e.g.*, I.R.C. § 901 (1986) (allowing foreign tax credits in the United States).

55. I.R.C. § 875(l) (1986).

56. I.R.C. § 871(b) (1986).

57. *But see* I.R.C. § 897 (1986) (effectively treating a foreign corporation's share of income from a United States partnership as income from a United States branch operation and imposing a so-called dividend equivalent tax on such profits).

58. *See supra* note 54 and accompanying text.

c. *Potential Benefits of the Corporate Tax Regime*

In addition to the fundamental difference between the double taxation of corporate income and the pass-through taxation of partnership income, there are other significant differences in the tax regimes.[59] One disadvantage of the partnership form often presented is that partnerships may not be acquired in a tax-free reorganization.[60] It is unquestionably true that partnerships may not be acquired in a tax-free reorganization,[61] but it is less clear that this is a significant disadvantage. Partnerships are subject to only a single level of tax, and that tax generally cannot be deferred by means of a

59. For a nonjudgmental and relatively complete topic by topic comparison of the tax rules governing corporations and partnerships, see Elliot Tannenbaum, *The Business Entity: C Corp. v. S Corp. v. Partnership*, 45 INST. ON FED. TAX'N § 6.01 (1987).

60. I.R.C. § 368(a) (West 1992) defines a reorganization as a transaction involving corporations. The partnership and the partners can engage in reorganization-like transactions only if they qualify for nonrecognition under I.R.C. § 351. *See infra* note 61. S corporations can be acquired in a tax-free reorganization. *See* I.R.C. § 1371(a) (1986).

The ability to engage in a tax-free transaction is most significant when the only consideration available is the purchaser's stock and that stock cannot be readily converted into cash, at least to the extent necessary to meet any current tax liability. This is usually the case when the purchaser is not a publicly traded corporation. On the other hand, if the purchaser had adopted a form that qualified as a partnership for tax purposes (*see infra* text accompanying notes 312-98), any acquisition could be structured to defer gain under I.R.C. § 721 without the burden of qualifying under the baroque rules of I.R.C. § 368. It is possible that this section of this Article could have been organized as a discussion of the ease of acquistions by partnerships rather than as a discussion of the difficulty partnerships have in being acquired by corporations.

61. A leading treatise notes that the inability to engage in reorganizations is a disadvantage of the partnership form, but adds the tantalizing qualification that partnerships can with "[c]areful planning . . . overcome this limitation." MCKEE ET AL., *supra* note 37, at 2-13. There is no suggestion whatsoever as to what planning the authors envision in this respect. Possibly they contemplate incorporation as a precursor to the reorganization. If the partnership can incorporate on a tax-free basis and then after incorporation engage in a reorganization, there is little significance to their inability to engage in a reorganization while still a partnership. However, for the incorporation to be tax-free, it must not be considered to be a step in the overall transaction by which the partners disposed of the business. *See* Rev. Rul. 70-140, 1970-1 C.B. 73 (an incorporation followed by a planned disposition of the stock received held a taxable exchange). Alternatively, they may contemplate a transfer to the acquiring corporation qualifying for nonrecognition under I.R.C. § 351 because of contemporaneous and related transfers by existing shareholders. *Cf.* Treas. Reg. § 1.351-1(a)(1)(ii) (as amended in 1967). Another possibility would be a transfer by the partners to a new corporation with the shareholders of the acquiring corporation making contemporaneous transfers of the stock of their corporation, which would thereafter be a subsidiary. I.R.C. § 351 should provide both the partners and the shareholders with nonrecognition of their gains, at least where the old corporation continues to exist as a subsidiary. *Cf.* Rev. Rul. 68-349, 1968-2 C.B. 143 (transferee corporation treated as a continuation of transferor corporation where transferor was liquidated pursuant to the plan, resulting in other transferors failing to qualify for nonrecognition under I.R.C. § 351).

tax-free reorganization. Thus, whatever gain exists in the partnership must be recognized at the time of the disposition of the partnership. On the other hand, income previously earned will already have been taxed completely and will not, whether or not it has been distributed, result in any additional tax burden when the business is sold.

When corporations are reorganized, shareholder gain or loss is not recognized to the extent that the consideration received is stock of the acquiring corporation.[62] The tax burden on the built-in gain is not forgiven; it is deferred. The shareholder-level gain is transferred to the stock received through an exchanged basis and thus will be subject to tax when disposition of that stock occurs.[63] It is this ability to defer the owner-level tax which makes a reorganization beneficial.

While reorganizations permit deferral of gain, it should be remembered that the gain deferred will include gain attributable to both accumulated income and to built-in gain. In addition to the shareholder level deferred gain, there will also be deferred corporate level tax on the built-in gains.[64] The acquired corporation or its successor in the acquisition will continue to hold the assets at their pre-acquisition basis. It will therefore recognize any built-in gain and incur a tax liability at the corporate level either upon the disposition of those assets or through their use in the business. It will do so without depreciation allowances which reflect their economic cost in the acquisition. Because the purchaser is assuming the tax liability associated with low basis assets, it must, at least in theory, reduce the purchase price it is willing to pay in order to reflect this assumed liability in the same way it would reduce the purchase price for any other liabilities assumed.[65]

In light of the above, whether the ability to engage in reorganization transactions is a benefit militating in favor of the corporate form depends upon whether the immediate single level tax imposed on the built-in gain in a partnership will be greater than the sum of (1) the present value of the deferred double taxation on the built-in gain of the corporation, (2) the deferred shareholder-level tax on accumulated income, and (3) the double tax cost already incurred on income previously earned and distributed. In view of this balancing, it may be more accurate to consider the reorganization provisions as a

62. I.R.C. §§ 354, 356 (1986).
63. I.R.C. § 358(a)(1) (1986).
64. Corporate-level gain is deferred but is not eliminated through a tax-free reorganization. *See* I.R.C. §§ 361, 362(b) (1986).
65. It is probably true in most large acquisitions that the tax liability associated with any built-in gains may not become the subject of direct negotiations. This does not necessarily mean that tax liability is not factored into the analysis.

means by which to ameliorate the more onerous tax burden otherwise associated with the corporate form than to characterize the ability to participate in a reorganization transaction as a benefit of the corporate form.

Depending upon whether the corporate or a pass-through form is adopted, there is some difference in the ability to provide nontaxable fringe benefits to active owners. But most of the significant disparities have been eliminated by the equalization of treatment of qualified plans.[66] Only a limited number of differences remain, and these differences are generally not very substantial.[67]

d. Other Differences

Further differences between corporations and partnerships for tax purposes involve the taxation of admissions of new members in exchange for contributions of appreciated property,[68] the taxation of redemptions,[69] and the taxation of distributions inkind.[70] In each case, the partnership regime permits rearrangements of the business relationship without significant tax liability at the time of the transaction, whereas a similar transaction in the corporate context would result in recognition of gain.[71]

e. Summary

In summary, there are situations in which corporate taxation may be either necessary or desirable. However, in the absence of such situations, businesses will find that avoidance of corporate income taxation will result in a significant tax savings.[72]

B. Preference for Incorporation for Business Purposes

The principal reasons that businesses will generally prefer to incorporate for non-tax purposes are that the corporate form provides

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66. *See generally* Jerome E. Harris, *Parity in Employee Benefit Plans and Fringe Benefits for the Self-Employed after TEFRA and TRA '84*, 62 TAXES 529 (1984).
67. *See generally*, MCKEE ET AL., *supra* note 37, at 2-16 to 2-18.
68. *Compare* I.R.C. § 351 *with* I.R.C. § 721.
69. *Compare* I.R.C. § 302 *and* § 311 *with* I.R.C. § 731.
70. *Compare* I.R.C. § 301 *and* § 311 *with* I.R.C. § 731.
71. *See generally* Tannenbaum, *supra* note 59.
72. *See* MCKEE ET AL., *supra* note 37, at 2-12, in which this conclusion is stated with far less equivocation. The authors state that the "tax advantages of the partnership form are so substantial that, in most situations, they will outweigh the tax and business disadvantages." *Id.*

statutory protection to the owners against personal liability for the obligations of the business[73] and that a corporation has a potentially perpetual existence.[74] In contrast, the partnership form, at least in theory, requires that one or more owners have personal liability for the obligations of the business[75] and that changes in the ownership of the partnership will cause its dissolution.[76]

1. *Owner Liability*

That owners of a business prefer to avoid personal liability is obvious. Of course, there are situations in which countervailing considerations, including tax considerations, could be of overriding significance. When countervailing considerations exist, a decision not to incorporate may be further justified by the fact that the unlimited liability of partners and the limited liability provided shareholders are not absolute. Most obviously, partnerships may be formed in which limited partners do not have any personal liability unless they participate in the management and control of the business.[77] Of course every limited partnership must have at least one general partner who will have unlimited personal liability.[78]

The practical exposure of general partners to liability can be ameliorated in several ways. With respect to tort and certain other kinds of liability, the general partner's practical risk can be greatly reduced through appropriate insurance. The general partner's risk for contractual liabilities can be avoided simply by obtaining the agreement of the creditor to limit its recourse to the assets of the partnership. Indeed, if a creditor would be willing to extend credit to a comparably capitalized corporation without guarantees from shareholders, they should be as willing to extend credit to a partnership with recourse limited to partnership assets. In addition, the personal liability of the ultimate individual owners can often be avoided through the use of a corporation to act as general partner.[79]

Just as partners need not necessarily discharge all partnership obligations personally, the corporate form does not necessarily protect

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73. REVISED MODEL BUSINESS CORP. ACT (MODEL CORPORATION ACT) § 6.22 (1984).
74. MODEL CORPORATION ACT § 14.02.
75. UNIFORM PARTNERSHIP ACT (UPA) § 15 (1914); REVISED UNIFORM LIMITED PARTNERSHIP ACT (RULPA) § 403(b) (1976) (amended 1985). Unless otherwise indicated, references to the RULPA are to the act as amended in 1985. When necessary to distinguish between the RULPA before and after the 1985 amendments, the pre-1985 RULPA is referred to as RULPA (1976) and the RULPA with the 1985 amendments as RULPA (1985).
76. UPA §§ 29, 30; RULPA § 801.
77. RULPA § 303. *See infra* text accompanying notes 272-86.
78. RULPA §§ 101(7), 403(b).
79. *See infra* text accompanying notes 279-86.

the shareholders in all events. Creditors will often extend credit to a corporation only with guarantees from shareholders. Further, the corporation will be an effective shield against liability only if the creditor is not permitted to "pierce the corporate veil"[80] or to proceed against the shareholder under theories sounding in agency, fraud, or estoppel.[81]

That partners may take steps to ameliorate their personal risk and that shareholders may be required to answer for the obligations of the corporation in some circumstances does not alter the facts that personal liability is often the paramount concern of persons investing or participating in a business and that the most direct protection against personal liability has been incorporation.

2. *Organizational Continuity*

The potentially perpetual existence of a corporation is also a significant consideration which favors the corporate form, at least when the organization has significant capital. It would simply be unacceptable if any owner could force the winding up of the business or, alternatively, demand redemption at any time. If a corporation is used, shareholders have no right to withdraw and thus cannot unilaterally cause the winding up of the corporation or withdraw and demand redemption. In the partnership context, general partners have the right to withdraw at any time unless there is a contrary agreement,[82] and any withdrawal by a general partner will at least potentially cause the dissolution of the organization and lead to the winding up of the partnership.[83] Even with a contrary agreement, the general partners retain the power, though not the right, to withdraw.[84] A general partner exercising the power to withdraw in contravention of the agreement will have to respond for damages, if any. Nevertheless, such partner will have the right to a distribution subject to the

80. *See generally* Cathy S. Krendl & James R. Krendl, *Piercing the Corporate Veil: Focusing the Inquiry*, 55 DENV. U. L. REV. 1 (1978) (endeavoring to identify the standards and the variations in the standards used to find shareholder liability).

81. For a discussion of the various theories for finding shareholder liability which are not based on piercing the corporate veil, see Krendl & Krendl, *supra* note 80, at 2. *See also* Note, *Liability of a Corporation for Acts of a Subsidiary or Affiliate*, 71 HARV. L. REV. 1122, 1123-25 (1958).

82. UPA § 31(1)(b); RULPA § 602.

83. *See* UPA § 31 (dissolution results on any withdrawal of a partner from a general partnership); RULPA § 801(4) (dissolution results on the withdrawal of a general partner unless a remaining or new general partner continues the business in accordance with the partnership agreement).

84. UPA § 31(2); RULPA § 602.

agreement of the partners and to offset it by any damages.[85] While something approaching corporate-like continuity of life can be accomplished by agreement, continued existence is of great importance and is most clearly and simply achieved through adoption of the corporate form.

3. *Other Business Considerations*

Other fundamental differences between the corporate and partnership form include disparate rules regarding management,[86] transferability of interests,[87] and organizational flexibility.[88] While it can be generally stated that limited liability and organizational continuity will militate in favor of incorporation in most businesses, generalization as to the impact of these additional considerations is not possible. Whether centralized, representational management or the ability to transfer interests are desirable will depend on the needs of the specific business. When such characteristics are desirable, the preference for incorporation should be strengthened because these attributes are typical of corporations. On the other hand, even if the owners desire a more flexible management structure and restrictions on transferability, attributes typical of partnerships, these facts alone should seldom lead a business to avoid incorporation.

While free transferability of corporate shares will exist in the absence of a contrary agreement, all that is necessary to restrict transferability is an agreement between the shareholders.[89] Any such

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85. *See* UPA § 38(2); RULPA § 604.

86. General corporation laws vest management in a board of directors elected by the shareholders. *See* MODEL CORPORATION ACT § 8.01(b). *But see* MODEL CORPORATION ACT § 8.01(c) (permitting corporations with fewer than 50 shareholders to establish a management structure that does not involve a board of directors); MD. CODE ANN., CORPS. & ASS'NS §§ 4-302, 4-303 (1989 & Supp. 1991) (permitting a flexible management structure in a so-called close corporation). In contrast, partnerships are directly owner managed by the general partners unless the partners have agreed to the contrary. *See* UPA §§ 18(e), (h); RULPA § 403(a).

87. *Compare* MODEL CORPORATIONS ACT § 6.27 (providing that shares of stock are, in general, freely transferable) *with* UPA § 27 *and* RULPA § 702 (generally providing that partners may not assign their rights as a partner and cause the assignee to be substituted in their place).

88. The relationship between partners is fundamentally contractual. Thus, while the UPA provides the terms of the contract, which will be controlling in lieu of a contrary agreement, the partnership acts expressly recognize the right of the partners to agree otherwise. Thus, for example, management can be vested equally in all partners or restricted to one person, whether or not a member and profits, losses, and distributions can be made per capita, in proportion to contributions, or in any other manner the human mind can conceive. *See* UPA § 18. The corporate form is more rigid. Generally, absent the applicability of a unique state law statute or qualification as a close corporation, management is necessarily vested in a board of directors. Voting rights and economic rights are held in proportion to the ownership of shares and any desire to have varying rights must be accomplished by the creation of a different class or series of shares.

89. MODEL CORPORATION ACT § 6.27(a). *But see* MODEL CORPORATION ACT

agreement can be enforced against purchasers simply by disclosing the existence of any restrictive agreement by a legend on the share certificates.[90] A flexible management structure may be more difficult to create in a corporation,[91] but the constraints on the management form by themselves will seldom be sufficient to lead the owners to forego limited liability or organizational continuity.[92]

An additional factor which may, at least in the past, have strongly militated in favor of incorporation has been the fact that corporate law is better developed, more certain, and generally more familiar to investors and the bar alike.[93] How significant any such disparity really has been, and whether it will continue, are entirely speculative.[94] It also seems reasonable to suggest that most uncertainty or unfamiliarity with the partnership form arises from the different ways in which the two organizations have been used. To the extent that one considers the tax-shelter partnerships of the 1970s and 1980s as the prototype of the business partnership, the conclusion suggested is approrpriate. These partnerships were enormously complex with tier upon tier of allocation and distribution provisions and innumerable special provisions that served no apparent function other than to cope with various tax concepts.[95] When the partnership will simply provide for all distributions and allocations to be made pro rata to

§ 6.27(c) (requiring a reasonable purpose for restricting transferability).

90. MODEL CORPORATION ACT § 6.27(b).

91. *But see supra* note 88.

92. Another difference may arise under the securities laws. While corporate stock will always be a security, non-stock interests may not be. *See generally* Mark A. Sargent, *Are Limited Liability Company Interests Securities?*, 19 PEPP. L. REV. 1069 (1992).

93. This may, of course, be due in large part to the fact that partnerships are simply more flexible. There is little to understand except that the desired relationship must be created by agreement rather than imposed by statute.

94. *See* MCKEE ET AL., *supra* note 37, at 2-12, suggesting that, to the extent this difference existed, it has likely narrowed significantly with the widespread adoption of the RULPA and the acceptance of the limited partnership form for public companies, in leveraged buy-outs and other business transactions.

95. A good illustration of the type of provision which inordinantly complicates many partnership agreements is the "qualified income offset" provision. *See* Treas. Reg. § 1.704-1(b)(2)(ii)(d) (as amended in 1988). Inclusion of such a provision is one means provided in the regulations to cause the allocations of income under the partnership agreement to have economic effect as required by I.R.C. § 704(b) without requiring all partners to repay capital accounts. While the presence of this provision leads to the conclusion that the allocations, at least in part, have economic effect, it is expected that this provision will never in fact be relevant in determining the proper allocation of income under the agreement. Indeed, by its terms, it applies only in unexpected circumstances.

Other complicating provisions include the innumerable and varied means that were conceived for limiting the impact of the at-risk rules on the deduction of losses. *See* I.R.C. § 465 (1992).

the ownership of units, as would be the case with simple corporations, it seems unlikely that many would object that the arrangement is unfamiliar or uncertain.

4. *Summary*

In summary, if tax considerations are disregarded, the protection against liability and the presence of organizational continuity afforded by the corporate form would lead most businesses to incorporate.

C. *The Dilemma*

It is difficult to generalize regarding the proper organizational form for a new business. There are simply too many variables that will result in significant exceptions to any statement of purportedly general application. However, with the caveat that there will be significant exceptions, the above discussion points to a common dilemma faced by many new businesses: the desire to avoid incorporation for tax purposes versus the desire to incorporate for non-tax, business purposes.

Where this common choice of entity dilemma exists, the problem is how it can or should be resolved. Three basic options are available: 1) incorporate and elect to be subject to the pass-through taxation provided in subchapter S of the Code,[96] 2) incorporate and take steps to ameliorate the increased tax burden,[97] and 3) avoid incorporation and endeavor to address the business issues by other means.[98]

III. THE S CORPORATION SOLUTION TO THE DILEMMA

Incorporation and election to be taxed on a pass-through basis under subchapter S may appear as the obvious and best solution to the choice of entity dilemma. For those who qualify, it is probably the solution most often chosen. However, not all businesses can qualify to make the election under subchapter S, and not all businesses that qualify should adopt this solution.

A. *Limited Availability of the S Election*

To qualify for the subchapter S election, the corporation may not have more than thirty-five shareholders,[99] have any shareholders who

96. *See* I.R.C. §§ 1361-78 (1992). *See infra* text accompanying notes 104-67.
97. *See infra* text accompanying notes 168-74.
98. It is this alternative that has expanded substantially in recent years and that has the potential to finally solve the choice of entity dilemma. *See infra* text accompanying notes 176-398.
99. I.R.C. § 1361(b)(1)(A) (1992).

are not United States citizens or resident individuals,[100] have more than one class of stock,[101] or be a member of an affiliated group.[102] These limitations can make the S election impracticable for many businesses.

The subchapter S election is particularly problematic when one of the owners desires to have some preference to the earnings or assets of the business, while the business cannot realistically take on the burden of annual interest payments or the obligation to repay loans at a certain time in the future. In any such case, the prohibition against two classes of stock will make the S election impracticable.[103]

To a new business seeking capital, the prohibition against having shareholders who are not United States individuals is probably the most debilitating. A new business in need of capital can ill-afford to shut itself off from investments by tax-exempt entities, nonresidents, partnerships, corporations, or other nonindividual sources.

100. I.R.C. § 1361(b)(1)(A), (C)(1992).
101. I.R.C. § 1361(b)(1)(D) (1992).
102. I.R.C. § 1361(b)(2) (1992).
103. The desire for preferences may arise simply from the differing investment desires of the investors, but will arise in other ways as well. The need for a preferential class of stock can also arise when the corporation desires to issue shares to a service provider to whom the parties wish to provide only a share of the future income and growth in value. This may be a particular concern in that a shift of capital could result in a prohibitive tax being imposed on the service provider. *See* I.R.C. § 83 (1992); St. John v. United States, 84-1 U.S. Tax Cas. (CCH) ¶ 9158 (C.D. Ill. Nov. 16, 1983). In order to avoid the transfer of a current capital interest, the capital of the business must be secured to the non-service providers. This is possible only through the creation of preferences. In an S corporation, the prohibition against the use of a second class of stock necessitates that the preference be established in the form of an indebtedness. This indebtedness must in turn be sufficiently reflective of an arm's length transaction to avoid characterization as an equity interest violating the prohibition against S corporations issuing more than one class of stock. It can prove extremely difficult to achieve both the tax and business objectives in this context.

Since 1990, the use of an S corporation can be even more problematic if there is to be a contributor of appreciated property in a business formation that will include a service provider. Again, the property contributor must receive a preferential right to return of the capital contributed in order to avoid shifting capital to the service provider, but the limitations on the use of an S corporation preclude use of a preferred stock interest for this purpose. The use of indebtedness, however, to establish the capital preference will not qualify for nonrecognition of gain under section 351 because of the elimination of securities from the type of property permitted to be received tax free in exchange for a contribution of appreciated property. *See* I.R.C. § 351(a) (1992).

B. Tax Disadvantages of Subchapter S Versus Partnership Taxation

Beyond the fact that subchapter S may not be available to or practical for every business, it should also be noted that taxation under subchapter S may, in certain situations, be significantly greater than the taxation that would have been imposed had a partnership been utilized.[104] Particularly since *General Utilities & Operating Co. v. Helvering*[105] was superceded by statute, the S election can have significant adverse tax consequences as compared to a partnership.

1. Inability to Adjust Inside Basis

The principal adverse tax consequence that can arise from the use of an S corporation stems from the fact that, unlike a partnership, events that cause an increase in the basis of the S corporation stock will not affect the basis of the S corporation's assets.[106]

In either a partnership or an S corporation, income attributable to increases in the value of the business assets can be recognized at either of two levels: inside the organization by means of a sale or disposition of the assets or outside the organization through a sale or disposition of the ownership interests at a price that reflects the increased value of the assets.[107] Gain exists inside the entity represented by the difference between the value and the adjusted basis of the asset. The same gain exists outside the entity represented by the

104. It is not without some trepidation that one suggests that the S corporation is not a very good solution given the number of S corporation elections in effect. This is particularly true given that many of the pitfalls of subchapter S have not previously drawn significant attention. *See, e.g.*, ZOLMAN CAVITCH, TAX PLANNING FOR CORPORATIONS AND SHAREHOLDERS § 3.07[2] (1992) (finding very little to list as a disadvantage of the S form). Nevertheless, the tax pitfalls, which are discussed in the pages that follow, are present in unambiguous form. It is possible that the disadvantages of the S election as compared to partnership taxation have not been highlighted simply because of the significantly more limited oportunities to use noncorporate forms in the past.

105. 296 U.S. 200 (1935). *See also supra* note 28. It does not appear that Congress necessarily considered the impact that the superceding of *General Utilities* by statute would have on S corporations.

106. *See generally* I.R.C. §§ 734(b), 743(b), 754 (1992). No comparable provisions exist for S corporations.

107. While a partnership is not treated as an entity for all tax purposes, it is treated as an entity in many respects. It is so treated for purposes of taxing the gain or loss from the disposition of the rights of the partners. *See* I.R.C. § 741 (1992). The partnership interest, as property that may be sold or otherwise disposed of, also has its own basis. I.R.C. § 705 (1992). Obviously, stock in a corporation, including an S corporation, is property, has a basis, and can be sold or disposed of by the owners. *See* I.R.C. § 1367 (1992) (providing special rules for the determination of the basis of the stock of an S corporation). Stock of an S corporation is otherwise treated as any other stock under the Code.

difference between the value and basis of the interest in the organization. Thus, the same amount of gain should be recognized either by a sale of the assets by the organization or a sale by the partners of their interests in the partnership.[108]

A single level of taxation of partnership and S corporation income is generally achieved in that income recognized inside the organization passes-through to and is treated as income of the owner.[109] The basis in the partnership interest or the stock of the S corporation is then increased by the amount of such income passed through to the owner, and the potential for taxing the same income twice is eliminated.[110] When and to the extent that the income is distributed, the basis of the owner's interest is reduced, but the distribution is not income.[111]

While the potential outside gain is eliminated through basis adjustments when the gain is recognized by the entity, the same kind of adjustment to eliminate potential inside gain is necessary when the gain has been recognized outside. The Code provides for such an adjustment in the case of a partnership by permitting the inside basis of partnership assets to be increased to reflect any outside gain recognition.[112] However, no comparable provision exists for S corporations. This means that even though the economic gain represented by the changes in the value of assets may have been recognized and taxed at the shareholder level, the low inside basis of the assets to the S corporation continues, with the result being that the same gain will be taxed a second time.

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108. This is most clearly illustrated in connection with a contribution of appreciated property to an entity in circumstances in which gain is not recognized either under I.R.C. § 351, if the organization is a corporation, or I.R.C. § 721, if the organization is a partnership. Assume the contributed property has a value of $100 and an adjusted basis of $50. The gain realized but not recognized is $50 on the transfer. The intention is to defer rather than eliminate this gain. The gain is preserved for future recognition by carrying over the basis of the asset from the contributor to the organization. *See* I.R.C. §§ 362(a), 723 (1992). Thus, if the organization disposes of the property, the $50 gain will be recognized at the entity level. It is also necessary to impose an exchanged basis on the interest in the entity received by the contributor so that the contributor is not able to avoid the recognition of gain by the sale of the interest. *See* I.R.C. §§ 358(a)(1), 722 (1992). Thus, on the sale of the interest, the same $50 of gain will be recognized. Obviously the result is that the single $50 of gain, which went unrecognized, now exists in two different properties. The gain has potentially been doubled.

109. I.R.C. §§ 702, 1366 (1992).

110. I.R.C. § 705(a), 1367(a) (1992).

111. I.R.C. § 731(a), 1368(b) (1992).

112. I.R.C. §§ 734(b), 743(b), 754 (1992). It should be noted that the recognition of outside loss also results in a corresponding reduction in basis inside the partnership when the election has been made.

The inability to adjust the bases of the S corporation's assets does not necessarily result in ultimately imposing double taxation, but rather creates distortions in the timing and character of taxable income that can have the same economic effect as double taxation. With a low basis in the corporate assets, the income determined at the corporate level and passed through to the shareholders can result in taxing the same gains twice. However, because the additional corporate income will further increase the shareholder's basis in the S corporation stock,[113] there will ultimately be a loss on the disposition of the stock that offsets such additional income. The problem is that this off-setting loss may be long-deferred[114] and will likely be a capital loss.[115] In either case, the loss may not effectively offset the excess income.[116]

The simplest example of how the absence of the basis increase at the corporate level will produce an adverse tax consequence can be illustrated by the situation of a two-person S corporation in which each shareholder has contributed $250,000 and the S corporation has no accumulated income or loss. Each shareholder should have a $250,000 stock basis. Assume also that the S corporation has ordinary income assets with a basis of $500,000 and a value of $1,000,000. Should one of the shareholders acquire the interest of the other, presumably paying $500,000 for the stock, the selling shareholder would have only a single level of tax on $250,000 of gain. The purchasing shareholder would take a cost basis in the newly acquired shares and thus an aggregate basis in all stock of $750,000. Having invested $750,000 in a business worth $1,000,000, the purchaser, like the seller, should have taxable income at some point of $250,000. However, the S corporation still has an asset with a $500,000 basis that is worth $1,000,000 because the stock purchase does not affect the basis of the S corporation's assets. The shareholder will therefore report taxable income of $500,000 when it is recognized at the corporate level. Because the $500,000 of income passed through to the shareholder will increase the stock basis to $1,250,000, the excess income reported will eventually be offset by a

113. I.R.C. § 1367(a) (1992).

114. The loss will not be recognized until the stock is sold or disposed of. *See* I.R.C. § 1001(a) (1992).

115. *See* I.R.C. § 1222 (1992). To the extent the stock qualified, I.R.C. § 1244 would allow up to $50,000 ($100,000 for a joint return) to be treated as ordinary income. I.R.C. § 1244(b) (1992). However, I.R.C. § 1244 will not apply to stock acquired other than by issuance from the corporation and will not provide relief in the circumstance of purchased or inherited property.

116. Obviously, there is a significant disadvantage to a current overstatement of income that will not be offset until some time in the future. The problem is exacerbated when the loss is a capital loss because there are substantial limitations on the ability to deduct capital losses. *See* I.R.C. §§ 165(f), 1211 (1992).

loss on disposition of the stock. However, unless this loss is recognized in the same year that the excess income is recognized and passed through, a material overstatement of income will exist for some time. Further, even if the excess income and loss occur in the same year, the loss on the sale of the stock will be a capital loss that will not be available to offset the excess ordinary income that was reported.[117]

The inside-outside basis disparity arises whenever gain has been recognized at the shareholder level, including gains on any sale of stock to third parties or in redemption. Thus, the situations in which it is appropriate to use shareholder level buy-sell agreements or redemption agreements should be narrowly limited in an S corporation context. It should also be recognized that the same problem can and will arise in other circumstances. Most notably, the date of death basis step-up for assets held by the decedent at death creates exactly the same problem. The decedent's stock will take a basis equal to fair market value as of the date of death,[118] but the corporation will continue to hold assets at historic basis. Thus, the use of an S corporation could eliminate the benefit of the tax law's last great loophole, the forgiveness of tax on appreciated assets held until death.[119]

Prior to the superceding of the *General Utilities* doctrine by statute, there were numerous techniques for avoiding the impact of the inside-outside basis imbalance, including in-kind distributions, tax-free liquidations, and sales incident to a twelve-month plan of liquidation. In each case, corporate level income went unrecognized and was eliminated, making the low inside basis immaterial.[120] All of these nonrecognition provisions have now been superceded.[121]

The sole opportunity for avoidance of corporate level recognition of gain in an S corporation is now found in Internal Revenue Code section 453B(h).[122] That section provides that the corporate level

117. If the taxpayer has capital gain from other sources, the loss will be deductible. If not, the taxpayer will be able to deduct $3,000 each year for the next 167 years ($500,000 ÷ $3,000). I.R.C. § 1211 (1992).

118. I.R.C. § 1014(a) (1992).

119. Here the problem is not that the gain was recognized outside. The effect of the date-of-death basis should be to eliminate the gain. Elimination of the gain outside is not very helpful if it will nevertheless be recognized inside and passed through to the shareholder.

120. Prior to 1986, the Code provided for the nonrecognition of corporate level gain on each of these transactions, thus making inside basis immaterial when these transactions were employed. *See* I.R.C. §§ 311, 333, 336, 337 (1954).

121. *See supra* note 28.

122. I.R.C. § 453B(h) (West 1992).

gain will not be recognized when the S corporation disposes of assets in an installment sale occurring pursuant to a plan of complete liquidation. Additionally, the shareholders must properly elect under section 453B(h)(1) to treat the payments received under the installment obligation as the receipt of payment for their stock in the liquidation rather than treating the receipt of the obligation itself as a payment.[123] If the taxpayers are willing and able to so arrange their affairs, the low inside basis will become immaterial. Of course, use of this approach means that the assets must be sold in exchange for the purchaser's installment note and the business liquidated. Even if this result is generally acceptable from a business and economic point of view, section 453B(h) will not provide complete relief. Section 453B(h) only permits the S corporation to defer the recognized gain of an installment sale. Recapture gain[124] cannot be so deferred.[125] Similarly, gain from dealer dispositions or sales of personal property required to be included in inventory are not subject to installment reporting, and such gain will be recognized at the corporate level notwithstanding section 453B(h).[126]

A sale of the stock in lieu of an asset sale will alleviate, but not eliminate, the inside-outside basis disparity problem. While the selling shareholder will directly incur only a single tax on the sale of the stock, the purchaser of the stock will effectively assume the tax liability associated with the low basis asset. In assuming that liability, the price a purchaser is willing to pay should reflect this liability. Thus, a sale of stock will indirectly result in the payment of the tax on built-in gain inside the corporation.

All of these problems can be avoided by the use of a partnership. Subchapter K of the Code permits partnerships to elect adjustment of asset bases to reflect the recognition of gain occurring outside the partnership. Similarly, adjustments to the outside basis at date of death can be reflected in the basis of the partnership's assets.[127]

2. *Taxation of In-Kind Distributions*

Another adverse aspect of subchapter S pass-through taxation arises in connection with distributions in kind. Since 1986 (again owing to the superceding of the *General Utilities* provisions by statute),

123. I.R.C. § 453B(h) (West 1992).
124. *See* I.R.C. §§ 1245, 1250 (1992).
125. I.R.C. § 453B(h) only applies to gain that would otherwise be recognized at the time the installment obligation is distributed. Thus, any gain that cannot be deferred under I.R.C. § 453 will be unaffected by I.R.C. § 453B(h). Recapture gain cannot be deferred through installment reporting. *See* I.R.C. § 453(i) (1992).
126. I.R.C. § 453(b)(1), (2) (1992).
127. *See* I.R.C. §§ 734(b), 743(b), 754 (1992). The basis adjustments are elective, not mandatory. Once made, the election will apply to all subsequent years. I.R.C § 754 (1992).

an in-kind distribution of assets as a dividend, in redemption of shares or in liquidation, will result in the recognition of gain at the corporate level.[128] Further, in the case of a redemption or liquidation, any additional gain in the stock will be recognized by the shareholder.[129] Under subchapter K, such distributions can be made by partnerships without the recognition of gain either to the partner or the partnership.[130] The significance of this difference is best explained by another illustration. Assume X, Y, and Z are equal owners of a business that has assets worth $1,500,000 and a basis of $600,000. Each owner also has a basis for their interest in the business of $200,000. X desires to retire and the parties wish to give X assets worth $500,000, which have a basis of $350,000, in redemption of X's interest in the business. If the business has been organized as an S corporation, the distribution will result in corporate level income of $150,000, which will be shared equally by X, Y, and Z. In addition, X will have a gain of $250,000 on the sale of the stock. Had the business been organized as a partnership, no partner would have recognized gain on this transaction.[131]

3. *Inclusion of Debt in Outside Basis*

Probably the most often discussed difference in taxation under subchapter S and subchapter K is the fact that corporate debt is not included in shareholder basis in an S corporation but is included in the outside basis of partners under subchapter K.[132] In theory, this difference could adversely affect the ability of shareholders of an S

128. *See* I.R.C. § 311, 336, 1371(a) (1992).
129. *See* I.R.C. §§ 302, 331, 1371(c)(2) (1992).
130. I.R.C. § 731 (1992). There are exceptions with respect to distributions of so-called 751 assets or when the redeemed partner is receiving assets in lieu of 751 assets. *See* I.R.C. § 751 (1992). These provisions require recognition of gain to the extent necessary to assure that each partner will recognize their appropriate share of ordinary income. *Id.*
131. This transaction also gives rise to an inside-outside basis disparity with the potential adverse consequences discussed above in that B and C will have a combined outside basis of $500,000 but the corporation will have an inside basis of only $250,000. Had a partnership been used, the partnership would have been entitled to increase the basis of assets so as to cause the aggregate bases of retained assets to equal the outside bases of the remaining partner's. I.R.C. §§ 734(b), 754 (1992).
132. *See* I.R.C. § 752(a) (1992) (treating partners as having contributed cash equal to their share of the partnership indebtedness). No similar provision exists for S corporations.

corporation to deduct losses incurred in the business.[133] This difference, while it may have some continuing significance in specific situations, should be of diminished concern given the adoption of at-risk and passive activity limitations on the use of losses.[134]

4. *Taxation of Contributions and Built-In Gain*

Subchapter S corporations and partnerships are also subject to differing treatment in regard to the ability to transfer appreciated assets to the business without the recognition of gain. Gain will go unrecognized on transfer to a corporation only if the persons transferring the property are in control of the corporation immediately after the transfer.[135] Thus, it is not possible to admit an additional shareholder in consideration of the transfer of appreciated assets without the recognition of gain unless the new shareholder becomes the owner of at least eighty percent of the stock or, alternatively, the existing shareholders make a significant additional contribution in the transaction.[136] Nonrecognition of gain on transfers to a partnership, in contrast, is available whether or not the transferor is in control of the partnership immediately after the transfer.[137]

When property is contributed to an S corporation without gain recognition, the gain inherent in the property[138] will, when recognized by the S corporation, be shared by all of the shareholders in proportion to their stock ownership.[139] Thus, some shareholders will report taxable income notwithstanding that they have not realized any income economically, while the contributing shareholder will have underreported his or her income. In some circumstances, this income shifting could be perceived as an advantage.[140] Most often it is not.

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133. *See* I.R.C. §§ 704(d), 1366(d)(1) (1992). S shareholders can deduct losses to the extent of their basis in any loans that they make to the partnership. I.R.C. § 1366(d)(2) (1992).

134. *See* I.R.C. §§ 465, 469 (1992).

135. I.R.C. § 351, 368(c) (1992).

136. Previously held shares can be counted toward satisfaction of the control test of I.R.C. § 368(c) provided that the shares issued to the owner of such previously owned shares in exchange for a new transfer are not relatively small in value. Treas. Reg. § 1.351-1(a)(1)(ii) (amended 1967). The Service will not treat the new shares as having a relatively small value as long as they represent at least 10% of the value of the total shares owned by the transferor. *See* Rev. Proc. 77-37, 1977-2 C.B. 568, at § 3.07.

137. I.R.C. § 721 (1992).

138. There will be built-in gain (or loss) in the property because the basis of the property contributed to the S corporation will be the same as the basis of the property to the transferor. *See* I.R.C. § 358(a)(1) (1992).

139. I.R.C. § 1366(a) (1992).

140. Income shifting between persons having common economic interests, as between family members, would be desirable if the result is to shift taxable income to a person taxed at a lower rate. Shifting tax liability between unrelated parties is far more problematic.

This situation again gives rise to a problem similar to the inside-outside basis disparity discussed above.[141] The party having reported taxable income in excess of economic income should have an offsetting loss at some point. However, the loss will effectively offset the overstatement of income only if it is not deferred too long and the shareholder can utilize a capital loss.[142] This problem does not arise in the partnership context because any item of income, gain, loss, or deduction which is attributable to the difference between the basis and the value of property at the time of contribution is allocated entirely to the contributing partner.[143]

C. *Possible Benefits of Subchapter S over Partnership Taxation*

1. *Partnership Termination Versus Section 382*

There are also differences between the taxation of S corporations and partnerships that are generally regarded as benefits of the S corporation. One such difference lies in the fact that a partnership will be deemed to have terminated, distributed its assets, and reformed if more than fifty percent of the capital and profit interests are sold or exchanged within a twelve-month period.[144] This deemed termination and reformation generally should not result in the recognition of any gain. Simply, the partnership's basis in its assets will be adjusted to reflect the aggregate outside basis of all of the partners.[145] If the aggregate outside basis of the partners is higher than the partnership's inside basis, the result of a termination under the Code would

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141. *See supra* text accompanying notes 106-27.

142. The offsetting loss exists because of the fact that there will be an increase in the basis of the stock to reflect the excess income reported. The inside-outside basis disparity arising from this transaction does not exist in the aggregate, but exists for individual shareholders. To illustrate, assume A contributes $200 in cash and B contributes property worth $200 but with a $100 basis. Assume there is no economic profit but that the $100 built-in gain is recognized. A and B will each report $50 of taxable income and will increase their outside basis to $250 in the case of A and $150 in the case of B. Because each owns stock worth $200, A has a built-in loss of $50 in the stock as a result of the overstatement of income, and B has a built-in gain of $50 reflecting the understatement of income. This is obviously a benefit to B and a disadvantage to A. B will ultimately recognize gain to correct the understatement of income. A will have a loss which will likely be a long-term capital loss, that may or may not effectively offset the overstatement of income. In this situation at least, I.R.C. § 1244 should provide some relief.

143. I.R.C. § 704(c) (1992). When applicable, the so-called "ceiling rule" can result in distortions of income in the partnership context which are similar to those that are present in an S corporation. *See* Treas. Reg. § 1.704-1(c)(2) (amended 1988).

144. I.R.C. § 708(b) (1992).

145. *See generally* Treas. Reg. § 1.708-1(b)(1) (1960).

be to increase the partnership's basis in the assets and thus produce a tax benefit. If the partnership's inside basis is greater than the outside basis, the result of the termination would be a reduction in the basis of the partnership's assets and would thus be detrimental. The actual benefit or detriment is in timing the differences and character of income or loss, but the termination will not change the net amount of income or loss ultimately reported by the partners. However, timing and character can obviously be of great significance.

The impact of the deemed termination rule is limited by the fact that inside and outside basis disparities will exist as an exception and not as the rule. Indeed, they are avoided by the optional basis adjustment rules. However, the deemed termination can be a disadvantage under particular circumstances. One circumstance is when there are significant declines in the value of the property of a partnership in which over fifty percent of the capital and profit interests have been sold or exchanged in a twelve-month period. While planning cannot avoid the economic decline in value, planning can avoid too great a transfer within a twelve-month period.

The suggestion that S corporations are preferable in this respect is based on the fact that there is no termination rule for S corporations and on the assumption that no other provision would produce a similar result. This assumption is probably incorrect. Section 382 generally applies to limit the use of net operating losses by a corporation following a change of ownership.[146] Because S corporations do not have net operating losses, these rules have never been applied or, at least prior to 1986, have never been applicable to an S corporation. However, section 382 now applies not only to net operating loss carryovers, but also to built-in losses.[147]

S corporations do have built-in losses, and the question therefore arises whether these built-in losses will be subject to limitation under section 382. One could argue that section 382 does not apply given that S corporations must determine income in the same fashion as an individual, and section 382 does not apply to individuals.[148] On the other hand, the rest of subchapter C is applicable to an S corporation, and there is no statutory basis for applying all of subchapter C other than section 382.[149] There is no indication that this result was intended when section 382 was amended. On the other hand, it is difficult to see why anyone should be able to avoid the impact of the section 382 limitations on built-in losses by making a subchapter S election.

If section 382 is applicable to an S corporation, events that would

146. I.R.C. § 382(a) (1992).
147. I.R.C. § 382(h)(1)(B) (West 1992).
148. *See* I.R.C. § 1363(b) (1992).
149. *See* I.R.C. § 1371 (1992).

have resulted in a termination of a partnership would certainly constitute a change of ownership triggering limitations on built-in losses.[150] Many other arrangements that vary the ownership of the S corporation could also trigger the applicability of the section 382 limitations because a change of ownership is very broadly defined for section 382 purposes.[151]

A termination of a partnership that has built-in losses will result in a reduction of basis in order to eliminate some built-in loss. However, the loss eliminated is that which has already been recognized as a loss by a partner through the sale of a partnership interest. The built-in loss allocable to partners who have not yet realized their loss from a sale of their partnership interest will not be affected.[152] Section 382, if applicable, will work in a much different way. Section 382 does not reduce basis. Instead, it limits the deductions that are attributable to the amount of basis which is in excess of the value of the asset.[153] This limitation is potentially applicable not only to the selling shareholder's share of the built-in loss, but also to the ongoing shareholders' share of such loss.[154] Under section 382, deductions that are attributable to the built-in loss at the time of an ownership change are subject to an annual limition equal to the value of the business as of the time of the ownership change multiplied by the federal long-term, tax-exempt interest rate.[155]

150. *See* I.R.C. § 382(a) (1992) (limiting deductions after a change of ownership); I.R.C. § 382(g) (1992) (defining an ownership change as any 50% increase in ownership by one or more 5% shareholders within a 3 year period). Many people can end up being 5% shareholders without owning 5% of the shares. *See generally* Parker, *supra* note 45, at 658-59.

151. A partnership termination results only when there has been a sale or exchange of more than 50% of the capital and profits within a 12-month period. I.R.C. § 708(b)(1)(B) (1992). Thus, changes in ownership that result from redemptions or new issuances cannot result in a termination. Similarly, because sales resulting in a termination must occur within a ½-month period, there is the possibility of simply deferring some transactions to avoid termination, as for example, by having some portion of the interests to be transferred delayed under an option or a contract to sell in the future. An ownership change under § 382, in contrast, is tested over a three-year period (I.R.C. § 382(i) (1992)) and takes into account changes in ownership however effected. I.R.C. § 382(g)(2) (1992); Temp. Treas. Reg. § 1.382-2T(e)(1)(i) (1986). Additionally, section 382 contains numerous provisions to assure that the parties do not take steps that avoid an ownership shift. *See* I.R.C. § 382(l)(3)(A)(iv) (1992) (treating options as exercised if it will result in an ownership change); I.R.C. § 382(k)(6) (1992) (permitting certain stock interests to be treated as not stock and certain non-stock interests to be treated as stock).

152. *See infra* the illustration in the text accompanying notes 156-61.

153. *See* I.R.C. §§ 382(h)(1)(B), (h)(2)(B) (1992).

154. *See infra* the illustration in the text accompanying notes 156-61.

155. I.R.C. §§ 382(a), (b) (1992).

The substantial differences in the nature of the limitations make it difficult to generalize as to their impact. In some cases, section 382 will be more onerous than a partnership termination and in some cases less. To give just one illustration of how the two rules might operate, assume that A and B are partners in a partnership and that A, having contributed $600,000, owns 60% of the capital and profits, and B, having contributed $400,000, owns the remainder. The partnership in turn owns assets with a basis of $1,000,000 and a value of $600,000. If A sells her partnership interest to C for $360,000 (60% of the value of the underlying asset), A will have a $240,000 loss. This will terminate the partnership, with the result being the basis of the partnership asset will be reduced to $760,000.[156] There is still a built-in loss of $160,000 that will, when recognized, be allocated to B.[157] Thus, the only effect of the termination is to reduce the built-in loss inside to reflect the fact that A's share of the loss has already been recognized outside.

Had an S corporation been used and the same events occurred, the sale by A to C would still produce a $240,000 loss to A. If section 382 applies, the sale would also be a change of ownership.[158] Because the S corporation has a net unrealized built-in loss,[159] the deduction of that loss, when recognized, either as a depreciation deduction or on sale,[160] will be limited to the tax-exempt rate multiplied by the value of the corporation at the time of the ownership change.[161] With a value of $600,000 and assuming a federal long-term, tax-exempt rate of 3%, only $18,000 of loss will be allowed in any year. B, as a 40% shareholder, will benefit from only $7,200 of this loss each year. On these facts, B obviously is losing the tax benefit of an economic loss in a circumstance in which the loss would have continued to be deductible if A and B had used a partnership form.

156. Treas. Reg. § 1.708-1(b)(1)(iv) (1960). The partnership is deemed to have distributed its assets to the partners and the partners are deemed to have recontributed the assets to a new partnership. On the deemed distribution, no gain or loss is recognized by the partnership or the partners. I.R.C. §§ 731(a), (b) (1992). The basis of the 60% of the assets deemed distributed to C will have a $360,000 basis and the 40% of the assets distributed to B will have a $400,000 basis. I.R.C. § 732(b) (1992). No gain or loss is recognized on the deemed recontribution. I.R.C. § 721(a) (1992). The partnership will take the partner's basis as its basis for the assets. I.R.C. § 723 (1992). Thus, the effect of the termination is simply to reduce the partnership basis from $1,000,000 to $760,000.

157. B is deemed to have contributed assets with a basis of $400,000 and a value of $240,000. *See supra* note 156. Deductions or losses attributable to the excess of the basis over value must be allocated to B. I.R.C. § 704(c) (1992).

158. I.R.C. § 382(g) (1992).

159. I.R.C. § 382(h)(3) (1992).

160. I.R.C. § 382(h)(2)(B) (1992).

161. I.R.C. §§ 382(a),(b), (h)(1)(B) (1992).

2. *Tax-Free Reorganizations*

A second difference suggested as a benefit of the S corporation is the ability to engage in tax-free reorganizations. As discussed earlier, the general significance of the corporate ability to engage in a tax-free exchange as to the selection of the proper entity is quite speculative.[162] The same is true with regard to S corporations. Obviously, a tax-free reorganization is valuable only if there is significant built-in gain in the S corporation's stock. When there is substantial built-in gain in S corporation stock, there will also be substantial built-in gain in the corporation's assets. If the business is acquired in a tax-free reorganization, the shareholder-level gain is deferred until the disposition of the shares of the acquiring corporation received in the reorganization.[163] However, in addition, the built-in gain in the corporation will also be subject to future taxation in the hands of the acquiring corporation, and the purchase price should, in theory, be reduced to reflect this assumed tax liability.[164] Thus, the preference for incorporation and election under subchapter S, owing to the ability to engage in reorganization transactions, should exist only if the single tax on the gain (which would be recognized immediately in the absence of a reorganization) will exceed the cost of the deferred shareholder-level tax, the immediate payment of the present value of the deferred corporate-level tax, and the disadvantage of being required to retain the acquiring corporation's stock to continue the deferral. At most, the ability of an S corporation to engage in a reorganization provides the flexibility to balance relevant considerations should the need arise.[165]

162. *See supra* text accompanying notes 60-66.

163. *See* I.R.C. § 354 (1992) (defering gain on the exchange of stock for stock of the acquiring corporation pursuant to a reorganization); I.R.C. § 358 (1992) (preserving the gain for future recognition by means of giving the new stock an exchange basis).

164. The liability assumed may have little impact if the built-in gain exists in goodwill, because the recognition of the built-in gain will be deferred indefinitely. If the built-in gain exists in inventory on the other hand, the gain to be recognized by the acquiring corporation will not be long deferred.

165. The ability to participate in a tax-free reorganization could be a great benefit if the acquiring corporation is unwilling to give any consideration other than stock and the stock will not be readily convertible into cash. A lower tax burden may not be much of a benefit if there is no cash available to pay the liability.

D. Summary

The above discussion details many of the potentially adverse impacts of using the S election as opposed to a partnership. The discussion is by no means exhaustive. The differences in treatment arise from the fact that subchapter S is simply less thorough in its efforts to create a single-level, pass-through tax regime, but continues to regard S corporations as corporations for most tax purposes. These shortcomings manifest themselves in many situations that cannot be exhaustively addressed in this Article. However, what has been discussed should be enough to justify the conclusion that, all other things being equal, taxation under subchapter K should be preferred to taxation under subchapter S.

Obviously, all other considerations are not equal. Most obviously, subchapter S is preferable if the business is already incorporated and there is a desire to convert to a pass-through tax regime. Conversion to a partnership would require a liquidation and would thus result in immediate taxation of all gains.[166] The election to have subchapter S apply does not involve any liquidation or recognition of gain.

With respect to new businesses, the preference for subchapter K will not necessarily be controlling unless the organization can also provide the owners with state law benefits comparable to incorporation. However, the conclusion of this Article is that comparable state law relationships are now possible without incorporation or corporate tax.[167]

IV. The Alternative of Incorporation with Tax Reduction Planning

It is likely that businesses which cannot utilize the subchapter S election and to which limited liability and organizational continuity have been of overriding concern have generally opted to incorporate and undertake efforts to reduce the burden of double taxation.[168]

Double taxation of the income earned through a corporation is not a significant problem in businesses in which capital is not a material income producing factor. Simply, the income in such a business is attributable to the services being provided and can typically be paid out by the corporation as deductible compensation, leaving little or no taxable income in the corporation.[169] Significant reduction of corporate taxable income is more difficult in a business in which capital

166. *See* I.R.C. §§ 331, 336 (1992).
167. *See infra* text accompanying notes 312-98.
168. This was probably due in part to the fact that prior to 1986 the corporate tax rate was lower than the individual tax rate. Thus, any income accumulated would be taxed at a lower rate by using a corporate form.
169. Of course, even a business that requires no capital investment may develop

is a material income producing factor. In such a business, the payment of all profits to shareholders as purported compensation would not be justifiable.[170]

Probably the most common arrangement for the reduction of double taxation in businesses in which capital is a material income producing factor is the use of a significant amount of debt financing. The benefits of debt financing are numerous: the payment of interest on the debt is deductible by the corporation with the result that at least a portion of the return to investors will escape the corporate level of taxation; the receipt of payment on the principal balance of the debt will not be subject to taxation, thereby permitting a significant amount of corporate assets and earnings to be used to repay the indebtedness without double taxation; and the need to repay the indebtedness will be treated as a reasonable need of the business justifying accumulations of income without incurring any accumulated earnings tax and thereby permitting the shareholder level tax to be deferred.[171]

The principal tax limitation on the use of debt to ameliorate the double tax is that loans from shareholders that in fact represent corporate equity will be so treated.[172] Treatment of putative debt as equity is particularly likely where the debt is proportionately held, the corporation's debt-to-equity ratio is unrealistically high, or the shareholder loans are subordinated to the claims of the corporation's other creditors.[173] Thus, while some debt can be utilized to lessen corporate taxation, it would certainly be unwise to endeavor to use debt financing to entirely eliminate corporate tax.

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intangible value, which adds to the production of income, and, in such a case, it may not be possible to legitimately eliminate corporate taxable income through salaries.

170. No doubt compensation and other types of purportedly deductible payments in excess of what is reasonable are often paid to shareholders to ameliorate the corporate tax burden. Such amounts would not be allowed as deductions if all facts were to become known, but all facts often do not become known. Thus, while not theoretically appropriate, the inability of the Service to audit all returns permits much corporate-level tax to be avoided through excessive payments to shareholders.

171. For a discussion of the tax benefits and costs of debt financing, see BITTKER & EUSTICE, *supra* note 18, at 4-28 to 4-49.

172. *See generally id.* at 4-2 to 4-27.

173. *See* I.R.C. § 385 (1992). There are currently no regulations implementing this provision, and given that the Treasury has been unable to provide regulations during the 23 years that have elapsed since § 385 was adopted, there is reason to be skeptical as to whether regulations ever will be issued. Section 385 is at least helpful as a partial listing of those factors that are relevant to the characterization of purported debt. For a discussion of the one time final regulations that never became effective, see Richard L. Kaplan & Lowell D. Yoder, *New Variations on an Old Enigma: The Treasury Department's Debt-Equity Regulations*, 1981 U. ILL. L. REV. 567 (1981).

In addition to tax-based limitations on the use of debt, it should be recognized that it is not always a simple matter to accommodate the use of significant indebtedness to the needs of the business. Simply, many businesses cannot undertake the burden of annual interest payments or commit to the return of capital at a certain time under their business plan.

An alternative means to avoidance of corporate taxation is to separate the ownership of assets from the business. To the extent shareholders can own assets, such as a building or equipment, outside of the corporate form and lease the property to the corporation, the income attributable to the ownership and use of the property should escape corporate taxation because of the corporation's ability to deduct rental payments. Of course, this will qualify the benefits of incorporation because liabilities associated with the property will be charged to the owners. The organizational structure adopted for the ownership of the property will have to deal with the issues of organizational continuity, lack of transferability, and lack of centralized management, all of which led to the adoption of the corporate form for the business in the first place.

There is neither time nor inclination to undertake in this Article a detailed review of techniques available to reduce the double tax burden.[174] Rather, suffice it to say that tax planning can greatly reduce the burden of double tax. However, tax planning cannot legitimately eliminate the double tax for all businesses. Thus, the decision to adopt the corporate form is often made in spite of the higher tax burden it entails. This decision must be based on the conclusion that the state law benefits of incorporation justify the cost. Again, this Article precisely suggests that this conclusion may no longer be valid.

V. Use of Noncorporate Forms Prior to 1988

Prior to the mid-1980s, efforts to address the choice of entity dilemma through unincorporated forms presented significant difficulties. The concerns regarding the use of this approach had dual origins. First, because the tax law defines corporations for tax purposes as including both incorporated entities and unincorporated associations, which more nearly resemble a typical corporation than a partnership, taxpayers have needed to address the state law issues without being too successful.[175] Second, businesses have needed to

174. *See generally* Cavitch, *supra* note 104, at v. The author notes that a "vast proliferation of tax materials is available to the lawyer and accountant, from compilations of primary sources to esoteric law review articles, from primers to encyclopedias, from the lowest level of basic mechanics to the loftiest reaches of academe." *Id.* Tax planning for corporations is not a subject to be digested and summarized briefly.

175. Prior to 1988, the only unincorporated organizations under state law that

discover means by which the state law issues could in fact be addressed without resorting to incorporation of the business.

A. *Entity Classification for Tax Purposes Prior to 1988*

1. *Background*

Federal income tax law takes cognizance of only two types of entities through which co-owners may conduct business—partnerships and corporations.[176] Congress understood early on that many of the diverse relationships permitted under state law could potentially be utilized to avoid the corporate income tax while providing owners with many of the benefits of incorporation. Because Congress did not intend the corporate tax system to be voluntary, it was necessary to extend the corporate income tax to other forms of organization permitted under state law that were functional equivalents of the corporate form. Congress sought to accomplish this end by defining corporations for tax purposes as including incorporated entities, joint stock companies, and "associations."[177] Partnerships, in turn, are defined to include any joint business endeavor that is not treated as a corporation.[178]

While there was uncertainty as to the meaning of the term "association" for many years,[179] the Supreme Court endeavored in 1935

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were reasonably available without corporate characterization for tax purposes were partnerships. *See supra* text accompanying notes 17-24. Since 1988, the limited liability company has emerged as another option. *See infra* text accompanying notes 312-76.

176. *See* I.R.C. §§ 761(a), 7701(a)(2) (1992) (defining a partnership as including any unincorporated organization through which any business is carried on that is not a corporation, trust, or estate). *See also* Treas. Reg. §§ 301.7701-2(a)(2) (amended 1983), 301.7701-4(b) (1986) (requiring that trusts engaged in the conduct of a business be treated as either a partnership or a corporation). Special tax regimes may apply to certain qualifying businesses that are not relevant to the present topic. *See, e.g.*, I.R.C. §§ 851-860 (1992) (dealing with regulated investment companies and real estate investment trusts).

177. I.R.C. § 7701(a)(3) (1992).

178. I.R.C. §§ 761(a), 7701(a)(2) (1992). *See also supra* note 176.

179. For early cases involving the scope of the definition of a corporation for various tax purposes, see Eliot v. Freeman, 220 U.S. 178, 185 (1911) (involving the Corporation Tax Law of 1909, ch. 6, § 38, 36 Stat. 11, 112 (1909), under which an excise tax was imposed on "corporations and joint stock associations . . . now or hereafter organized under the laws of the United States or of any State or Territory of the United States") (quoting the Corporation Tax Law of 1909); Crocker v. Malley, 249 U.S. 223, 233 (1919) (involving the Income Tax Law of 1913, ch. 16, 38 Stat. 114 (1913), imposed on income tax of "every corporation, joint-stock company or association, and every insurance company, organized in the United States, no matter how created or organized, not including partnerships") (quoting the Income Tax Act of 1913, ch. 16, § 2(G)(a), 38 Stat. 172 (1913)); Hecht v. Malley, 265 U.S. 144 (1924) (involving the imposition of an

to articulate a standard for identifying associations taxable as corporations in *Morrissey v. Commissioner*[180] and three companion cases.[181] The Court in *Morrissey* addressed the use of an express business trust to carry on business activities. The Court held that by including associations in the definition of a corporation for federal income tax purposes, Congress intended to extend corporate taxation not only to an organization that duplicated the corporate relationship, but also to any organization that closely resembled the corporate form.[182] The Court went on to conclude that the classification issue was not to be resolved by resort to "mere formal procedure," but that the test of corporate resemblance should be based on whether a particular organization possessed those attributes that typify the corporate form.[183]

In this connection, the court decided that the express trust at issue in the case possessed the corporate attributes of associates engaging in business for joint profit, centralized control of the business, continuity of existence independent of ownership, limited liability of the owners, and free transferability of the ownership interests.[184] Finding these attributes present, the Court held that the entity sufficiently resembled an incorporated organization to justify the conclusion that "Congress intended that the income of the enterprise should be

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excise tax on trusts under the Revenue Act of 1916, ch. 463, 39 Stat. 756 (1916), which defined the organizations subject to the tax in the same fashion as the Corporation Tax Law of 1909 considered in *Eliot*, and the Revenue Act of 1918, which used language substantially the same as that of the Income Tax Act of 1913 considered in *Crocker*). The *Hecht* Court followed *Eliot*, but did not feel itself bound by *Crocker*. *See also* Burk-Waggoner Oil Ass'n v. Hopkins, 269 U.S. 110, 113 (1925) (construing the Revenue Act of 1918, ch. 18, §§ 218(a), 335(c), 40 Stat. 1070, 1096 (1919) and applying the income tax portions of the Revenue Act of 1918 to a Texas organization in which trustees held the assets for the beneficial owners who were in turn treated as partners under Texas law). The Court therein held that the separate treatment under the Revenue Act of 1918 of partnerships was for "ordinary partnerships."

It should be pointed out that the term "ordinary partnerships" was commonly used to mean general partnerships as opposed to special or limited partnerships. Thus, *Burk-Waggoner* could be read to sanction taxation of limited partnerships as associations. However, it is reported that all states, with the possible exceptions of Arizona and Florida, had limited partnerships acts in effect at the time *Burk-Waggoner* was decided. *See* WARREN, *supra* note 17, at 306 n.3. The government did not endeavor to tax all limited partnerships as associations, however. Instead, the government referred primarily to the statute under which the limited partnership was formed, declaring some to always produce partnerships, some to always produce associations, and some to be dependant on the agreement. For a fairly complete coverage of the status of limited partnerships prior to 1960, see J.M. BARRETT & ERWIN SEAGO, PARTNERS AND PARTNERSHIPS: LAW AND TAXATION, ch. 13, § 6 (1956).

180. 296 U.S. 344 (1935).

181. Swanson v. Commissioner, 296 U.S. 362 (1935); Helvering v. Combs, 296 U.S. 365 (1935); Helvering v. Coleman-Gilbert Assocs., 296 U.S. 369 (1935).

182. *Morrissey*, 296 U.S. at 357.

183. *Id.* at 358.

184. *Id.* at 359.

taxed in the same manner as that of corporations."[185]

While the essential features of the corporate resemblance test established in *Morrissey* continue to be controlling, the test has had an interesting history since it was first articulated by the Supreme Court.[186] For present purposes it is sufficient to understand that regulations were issued in 1960 under which the test for imposing corporate taxation on unincorporated organizations was to be based on the determination of whether the organization possessed the principal corporate attributes enunciated in *Morrissey*, but with a significantly more explicit and mechanical test.[187]

2. *The Mechanical Test of the 1960 Regulations*

In general, Treasury Regulations sections 301.7701-2, 301.7701-3 (1967), and 301.7701-4(4)(1986) (the 1960 Regulations) require that corporate resemblance be determined by resort to the six characteristics that the Court found controlling in *Morrissey*: associates, conduct of a business for joint profit, centralized management, continuity of life, limited liability, and free transferability of interests.[188] The 1960 Regulations then provide that any characteristic typical of both a corporation and another form of entity be disregarded for purposes of determining the corporate resemblance of such an entity.[189]

The regulations expressly recognize that trusts and corporations both commonly possess all of the corporate attributes other than associates and the conduct of a business for joint profit. Thus, the regulations provide that a trust under state law will not be treated as a trust for tax purposes if it has associates conducting a business for joint profit.[190] As in *Morrissey*, this test will almost always result in any trust engaged in the conduct of a business being treated as a corporation.[191] Further, because all voluntarily created organizations must be a trust, a partnership, or a corporation for tax purposes, the

185. *Id.* at 360.
186. For a concise history of the corporate resemblance test after *Morrissey*, see McKEE ET AL., *supra* note 37, at ¶ 3.06[1].
187. *See* Treas. Reg. §§ 301.7701-2 (1983), 301.7701-3 (1967), 301.7701-4 (1986). These regulations will be referred to as the 1960 Regulations.
188. *See* Treas. Reg. § 301.7701-2(a)(2) (as amended in 1983).
189. Treas. Reg. § 301.7701-2(a)(1) (as amended in 1983).
190. *Id. See also* Treas. Reg. § 301.7701-4(b) (1967).
191. Business trusts that lack two of the corporate characteristics will be treated as a partnership for tax purposes. *See, e.g.*, Priv. Ltr. Rul. 91-07-028 (Nov. 20, 1990) (treating a business trust not having free transferability and continuity of life as a partnership for tax purposes).

result of the 1960 Regulations is to require all organizations engaging in business activities to be treated as either a partnership or a corporation.[192]

In distinguishing between partnerships and associations taxable as corporations, the regulations recognize that associates and conduct of a business for joint profit are common attributes of corporations and partnerships and are thus not relevant to tax classification.[193] Distinction between partnerships and corporations is therefore dependant on the corporate attributes of limited liability, continuity of life, centralized management, and free transferability.[194] The standard imposed under the 1960 Regulations for finding that an organization is an association taxable as a corporation is that the organization possess more corporate than noncorporate characteristics. Thus, at least three of the four relevant corporate attributes must be present for corporate income tax to be imposed. Any unincorporated organization not possessing at least three corporate attributes will be treated as a partnership.[195]

While the 1960 Regulations contemplate that other corporate or noncorporate characteristics may be relevant[196] and that in some instances free transferability might be accorded less weight than the other characteristics,[197] the express test of the 1960 Regulations does not allow for the consideration of any other factors or disproportionate weighing of factors. This inconsistency in the regulations was addressed by the Tax Court in *Larson v. Commissioner*.[198] The Tax Court held that the 1960 Regulations, as written and then in effect, did not permit consideration of any factors other than the four principal characteristics, that the characteristics necessarily carried equal weight, and that association status was not possible under the regulations unless at least three of the four corporate attributes were present.[199] In 1979, the Service acquiesced in this aspect of the *Larson* decision.[200]

3. *Definition of the Corporate Attributes*

In addition to imposing a mechanical test for corporate resemblance, the 1960 Regulations also undertook to explain the nature of the relevant attributes in detail. At the time the regulations were

192. *See* Treas. Reg. § 301.7701-4(b) (1967).
193. Treas. Reg. § 301.7701-2(a)(2) (as amended in 1983).
194. *Id.*
195. Treas. Reg. § 301.7701-2(a)(3) (as amended in 1983).
196. *See* Treas. Reg. § 301.7701-2(a)(1) (as amended in 1983).
197. *See* Treas. Reg. § 301.7701-2(e)(2) (as amended in 1983).
198. 66 T.C. 159 (1976), *acq.* 1979-1 C.B. 1.
199. *Id.* at 185-86.
200. 1979-1 C.B. 1. The Service simultaneously issued Rev. Rul. 79-106, 1979-1 C.B. 448, stating the terms of its acquiescence.

promulgated, the Service's principal concern was with preventing professional service organizations from being treated as corporations for federal income tax purposes. This would have enabled them to have access to the more favorable treatment accorded corporate retirement plans.[201] Thus, the regulations generally made avoidance of the corporate attributes fairly easy to accomplish.[202] While subsequent approval of professional corporations under state law and later the equalization of retirement benefits for corporate employees and partners[203] has eliminated the principal motivation underlying the definition of the corporate attributes, the 1960 Regulations have not changed.

The following subsections discuss the general nature of the relevant corporate attributes under the 1960 regulations.

a. *Centralized Management*

The 1960 Regulations recognize that corporate management is typically vested exclusively in a representative body rather than in owners. Consistent with this corporate norm, the 1960 Regulations state that the corporate attribute of centralized management is present in an organization only if "continuing exclusive authority" to manage the business is vested in representatives instead of in the owners.[204]

The 1960 Regulations state that general partnerships cannot possess the corporate characteristic of centralized management because each general partner has, in default of a contrary agreement, an equal right to participate in management and the right to bind the partnership for acts occurring within the usual course of business.[205] However, this conclusion holds under the 1960 Regulations even if the partners agree among themselves to vest management in a representative group resembling a board of directors because the agreement between the partners cannot remove the inherent power of a

201. The 1960 Regulations, *see supra* note 187, were issued a short time after and in direct response to the Ninth Circuit's decision that a group of physicians were an association taxable as a corporation and were therefore entitled to establish a qualified corporate pension plan. United States v. Kintner, 216 F.2d 418 (9th Cir. 1954). *See* MCKEE ET AL., *supra* note 37, at 3-49 to 3-50. Because the income of the association was attributable exclusively to the services of the physicians, all corporate income could be eliminated by the payment of salaries so that no corporate-level tax was in fact incurred.

202. *See infra* text accompanying notes 204-39.

203. *See supra* text accompanying notes 66 and 67.

204. Treas. Reg. § 301.7701-2(c)(1) (as amended in 1983).

205. *See* UPA §§ 9, 18(e), (h).

partner to bind the partnership with respect to any person not having knowledge or notice of the agreement.[206] This inherent power to bind the partnership causes the centralized management to be nonexclusive because the power to bind cannot be given exclusively to a centralized management group under state law.

Just as with a general partnership, the right of the general partner of a limited partnership to manage the business, as an owner, and the power of general partners to bind the partnership notwithstanding any agreement to the contrary will normally preclude a finding that a limited partnership has the corporate attribute of centralized management notwithstanding that limited partners are excluded from participation in management.[207] This conclusion holds true even if there is only one general partner.[208] Thus, the 1960 Regulations do not appear to be relying on the existence of the inherent power of partners in reaching this conclusion. Instead, it appears that the Regulations are relying on the fact that the management rights are held as an owner under state law rather than as a representative. Consistent with this view, the 1960 Regulations limit the conclusion to situations in which the general partner or partners possess a substantial interest in the organization.[209] When the general partner or partners of a limited partnership do not have a substantial interest, the 1960 Regulations seem to conclude that whatever rights and powers the general partners have are held in a representative capacity, sufficiently resembling the rights and powers of a corporate board of directors to find the corporate attribute of centralized management to be present.[210] Further, if limited partners have the ability to remove the general partner or partners, the likelihood of finding centralized management is increased. In such a case, the 1960 Regulations state that all facts and circumstances must be considered.[211] This is consistent with the notion that the 1960 Regulations are looking for someone who is managing the business as a representative of owners rather than as an owner.[212]

206. *See* Treas. Reg. § 301.7701-2(c)(4) (as amended in 1983); UPA § 9.

207. *See* RULPA § 403(a).

208. Treas Reg. § 301.7701-2(c)(4) (as amended in 1983).

209. *Id.* The rational for this exception is not articulated in the regulation. The regulation also gives no guidance as to what is necessary for an interest to be substantial. The Service will not issue a ruling that centralized management is absent unless the general partner(s) hold at least 20% of all interests in the partnership. *See* Rev. Proc. 89-12, 1989-1 I.R.B. 798, § 4.06.

210. Treas. Reg. § 301.7701-2(c)(4) (as amended in 1983).

211. *Id.* It is not clear what other facts and circumstances are relevant in this regard.

212. The 1960 Regulations provide that a substantially restricted right to remove the general partner, such as a right to remove for cause, will not of itself create centralized management. *See supra* note 187.

b. *Continuity of Life*

The existence of a corporation is not dissolved, terminated, or otherwise affected by changes in ownership. Rather, corporations have a potentially perpetual existence. In contrast, a general partnership under state law is not generally viewed as an entity for this purpose, but as a relationship between particular persons. When any person ceases to be a party to the relationship, that particular relationship ceases to exist; it is dissolved so far as state law is concerned.[213] Dissolution occurs under state law when the old relationship ceases to exist even though a new relationship involving most of the same people may immediately replace the dissolved relationship and continue its activities.[214] It is this fundamental difference between the identity of corporations and general partnerships under state law that is controlling under the 1960 Regulations.[215]

The Regulations provide that continuity of life is absent if the "death, insanity, bankruptcy, retirement, resignation, or expulsion of any member will cause a dissolution of the organization."[216] In applying this concept to general partnerships, dissolution is stated to have reference to the end of the mutual agency, which exists under state law within a general partnership, not to the ceassation of business conducted by the partners or their successor.[217] With respect to general partnerships, the 1960 Regulations thereby make it impossible to conclude that the corporate attribute of continuity of life will ever be present for tax purposes. So that there be no misunderstanding that this is precisely what is intended, the 1960 Regulations further provide that a partnership formed under a statute corresponding to the Uniform Partnership Act (UPA) will never possess the corporate attribute of continuity of life.[218]

The 1960 Regulations reach the same conclusion with respect to

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213. *See* UPA §§ 29, 30.
214. *See* UPA § 30.
215. Treas. Reg. § 301.7701-2(b)(1) (as amended in 1983).
216. *Id.*
217. Treas. Reg. § 301.7701-2(b)(2) (as amended in 1983). *Compare* UPA § 29 *with* UPA § 30 (distinguishing between dissolution and termination of a partnership). *See also* UPA §§ 38(2)(b), 41 (dealing with circumstances under which a partnership may be continued without winding up following a dissolution).
218. Treas. Reg. § 301.7701-2(b)(3) (as amended in 1983). It is reported that 49 states plus the District of Columbia, Guam, and the Virgin Islands have adopted the UPA. *See* 6 U.L.A. 1-2 (West Supp. 1992). Only Louisiana appears not to have the UPA in effect. While many states have adopted variations from the UPA, only Arkansas has adopted a provision that provides that a change in the relations between partners will not be a dissolution when the partners have so agreed. *See* 6 U.L.A. 364 (1969).

limited partnerships,[219] though the rationale for this conclusion is less clear. Again, the stated test for continuity of life is whether the bankruptcy, retirement, death, or insanity of any partner would cause a dissolution absent agreement of the remaining general partners or of all partners to continue the partnership.[220] In turn, the Uniform Limited Partnership Act (ULPA) provides that the retirement, death, or insanity of a general partner will dissolve the partnership unless the remaining general partners continue the business (1) under a right to do so stated in the certificate of limited partnership or (2) with the consent of all other members.[221] Because the 1960 Regulations expressly recognize that the corporate attribute of continuity of life will not be present in limited partnerships formed under a statute corresponding to the ULPA, the regulations must be construed so as to treat continuation of the partnership without dissolution under a right to do so stated in the partnership agreement as continuation with the consent of the remaining general partners or of all other partners.[222]

This conclusion is explainable in one of three ways. First, the consent of all of the other partners could be read so as not to require that the consent be contemporaneous. In such event, the requirement of the 1960 Regulations that all other partners consent would be satisfied by reason of the consent given at the time the agreement was entered into and the certificate was filed. Second, because a general partner cannot be forced to continue as a partner, the general partners continuing the business under a right to do so set forth in the certificate are necessarily consenting. Third, continuity could be lacking because the last remaining general partner, even if not yet known, will have the power to dissolve the partnership because there is no remaining partner to continue the business. Regardless of the explanation for the result, the result is unequivocal. An organization formed under a statute corresponding to the ULPA does not possess continuity of life.

The Revised Uniform Limited Partnership Act (RULPA) is substantially the same as the ULPA in regard to dissolution with one

219. Treas. Reg. § 301.7701-2(b)(4) (as amended in 1983) (stating that a partnership formed under a statute corresponding to the ULPA generally will not possess continuity of life). *See also* Treas. Reg. § 301.7701-2(a)(5) (as amended in 1983) (providing that all references to the UNIFORM LIMITED PARTNERSHIP ACT (ULPA) (1969) also refer to the RULPA). It is clear that the RULPA (1976) is addressed by this regulation. It is not clear whether the reference includes the RULPA (1985).

220. Treas. Reg. § 301.7701-2(b)(1) (as amended in 1983).

221. ULPA § 20. The withdrawal of limited partners does not cause a dissolution under the ULPA unless the partners have all agreed otherwise. The difference in the concept of dissolution for general and limited partnerships is no doubt attributable to the fact that the partners in a limited partnership are not in fact all party to a mutual agency.

222. Treas. Reg. § 301.7701-2(b)(3) (as amended in 1983).

notable exception. As in the ULPA, the withdrawal of a general partner will not cause dissolution if there remains at least one general partner and the remaining general partner continues the partnership under a right to do so set forth in the certificate of limited partnership.[223] The one significant difference is that even if there is no remaining general partner, the limited partners may, within ninety days, appoint a new general partner who may then continue the partnership.[224] The 1960 Regulations expressly provide that the statement that a limited partnership formed under a statute corresponding to the ULPA cannot have continuity of life also applies to limited partnerships formed under the RULPA.[225]

It should be noted that the Internal Revenue Service (Service) has taken the position that it will not give an advance ruling that a partnership lacks continuity of life if a new general partner can be admitted to and continue the partnership without the contemporaneous consent of at least a majority of the limited partners given at the time of the admission of the new general partner.[226] It is difficult to determine the exact scope of this ruling position. However, it appears if the continuation does not necessitate the admission of a new general partner, then the ruling standard will have been satisfied whether or not continuation with an old general partner requires consent of the limited partners. Interpreted in this way, the ruling

223. RULPA (1976) § 801(3). The RULPA (1985) drops the reference to the ability to continue without dissolution with the consent of all other partners. This might appear to be a significant change, but it is a nonsubstantive amendment. If all of the limited partners consent to continue and the general partner is unwilling to do so, it will dissolve. On the other hand, if the general partner is willing to continue and has the right to do so, whether or not the right is pre-existing, arises from contemporaneous consent of the limited partners, or from any other source, the partnership will continue. RULPA (1985) § 801(4) also permits the right to continue to be established in the partnership agreement without inclusion in the certificate of limited partnership. This is consistent with the fact that the certificate of limited partnership under RULPA (1985), like most corporate filings, has become more perfunctory.

224. RULPA (1976) § 801(3). Prior to the RULPA, the situation was not greatly different. Instead, the limited partners simply needed to find and admit a new general partner before the old general partner technically withdrew. The RULPA has simply eliminated the need for advance notice and has dealt with potential surprises. Even under the ULPA, if the limited partners wished to continue after dissolution, they simply found a new general partner and formed a new partnership. The fact of dissolution was of little practical significance.

225. Treas. Reg. § 301.7701-2(a)(5) (as amended in 1983).

226. Rev. Proc. 89-12, 1989-1 I.R.B. 798, § 4.05. It should be noted that the Service is implicitly stating that it will issue a ruling where at least contemporaneous majority consent is required. It should also be noted that the ruling standard does not necessarily reflect the Service's view of the substantive law.

position is consistent with the 1960 Regulations other than the statement in the regulations that a partnership formed under the RULPA cannot possess continuity of life. Of course, it is hard to imagine the circumstance in which a new general partner would be admitted to continue the business without consent of a majority of the limited partners. Even if the limited partners have contracted to consent to continuation, they would at least retain some control over who is to be admitted.

c. *Limited Liability*

No shareholder of a corporation is liable for the obligations of the corporation simply by reason of being a shareholder. In contrast, general partners, whether of a general partnership or a limited partnership, are personally liable for all of the obligations of the partnership.[227] Thus, the 1960 Regulations state that partnerships will not possess the corporate characteristic of limited liability.[228] The only exception to this conclusion under the regulations is that where the general partner of a limited partnership has no substantial assets and is a mere "dummy acting as agent of the limited partners," the corporate attribute of limited liability will be present.[229]

227. UPA § 15; RULPA § 403(b).

228. Treas. Reg. § 301.7701-2(d)(1) (as amended in 1983).

229. Treas. Reg. § 301.7701-2(d)(2) (as amended in 1983). No effort has been made in the regulations to suggest what will cause a partner to be a dummy acting as an agent of the limited partners. Because the regulations require that the general partner be both a dummy and lack substantial assets, the lack of assets alone does not make the general partner a dummy. It is interesting to note that even if the general partner is a dummy acting as agent of the limited partners and lacks substantial assets and the organization therefore appears to possess limited liability under the 1960 Regulations, *see supra* note 187, the 1960 Regulations go on to state that this corporate attribute will not be present because the limited partners, as principals of the general partner, will be personally liable. It seems that the 1960 Regulations are providing that limited liability will be absent for tax purposes if for any reason the limited partners will be liable under state law. As written, the 1960 Regulations would certainly suggest that potential liability under state law as shareholders of a corporate general partner will be enough. Because this will always be a possibility, all that is necessary to avoid limited liability is to ensure that at least one limited partner owns stock of the corporate general partner. One is led to conclude that limited liability will be present if the general partner lacks reality for reasons other than the absence of assets, but not if the general partner so lacks reality as to cause the state law to impose liability on the limited partners. This would clearly seem to apply to a very narrow range of circumstances, if it would apply to any circumstances at all. It is certainly difficult to see how the Service will be able to administer rules based on such narrow questions of state law. Possibly the conclusion should be simply that no organization formed under the RULPA will possess limited liability. However, one questions why the potential to pierce the corporate veil will lead to the conclusion that the corporate attribute of limited liability is absent, but guarantees of all partnership indebtedness will not.

d. *Free Transferability*

Absent contrary agreement, a shareholder's rights in a corporation attach to the shares, with the shares being freely tansferable. In contrast, ownership of a partnership is a diverse bundle of rights that, at least in theory, exist and may be dealt with independently.[230] The partner's interest in the partnership means the partner's right to share economically in the partnership.[231] This property right may be freely assigned under partnership law without the consent of the other partners.[232] In addition to the right to share economically, general partners also have rights in specific partnership property and the right to participate in management.[233] For limited partners, the additional rights include the right to inspect the books and could include the right to vote on certain matters.[234] A purported assignment does not transfer these noneconomic rights nor permit the assignee to exercise any of these rights as a partner without the consent of the other members.[235] It is in this respect that the rights of partners are viewed as not freely transferrable.

The 1960 Regulations confirm that the above limitations on the ability of partners to transfer their noneconomic rights prevents the corporate attribute of free transferability from existing in a partnership even though the right to share financially in the partnership may be freely transferred.[236] However, the 1960 Regulations do provide that free transferability will exist where the persons owning substantially all of the interests in the organization have the power, by agreement, to fully substitute another in their place with respect to all of the assigning partner's property rights.[237] It seems this conclusion should not apply to a general partnership as any such substitution would result in a dissolution of the partnership. Thus, free

230. UPA § 24.
231. UPA § 26.
232. UPA § 27(1).
233. *See* UPA § 24.
234. *See* RULPA (1976) §§ 302, 305.
235. UPA § 27(1); RULPA §§ 702, 704. The UPA does not directly recognize the right of the assignee to be admitted as a substituted partner even with the consent of the other partners, though it does recognize the ability of the partners to agree to allow the assignee to exercise the rights of a partner. It seems that substitution should not be possible simply because the withdrawal of the assigning partner is a dissolution of the partnership. If the assignee is to become a partner, it should be as a partner of a new partnership. In all events, it is beyond question that if everyone wants to be partners with each other, they will be and it makes no difference, except under the 1960 Regulations, *see supra* note 187, whether the same or a new partnership exists.
236. Treas. Reg. § 301.7701-2(e)(1) (as amended in 1983).
237. *Id.*

transferability can exist only in a limited partnership and only if an agreement of the partners permits the assignment of all rights and provides partners with the unilateral ability to substitute the assignee as a member of the partnership.

The 1960 Regulations also state that when the only limitation on a partner's right to substitute an assignee is a right of first refusal in the partnership or the other partners, free transferability is present.[238] However, the regulations are not entirely clear whether free transferability will be present when less than unanimous consent is required for a partner to have the right to substitute another. The authority available suggests that the right to transfer with mere majority consent will not cause free transferability to exist.[239]

No authority suggests that granting partners certain rights conditional on a refusal to consent to transfer would change the conclusion on whether free transferability exists under the regulations even if such rights create an economic incentive for the other partners to consent. However, unlike the other characteristics, the presence of free transferability seems to be a substantive inquiry under the 1960 Regulations. Thus, any arrangements that grant to partners of a limited partnership the right to substitute another in their place could give rise to the corporate attribute of free transferability for tax purposes. It does seem odd that the only substantive inquiry under the regulations that seek to identify which organizations must pay corporate tax should be the transferability of the owners' noneconomic interests.

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238. Treas. Reg. § 301.7701-2(e)(2) (as amended in 1983). The regulations refer to this as modified free transferability. For all intents and purposes though, it is free transferability. *See* Larson v. Commissioner, 66 T.C. 159 (1976). This rule should not extend to general partnerships because an assignee cannot replace a former partner in the same partnership. *See supra* note 235.

239. *See* Priv. Ltr. Rul. 90-10-028 (Dec. 7, 1989) (holding that free transferability was not present in an organization in which the transferor was required to obtain majority consent, which consent could not be unreasonably withheld); Gen. Couns. Mem. 34,407 (Jan. 22, 1971) (free transferability not present when right of transferee to participate in management depended on the majority vote of the members). *But cf.* Larson v. Commissioner, 66 T.C. 159, 183 (1976); Gen. Couns. Mem. 36,910 (Nov. 4, 1976). An ABA Tax Section Subcommittee on LLCs has reported that it met with several members of the Service having responsibility for the issue and that it was told that a requirement of majority consent to transfer would not, in their view, result in the corporate attribute of free transferability being present. Letter from Barbara K. Spudis (Co-Chairman, ABA Subcommittee) to the members of the ABA Subcommittee (Nov. 19, 1990) (on file with author) (describing the Service's responses to ABA Subcommittee inquiries at a meeting with Paul Kugler (Assistant Chief Counsel, Passthroughs and Special Industries, Branch 2), Arthur Ernst (Chief Counsel, Passthroughs and Special Industries, Branch 2), J. Thomas Hines (Attorney, Branch 2), Susan Hamill (Attorney, Branch 1), and Richard Manfreda (Deputy Assistant Chief Counsel, Passthroughs and Special Industries)).

4. *The Uncertain Role of Limited Liability*

The benefit of the 1960 Regulations should be the substitution of a clear test for entity characterization in lieu of what would otherwise be a vague resemblance test applied largely on a case-by-case basis. Certainty in this area is possibly more important than substance. So far as entity characterization is concerned, taxpayers could live with almost any rational rule so long as they can do so with relative certainty.

The 1960 Regulations promised this certainty. Unfortunately, the Service seemed unsatisfied with the substance and demonstrated this dissatisfaction through ruling policies that are in conflict with the regulations[240] and through a willingness, at least prior to 1976, to assert the propriety of imposing corporate income tax in situations in which the 1960 Regulations clearly would have characterized the organization as a partnership.[241] Thus, the desired predictability of the 1960 Regulations could not be fully attained. The Tax Court clearly rejected any effort by the Service to apply rules to entity characterization that were in conflict with the 1960 Regulations.[242] The *Larson* decision coupled with the Service's acquiescence[243] should have finally added the certainty needed in this area. Unfortunately, the promise of certainty under *Larson* also did not survive long.

In *Larson*, the Tax Court reminded the Service that, while the 1960 Regulations would be strictly followed so long as they were in effect, it was for the Treasury and the Service to decide whether the regulations should be withdrawn or modified.[244] In 1977 and again in 1980, new regulations were issued that would have substantially altered the treatment of organizations possessing limited liability.[245] The 1977 proposed regulations were almost immediately withdrawn,[246] and the effective date of the 1980 proposed regulations was

240. *See* Rev. Proc. 72-13, 1972-1 C.B. 735.

241. *See* Larson v. Commissioner, 66 T.C. 159, 171 (1976); Zuckman v. United States, 524 F.2d 729 (Ct. Cl. 1975).

242. *See Larson*, 66 T.C. 159 (1976). *See also supra* note 198 and accompanying text.

243. *See supra* note 200 and accompanying text.

244. *Larson*, 66 T.C. at 185-86.

245. *See* 42 Fed. Reg. 1,038 (1977) (to be codified at 26 C.F.R. pt. 30) (proposed Jan. 5, 1977); 45 Fed. Reg. 75,709 (1980) (to be codified at 26 C.F.R. pt. 301) (proposed Nov. 17, 1980).

246. 42 Fed. Reg. 1,489 (1977).

repeatedly delayed[247] and finally withdrawn in 1982.[248] While these regulatory efforts never became effective, it was clear that the Service was actively pursuing means by which to protect the corporate tax base.

In 1982, in connection with the withdrawal of the 1980 proposed regulations, the Service announced it would undertake a study of entity characterization with particular emphasis on whether the attribute of limited liability should be redefined for federal income tax purposes and whether limited liability should be treated as a factor of overriding significance.[249] In addition, the announced study was to reconsider the Service's acquiescence in *Larson* to the extent the acquiescence was inconsistent with the imposition of a minimum net worth requirement.[250] Given the abortive efforts to change the entity characterization regulations, the announcement of ongoing study of the entity characterization rules, the reconsideration of the *Larson* acquiescence, and the continuing refusal of the Service to issue advance rulings unless there was a general partner with substantial assets,[251] it is simply not possible for anyone to employ a noncorporate form that effectively accomplished limited liability for the owners without very serious misgivings in regard to its eventual tax treatment.[252]

B. Imposition of Corporate Tax Under National Carbide

Prior to 1988, an additional theory for the imposition of corporate taxation on partnerships existed if the limited partners controlled the corporate general partner. The argument pressed by the Service arose from the axiom of taxation that income must be taxed to the owner of the income and cannot be diverted to others through anticipatory arrangements.[253] To further this principle and assure that the treatment of corporations as separate taxpayers was not subverted,[254] it had long been recognized that special scrutiny must be given to any situation in which shareholders claim that their corporation was

247. *See* I.R.S. Ann. 81-166, 1981-43 I.R.B. 21; I.R.S. Ann. 82-60, 1982-17 I.R.B. 23; I.R.S. Ann. 82-140, 1982-45 I.R.B. 30.
248. *See* I.R.S. Ann. 83-4, 1983-2 I.R.B. 31.
249. *Id.*
250. *Id.*
251. *See* Rev. Proc. 72-13, 1972-1 C.B. 735.
252. This is somewhat of an overstatement. Anyone willing to comply with the ruling standards of Rev. Proc. 72-13 could be certain of the results. However, certainty achieved in this way is objectionable unless one is willing to concede that the Service has the right to regulate this area without compliance with regulatory procedures.
253. *See* Helvering v. Horst, 311 U.S. 112 (1940).
254. *See* Moline Properties v. Commissioner, 319 U.S. 436 (1943).

acting as merely an agent on their behalf.[255] In general, courts uniformly recognized that an agency between a corporation and its shareholders should not be recognized unless the relationship meets the standards established in *National Carbide Corp. v. Commissioner*[256] for recognizing a corporation as "a true corporate agent . . . of its owner-principal."[257]

In *Jones v. Commissioner*,[258] the Service successfully argued that the principles of *National Carbide* should be applied to a partnership in which the general partner was a corporation owned by the limited partners. While it seems perfectly appropriate to apply the standards for recognizing a true corporate agent to the agency relationship between a corporate general partner and shareholder or limited partners, how those standards should be applied was far from clear.[259] The most troublesome of the *National Carbide* factors in the context of a partnership between shareholders and their corporation was the statement that the corporation's "relations with its principal must not be dependent upon the fact that it is owned by the principal, if such is the case."[260] Objectively, it is difficult to fathom what this statement meant because any agency relationship between a corporation and its shareholder is obviously dependent on the fact of ownership, at least to some extent. However, the Fifth Circuit in *Jones* did not seem interested in any search for deeper meaning, but was satisfied to find that the ownership of the corporate general partner in that case indicated that no true agency existed between the corporate general partners and the shareholder or limited partners.[261] Having found no agency or partnership to exist, the corporation was

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255. *See, e.g.*, Frink v. Commissioner, 798 F.2d 106 (4th Cir. 1986), *vacated*, 485 U.S. 973 (1988); George v. Commissioner, 803 F.2d 144 (5th Cir. 1986), *vacated*, 485 U.S. 973 (1988). *See also* BITTKER & EUSTICE, *supra* note 18, ¶ 2.10, at 2-34 to 2-37.

256. National Carbide Corp. v. Commissioner, 336 U.S. 422 (1949).

257. *Id.* at 437.

258. Jones v Commissioner, 640 F.2d 745 (5th Cir.), *cert. denied*, 454 U.S. 965 (1981).

259. The Court stated that the relevant considerations should be as follows:

> Whether the corporation operates in the name and for the account of the principal, binds the principal by its actions, transmits money received to the principal, and whether receipt of income is attributable to the services of employees of the principal and to assets belonging to the principal are some of the relevant considerations in determining whether a true agency exists. If the corporation is a true agent, its relations with its principal must not be dependent upon the fact that it is owned by the principal, if such is the case. Its business purpose must be the carrying on of the normal duties of an agent.

National Carbide Corp., 336 U.S. at 437 (footnotes omitted).

260. *Id.*

261. *See Jones*, 640 F.2d at 754.

determined to be the true owner of the business and was required to include all income and deductions in its taxable income for the year.

The scope of the *Jones* decision and the application of the *National Carbide* factors to partnerships between corporations and their shareholders was very indefinite. It is possible that disregard of the partnership in *Jones* was dependent on the fact that the corporation held legal title to the assets, but such is not made clear in the case. Alternatively, it may have been possible to have avoided the issue merely by varying ownership in some fashion.[262] Regardless of the exact scope of the holding, *Jones* had a chilling effect on the use of a limited partnership with a controlled general partner.[263]

C. State Law Restraints on Use of Noncorporate Forms

Under the 1960 Regulations, the partnership was the only business form that offered any hope of creating corporate-like relationships without corporate taxation.[264] This was true because the 1960 Regulations gave great significance to highly technical UPA and RULPA concepts in determining the presence of certain corporate characteristics. As a result, some characteristics can be substantively present without causing the organization to possess that characteristic for tax purposes. Organizations that were substantively very similar would find the 1960 Regulations typically less accommodating simply because the technical provisions of state law differed.[265]

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262. *See* Raphan v. United States, 759 F.2d 879 (Fed. Cir. 1985), *cert. denied*, 474 U.S. 843 (1985) (ownership of corporation by a 50% owner of partnership enough to justify conclusion of true agency). *But see* Frink v. Commissioner, 798 F.2d 106, 110 (4th Cir. 1986) (common ownership is sufficient to disregard agency notwithstanding disparity between ownership of corporation and ownership of the partnership). *But see* McKEE ET AL., *supra* note 37, ¶ 3.04[2] & n.138 (suggesting that limited partnership interests might be treated as preferred stock if the limited partners own the corporate general partner without any suggestion that this should be limited to a narrow range of facts).

263. Professors Bittker and Eustice offered the following advice:

> Because of the ineluctably factual nature of the nominee-agency issue, the decided cases are scattered along a spectrum, so that generalizations and, a fortiori, predictions, are perilous. Taxpayers who want to strengthen their cases are well advised to use unrelated (and compensated) third-party entities for nominee functions when feasible.

BITTKER & EUSTICE, *supra* note 18, at 2-36.

264. By 1988, there were two states that had adopted limited liability company acts, Wyoming (WYO. STAT. §§ 17-15-101-136 (1977) [hereinafter the Wyoming Act]) and Florida (FLA. STAT. ANN. §§ 608.401-.471 (West Supp. 1992) [hereinafter the Florida Act]). *See* text accompanying notes 312-76 regarding the nature of limited liability companies. Because of the Service's refusal to rule on the proper tax characterization of limited liability companies (*see* Rev. Proc. 88-3, 1988-1 C.B. 579), it appears that no organizations were formed and operated under either of these statutes prior to 1988.

265. For example, a partnership that is dissolved on the withdrawal of any member lacks continuity under the regulations, yet an organization has potentially perpetual existence under statute but that grants each person a contractual right to terminate would probably have continuity for tax purposes. The substance is the same. The only difference

It is abundantly clear that general partnerships will never be treated as associations taxable as corporations. They will always lack, at the very least, the corporate characteristics of limited liability, continuity of life, and centralized management as those terms are defined in the 1960 Regulations.[266] However, the general partnership form does not offer an acceptable solution to the choice of entity dilemma. Simply, there is no effective way to utilize the general partnership form and create protections against owner liability that is comparable to corporate protection.

There has always been a significantly greater ability to use a limited partnership to create corporate-like relations. Indeed, in the early 1980s there were numerous organizations that were able to utilize the limited partnership form even though the interests in the partnership were represented by certificates of beneficial interest, which were actively traded on the New York Stock Exchange.[267]

The sole general partners of most publicly traded partnerships were independent sponsoring corporations. Thus, no individual was subject to personal liability, and yet the partnerships lacked the corporate characteristic of limited liability within the meaning of the 1960 Regulations. Similarly, because the bankruptcy, dissolution, or withdrawal of the corporate general partner would potentially dissolve the partnerships, they lacked the corporate characteristic of continuity of life under the 1960 Regulations even though the partnerships would continue for as long as the corporate general partner continued. Because the partnership interests were traded on the New York Stock Exchange, there was obviously free transferability for all practical purposes. However, the fact that the transfers conveyed only the right to share economically and the assignee could not be admitted as a limited partner without the consent of the general partner was enough to avoid having free transferability for purposes of the 1960 Regulations. The fact that the general partners regularly and consistently consented to the admission of assignees as limited partners was simply not relevant to entity characterization.

The only corporate attribute that these organizations possessed for purposes of entity characterization under the 1960 Regulations was centralized management (management was vested in a general partner which did not have a substantial interest in the partnership). Interestingly, it is with respect to management that the public limited

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is that the Treasury disregarded substance with respect to partnerships.

266. *See supra* text accompanying notes 176-252.

267. *See generally* Taylor, *supra* note 22.

partnership form did not duplicate the relationship, which would be typical of a corporation. In a corporation, the shareholders have the right to elect the board of directors. In the public limited partnerships, the corporate general partner was independent of the limited partners and thus the beneficial owners of the business were not able to elect the representatives that would be charged with the management of the business.[268]

While the use of the limited partnership form for public companies was gaining increasing momentum in the early 1980s, it did not survive for long. In 1987, this alternative was statutorily withdrawn by the enactment of section 7704, which requires that any business having interests traded on an established securities market be taxed as a corporation.[269]

The imposition of corporate taxation on publicly traded partnerships obviously has no affect on the ability of nonpublic companies to employ the partnership form. However, at least through the mid-1980s it was much more difficult for nonpublic businesses to adapt the limited partnership form to serve as an alternative to incorporation. Part of the success achieved by publicly traded partnerships resulted from the corporate general partner's independence from the limited partners. In nonpublic businesses, this arrangement is unacceptable simply because it divorces management and control of the business from ownership of the business. Thus, the use of a limited partnership with an independent general partner was seldom acceptable.[270] On the other hand, there was significant reason to be concerned that the use of a limited partnership with a controlled corporate general partner would not achieve the desired limitation on the liability of the owners who acted as employees, officers, directors, and shareholders of the corporate general partner.[271]

Under ULPA section 7, which was widely in effect through the

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268. While the public limited partnership form failed to match the management relationship, which would have existed had the business been incorporated, this difference does not appear to have been material. This is probably because of the relative inability of most owners of stock in a public corporation to realistically affect the selection of directors in any event.

269. *See* I.R.C. § 7704 (1987).

270. There are obvious exceptions to this generalization, particularly when the business is for a single undertaking. Indeed, the limited partnership form was ideally suited to real estate development activities, equipment leasing, and similar activities in which the separation of management from ownership was not only acceptable, but desirable. However, for ongoing or diverse business operations, the use of a limited partnership with an independent corporate general partner was not an acceptable alternative.

271. Part of the concern may have involved the propriety of having a corporate general partner. *See* Frigidare Sales Corp. v. Union Properties, Inc., 544 P.2d 781 (Wash. Ct. App. 1976), *aff'd*, 562 P.2d 244 (Wash. 1977) (suggesting that the liability of limited partners who were shareholders of the corporate general partner in *Delaney v. Fidelity Lease Ltd.*, 526 S.W.2d 543 (Tex. 1975), may have been based on the theory that corporations could not be general partners). ULPA § 1 defines a partnership as

mid-1970s,[272] limited partners would become liable to creditors if they took part in the control of the business. Applying this rule, at least one court found that the general protection against liability was forfeited when limited partners took part in control of the partnership business notwithstanding that their participation occurred in their capacity as agents or employees of the corporate general partner.[273] Contrary decisions under ULPA section 7 stated that this conduct alone was not sufficient to impose liability on the limited partners in the absence of knowledge and reliance by the creditor on the conduct of the limited partner as a basis for believing personal liability to exist and in deciding to extend credit.[274] Unfortunately for partnership businesses, the principal case imposing the necessity of creditor reliance in order to find limited partner liability also suggested that a different result might have been obtained had the corporate general partner been a newly organized corporation without other substantial business activity.[275]

In 1976, the RULPA was promulgated and replaced ULPA section 7 with new section 303. Where adopted, section 303 expressly provided that being an employee or agent of the limited partnership or of a general partner would not constitute taking part in the control of the business.[276] It also added that creditor knowledge of the limited partner's participation in control would be required to impose liability on the limited partners at least in some cases.[277] However, the exact scope of the protection afforded by the limited partnership form to limited partners, and particularly to limited partners who

being formed by two or more persons but the ULPA does not define "person." In addition, ULPA § 20 did not include dissolution of a general partner as an event of dissolution. *But see* RULPA §§ 101(7), (11) (clearly permitting corporate partners).

272. *See* ULPA, 6 U.L.A. 559 (1969) (listing 43 states as having adopted the ULPA as of 1969).

273. Delaney v. Fidelity Lease Ltd., 526 S.W.2d 543 (Tex. 1975). *See also* Mursor Builders, Inc. v. Crown Mountain Apartments Assocs., 467 F. Supp. 1316 (C.D.V.I. 1978) (holding limited partners who were also officers of a corporate general partner were liable under ULPA § 7 as general partners when they failed to maintain their corporate officer identity in conducting the partnerships affairs and otherwise failed to follow appropriate corporate formalities).

274. Frigidaire Sales Corp. v. Union Properties, Inc., 562 P.2d 244 (Wash. 1976). *See also* Outlet Co. v. Wade, 377 So. 2d 722 (Fla. Dist. Ct. App. 1979).

275. *Frigidare Sales Corp.*, 562 P.2d at 246.

276. RULPA (1976) § 303(b)(1).

277. RULPA (1976) § 303(a) created a dual approach to finding liability. Liability existed if the limited partner's participation in control was substantially the same as the exercise of the powers of a general partner, and limited partners would otherwise be liable only if the creditor actually knew of the participation in control.

were also officers, directors, and shareholders of the corporate general partner, remained fairly uncertain under the RULPA.[278]

In light of the uncertainty regarding the liability of the limited partners who were also officers, directors, and shareholders of the corporate general partner, the use of the limited partnership form was reasonable only where there would be an independent general partner. If the separation of management from ownership was a problem, then efforts could be made to shift effective control back to the limited partners. For example, a significant measure of control might be achieved through the right of limited partners to appoint a new general partner and to expel the old. Of course, these efforts had to stop short of vesting control in the limited partners to such an extent as to create liability or expose the organization to corporate taxation. At the least, the use of a limited partnership under these circumstances resulted in great expense, confusion, and uncertainty.

VI. Recent Changes Affecting the Choice of Entity

A. *Liability of Limited Partners*

Given that owners desiring to be active in a business could avoid personal liability by the mere act of incorporation, it is difficult to perceive any public policy requiring the imposition of personal liability on owners who choose not to incorporate when creditors have no reason to believe that such liability exists. Overwhelmingly, state legislatures seem to have reached this same conclusion.

The risk of personal liability for limited partners arose under section 7 of the ULPA, which simply provided that limited partners would be liable to creditors if they took part in the control of the business. The RULPA, promulgated in 1976, modified the rule but

278. For example, it is not clear under RULPA (1976) § 303 what participation would be similar to exercise of the powers of a general partner. It was also not clear in other circumstances whether the creditor needed to have believed the limited partner was a general partner as a result of the knowledge of participation in control. It also remained unclear what would be considered participation in control. Finally, the creation of a safe harbor for persons who were agents or employees of the general partner left open the question of how to deal with persons who were officers, directors, or shareholders of a corporate general partner. The ambiguity of RULPA (1976) § 303 is illustrated by Alzado v. Binder, Robinson & Co., 752 P.2d 544 (Colo. 1988). The plaintiff, who was also the vice-president of the corporate general partner, had succeeded at the trial level in imposing liability on a corporate limited partner. Obviously, the plaintiff knew that the defendant was not a general partner, but the trial court apparently felt it sufficient that the plaintiff knew of the acts that constituted taking part in control, whether or not this knowledge led to a reasonable belief that the defendant was in fact a general partner. While the decision of the trial court was reversed, the court did not suggest that liability required a reasonable belief that the defendant was a general partner. Instead the court relied on the fact that the activities of the limited partner were not significant enough to establish that it took part in the control of the business. *Id.* at 551-53. *See generally* Gavin L. Phillips, Annotation, *Liability of Limited Partner Arising from Taking Part in Control of Business Under Uniform Limited Partnership Act*, 79 A.L.R.4th 427 (1990).

did not eliminate all uncertainties. In particular, it remained uncertain whether limited partners could be liable to creditors when they were officers, directors, and shareholders of the corporate general partner. A further effort to clarify the law in this area was finally made in 1985 through the amendment of RULPA section 303.[279]

Amended section 303 provides an expanded list of activities that will not be considered to be taking part in the control of the business. Included in the expanded list are any actions taken as contractor, agent, employee, officer, director, or shareholder of a corporate general partner.[280] In addition, section 303 was amended to provide that any acts that did constitute taking part in the control of the business would result in liability only if the creditor reasonably believed, based on such conduct, that the limited partner was in fact a general partner.[281]

It is inconceivable that limited partners will have a significant exposure to personal liability under amended section 303 of the RULPA except in very unusual circumstances. Given the safe harbor afforded to acts in the capacity of an agent, employee, officer, director, or shareholder of a corporate general partner, it seems clear that liability should be avoided simply by assuring that the organizational documents do not give the limited partner the right to participate as a general partner, by observing ordinary corporate formalities, and by giving each active partner an employment capacity with the corporation. Further, even if a limited partner engages in activities that are found to be taking part in control of the business because such limited partner was not acting in a corporate capacity, these acts will result in personal liability only if they caused a creditor to reasonably believe that such person was a general partner. So long as the name of the organization clearly discloses that the organization is a limited partnership, as required under RULPA in any event,[282] combined with the fact that limited partners can participate in the business in so many other capacities without being a general partner, it is difficult to imagine how a creditor could have a reasonable belief that someone is a general partner without some affirmative misconduct on the part of that partner. It certainly seems, at the very least, that vicarious liability to a tort creditor will be rare since the normal tort creditor will not have had dealings with

279. *See supra* text accompanying notes 272-78.
280. RULPA § 303(b)(1).
281. RULPA § 303(a).
282. RULPA § 102(1).

the partnership or any partner such as to have formed any belief at all.

At the current time, there is a clear and rapid trend in the states toward expanding the role that limited partners are permitted to play in the conduct of the business while maintaining protection against personal liability. Only two states, Alaska and Vermont, still have ULPA section 7 in effect.[283] Only five states that adopted RULPA continue to have the 1976 version of section 303 in effect.[284] Five states also continue to have provisions similar to the 1976 version of section 303(a), but have added provisions stating that actions as an officer, director, or shareholder of a corporate general partner will not be considered to be taking part in control.[285] Within the last few years, thirty-seven states and the District of Columbia have already adopted provisions at least as restrictive as the 1985 version of section 303.[286]

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283. ALASKA STAT. § 32.10.060 (Supp. 1991); VT. STAT. ANN. tit. 11, § 1397 (1984). Several other states still have the ULPA in effect, but have also enacted RULPA, which is in effect for new organizations. UNIFORM LTD. PARTNERSHIP ACT, 6 U.L.A. 203 (Supp. 1992).

284. ARIZ. REV. STAT. ANN. § 29-319 (1956); MICH. COMP. LAWS ANN. § 449.1303 (West 1989); MONT. CODE ANN. § 35-12-703 (1991); OHIO REV CODE ANN. § 1782-19 (Baldwin 1991); WYO. STAT. § 17-14-403 (1977).

285. ALA. CODE § 10-9A-42 (1975); IOWA CODE ANN. § 545.303 (West 1987); N.J. STAT. ANN. § 42:2A-27 (West Supp. 1990); N.C. GEN. STAT. § 59-303 (1989); S.C. CODE ANN. §33-42-430 (Law. Co-op. 1990).

286. ARK. CODE ANN. § 4-43-303 (Michie 1991); CAL. CORP. CODE § 15632 (West 1991); COLO. REV. STAT. ANN. § 7-62-303 (West 1990); CONN. GEN. STAT. ANN. § 34-15 (West 1990); DEL. CODE ANN. tit 6, § 17-303 (Supp. 1990); D.C. CODE ANN. § 41-433 (1990); FLA. STAT. ANN. § 620.129 (West Supp. 1992); GA. CODE ANN. § 14-9-303 (Harrison 1990); HAW. REV. STAT. § 425D-303 (Supp. 1991); IDAHO CODE § 53-219 (Supp. 1991); ILL. ANN. STAT. ch. 106 ½, ¶ 153-3 (Smith-Hurd Supp. 1992); IND. CODE ANN. § 23-16-4-3 (Burns 1989); KAN. STAT. ANN. § 56-1a203 (Supp. 1991); KY. REV. STAT. ANN. § 362.437 (Baldwin 1991); ME. REV. STAT. ANN. tit. 31, § 433 (West Supp. 1991); MD. CODE ANN., CORPS. & ASS'NS § 10-303 (1985 & Supp. 1991); MASS. GEN. L. ch. 109, § 19 (1990); MINN. STAT. ANN. § 322A.26 (West Supp. 1992); MISS. CODE ANN. § 79-14-303 (1989); MO. ANN. STAT. § 359.201 (Vernon 1992); NEB. REV. STAT. § 67-251 (1990); NEV. REV. STAT. § 88.430 (1991); N.H. REV. STAT. ANN. § 304-8:19 (Supp. 1991); N.M. STAT. ANN. § 54-2-20 (Michie 1988); N.Y. PARTNERSHIP LAW § 121-303 (McKinney Supp. 1992); N.D. CENT. CODE § 45-10.1-22 (Supp. 1991); OKLA. STAT. ANN. tit 54, § 320 (West 1991); OR. REV. STAT. § 70.135 (1988); 15 PA. CONS. STAT. ANN. § 8523 (1992); R.I. GEN. LAWS § 7-13-19 (Supp. 1991); S.D. CODIFIED LAWS ANN. § 48-7-303 (1991); TENN. CODE ANN. § 61-2-301 (1989); TEX. REV. CIV. STAT. ANN. art. 6132a-1, art. 3.03 (West Supp. 1992); UTAH CODE ANN. § 48-2a-303 (1992); VA. CODE ANN. § 50-73.24 (Michie Supp. 1991); WASH. REV. CODE ANN. § 25.10.190 (West Supp. 1992); W. VA. CODE § 47-9-19 (1992); WIS. STAT. ANN. § 179.23 (West 1989 & Supp. 1991).

In some of these states, the protection afforded limited partners goes even further than RULPA (1985) § 303. For example, in Georgia, the statute simply states that limited partners will not be liable for the obligations of the partnership. GA. CODE ANN. § 14-9-303 (Harrison 1990). Maryland goes on to clarify that a limited partner will not be considered to be taking part in the control of the business as an officer, shareholder, or director of a corporate general partner, even if the corporate general partner is the sole

B. *Limited Liability Companies*

The trend to limit the personal liability of the owners of unincorporated organizations is not occurring solely with respect to limited partnership acts. In recent years, a number of states have adopted Limited Liability Company (LLC) acts, which authorize a new form of organization in which personal liability of owners is limited.[287]

The LLC acts that have been adopted borrow from both corporate and partnership law in order to create a new hybrid form of organization.[288] The most salient feature of the limited liability company form is that the owners, designated as members, are statutorily protected from personal liability for the obligations of the business in the same way that shareholders are protected from liability for the obligations of a corporation.[289] In most other respects, the various

general partner and even if the limited partner is the only officer, director, and shareholder of the only general partner. MD. CODE ANN., CORPS. & ASS'NS § 10-303 (1985 & Supp. 1991).

287. Through June of 1992, LLC acts exist in Arizona (ARIZ. REV. STAT. ANN. §§ 29-601 to -857 (Supp. 1992)); Colorado (COLO. REV. STAT. §§ 7-80-101 to -913 (1990)); Delaware (Delaware Limited Liability Company Act, 1992 Del. Laws ch. 434 (H.B. 608) (WESTLAW) (1992) (to be codified at DEL. CODE ANN. tit. 6, §§ 18-101 to -1107)); Florida (FLA. STAT. ANN. §§ 608.401-.471 (West Supp. 1992)); Illinois (Illinois Limited Liability Company Act, 1992 Ill. Legis. Serv. P.A. 87-1062, sec. 180, §§ 322B.01-.955); Iowa (Iowa Limited Liability Company Act, 1992 Ia. Legis. Serv. ch. 2369 (WESTLAW) (to be codified at IOWA CODE ANN. §§ 490A.100-.1601)); Kansas (KAN. STAT. ANN. §§ 17-7601 to -7651 (Supp. 1991)); Louisiana (Louisiana Limited Liability Company Act, 1992 La. Sess. Law Serv. Act 780 (H.B. 1262) (WESTLAW) (to be codified at LA. REV. STAT. Ann. §§ 12:1301-1369)); Maryland (MD. CODE ANN., CORPS. & ASS'NS §§ 4A-101 to -1103 (Supp. 1992)); Minnesota (Minnesota Limited Liability Company Act, ch. 517, art. 2, §§ 1-141 (to be codified at MINN. STAT. ANN. §§ 322B.001-.912)); Nevada (NEV. REV. STAT. §§ 86.010-.571 (1991)); Oklahoma (OKLA. STAT. ANN. tit. 18, §§ 2000-2060 (West 1992)); Rhode Island (R.I. GEN. LAWS §§ 7-16-1 to -75 (1992)); Texas (TEX. REV. CIV. STAT. ANN. art. 1528n, arts. 1.01-9.02 (West Supp. 1992)); Utah (UTAH CODE ANN. §§ 48-2b-101 to -156 (1991)); Virginia (VA. CODE ANN. §§ 13.1-1000 to -1069 (Michie Supp. 1991)); West Virginia (W. VA. CODE §§ 31-1A-1 to -69 (Supp. 1992)); Wyoming (WYO. STAT. §§ 17-15-101 to -136 (1977)). These acts are hereafter referred to collectively as the "LLC acts" and individually as the "act" of a particular state. Six of the LLC acts were adopted in the first six months of 1992. By the time of publication of this article, it is likely that several more states will have adopted LLC acts.

It is reported that at least a number of other states have bills pending or groups studying LLC legislation. *See* Robert R. Keatinge et al., *The Limited Liability Company, A Study of the Emerging Entity*, 47 BUS. LAW. 375, 379 n.5 (1992).

288. For an exhaustive comparison of the provisions of the LLC acts, see Keatinge et al., *supra* note 287, at 386-403.

289. *See* ARIZ. REV. STAT. ANN. § 29-651 (Supp. 1992); COLO. REV. STAT. § 7-80-705 (1990); Delaware Limited Liability Company Act, 1992 Del. Laws ch. 434 (H.B. 608) (WESTLAW) (to be codified at DEL. CODE ANN. tit. 6, § 18-303); FLA. STAT. ANN. § 608.436 (West Supp. 1992); Illinois Limited Liability Company Act, 1992 Ill. Legis. Serv. P.A. 87-1062, sec. 180, § 10-10a (S.B. 2163) (WESTLAW); Iowa Limited

LLC acts adopt provisions most closely resembling partnership law. For example, management of an LLC is vested in the members unless the members otherwise agree;[290] the LLC is dissolved upon the death, dissolution, withdrawal, or bankruptcy of any member unless the other members agree to continue;[291] the members may not substitute another person in their place without the consent of the other

Liability Company Act, 1992 Ia. Legis. Serv. ch. 2369 (WESTLAW) (to be codified at IOWA CODE ANN. § 490A.601); KAN. STAT. ANN. § 17-7620 (1990); Louisiana Limited Liability Company Act, 1992 La. Sess. Law Serv. Act 780 (H.B. 1262) (WESTLAW) (to be codified at LA. REV. STAT. ANN. § 12:1320(b)); MD. CODE ANN., CORPS. & ASS'NS § 4A-301 (Supp. 1992); Minnesota Limited Liability Company Act, ch. 517, art. 2, §§ 1-141 (to be codified at MINN. STAT. ANN. § 322B.302); NEV. REV. STAT. § 86.371 (1991); OKLA. STAT. ANN. tit. 18, § 2022 (West 1992); R.I. GEN. LAWS § 7-16-23 (1992); TEX. REV. CIV. STAT. ANN. art. 1528n, art. 4.03(A)(West Supp. 1992); UTAH CODE ANN. § 48-2b-109 (1992); VA. CODE ANN. § 13.1-1019 (Michie Supp. 1991); W. VA. CODE § 31-1A-33 (Supp. 1992); WYO. STAT. § 17-15-113 (1977).

290. ARIZ. REV. STAT. ANN. § 29-681(a)(Supp. 1992); Delaware Limited Liability Company Act, 1992 Del. Laws ch. 434 (H.B. 608) (WESTLAW) (to be codified at DEL. CODE ANN. tit. 6, § 18-402); FLA. STAT. ANN. § 608.422 (West Supp. 1992); Illinois Limited Liability Company Act, 1992 Ill. Legis. Serv. P.A. 87-1062, sec. 180, § 15-1 (S.B. 2163) (WESTLAW); Iowa Limited Liability Company Act, 1992 Ia. Legis. Serv. ch. 2369 (WESTLAW) (to be codified at IOWA CODE ANN. § 490A.702); KAN. STAT. ANN. § 17-7612 (1991); Louisiana Limited Liability Company Act, 1992 La. Sess. Law Serv. Act 780 (H.B. 1262) (WESTLAW) (to be codified at LA. REV. STAT. ANN. § 12-1311); NEV. REV. STAT. § 86.291 (1991); R.I. GEN. LAWS § 7-16-14 (1992); UTAH CODE ANN. § 48-2b-125 (1992); VA. CODE ANN. § 13.1-1022 (Michie Supp. 1991); W. VA. CODE § 31-1A-18 (Supp. 1992); WYO. STAT. § 17-15-116 (1977). Minnesota, Oklahoma, and Texas appear to reach the same result by vesting management in managers unless reserved to the members in the LLC's regulations. *See* Minnesota Limited Liability Company Act, 1992 ch. 517, art. 2, §§ 1-141 (to be codified at MINN. STAT. ANN. §§ 322B.605, .322); OKLA. STAT. ANN. tit. 18, §§ 2013, 2015 (West 1992); TEX. REV. CIV. STAT. ANN. art. 1528n, art. 2.12 (West Supp. 1992). *But see* COLO. REV. STAT. § 7-80-401 (1990) (vesting management exclusively in managers).

The Maryland Act does not expressly state who has the right to manage the business, but the absence of any reference to managers, the recognition of broad authority in all members to bind the LLC (MD. CODE ANN., CORPS. & ASS'NS § 4A-401 (Supp. 1992)), and the general requirement of majority consent for decisions concerning business affairs of the LLC (MD. CODE ANN., CORPS. & ASS'NS § 4A-303(b)(Supp. 1992)) clearly indicate that there will be member management unless otherwise agreed.

291. ARIZ. REV. STAT. ANN. §§ 29-733, 734, 781(a)(3)(Supp. 1992); COLO. REV. STAT. § 7-80-801 (1990); Delaware Limited Liability Company Act, 1992 Del. Laws ch. 434 (H.B. 608) (WESTLAW) (to be codified at DEL. CODE ANN. tit. 6, § 18-801(4)); FLA. STAT. ANN. § 608.441 (West Supp. 1992); Illinois Limited Liability Company Act, 1992 Ill. Leg. Serv. P.A. 87-1062, Sec. 180, § 35-1(3) (S.B. 2163) (WESTLAW); Iowa Limited Liability Company Act, 1992 Ia. Legis. Serv. ch. 2369 (WESTLAW) (to be codified at IOWA CODE ANN. § 490A.1301); KAN. STAT. ANN. § 17-7622 (1991); Louisiana Limited Liability Company Act, 1992 La. Sess. Law Serv. Act 780 (H.B. 1262) (WESTLAW) (to be codified at LA. REV. STAT. ANN. § 12:1334(3)); MD. CODE ANN., CORPS. & ASS'NS §§ 4A-606, 4A-901 (Supp. 1992); Minnesota Limited Liability Company Act, ch. 517, art. 2, §§ 1-141 (to be codified at MINN. STAT. ANN. §§ 322B.303, .801); NEV. REV. STAT. § 86.491 (1991); OKLA. STAT. ANN. tit. 18, § 2037 (West 1992); R.I. GEN. LAWS § 7-16-39(d)(1992); TEX. REV. CIV. STAT. ANN. art. 1528n, art. 6.01 (West Supp. 1992); UTAH CODE ANN. § 48-2b-137 (1992); VA. CODE ANN. § 13.1-1046 (Michie Supp. 1991); W. VA. CODE § 31-1A-35 (Supp. 1992); WYO. STAT. § 17-15-123 (1977).

members, though they may assign their economic rights;[292] the organization is formed by the filing of a document closely resembling a certificate of limited partnership and which must be amended in largely the same circumstances in which a certificate of limited partnership is amended;[293] and the parties are permitted to establish variations in their relationship under an operating agreement.[294] Thus,

292. ARIZ. REV. STAT. ANN. § 29-732. (Supp. 1992); COLO. REV. STAT. § 7-80-702 (1990); Delaware Limited Liability Company Act, 1992 Del. Laws ch. 434 (H.B. 608) (WESTLAW) (to be codified at DEL. CODE ANN. tit. 6, § 18-702 (1992)); FLA. STAT. ANN. § 608.432 (West Supp. 1992); Illinois Limited Liability Act, 1992 Ill. Legis. Serv. P.A. 87-1062, sec. 180, § 30-5 (SB 2163) (WESTLAW); Iowa Limited Liability Act, 1992 Ia. Legis. Serv. ch. 2369 (WESTLAW) (to be codified at IOWA CODE ANN. § 490A.902 (West 1992); KAN. STAT. ANN. § 17-7618 (1991); Louisiana Limited Liability Company Act, 1992 La. Sess. Law Serv. Act 780 (H.B. 1262) (WESTLAW) (to be codified at LA. REV. STAT. ANN. § 12:1330(a) (West 1992)); MD. CODE ANN., CORPS. & ASS'NS § 4A-603 (Supp. 1992); Minnesota Liability Company Act, ch. 517, art. 2, §§ 1-141 (to be codified at MINN. STAT. ANN. § 322B.304 (West 1992)); NEV. REV. STAT. § 86.351 (1991); OKLA. STAT. ANN. tit. 18, § 2033 (West 1992); R.I. GEN. LAWS § 7-16-35 (1992); TEX. REV. CIV. STAT. art. 1528n, arts. 4.05, 4.07 (West Supp. 1992); UTAH CODE ANN. § 48-2b-131 (1992); VA. CODE ANN. §§ 13.1-1039 to -1040 (Michie Supp. 1991); W. VA. CODE § 31-1A-34 (Supp. 1992); WYO. STAT. § 17-15-122 (1977).

293. ARIZ. REV. STAT. ANN. § 29-632 (Supp. 1992); COLO. REV. STAT. § 7-80-204 (1990); Delaware Limited Liability Company Act, 1992 Del. Laws ch. 434 (H.B. 608) (WESTLAW) (to be codified at DEL. CODE ANN. tit. 6, §§ 18-201, -202); FLA. STAT. ANN. § 608.409 (West Supp. 1992); Illinois Limited Liability Company Act, 1992 Ill. Legis. Serv. P.A. 87-1062, sec. 180, §§ 5-1, -10 (S.B. 2163) (WESTLAW); Iowa Limited Liability Company Act, 1992 Ia. Legis. Serv. ch. 2369 (WESTLAW) (to be codified in IOWA CODE ANN. § 490A.303 (West 1992); KAN. STAT. ANN. § 17-7607 (1991); Louisiana Limited Liability Company Act, 1992 La. Sess. Law Serv. Act 780 (H.B. 1262) (WESTLAW) (to be codified at LA. REV. STAT. ANN. §§ 12:1304, 1309); MD. CODE ANN., CORPS. & ASS'NS § 4A-204 (Supp. 1992); Minnesota Liability Company Act, ch. 517, art. 2, §§ 1-141 (to be codified at MINN. STAT. ANN. § 322B.104); NEV. REV. STAT. § 86.161 (1991); OKLA. STAT. ANN. tit. 18, § 2005 (West 1992); R.I. GEN. LAWS §§ 7-16-5, -12 (1992); TEX. REV. CIV. STAT. ANN. art. 1528n, art. 301 (West Supp. 1992); UTAH CODE ANN. § 48-2b-116 (1992); VA. CODE ANN. § 13.1-1011 (Michie Supp. 1991); W. VA. CODE § 31-1A-8 (Supp. 1992); WYO. STAT. § 17-15-107 (1977).

294. ARIZ. REV. STAT. ANN. § 29-682 (Supp. 1992); COLO. REV. STAT. § 7-80-102(11) (1990); Delaware Limited Liability Company Act, 1992 Del. Laws ch. 434 (H.B. 608) (WESTLAW) (to be codified at DEL. CODE ANN. tit. 6, § 18-101(6)); FLA. STAT. ANN. § 608.423 (West Supp. 1992); Illinois Limited Liability Company Act, 1992 Ill. Legis. Serv. P.A. 87-1062, sec. 180, § 15-5 (S.B. 2163) (WESTLAW); Iowa Limited Liability Company Act, 1992 Ia. Legis. Serv. ch. 2369 (WESTLAW) (to be codified at IOWA CODE ANN. § 490A.703); KAN. STAT. ANN. § 17-7613 (1991); Louisiana Limited Liability Company Act, 1992 La. Sess. Law Serv. Act 780 (H.B. 1262) (WESTLAW) (to be codified at LA. REV. STAT. ANN. § 12:1301(16)); MD. CODE ANN., CORPS. & ASS'NS § 4A-402 (Supp. 1992); Minnesota Limited Liability Company Act, ch. 517, art. 2, §§ 1-141 (to be codified at MINN. STAT. ANN. §§ 322B.322, .602); NEV. REV. STAT. § 86.101 (1991); R.I. GEN. LAWS § 7-16-2(s)(1992); TEX. REV. CIV. STAT. art. 1528n, art. 3.05 (West Supp. 1992); UTAH CODE ANN. § 48-2b-126 (1992); VA. CODE ANN. § 13-1-1023 (Michie Supp. 1991); W. VA. CODE § 31-1A-19 (Supp. 1992).

the LLC would be most appropriately characterized as a partnership in which no partner is personally liable for the obligations of the business.

C. *Clarification of the Role of Limited Liability in Entity Characterization*

The Service's study of the 1960 Regulations and of the role that limited liability should play in entity characterization was completed in 1988. The conclusion announced was that there would be no recommended changes to the 1960 Regulations.[295] Implicit in this ruling is the conclusion that limited liability would continue to be merely one factor in determining entity characterization.

The Service's conclusion regarding the role which limited liability should play was immediately reflected in Revenue Ruling 88-76.[296] The ruling involved the proper characterization for federal income tax purposes of a limited liability company formed under the Wyoming Act.[297] That the Service would issue this ruling is surprising in several respects. First, it is somewhat surprising, given the content of the proposed regulations issued in 1977 and 1980, that the Service finally determined that limited liability should have no greater significance than the other characteristics. Secondly, it is somewhat surprising that the Service was willing to recognize an LLC as an unincorporated organization to which the entity characterization regulations apply.[298] The third surprise is that the Service appears to be quite satisfied with the ruling notwithstanding all that it portends.[299]

The Oklahoma and Wyoming Acts contemplate, but do not expressly authorize or define, operating agreements. *See* OKLA. STAT. ANN. tit. 18, § 2001(16) (West Supp. 1993); WYO. STAT. § 17-15-116 (1977).

295. I.R.S. Ann. 88-118, 1988-38 I.R.B. 25.

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

297. WYO. STAT. §§ 17-15-101 to -136 (1977).

298. The 1960 Regulations, *see supra* note 187, only apply to unincorporated organizations. Treas. Reg. § 301.7701-2(a)(3) (as amended in 1983). It is difficult to figure out what this means if it does not refer to a fictional person recognized by the law. It also seems that an organization that can own property, sue and be sued, and for the obligations of which no owner will be liable must come pretty close to being a fictional person recognized under law. Early cases held that the term "associations" included organizations created by statute or deriving statutory benefits. *See* Eliot v. Freeman, 220 U.S 178, 187 (1910). The Service could have taken the position that the extension of the association concept to other organizations which resemble corporations did not remove statutorily created organizations from the definition of associations. *But see* Treas. Reg. § 301.7701-3(c) (1967) (providing that the corporate resemblance test would apply to so-called partnership associations that are also statutory creations).

299. *See infra* text accompanying notes 331-76 (suggesting that the emergence of the LLC will, if unchecked, contribute to making corporate income tax an elective regime).

While the willingness to rule and the satisfaction with the prospects of the ruling are surprising, the result reached in the ruling is not itself surprising. Applying the 1960 Regulations, the only possible conclusion was that the LLC was a partnership. Obviously the LLC possessed the corporate characteristic of limited liability.[300] The LLC at issue in the ruling had also elected, as permitted under the Wyoming Act,[301] to be managed by "managers" rather than by the members and therefore possessed the corporate characteristic of centralized management.[302] Thus, treatment of the entity as a partnership for federal income tax purposes depended upon the entity lacking continuity of life and free transferability.[303]

The ruling held that free transferability was absent because the Wyoming Act prohibited transfer of anything more than the right to share in profits, losses, and distributions without the consent of the other members.[304] Because management rights had been divorced from membership, this effectively meant that any right to vote could not be assigned. Under the regulations, this is enough to establish that free transferability does not exist.[305]

The ruling also concluded that the LLC lacked continuity of life because the Wyoming Act provides that LLCs will be dissolved upon the death, withdrawal, or bankruptcy of any member unless the other members all agreed to continue the business.[306] Because the

300. WYO. STAT. § 17-15-113 (1977) (providing that no member will be liable "for a debt, obligation or liability of the limited liability company").

301. WYO. STAT. § 17-15-116 (1977) (providing that "if provision is made for it in the articles of organization, management of the limited liability company may be vested in a manager or managers who shall be elected by the members in the manner prescribed by the operating agreement").

302. WYO. STAT. § 17-15-117 (1977) prohibits any person other than a manager from contracting debt on behalf of the LLC if management has been vested in managers. Thus, no member possessed any right or power to bind the LLC, and the management clearly was centralized within the meaning of the 1960 Regulations. *Cf.* Treas. Reg. § 301.7701-2(c)(3) (as amended in 1983) (defining "centralized management").

303. *See* Treas. Reg. § 301.7701-2(a)(3) (as amended in 1983).

304. *See* WYO. STAT. § 17-15-122 (1977); Treas. Reg. § 301.7701-2(e) (as amended in 1983).

305. Because the LLC at issue had elected to be managed by managers, the non-manager members would have no right to participate in the conduct of the business. At most, the members would have possessed any voting rights left with members and the right to inspect the books. It is not entirely clear from the ruling whether there were any matters upon which the members would be entitled to vote or consent other than a transfer of interests. It is possible, therefore, that consent to transfer affected only the ability to give the transferee the right to reasonable inspection of the books and to consent to the next proposed transfer. *See* Rev. Rul. 88-76, 1988-2 C.B. 360.

306. WYO. STAT. § 17-15-123 (1977); *see* Treas. Reg. § 301.7701-2(b) (as amended in 1983).

limited liability company lacked continuity of life and free transferability, the proper characterization of the entity for federal income tax purposes was held to be that of a partnership.

D. *Modification of the* National Carbide *Standards*

Jones v. Commissioner,[307] based on the application of the *National Carbide* standards for recognizing true agencies,[308] suggested that a limited partnership in which a limited partner controlled corporation served as general partner would not, in at least some circumstances, avoid corporate taxation, independent of whether the organization passed muster under the 1960 Regulations. Notwithstanding the Service's successes with this argument in *Jones*, it is no longer available to the Service so long as a written partnership exists and the fact that the corporation is acting as general partner is disclosed to third parties.

In 1988, the Supreme Court decided *Commissioner v. Bollinger*,[309] substantially clarifying the issue of when a corporation would be a true agent. The Court stated:

> the genuineness of the agency relationship is adequately assured, . . . when the fact that the corporation is acting as agent for its shareholders with respect to a particular asset is set forth in a written agreement at the time the asset is acquired, the corporation functions as agent and not principal with respect to the asset for all purposes, and the corporation is held out as the agent and not the principal in all dealings with third parties relating to the asset.[310]

To the extent that *National Carbide* required any greater showing, it is no longer applicable.[311]

Under *Bollinger*, a partnership between a corporation and its shareholders will certainly be recognized as the true owner of the business if there is a written partnership agreement, the assets are in the partnership's name, and the business is conducted in the name of the limited partnership.

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307. 640 F.2d 745 (5th Cir.), *cert. denied*, 454 U.S 965 (1981).
308. National Carbide Corp. v. Commissioner, 336 U.S 422 (1949).
309. 485 U.S. 340 (1988). The occurrence in 1988 of both the *Bollinger* decision and Rev. Rul. 88-76, 1988-2 C.B. 360 (holding that a limited liability company would be taxed as a partnership) was likely coincidental, but the result was to make 1988 a pretty good year for taxpayers desiring limited liability without corporate tax.
310. *Bollinger*, 485 U.S. at 349-50.
311. *See* George W. Heaton, 58 T.C.M. (CCH) 2197 (1989) (holding that the three requirements set out in *Bollinger* will be controlling on the issue of whether a partnership between a corporation and its shareholders will be recognized as the owner of the business).

VII. Choice of Unincorporated Forms After 1988

A. Choice of the Limited Liability Company Form

1. In General

The emergence of LLCs should add a significant alternative for new businesses facing the choice of entity dilemma,[312] but predicting the role that LLCs can or will play is complicated by several factors. First, while LLCs are receiving a great deal of attention, so far they have only been authorized in eighteen states.[313] Unless a business happens to be engaging in activities only within those eighteen states, uncertainty regarding the treatment of LLCs in other states may militate against use of this form.[314] Second, the choice of the LLC form is also limited currently by the fact that existing LLC acts are not uniform and contain significant ambiguities and uncertainties.[315] Finally, while the application of the 1960 Regulations to various arrangements that may be established under the LLC acts does not appear to be particularly uncertain, it is not yet clear whether the Service will accept the apparent application of the 1960 Regulations or will endeavor to impose more stringent rules either substantively or for ruling purposes.[316]

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312. Existing businesses may also find that the LLC better suits their needs. For those already organized as a partnership for tax purposes, conversion to an LLC will not involve any tax liability. Indeed, the LLC will be deemed to be the same partnership as its predecessor for tax purposes. *See* I.R.C. § 708(a) (1992). For businesses that are incorporated, conversion to the LLC form will entail a liquidation of the corporation and therefore recognition of all gains. *See* I.R.C. §§ 331, 336 (1992).

313. *See supra* note 287.

314. The choice of law applicable to an LLC operating in a state that does not have an LLC act is simply unknown as yet. *See* Keatinge et al., *supra* note 287, at 442.

315. *See generally infra* text accompanying notes 331-73.

316. A principal uncertainty is whether and to what extent the Service will treat LLCs that are governed in certain respects by provisions corresponding to the UPA or the ULPA as being covered by statements of general application to UPA or ULPA partnerships. For example, partnerships formed under statutes corresponding to the UPA or the ULPA cannot possess continuity of life (Treas. Reg. § 301.7701-2(b)(3) (as amended in 1983)) and usually cannot possess centralized management (Treas. Reg. § 301.7701-2(c)(4) (as amended in 1983)). Obviously, LLC acts do not correspond to the UPA or the ULPA in an overall sense, but may correspond very closely with the UPA or the ULPA so far as management or continuity of life are concerned. Because the only relevance to the presence of continuity of life or centralized management are the provisions that govern the life and management of the LLC when these provisions correspond to the partnership acts, the same conclusions should obtain.

2. *Ideal LLC Legislation*

LLCs will become a significant alternative only if authorizing legislation becomes more widespread, more uniform, and more aptly suited to the goal of finally solving the choice of entity dilemma. It seems likely that these events will occur.[317] While it is beyond the scope of this article to attempt to predict what future LLC legislation will provide or to recommend a model LLC act, it can be suggested what the ideal LLC legislation might look like in general terms. An ideal LLC act probably should do little more than restate the UPA, adopt a provision granting members limited liability, and otherwise depart from the UPA only to the extent clearly necessary to respond to a legitimate business or public interest.

The principal benefits of such an ideal act would arise from the fact that such an act would be uniform and would contain provisions that have a significant history and that are fairly widely understood. Perhaps as significant, such an ideal act would create relationships that have been expressly addressed by the 1960 Regulations and that should have a more certain federal tax consequence.

Beyond increased certainty both under state law and under federal tax law, the ideal act would provide maximum flexibility for the owners to establish relationships suited to their particular business. The UPA generally recognizes that the relationship between owners is fundamentally contractual,[318] and an LLC act following the UPA would allow the same degree of flexibility. A more rigid LLC act will simply cause the LLC form to be inappropriate for many business to which it ought reasonably to be available. For example, the LLC form would seem to be the most obviously appropriate form for a small business with a limited number of owners who are all active in the business. In such a business, centralized management may be neither necessary nor appropriate. If the LLC act mandates centralized, representational management, this business would be required to accept a relationship which is not particularly well suited to its business in order to use the LLC form.[319]

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317. *See supra* note 287 (regarding the number of states considering LLC legislation). There are projects underway within the American Bar Association and with the Commissioners on Uniform State Laws regarding LLCs. *See* Keatinge et al., *supra* note 287, at 456.

318. Most of the UPA provisions regulating the relationship of the partners *inter sese* apply only in the absence of agreement. *See* UPA § 9 (scope of the partners' authority), § 18 (economic and management rights), § 19 (maintenance of books), § 22 (right to an account), § 23(1) (continuation), § 25(2)(a) (right to occupy partnership property), § 27(1) (rights of an assignee), § 31 (events of dissolution and right to dissolve), § 36 (effect of dissolution on existing liabilities), § 37 (right to wind up), § 38 (right to distribution and winding up following dissolution), and § 42 (rights of withdrawing members in the event of continuation).

319. Colorado imposes just this requirement. *See* COLO. REV. STAT. § 7-80-401 (1990) (vesting management exclusively in managers).

Flexibility in LLC acts is particularly important given that the ultimate purpose of the legislation is to authorize a new form of organization that provides limited liability to the owners without causing them to incur corporate taxation. The price to be paid to avoid corporate taxation is that the business must be willing to forego at least two of the principal corporate attributes as they are defined in the 1960 Regulations. A rigid LLC act, which necessarily creates two corporate characteristics in every LLC, limits the ability of the legislation to accomplish this goal. Following the example above, if a rigid LLC act requires centralized management, then all LLCs formed under the act will possess both limited liability and centralized management under the 1960 Regulations. As a result, any business (including those that do not need or desire centralized management) in which freely transferable interests, for example, are necessary will have a difficult time avoiding corporate characterization for tax purposes should they wish to use an LLC. If a rigid LLC act also prohibited the creation of free transferability by agreement, this business will simply be foreclosed from the use of an LLC.[320] At the same time, there is no conceivable reason why this business should be denied access to the LLC form.

Variations from the UPA under an ideal LLC act would be necessary, but should be only as are clearly justified by business or state concerns. No such variations would be necessary to facilitate an appropriate relationship between the owners because the members will be free to establish any relationship they desire by agreement.[321] At most, variations should do no more than to alter some of the terms that will apply in default of an agreement. For example, profit sharing in the absence of contrary agreement could be based on contributions rather than being per capita as is required under the UPA in the absence of contrary agreement.[322]

Variations from the UPA will be appropriate to clarify and establish the relationship of the LLC to the state. Most obviously, it is appropriate to require a state filing as a condition to claiming the benefits of formation under the LLC acts.[323] Similarly, because the

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320. Not only does Colorado prohibit member management (COLO. REV. STAT. § 7-80-401 (1990)), it also seems not to permit free transferability to be created by agreement. COLO. REV. STAT. § 7-80-702 (1990). While this rigid statute may prevent anyone from inadvertently creating an LLC that is taxable as a corporation, it does so by making it very difficult for some businesses to employ the LLC.

321. *See supra* note 318.

322. *See* UPA § 18(a).

323. The LLC acts all provide that the LLC is formed upon the filing of articles of

LLC is created by a state filing, additional filings disclosing dissolution or other alteration of the organization are appropriate.[324] Other departures could include provisions permitting mergers[325] or the registration and regulation of foreign LLCs.[326] Finally, because there

organization. *See* ARIZ. REV. STAT. ANN. § 29-631 (Supp. 1992); COLO. REV. STAT. § 7-80-203 (Supp. 1992); Delaware Limited Liability Company Act, 1992 Del. Laws ch. 434 (H.B. 608) (WESTLAW) (to be codified at DEL. CODE ANN. tit. 6, § 18-201); FLA. STAT. ANN. § 608.405 (West Supp. 1992); Illinois Limited Liability Company Act, 1992 Ill. Legis. Serv. P.A. 87-1062, Sec. 180, § 5-1 (S.B. 2163) (WESTLAW); Iowa Limited Liability Company Act, 1992 Ia. Legis. Serv. ch. 2369 (WESTLAW) (to be codified at IOWA CODE ANN. § 490A.301); KAN. STAT. ANN. § 17-7605 (Supp. 1991); Louisiana Limited Liability Company Act, 1992 La. Sess. Law Serv. Act 780 (H.B. 262) (WESTLAW) (to be codified at LA. REV. STAT. ANN. § 12:1304); MD. CODE ANN., CORPS. & ASS'NS § 4A-202 (Supp. 1992); Minnesota Limited Liability Company Act, ch. 517, art. 2, §§ 1-141 (to be codified at MINN. STAT. ANN. § 322B.102); NEV. REV. STAT. § 86.151 (Supp. 1991); OKLA. STAT. ANN. tit. 18, § 2004 (West 1992); R.I. GEN. LAWS § 7-16-5 (1992); TEX. REV. CIV. STAT. ANN. art. 1528n, art. 3.03 (West Supp. 1992); UTAH CODE ANN. § 48-2b-103 (1992); VA. CODE ANN. § 13.1-1010 (Michie Supp. 1992); W. VA. CODE § 31-1A-7 (Supp. 1992); WYO. STAT. § 17-15-106 (1977).

324. *See* ARIZ. REV. STAT. ANN. § 29-783 (Supp. 1992); COLO. REV. STAT. § 7-80-807 (1990); Delaware Limited Liability Company Act, 1992 Del. Laws ch. 434 (H.B. 608) (WESTLAW) (to be codified at DEL. CODE ANN. tit. 6, § 18-203); FLA. STAT. ANN. §§ 608.411, .445 (West Supp. 1992); Illinois Limited Liability Company Act, 1992 Ill. Legis. Serv. P.A. 87-1062, sec. 180, § 35-15 (S.B. 2163) (WESTLAW); Iowa Limited Liability Company Act, 1992 Ia. Legis. Serv. ch. 2369 (WESTLAW) (to be codified at IOWA CODE ANN. § 490A.1305); KAN. STAT. ANN. §§ 17-7610, -7627 (1991); Louisiana Limited Liability Company Act, 1992 La. Sess. Law Serv. Act 780 (H.B. 1262) (WESTLAW) (to be codified at LA. REV. STAT. ANN. §§ 12:1339, :1340); MD. CODE ANN., CORPS. & ASS'NS § 4A-909 (Supp. 1992); Minnesota Limited Liability Company Act, ch. 517, art. 2, §§ 1-141 (to be codified at MINN. STAT. ANN. § 322B.804); NEV. REV. STAT. §§ 86.221, .531 (Supp. 1991); OKLA. STAT. ANN. tit. 18, § 2041 (West 1992); R.I. GEN. LAWS § 7-16-47 (1992); TEX. REV. CIV. STAT. ANN. art. 1528n, art. 6.07 (West Supp. 1992); UTAH CODE ANN. §§ 48-2b-121, -140 (1992); VA. CODE ANN. §§ 13.1-1014, -1050 (Michie Supp. 1992); W. VA. CODE §§ 31-1A-39, -40 (Supp. 1992); WYO. STAT. §§ 17-15-127, -129 (1977).

325. *See* ARIZ. REV. STAT. ANN. §§ 29-751 to -757 (Supp. 1992); Iowa Limited Liability Company Act, 1992 Ia. Legis. Serv. ch. 2369 (WESTLAW) (to be codified at IOWA CODE ANN. §§ 490A.1201-.1206); KAN. STAT. ANN. § 17-7650 (1991); Louisiana Limited Liability Company Act, 1992 La. Sess. Law Serv. Act 780 (H.B. 1262) (WESTLAW) (to be codified at LA. REV. STAT. ANN. §§ 12:1357-:1362); MD. CODE ANN., CORPS. & ASS'NS §§ 4A-701 to -710 (Supp. 1992); Minnesota Limited Liability Company Act, ch. 517, art. 2, §§ 1-141 (to be codified at MINN. STAT. ANN. §§ 322B.701-.709); OKLA. STAT. ANN. tit. 18, § 2054 (West 1992); R.I. GEN. LAWS §§ 7-16-59 to -64 (1992); UTAH CODE ANN. § 48-2b-149 (1992); W. VA. CODE §§ 31-1A-41 to -46 (Supp. 1992).

326. *See* ARIZ. STAT. REV. ANN. §§ 29-801 to -812 (Supp. 1992); COLO. REV. STAT. §§ 7-80-901 to -913 (1990); Delaware Limited Liability Company Act, 1992 Del. Laws ch. 434 (H.B. 608) (WESTLAW) (to be codified at DEL. CODE ANN. tit. 6, §§ 18-901 to -911); Illinois Limited Liability Company Act, 1992 Ill. Legis. Serv. P.A. 87-1062, sec. 180, §§ 45-1 to -45 (S.B. 2163) (WESTLAW); Iowa Limited Liability Company Act, 1992 Ia. Legis. Serv. ch. 2369 (WESTLAW) (to be codified at IOWA CODE ANN. §§ 490A.1401-.1410); KAN. STAT. ANN. § 17-7605 (Supp. 1991); Louisiana Limited Liability Company Act, 1992 La. Sess. Law Serv. Act 780 (H.B. 1262) (WESTLAW) (to be codified at LA. REV. STAT. ANN. §§ 12:1342-:1356); MD. CODE ANN., CORPS. & ASS'NS §§ 4A-1001 to -1012 (Supp. 1992); OKLA. STAT. ANN. tit. 18, §§ 2042-2050 (West 1992); R.I. GEN. LAWS §§ 7-16-48 to -55 (1992); UTAH CODE ANN. § 48-2b-143 (1992); VA. CODE ANN. §§ 13.1-1051 to -1060 (Michie Supp. 1991);

will be a state filing, this filing could be used to give certain kinds of notice, including notice that would otherwise involve the rather meaningless act of publication in a newspaper of general circulation.[327] While variations as to the formalities of formation are appropriate, there seems little reason to depart from the substantive notions of the UPA as to the nature of the organization.

Having generally identified what an ideal act might be, it must be conceded that it is difficult to know how close any particular LLC act is to such an ideal. Because of the uncertainties in the LLC acts, the discussion which follows endeavors to analyze how the LLC could be utilized if formed under the ideal act described and to identify to what extent other LLC acts will or might permit the same result.

3. *General Uses of the LLC Form*

It is difficult to conceive of a reason why any business that in the past would have adopted a general partnership form will not in the future use an LLC. An LLC will vary from the general partnership form primarily in providing the owners limited liability and in requiring a state filing as a condition to obtaining this benefit.[328] It seems a safe assumption that statutory limited liability will always be perceived to be a benefit. It also seems safe to assume that the need to file articles of organization is a nominal price to pay for this benefit. Thus, the LLC seemingly should supplant the general partnership form whenever and wherever it is available.[329]

Beyond supplanting the general partnership form, it seems clear that the LLC should be a very accommodating and possibly the preferred form of organization when the owners desire limited liability and not more than one of the other principal corporate attributes. The ability to have limited liability and avoid corporate taxation in

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W. VA. CODE §§ 31-1A-48 to -63 (Supp. 1992).

327. *See* UPA §§ 35(1)(b)(II), (3)(c)(II) (requiring notice of dissolution to be published in a newspaper in order to fully terminate the power of partners to bind the partnership). *See* MD. CODE ANN., CORPS. & ASS'NS § 4A-401(a)(3)(ii) (Supp. 1992) (permitting the members to give in the articles of organization constructive notice of limitations on authority to bind the partnership).

328. *See supra* notes 289 and 293 and accompanying text.

329. Many relationships are partnerships under state law simply because the relationship created was not recognized by the participants as anything more than co-ownership or some other relationship not generally regarded as creating a business organization. *See* UPA §§ 6, 7. Many of these relationships will continue to be treated as general partnerships. With limited liability available, it may also be that many people will now affirmatively endeavor to place their relationships under the LLC form.

such situations is clear. Only incorporation and an S election would provide an equally simple and direct solution. However, given the strict limitations on the availability of the S election and the less favorable tax treatment accorded to S corporations in many situations compared to the treatment of an LLC taxed as a partnership,[330] the LLC should be preferred over the S corporation in this context.

B. *Use of the LLC to Obtain Corporate Benefits Without Corporate Taxation*

The most interesting question is to what extent an LLC can be used to solve the common choice of entity dilemma when the owners desire that their organization possess more than two of the principal corporate characteristics for state law purposes. Under an ideal LLC act, limited liability will be present and all of the other corporate attributes could be established by agreement; achieving the desired structure for state law purposes should be merely a drafting issue. However, again under the ideal statute, the LLC need not necessarily have any corporate attribute for tax purposes except limited liability. Thus, the use of an LLC to solve the choice of entity dilemma in this context depends upon the ability to draft agreements that satisfy the need for continuity of life, centralized management, and free transferability for business purposes without also causing those attributes to be present for tax purposes. The discussions that follow suggest that this should be possible.

1. *Centralized Management*

Under an ideal act, and most of the existing LLC acts, if the members desire to retain management, they may do so.[331] In any

330. *See supra* text accompanying notes 104-67.

331. Most of the LLC acts vest management authority in members unless the parties have provided for management by managers in the articles of organization. *See* ARIZ. REV. STAT. ANN. § 29-681(a)(Supp. 1992); FLA. STAT. ANN. § 608.422 (West Supp. 1992); Illinois Limited Liability Company Act, 1992 Ill. Legis. Serv. P.A. 87-1062, sec. 180, § 15-1 (S.B. 2163) (WESTLAW); KAN. STAT. ANN. § 17-7612 (1991); Louisiana Limited Liability Company Act, 1992 La. Sess. Law Serv. Act 780 (H.B. 1262) (WESTLAW) (to be codified at LA. REV. STAT. ANN. § 12:1311); NEV. REV. STAT. § 86.291 (1991); UTAH CODE ANN. § 48-2b-125 (1992); WYO. STAT. § 17-15-116 (1977). Iowa, Rhode Island, Virginia, and West Virginia are similar except that they also allow the agreement to use managers to be established in the operating agreement. *See* Iowa Limited Liability Company Act, 1992 Ia. Legis. Serv. ch. 2369 (WESTLAW) (to be codified at IOWA CODE ANN. § 490A.702); R.I. GEN. LAWS § 7-16-14 (1992); VA. CODE ANN. § 13.1-1010 (Michie Supp. 1991); W. VA. CODE § 31-1A-18 (Supp. 1992). Minnesota, Oklahoma, and Texas vest management in managers unless the articles or an agreement provide for member management. *See* Minnesota Limited Liability Company Act, ch. 517, art. 2, §§ 1-141 (to be codified at MINN. STAT. ANN. §§ 322B.603, .322); OKLA. STAT. ANN. tit. 18, §§ 2013, 2015 (West 1992); TEX. REV. CIV. STAT. ANN. art.

such event, centralized management should not be present for tax purposes.[332] On the other hand, if the members establish a representational management structure either by mandate of the LLC act or through their articles of organization, centralized management will likely be present both for business purposes and for tax purposes.[333]

1528n, art. 2.12 (West Supp. 1992). The Delaware and Maryland acts most closely resemble the UPA. The Delaware Act provides for management by members unless the members otherwise agree. Delaware Limited Liability Company Act, 1992 Del. Laws ch. 434 (H.B. 608) (WESTLAW) (1992) (to be codified at DEL. CODE ANN. tit. 6, § 18-402). Indeed, the Maryland Act does not even refer to managers. However, the Maryland Act will permit the members to create any management structure they desire by agreement. *See* MD. CODE ANN., CORPS. & ASS'NS § 4A-402(a)(1)(Supp. 1992). Colorado vests management in managers and does not permit members to manage their own business as members. *See* COLO. REV. STAT. § 7-80-203 (1990).

332. *See* Treas. Reg. § 301.7701-2(c) (as amended in 1983).

333. Rev. Rul. 88-76, 1988-2 C.B. 360; Priv. Ltr. Rul. 91-47-017 (Aug. 12, 1991); Priv. Ltr. Rul. 91-19-029 (Feb. 7, 1991); Priv. Ltr. Rul. 90-52-039 (Oct. 2, 1990); Priv. Ltr. Rul. 90-29-019 (Apr. 19, 1990). Only Colorado mandates centralized management. *See* COLO. REV. STAT. § 7-80-401 (Supp. 1991). When not required, the LLC acts generally permit the use of managers to be established by provision to that effect in the articles of organization. *See supra* note 331. This arrangement, because it vests management in a group that does not include all of the members, will cause centralized management to be present for tax purposes under the 1960 Regulations as long as the members do not retain the power to bind the LLC. *See* Treas. Reg. § 301.7701-2(c)(4) (as amended in 1983). At the very least, it seems that a provision in the articles of organization taking management away from members should also take from the members any power to bind the LLC. Such power is expressly removed in many states. *See* ARIZ. REV. STAT. ANN. § 29-654 (Supp. 1992); COLO. REV. STAT. §§ 7-80-407, -408 (Supp. 1991); FLA. STAT. ANN. §§ 608.424, .425 (West Supp. 1992); KAN. STAT. ANN. § 17-7614 (Supp. 1991); NEV. REV. STAT. §§ 86.301, .311 (Supp. 1991); TEX. REV. CIV. STAT. ANN. art. 1528n, art. 2.12 (West Supp. 1992); UTAH CODE ANN. § 48-26-127 (1992); W. VA. CODE § 31-1A-21 (Supp. 1992); WYO. STAT. §§ 17-15-117, -118 (1977).

It is hard to understand why the use of managers should be required to be disclosed in the articles of organization. The disclosure is generally not self-executing. There will still need to be an agreement governing the number of managers, how they are elected, how long they are to serve, how often they are to meet, what powers they are to have, what issues are reserved to members, and a slew of other questions. Because the real purpose for inclusion in the articles of organization is a topic for agreement, the only good explanation for inclusion in the articles of organization is to give notice of this fact. One is left to wonder why notice is mandatory, what happens if the members change their mind and forget to amend, or if they simply operate otherwise. For limited partnerships, the RULPA has moved toward a perfunctory state law filing with the ability to include other matters. *See* RULPA § 201. Probably the real reason that the LLC acts require significantly greater information, including whether there are managers, is that Wyoming adopted such a provision prior to the time when partnership filings became perfunctory, and others have simply followed suit.

The Minnesota LLC Act provides for management by a Board of Governors. Minnesota Limited Liability Company Act, ch. 517, art. 2, §§ 1-141 (to be codified at MINN. STAT. ANN. § 322B.603(1)). But member management can be substituted under a "Member Control Agreement." Minnesota Limited Liability Company Act, ch. 517, art. 2, §§ 1-141 (to be codified at MINN. STAT. ANN. § 322B.322). The Minnesota Act is different from, and more complicated than, any other LLC act. Therefore, practitioners

Thus, if effectively centralized management is desired without this attribute under the 1960 Regulations, some other arrangement will have to be established by agreement.

A suggestion is that the LLC not vest management in representatives in the state filing, but that they create a form of centralized management under an operating agreement. Under an ideal act, this distinction alone should be enough to avoid centralized management. In such event, each member would have the power to bind the LLC for transactions occurring in the ordinary course of business when dealing with a third party who does not know of the restrictions on the authority of the members.[334] The 1960 Regulations expressly recognize that this kind of power to bind, which is statutorily vested in owners, prevents centralized management.[335]

Whether this approach will be possible under existing LLCs is uncertain. In Colorado, this approach is not available simply because the statute vests management in a representative group.[336] Arizona and Louisiana clearly recognize inherent authority in members absent the disclosure of the use of managers in the articles of organization.[337] Thus, centralized management in Arizona is avoided simply by not providing for the use of managers in the articles. Since Maryland generally follows the UPA with regard to the agency power of members, centralization of management for tax purposes should not be possible for Maryland LLCs even if, by agreement, management is vested in a group resembling a board of directors.[338] Delaware, Iowa, Minnesota, Rhode Island, and Virginia clearly will permit the creation of representative management by operating agreement,[339] as

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will find predictions as to its effect much more difficult.

334. *See* UPA § 9(1).

335. *See* Treas. Reg. § 301.7701-2(c)(4) (as amended in 1983). *See also* Priv. Ltr. Rul. 90-10-027 (Dec. 7, 1989) (holding that an LLC (the state of organization cannot be ascertained from the ruling) in which the members had inherent power to bind, notwithstanding an agreement to the contrary, prevented the organization from possessing centralized management under the 1960 Regulations (*See supra* note 187)).

336. *See* COLO. REV. STAT. § 7-80-401 (Supp. 1991).

337. ARIZ. REV. STAT. ANN. § 29-654 (Supp. 1992); Louisiana Limited Liability Company Act, 1992 La. Sess. Law Serv. Act 780 (H.B. 1262) (WESTLAW) (to be codified at LA. REV. STAT. ANN. § 12:1317(a)).

338. *See* MD. CODE ANN., CORPS. & ASS'NS § 4A-401 (Supp. 1992). The Maryland Act does permit a statement in the articles to provide constructive notice of limitations on member authority to third parties. It is possible that the Service will take the position that use of this notice provision is enough to remove the inherent authority necessary to avoid centralized management under the 1960 Regulations. *See* MD. CODE ANN., CORPS. & ASS'NS § 4A-401(a)(3) (Supp. 1992).

339. *See* Delaware Limited Liability Company Act, 1992 Del. Laws ch. 434 (H.B. 608) (WESTLAW) (to be codified at DEL. CODE ANN. tit. 6, § 18-402); Iowa Limited Liability Company Act, 1992 Ia. Legis. Serv. ch. 2369 (WESTLAW) (to be codified at IOWA CODE ANN. § 490A.702); Minnesota Limited Liability Company Act, ch. 517, art. 2, §§ 1-141 (to be codified at MINN. STAT. ANN. § 322B.322); R.I. GEN. LAWS § 7-16-14 (1992); VA. CODE ANN. § 13.1-1022 (Michie Supp. 1991).

will Texas.[340] In the other states, while not entirely clear, it is at least arguable that representational management can be created by an operating agreement without being made part of the articles of organization.[341] However, to be effective in avoiding the tax characteristic of centralized management, the centralized management created under agreement must leave the members with authority to bind the organization when dealing with persons who do not have knowledge of the agreement. It is not clear whether any such power would exist under LLC acts other than Arizona and Maryland when representatives are given management authority by agreement. Except for Arizona and Maryland, no state has an act that includes a provision similar to UPA section 9, which expressly recognizes such power in general partners. At most, the LLC acts provide that no

340. Texas vests management in managers unless the regulations reserve management to members. *See* TEX. REV. CIV. STAT. ANN. art. 1528n, art. 2.13 (West Supp. 1992). Thus, the ability to vest management in members by agreement is expressly established.

341. Most LLC acts vest management authority in members unless the parties have provided for management by managers in the articles of organization. *See* ARIZ. REV. STAT. ANN. § 29-681(a) (Supp. 1992); FLA. STAT. ANN. § 608.422 (West Supp. 1992); Illinois Limited Liability Company Act, 1992 Ill. Legis. Serv. P.A. 87-1062, sec. 180, § 15-1 (S.B. 2163) (WESTLAW); KAN. STAT. ANN. § 17-7612 (Supp. 1991); Louisiana Limited Liability Company Act, 1992 La. Sess. Law Serv. Act 780 (H.B. 1262) (WESTLAW) (to be codified at LA. REV. STAT. ANN. § 12:1311); NEV. REV. STAT. § 86.291 (1991); UTAH CODE ANN. § 48-2b-125 (1992); WYO. STAT. § 17-15-116 (1977). Whether the parties could omit such a provision for management by managers from the articles of organization in these states and then create essentially the same arrangement by agreement is unclear. The reality is that they can and will do so, but it is not clear that this result is sanctioned by law. Generally, these LLC acts permit the members to enter into an operating agreement (referred to variously as by-laws, regulations, or an operating agreement) to regulate the internal affairs of the LLC so long as the agreement is not inconsistent with law or the articles of organization. *See* ARIZ. REV. STAT. ANN. § 29-682 (Supp. 1992); FLA. STAT. ANN. § 608.423 (West Supp. 1992); Illinois Limited Liability Company Act, 1992 Ill. Legis. Serv. P.A. 87-1062, sec. 180, § 15-1 (S.B. 2163) (WESTLAW); KAN. STAT. ANN. § 17-7613 (Supp. 1991); Louisiana Limited Liability Company Act, 1992 La. Sess. Law Serv. Act 780 (H.B. 1262) (WESTLAW) (to be codified at LA. REV. STAT. ANN. § 12:1301(16)); UTAH CODE ANN. § 48-2b-126 (1992). *See also* NEV. REV. STAT. § 86.101 (Supp. 1991). While Wyoming has no express provision concerning operating agreements, their existence is acknowledged. *See* WYO. STAT. § 17-15-116 (1977). Thus, the issue will exist whether an agreement vesting management in managers without so providing in the articles of organization is inconsistent with the law or the articles. This issue cannot yet be answered. It does seem that management by members should not foreclose delegation of management authority to others, and the extent of such delegation probably should not be limited by the ability to have created managers through the articles. *But see* FLA. STAT. ANN. §§ 608.424, .425 (West Supp. 1992); KAN. STAT. ANN. § 17-7614 (Supp. 1991); NEV. REV. STAT. §§ 86.301, .311 (1991); UTAH CODE ANN. § 48-2b-126 (1992); WYO. STAT. §§ 17-15-117, -118 (1977), each of which provide that only a member can bind a member-managed LLC.

one other than any member can bind a member managed LLC.[342] Thus, before it can be determined whether this approach will work under existing LLC acts, the nature and extent of the authority of the members will have to be determined by the courts of each state.[343]

The inherent power of members, if any, to bind an LLC notwithstanding an agreement to the contrary could cause the suggested arrangement to fall short of the centralized management desired for business purposes. In light of this fact, it would be appropriate if the ideal LLC act also permitted the LLC to give notice of an agreement limiting the inherent power of the members in the organizational filing.[344] This seems to be the effect of providing for representational management in the articles of organization. However, if the inherent power of members to bind the LLC can be and is eliminated by a statutory filing, it may be that the absence of any inherent power of the members to bind will cause the organization to have centralized management.

An alternative means to avoiding centralized management for tax purposes under the 1960 Regulations is to make the centralized management noncontinuous or nonexclusive. The test for centralized management under the 1960 Regulations is whether "continuing exclusive" authority to manage the business is vested in representatives.[345] One could argue that, if centralized management can be created by operating agreement,[346] any centralized management created by an agreement that the members can amend at any time does not create a continuous and exclusive authority to manage the business. Going a step further, continuous management rights should clearly be avoided merely by creating a representative management structure that will continue for only one year. Even if the members acting by majority vote under the operating agreement determine to

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342. The same provisions that limit authority to bind a manager-managed LLC provide that only members can bind a member-managed LLC. *See supra* note 333. These provisions are interesting in certain respects. Presumably they are not intended to mean that the LLC cannot authorize others to act as the agent of the LLC. Perhaps, then the import is to remove inherent agency powers from members when the LLC has managers and to confirm such powers when there is member management, at least when the managers are established by a provision in the articles of organization. It is unclear what effect there would be on the authority of members who vest management in others by agreement. *Compare* ARIZ. REV. STAT. ANN. § 29-654 (Supp. 1992) *and* Louisiana Limited Liability Company Act, 1992 La. Sess. Law Serv. Act 780 (H.B. 1262) (WESTLAW) (to be codified at LA. REV. STAT. ANN. § 12:1317) *with* MD. CODE ANN., CORPS. & ASS'NS § 4A-401 (Supp. 1992).

343. *See* Priv. Ltr. Rul. 90-10-027 (Dec. 7, 1989), in which the Service assumed without analysis that a member's inherent power to bind a member-managed LLC existed notwithstanding a contrary agreement.

344. *See* MD. CODE ANN., CORPS. & ASS'NS § 42-401(a)(3)(Supp. 1992).

345. *See* Treas. Reg. § 301.7701-2(c)(1) (as amended in 1983).

346. *See supra* notes 336-41 and accompanying text.

vest exclusive management in a representative group for a second year, or a third, or fourth, and so on, the management structure is not continuous in the corporate sense. Alternatively, or additionally, the centralized management could be made nonexclusive simply by permitting the members by majority vote to exercise management by majority and to override any decisions of the representative managers.[347]

The only basis on which the Service would be able to assert that centralized management is present under this arrangement is that the substance of the arrangement will closely resemble the centralized management present in corporations. This arrangement certainly does achieve largely the same end for business purposes, but the test of the regulations is highly formal. While the operative effect may be very similar, the authority vested in the centralized representative management group is nonexclusive and noncontinuous, and the 1960 Regulations expressly state that these factors are determinative of the presence of centralized management for tax purposes.[348] The fact that the 1960 Regulations are not satisfied with a situation that substantially accomplishes centralized management is abundantly clear from the fact that a partnership management structure that by agreement of the partners is centralized, continuous, and exclusive does not create centralized management because of the inherent power of partners to bind the partnership, albeit that any exercise of that power would constitute a breach of contract. The conclusion in the 1960 Regulations is that this circumstance leaves the centralized management group without the *sole* authority to manage the business, and thus without centralized management under the 1960 Regulations.[349]

2. *Continuity of Life*

Under an ideal act, the LLC would be dissolved any time a person ceases to be a member.[350] Any continuation of the business would necessarily involve a new organization that replaces the dissolved organization. Under such a statute, an LLC could not have continuity

347. When operating agreements are permitted to establish management, non-continuous or non-exclusive arrangements should be simple to establish. *See supra* note 333. *Cf.* Minnesota Limited Liability Company Act, ch. 517, art. 2, §§ 1-141 (to be codified at MINN. STAT. ANN. § 322B.603(2)).

348. *See* Treas. Reg. § 301.7701-2(c)(1) (as amended in 1983).

349. Treas. Reg. § 301.7701-2(c)(4) (as amended in 1983).

350. *See* UPA § 31.

of life within the meaning of the 1960 Regulations.[351]

The 1960 Regulations provide that continuity is absent if the organization is dissolved when any person ceases to be a member.[352] For this purpose, the 1960 Regulations expressly state that reference is to be made exclusively to state law to determine if there has been a dissolution.[353] When dissolution results under state law, the regulations expressly state that the organization cannot possess continuity of life even if the remaining owners continue the business in a new organization.[354] Thus, any LLC act that simply provides that the LLC will be dissolved upon any change in membership will necessarily cause continuity of life to be absent.[355]

While the ideal act would preclude a finding of continuity of life for tax purposes, it should not impede the creation of acceptable continuity of life for business purposes. The members could simply agree that no one would voluntarily cause dissolution, and that upon dissolution, a new LLC would immediately be formed to replace the old LLC and to succeed to the business and all of the assets and liabilities of the old LLC. The agreement could further provide that all of the members of the old LLC that did not cause the dissolution would have rights as owners of the new LLC that reflect their interests in the old, that any owner, or the legal representative of any deceased owner, who did not cause the dissolution in violation of the agreement could be admitted as a member of the new LLC with interests that reflect the interest held in the old LLC. The Regulations also provide that any persons who caused the dissolution of the old LLC or who do not elect to become members of the new LLC will have the right to be paid for their interest in the old LLC either at a price that will clearly discourage withdrawal or on terms that match the distributions such owners would have received were they still members.[356]

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351. *See* Treas. Reg. § 301.7701-2(b)(2) (as amended in 1983). *See also supra* notes 213-26 and accompanying text.

352. Treas. Reg. § 301.7701-2(b)(1) (as amended in 1983).

353. Treas. Reg. § 301.7701-2(b)(2) (as amended in 1983).

354. Treas. Reg. § 301.7701-2(b)(2)(last sentence) (as amended in 1983).

355. Only Maryland has adopted such a provision. *See* MD. CODE ANN., CORPS. & ASS'NS §§ 4A-901 to -911 (Supp. 1992).

356. The ability of partners to control their relationship by contract would allow this sort of agreement. The UPA generally permits partners of a dissolved partnership to demand a winding up and distribution of assets only if they have not otherwise agreed. *See* UPA § 38(1). More troublesome is the ability to vary the rights of the partner who has wrongfully caused a dissolution. *See* UPA § 38(2)(c). However, such a partner is merely entitled to the ascertainment and payment of the value of the partnership interest in cash or secured by bond. If the partnership agreement fixes the rights of a defaulting member, this should be taken into account in the ascertainment of the value of the partnership agreement. Further, while UPA § 38(2)(c) provides a defaulting partner rights without express recognition of the ability to agree otherwise, partners (like anyone else a party to a contract) can waive rights they would otherwise possess.

Instead of adopting provisions similar to the general partnership rules, most states have adopted a provision that more closely resembles the ULPA in regard to dissolution.[357] In general, the LLC acts provide that the LLC will dissolve on the withdrawal of any member unless continued under certain authorized circumstances.[358] Under these acts, there is no right to continue under circumstances in which the ULPA or the RULPA would not have permitted continuation.[359]

Under the general description of continuity of life in the 1960 Regulations, it would seem possible to create an organization that possesses continuity of life because the regulations require that dissolution follow an event of withdrawal unless the remaining owners all agree to continue.[360] The 1960 Regulations also provide that if the effect of an agreement is that no partner has the power to dissolve the organization, continuity of life is present.[361] On the other hand, the Regulations also state that continuity of life is absent in any organization formed under a statute corresponding to the ULPA.[362] Because the LLC acts recognize that dissolution is caused by the same events that cause dissolution of a partnership and do not permit continuation in any circumstances in which the ULPA or the RULPA would not do so, this conclusion should extend to LLCs as well.

If the Service would be willing to acknowledge that the blanket

357. The reason that the state statutes more closely resemble the ULPA than the RULPA is probably due to the fact that Wyoming adopted the first act and did so while the ULPA was still in effect. Other states have merely followed Wyoming's lead notwithstanding that partnership law has changed.

358. *See* ARIZ. REV. STAT. ANN. § 29-781(a)(3)(Supp. 1992); COLO. REV. STAT. § 7-80-801(1)(c) (Supp. 1991); Delaware Limited Liability Company Act, 1992 Del. Laws ch. 434 (H.B. 608) (WESTLAW) (to be codified at DEL. CODE ANN. tit. 6, § 18-801(4)); FLA. STAT. ANN. § 608.441(1)(c) (West Supp. 1992); Illinois Limited Liability Company Act, Ill. Legis. Serv. P.A. 87-1062, sec. 180, § 35-1(3) (S.B. 2163) (WESTLAW); Iowa Limited Liability Company Act, 1992 Ia. Legis. Serv. ch. 2369 (WESTLAW) (to be codified at IOWA CODE ANN. § 490A.1301(3)); KAN. STAT. ANN. § 17-7622(a)(3) (Supp. 1991); Louisiana Limited Liability Company Act, 1992 La. Sess. Law Serv. Act 780 (H.B. 1262) (WESTLAW) (to be codified at LA. REV. STAT. ANN. § 12:1334(3)); Minnesota Limited Liability Company Act, ch. 517, art. 2, §§ 1-141 (to be codified at MINN. STAT. ANN. § 322B.801(1)(5)); NEV. REV. STAT. § 86.491(1)(c)(1991); R.I. GEN. LAWS § 7-16-39(d)(1992); TEX. REV. CIV. STAT. ANN. art. 1528n, art. 6.01 (West Supp. 1992); UTAH CODE ANN. § 48-2b-137(3) (1992); VA. CODE ANN. § 13.1-1046(3) (Michie Supp. 1991); WYO. STAT. § 17-15-123(a)(iii) (1977).

359. *See* ULPA § 20; RULPA § 801(4).

360. Treas. Reg. §§ 301.7701-2(b)(1),(3)(as amended in 1983).

361. Treas. Reg. § 301.7701-2(b)(3) (as amended in 1983).

362. *Id.*

statement in the 1960 Regulations—that ULPA and RULPA partnerships cannot have continuity of life—also extends to LLCs formed under acts virtually identical to the ULPA with regard to dissolution, continuity of life will always be absent for tax purposes. The only problem is to create adequate continuity under these LLC acts for business purposes.

Creation of acceptable organizational continuity for business purposes could be most effectively achieved when the articles of organization or, when permitted, the operating agreement could simply provide that the LLC will continue following an event of dissolution so long as some number of owners desire to continue. Because the desire to continue is the inverse of the desire to liquidate, the vote required to continue could be simply the inverse of the vote required to liquidate.[363] In such a case, an event of withdrawal will do little

363. The ability to insert such a provision under the various LLC acts is not entirely clear. Some of the LLC acts provide that the LLC can continue only with the consent of all members under a right to do so stated in the articles of incorporation. *See* COLO. REV. STAT. § 7-80-801(1)(c) (Supp. 1991); Minnesota Limited Liability Company Act, ch. 517, art. 2, §§ 1-141 (to be codified at MINN. STAT. ANN. § 322B.801(1)(5)); NEV. REV. STAT. § 86.491(1)(c) (1991); WYO. STAT. § 17-15-123(a)(iii) (1977). The inclusion of the right to continue in the articles already requires at least the conditional consent of all members to continuation. Presumably at least, such a provision could not get into the articles unless the members have so agreed. Thus, the additional requirement of consent under the statute must contemplate consent which is contemporaneous with the continuation. *But see* Illinois Limited Liability Company Act, 1992 Ill. Legis. Serv. P.A. 87-1062, sec. 180, § 35-5 (S.B. 2163) (WESTLAW) (requiring only the agreement of members to continue); Minnesota Limited Liability Company Act, ch. 517, art. 2, §§ 1-141 (to be codified at MINN. STAT. ANN. § 322B.011(4)) (expressly recognizing ability of members to contractually bind themselves to give the contemporaneous consent in the future). Otherwise, the additional consent requirement in the statute would be redundant. If this is the proper interpretation, the statutes have unreasonably restricted the members' freedom of contract for no apparent reason. Still, the need to have any agreement concerning continuity reflected in the articles of organization is a little baffling. If all the parties must agree to the continuation, why must they have also previously agreed that they could so agree and have reflected this fact in the articles? In all events, these states do not appear to permit the type of provision suggested.

The Utah LLC Act is unique in requiring only majority consent to continue, but it still requires that the continuation by vote occur under a right to do so stated in the articles of organization. *See* UTAH CODE ANN. § 48-2b-137(3) (1992). Thus, it has the same statutory interpretation problem that exists in Colorado, Nevada, and Wyoming and apparently will not permit continuation with less than contemporaneous majority consent.

Other states permit continuation either with the consent of all of the members *or* under a right to do so stated in the articles of organization. *See* FLA. STAT. ANN. § 608.441(1)(c) (West Supp. 1982); Iowa Limited Liability Company Act, 1992 Iowa Acts 2369 (to be codified at IOWA CODE ANN. § 490A.1301(3)); KAN. STAT. ANN. § 17-7622(a)(3) (Supp. 1991). The need to have the right disclosed in the articles of organization implicitly indicates that the partners must have agreed that there will be the possibility of continuation. *See also* ARIZ. REV. STAT. ANN. § 29-781(a)(3)(Supp. 1992); Delaware Limited Liability Company Act, 68 Del. Laws 434 (1992) (to be codified at DEL. CODE ANN. tit. 6, § 18-801(3)); Louisiana Limited Liability Company Act, 1992 La. Acts 780 (to be codified at LA. REV. STAT. ANN. § 12:1334(3)); TEX. REV. CIV. STAT. ANN. art. 1528n, art. 6.01 (West Supp. 1992) (permitting continuation either more than put before the members the question of whether to liquidate. For example, if a two-thirds vote is required to liquidate the LLC, a one-third vote to continue after a withdrawal would be appropriate. If a majority vote to liquidate would suffice, then a majority vote for continuation should be necessary. The only other matter that would need to be addressed by the agreement of the parties is the rights of the withdrawing members or their legal representatives. Presumably, the legal representative of any deceased member could be given the option to become a substituted member, as could any other persons for whom such a right seems appropriate. Other former members could be given limited rights to payment that discourage withdrawal or that provide rights equal to the distribution rights they held as members.[364]

Notwithstanding clear approval in the 1960 Regulations of the above suggested arrangement, when permitted under the LLC acts, the Service apparently may not be willing to recognize the absence of continuity of life in any organization if continuation following withdrawal can occur with consent of less than a majority of the remaining owners.[365] That the Service is unwilling to rule in regards to certain arrangements does not necessarily mean that they believe the arrangement does not satisfy the substantive requirements of

under a right established by agreement, which does not need to be reflected in the articles, or by consent of all members). These states will permit provisions of the kind suggested. *See also* R.I. GEN. LAWS § 7-16-39(d)(1992) (permitting continuation as provided by the articles of organization or the operating agreement).

Virginia permits continuation following withdrawal only if the remaining members unanimously consent, but there is no indication that the consent must be contemporaneous. *See* VA. CODE ANN. § 13.1-1046(3) (Michie Supp. 1991). Thus, it seems that Virginia would permit organizational continuity to be established in the fashion suggested.

Maryland LLCs dissolve, but a new LLC will replace the old if the business is continued. MD. CODE ANN., CORPS. & ASS'NS §§ 4A-901 to -911 (Supp. 1992). *See also supra* note 355 and accompanying text. The parties appear free to enter into any contract they desire with respect to continuation.

364. *See supra* note 356.

365. *See* Rev. Proc. 89-12, 1989-1 C.B. 798, at § 4.05. *But see* Priv. Ltr. Rul. 90-10-027 (Dec. 7, 1989) (holding that there was continuity of life owing to the fact that the LLC could be continued by majority approval, although the LLC was held to be a partnership for tax purposes because it lacked free transferability and centralized management). Rev. Proc. 89-12 does not require contemporaneous majority consent to all continuations. It merely requires contemporaneous majority consent to the admission of a new general partner who will continue the business. This seems consistent with Treas. Reg. § 301.7701-2(b)(1), which requires only the consent of either the remaining general partners or all remaining partners. Without an existing general partner to consent, the regulation does require the consent of the limited partners. On the other hand, if there is an existing general partner who will continue, the requirement of limited partner consent under Rev. Proc. 89-12 would not apply.

law. Nor is there any indication that the Service would be willing to litigate the issue should an organization fail to meet the ruling standards. Even if the Service were willing to litigate the issue, it seems very unlikely that they could prevail in light of the rather unambiguous statements in the 1960 Regulations. Nevertheless, for businesses that desire advance assurance from the Service, at least majority consent to continuation will apparently be required.[366]

Alternatives to the above suggested arrangement are possible that would also create adequate continuity for business purposes without creating continuity for tax purposes. One such possibility would be to give an option to purchase the business and assets of the dissolving LLC to members desiring to continue the business. This option can be assigned to a newly formed LLC. Under such an arrangement, the withdrawal of any member will simply be permitted to lead to dissolution of the old LLC under state law and, thus, continuity of life should be absent under the 1960 Regulations. The fact that a new organization is formed and continues the business of the dissolved LLC should be irrelevant.[367] Under this option, the consideration to be paid by the new LLC could be interests in the new LLC. In such a case, the dissolution of the old LLC under state law should not have any significance other than under the 1960 Regulations. Interests in the new LLC would simply be distributed to the continuing members of the old LLC. The consideration paid could also include other consideration that by agreement would be paid to the old members who wrongfully caused dissolution. Again, such additional consideration could be at a level that will discourage anyone from causing a dissolution or could closely resemble the distribution rights that such member would otherwise have been entitled to.[368]

The Service might argue that this arrangement is in substance a continuation of the old. Of course it is. For all other tax purposes, the new LLC would be treated as the same partnership.[369] While for all other tax purposes the old and the new LLCs would be treated as if they were the same organization, the 1960 Regulations expressly look to a different rule for purposes of determining whether there is continuity of life. While a technical dissolution under state law is not relevant for most tax purposes, it is made the only relevant consideration with respect to the presence or absence of continuity of life.

366. Proposed regulations were issued on July 22, 1992, confirming that majority consent to continuation would not cause the organization to possess corporate-like continuity of life. *See* Prop. Treas. Reg. § 301.7702-2(b)(1), 57 Fed. Reg. 32472 (1992).

367. Treas. Reg. § 301.7701-2(b)(2)(last sentence) (as amended in 1983).

368. An agreement to this effect would not be inconsistent with law or the operating agreement and therefore should be possible in all states.

369. *See* I.R.C. § 708(a) (1992).

While everyone would agree that the rule is nonsensical, it is nevertheless the rule.

3. Free Transferability

Free transferability will be the most difficult characteristic to create for business purposes without also having the characteristic for tax purposes. Fortunately, for LLCs formed under an ideal act or most of the existing LLC acts, the apparent ease of avoiding centralized management and continuity of life under the 1960 Regulations means that it should typically not be necessary to avoid free transferability for tax purposes.

The first hurdle in addressing this problem is determining whether ownership interests can be made transferable under state law. Under an ideal act, members would be able to do anything they agree to do. Only Maryland has such a provision.[370] Under existing LLC acts, the issue is not so clear. In connection with transfers of interests, the other LLC acts are surprisingly uniform. In general, they provide that the interests in the LLC may be assigned to the extent provided in the articles of organization or in an operating agreement. However, they further provide that any assignment made pursuant to the articles or an operating agreement will transfer only the right to receive distributions unless the other members consent to the substitution of a new member.[371]

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370. Under an ideal act, the parties may not be able to substitute an old member for a new member in the same LLC. *See supra* note 235. However, by agreement the old LLC could be dissolved and a new one formed with the substituted member without anyone noticing that there has been a change. *See* MD. CODE ANN., CORPS. & ASS'NS §§ 4A-902, -904 (Supp. 1992).

371. *See* COLO. REV. STAT. § 7-80-702(1) (Supp. 1991); FLA. STAT. ANN. § 608.432 (West Supp. 1992); Illinois Limited Liability Company Act, 1992 Ill. Legis. Serv. P.A. 87-1062, sec. 180, § 30-5 (S.B. 2163) (WESTLAW); Iowa Limited Liability Company Act, 1992 Ia. Legis. Serv. ch. 2369 (WESTLAW) (to be codified at IOWA CODE ANN. §§ 490A.902, .903); KAN. STAT. ANN. § 17-7618 (Supp. 1991); Minnesota Limited Liability Company Act, ch. 517, art. 2, §§ 1-141 (to be codified at MINN. STAT. ANN. § 322B.31(2)); NEV. REV. STAT. § 86.351 (Supp. 1991); R.I. GEN. LAWS §§ 7-16-35, -36 (1992); WYO. STAT. § 17-15-122 (1977). *See also* Minnesota Limited Liability Company Act, ch. 517, art. 2, §§ 1-141 (to be codified at MINN. STAT. ANN. § 322B.011(5)) (allowing the parties to contract in advance to give consent to transfers). Utah differs from the above only in that consent need only be given by a majority of the other members. *See* UTAH CODE ANN. § 48-2b-131(1) (1992). Again, it is a little baffling why the members must agree that they can agree to substitute a new member and must further reflect such an agreement in the articles.

Virginia permits the right to transfer to be governed entirely by the operating agreement, but then limits the assignees rights to be admitted as members by requiring the unanimous consent of the other members. *See* VA. CODE ANN. §§ 13.1-1038, -1039

As written, most of these statutes do not appear to permit the requirement of consent to be waived or modified by agreement of the parties.[372] There is no apparent explanation why the LLC acts should not permit the parties to grant the right to assignment without contemporaneous consent by agreement among themselves. While there is no express requirement that the unanimous consent required by the LLC acts needs to be contemporaneous, the additional requirement of consent would be redundant unless it is so interpreted.[373] On the other hand, limiting the flexibility of the

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(Michie Supp. 1991). The effect of these two provisions is the same as the other states, but at least the agreement that the members can agree does not have to be in the articles.

Arizona, Delaware, Iowa, Louisiana, Rhode Island, and Texas depart from the norm. In Arizona, Delaware, and Iowa, the members can establish any desired substitution provision in their operating agreement. *Compare* ARIZ. REV. STAT. ANN. § 29-731 (b) (Supp. 1992); Delaware Limited Liability Company Act, 1992 Del. Laws ch. 434 (H.B. 608) (WESTLAW) (1992) (to be codified at DEL. CODE ANN. tit. 6, § 18-702) *and* Iowa Limited Liability Company Act, 1992 Ia. Legis. Serv. ch. 2369 (WESTLAW) (to be codified at IOWA CODE ANN. § 490A.903) *with* Minnesota Limited Liability Company Act, ch. 517, art. 2, §§ 1-141, 1992 Minn. Laws 517 (to be codified at MINN. STAT. ANN. § 322B.011(5)). In Louisiana and Rhode Island, an assignee may be admitted either upon unanimous vote or as provided in the operating agreement. *See* Louisiana Limited Liability Company Act, 1992 La. Sess. Law Serv. Act 780 (H.B. 1262) (WESTLAW) (to be codified at LA. REV. STAT. ANN. § 12:1332); R.I. GEN. LAWS § 7-16-36 (1992). In Texas, the parties may establish any arrangement regarding transfer that they desire by company regulations. *See* TEX. REV. CIV. STAT. ANN. art. 1528n, arts. 4.05-.07 (West Supp. 1992).

372. *But see* ARIZ. REV. STAT. ANN. § 29-731(b) (Supp. 1992); Delaware Limited Liability Company Act, 1992 Del. Laws ch. 434 (H.B. 608) (WESTLAW) (to be codified at DEL. CODE ANN. tit. 6, § 18-702); Iowa Limited Liability Company Act, 1992 Ia. Legis. Serv. ch. 2369 (WESTLAW) (to be codified at IOWA CODE ANN. § 490A.903(1)); Louisiana Limited Liability Company Act, 1992 La. Sess. Law Serv. Act 780 (H.B. 1262) (WESTLAW) (to be codified at LA. REV. STAT. ANN. § 12:1332); R.I. GEN. LAWS § 7-16-36 (1992); TEX. REV. CIV. STAT. ANN. art. 1528n, arts. 4.05-.07 (West Supp. 1992), which do permit such waiver.

At this point the temptation to strongly criticize the legislative effort in a number of states becomes irresistable. By precluding any degree of organizational continuity from being established, one wonders who would be willing to spend significant energy organizing capital and acquiring assets. Combined with the inability to establish any possible right to sell the interests, this provision also makes it difficult to imagine who would invest. Thus, LLC acts which impose an unwaivable requirement of contemporaneous, unanimous consent to continuation or substitution of new members have probably restricted use of the LLC to service businesses and businesses in which all of the capital will be provided by active owners. Both Nevada and Wyoming impose these requirements. It is hard to understand why they have done so.

The act which makes no sense, however, is Colorado. It requires contemporaneous, unanimous consent to continuation or substitution and, like Nevada and Wyoming, will be appropriate mainly for service businesses and businesses in which active owners provide the capital. However, Colorado also requires that the business be managed by managers. Such a requirement is only appropriate, if ever, when a business has inactive investors. One is left to wonder what Colorado had in mind when they adopted these inconsistent provisions.

373. These provisions are unfathomable. It seems clear that contemporaneous, unanimous consent is necessary under the statutes. Otherwise the consent evidenced by a

members to establish the type of relationship appropriate and desirable to their business by passing statutes imposing an unwaivable requirement of contemporaneous unanimous consent to substitutions is unforgivable. Certainly, if state interests are not frustrated by transfers with contemporaneous consent, there is no reason to think that they would be frustrated by allowing the consent to be given in advance.

When partners can and do create the right to substitution without the need for contemporaneous unanimous consent, the right could be made absolute or conditional on subsequent events, including contemporaneous majority consent. If the right is made absolute, the organization will have free transferability under the 1960 Regulations as well.[374] This will not be a problem if continuity of life and centralized management have been avoided. On the other hand, if at least contemporaneous majority consent is required for substitution, there should be no free transferability under the 1960 Regulations.[375]

Requiring only majority consent will be a more acceptable arrangement for businesses that desire free transferability, but it will not be entirely satisfactory. If greater transferability is desired, it may be that a member who is denied consent to transfer can be given certain rights that arise upon the refusal to consent. For example, following the refusal to consent, it might be possible to give any such members the right to put their interests to the LLC at a price equal to the consideration in the proposed transfer. In such event, while the necessity of consent to a transfer remains, the contingent

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provision in the articles of organization would suffice. On the other hand, if contemporaneous consent is required, what reason is there to require that the members have previously agreed that they could subsequently agree to a substitution? The dual requirement is particularly silly if the partners can amend their articles of organization at any time. One supposes that the failure to include the provision in the articles will simply necessitate that the members first agree that they can agree to a transfer, then amend the articles, then agree to the transfer.

An alternative thought which the drafters may have contemplated is that the provision in the articles goes to the ability to assign the right to receive distributions, whereas the contemporaneous consent goes to the right of the assignee to become a substituted member. The problem with such a theory is that any statute which attempts to remove a person's right to assign future payments, particularly if the rule would extend to involuntary assignments, would have to be much clearer. If this was the purpose, it probably has not been achieved.

See also Minnesota Limited Liability Company Act, ch. 517, art. 2, §§ 1-141 (to be codified at MINN. STAT. ANN. § 322B.011(5)) (requiring contemporaneous consent to a transfer but permitting the parties to contract in advance to give such consent).

374. Treas. Reg. § 301.7701-2(e) (as amended in 1983).

375. *See* Rev. Proc. 89-12, 1989-1 C.B. 798, § 4.06.

right creates the economic incentive for the other members to give consent.

It should be noted that this arrangement is really no different from a right of first refusal in the LLC because the interest will in all events be transferred either to the LLC or the proposed transferee. This may be enough to create free transferability under the 1960 Regulations.[376] While the presence of the other characteristics depend upon very technical considerations, free transferability under the 1960 Regulations appears to be a more substantive inquiry. If a right creates free transferability as the equivalent of merely a right of first refusal, it is possible that some other contingent right could be substituted to assure that consent would not be unreasonably withheld while not creating a situation which is equivalent to a right of first refusal.

4. Summary

Given an ideal LLC act, it appears that the LLC could be used in a fashion that permits the principal corporate attributes to be created for business purposes without subjecting the LLC to corporate income taxation. As such, it should provide a solution to the choice of entity dilemma. Of course, LLCs are not yet a solution to the choice of entity dilemma. LLCs have only been authorized in eight states, and there are substantial ambiguities in the statutes adopted in those states that make uncertain just what can be accomplished under those Acts. However, it does appear that LLCs will become much more common, and it is likely that over time uniformity and clarity of these laws will increase. Further, given that the impetus for the significant level of legislative activity is the promise of Revenue Ruling 88-76, the trend in future legislation will no doubt be to press further toward statutes that facilitate the attainment of this end, such as the ideal act suggested herein.

While the current LLC acts may not be ideal, most will provide possible solutions to the choice of entity dilemma. It will take time to understand what is and is not possible under the various acts.

It cannot yet be known how the Service will respond to aggressive efforts to use an LLC to create corporate relationships which rely heavily on technical aspects of the 1960 Regulations in order to avoid corporate tax. As a theoretical matter, the reaction should be that it is not right and makes no sense. As a practical matter, the reaction should be that it works under the 1960 Regulations, and if

376. *See* Treas. Reg. § 301.7701-2(e)(2) (as amended in 1983). While the regulations refer to a right of substitution subject to a right of first refusal (a modified form of free transferability), modified free transferability has the same significance as the unmodified variety. *See* Larson v. Commissioner, 66 T.C. 159 (1976).

law is to be brought in line with theory, it must occur by a change in the regulations.

The LLC solution to the choice of entity dilemma will not come without some complexity. How great the complexity depends on the particular act under which it is formed. However, as with other business organizations, the complexity should diminish as practitioners develop and become comfortable with forms that accomplish the ends sought.

C. *Choice of the Limited Partnerships Form*

1. *Suggested Use*

The combined impact of the clarification of the role of limited liability under the 1960 Regulations and the move generally to free owners from personal liability for the obligations of an unincorporated business (at least absent a reasonable belief of the creditor that the limited partner is a general partner) suggests that a limited partnership with a corporate general partner also can now be utilized to solve the choice of entity dilemma in a significantly increased range of circumstances.

A limited partnership with a limited partner controlled corporate general partner has become a very simple and effective means to accomplishing the corporate relationship without corporate tax. The suggestion is that this result can be achieved by the use of a limited partnership with a single corporate general partner owned proportionately by the limited partners. Under this suggestion, the limited partners will not be given the right to substitute another in their place.

2. *Federal Tax Treatment of the Suggested Use*

The first question is whether this suggested form will be taxed as a partnership. The clear answer under the 1960 Regulations is that it will. The organization will possess the corporate characteristics under the 1960 Regulations of limited liability[377] and centralized management.[378] However, the fact that the dissolution, withdrawal, or bankruptcy of the corporate general partner will potentially dissolve the limited partnership will prevent the corporate attribute of

377. Treas. Reg. § 301.7701-2(d)(2) (as amended in 1983). *See also supra* text accompanying notes 227-29.

378. Treas. Reg. § 301.7701-2(c)(4) (as amended in 1983). *See also supra* text accompanying notes 204-12.

continuity of life from being present for tax purposes.[379] Similarly, the fact that the limited partners will have no right to substitute an assignee in their place without the consent of the other partners will prevent the organization from having the corporate attribute of free transferability for tax purposes.[380] Because the organization will possess only two of the four corporate characteristics, it will be treated as a partnership for federal income tax purposes.[381]

Older authorities suggest an alternative basis for arguing that corporate tax should be imposed in this context. The argument is that when substantial identity exists between the owners of the limited partnership interests and the stock of the corporate general partner, then the existence of the limited partnership should simply be ignored and the limited partnership interests treated as simply preferred stock of the corporation.[382] However, any such argument is in conflict with *Bollinger*,[383] the 1960 Regulations, *Larson*,[384] and the Service's acquiescence in *Larson*.

If the basis of this argument is that the corporation is actually the party in interest, the argument has been directly rejected by *Bollinger*.[385] If the argument is viewed as an effort to tax the true substance of the relationship, it is in conflict with the 1960 Regulations and *Larson*. It is unquestionably true that very similar rights can be created through limited partnership interests or preferred stock. This is true whether the limited partners own the general partner or not. While the two could be fashioned so as to accomplish the same result, it is no more true to state that the limited partnership interests are preferred stock than it would be to suggest that preferred stock is really a partnership interest. The problem is that state law authorizes two different relationships that may have little substantive distinction. This is precisely the reason associations are taxable as corporations. Moreover, determining whether the relationships created under state law should result in corporate taxation is exactly the issue which the 1960 Regulations address. Thus, *Larson* clearly and unequivocally mandates that corporate taxation be imposed only

379. Treas. Reg. §§ 301.7701-2(b)(3), (a)(5) (as amended in 1983). *See also supra* text accompanying notes 213-26.

380. Treas. Reg. § 301.7701-2(e)(1) (as amended in 1983). *See also supra* text accompanying notes 230-39.

381. Treas. Reg. § 301.7701-2(a)(3) (as amended in 1983). *See also supra* text accompanying notes 188-200.

382. *See* Jones v. Commissioner, 640 F.2d 745 (5th Cir.), *cert. denied*, 454 U.S. 965 (1981).

383. Commissioner v. Bollinger, 485 U.S. 340 (1988). *See also supra* note 309 and accompanying text.

384. *See* Larson v. Commissioner, 66 T.C. 159 (1976). *See also supra* note 198 and accompanying text.

385. *See* George W. Heaton, 58 T.C.M. (CCH) 2197 (1989). *See also supra* note 311 and accompanying text.

if the organization is properly characterized as an association under the 1960 Regulations.[386]

3. *Corporate Equivalence of the Suggested Use*

a. In General

The second major question is whether the suggested limited partnership arrangement will provide the owners with the principal benefits of incorporation for state law purposes. The conclusion should clearly be that it does.

If the business were to incorporate, it would have management centralized in a board of directors elected by the shareholders. In the proposed partnership arrangement, the business is owned by the limited partnership but only the general partner has the right to manage the business.[387] The general partner is in turn a corporation in which the management is centralized in a board of directors elected by the shareholders. In that the shares of the corporate general partner are owned by the limited partners in proportion to their ownership of the limited partnership, the management and control of the business is entirely unaffected by the fact that a limited partnership has been used in lieu of mere incorporation.

Had the business merely been incorporated, the organization would continue until the shareholders elected to dissolve or other circumstances arose that caused an involuntary dissolution of the corporation. Because the limited partnership will generally be dissolved only by the withdrawal, bankruptcy, or dissolution of the corporate general partner,[388] which will occur under precisely the same circumstances that would have resulted in a dissolution of the corporation had the business merely incorporated, it is clear that the continuity of the life of the limited partnership will be exactly that of an incorporated business. Indeed, the ability to create and admit a new general partner will give the limited partnership an opportunity to provide even greater continuity.[389]

Had the business merely been incorporated, the shareholders would be free to transfer their shares subject only to applicable securities laws and any agreements that they enter into. In the suggested partnership arrangement, the owners will still be free to

386. *Larson*, 66 T.C. at 185-86. *See also* Rev. Rul. 79-106, 1979-1 C.B. 448.
387. *See* RULPA § 403(a).
388. *See* RULPA § 801(4).
389. *Id.*

transfer their stock in the corporate general partner to a like extent. The limited partners will also be free to assign the economic interest in the partnership.[390] The only thing the partners may not do is substitute another person in their place without consent of the other partners.[391] However, through a combined sale of the stock and the assignment of partnership interests, the partners can transfer all ownership rights to as great an extent as if the business had simply incorporated. Further, because the purchaser would have all substantial rights, there would be no reason for partners not to consent to transfer if the assignee so desired.[392]

Had the business incorporated, no owner would be liable for the obligations of the business unless they had agreed to such liability, they had used the corporation to commit a fraud on the creditors, or the protection against liability would work a manifest injustice.[393] In the suggested partnership form, the general partner is liable for the obligations of the business, but because the general partner is itself a corporation, the ultimate owners will not be liable except under the same standards that they would have been liable had they merely adopted the corporate form.

b. *Piercing the General Partner's Corporate Veil*

A concern could legitimately arise as to whether the protection against liability of the limited partnership arrangement is as effective as would be achieved with incorporation or the use of a limited liability company. The source of concern should not arise, in most states, under limited partnership acts. As discussed above, at least in those thirty-seven jurisdictions which have adopted provisions at least as restrictive as the 1985 amended version of RULPA section 303, there should no longer be any significant concern that the activities of the limited partners in the management and control of the business will result in personal liability.[394] Any increased concern should be only that courts might be willing to pierce the corporate veil when the corporate general partner is thinly capitalized and is

390. *See* RULPA § 702.

391. *See* RULPA § 704. The partners would generally not want to agree in advance to eliminate this limitation on substitution because this limitation is what prevents free transferability from existing for tax purposes. If the partners wish, they could lessen the consent necessary to majority consent.

392. If the right of substitution were to require majority consent, the fact that there is no reason not to consent should be adequate assurance that substitution will always be allowed.

393. *See generally* Krendl & Krendl, *supra* note 80 (discussing the general standards employed by the courts in determining whether to pierce the corporate veil).

394. *See supra* text accompanying notes 279-86.

owned proportionately by the limited partners.[395]

In considering this issue, it is important to bear in mind that the use of a limited partnership with a limited partner owned corporate general partner has been expressly sanctioned by the RULPA. Thus, the structure, in and of itself, cannot be viewed as accomplishing any illicit or illegal purpose. Further, the fact that the business could have been incorporated or, in several states, formed as an LLC indicates that there is no longer any policy for imposing liability on active owners. However, the corporate veil should not be permitted to protect shareholders from the consequences of their fraud or to permit a result that is manifestly unjust. Regardless of the form of organization used, the method of attaining protection against personal liability should be qualified by these concepts.

The suggested arrangement should not result in any greater risk of piercing the corporate veil because of fraud. The form of organization does not, in and of itself, give rise to any fraud that could not as easily or as often occur in the corporate context independent of the existence of a partnership. The only increased concern that could arise from the use of a thinly capitalized corporate general partner should stem from the question of whether honoring the corporate veil will work a manifest injustice. Generally, thin capitalization of the organization, while not alone enough to lead courts to pierce the corporate veil, is clearly the threshold issue that commands the greatest attention.[396]

In determining whether the owners in the suggested form of organization are susceptible to greater liabilities because of inadequate capitalization of the corporate general partner, it is not appropriate to look only to the assets of the corporate general partner. The question should be whether the business was adequately capitalized, and in that inquiry, reference should be to the assets of both the partnership and the general partner. Were the business simply incorporated, or an LLC used, the creditors would generally be able to reach the assets of the business and no further. If the suggested partnership arrangement is used, the creditor will still be able to reach the same assets, that being all of the assets of the business. Stated another way, if the partnership form is used but the assets of the business are otherwise the same, the choice of the form of organization has not in

395. *But see* Krendl & Krendl, *supra* note 80, at 14 (stating that only the California courts pierce the corporate veil solely as a result of thin capitalization).
396. *See generally* Krendl & Krendl, *supra* note 80.

any way contributed to greater injustice to creditors. Simply, the obligor is the partnership rather than the corporation. Because the use of the suggested form does not diminish the assets available to creditors, it is difficult to see that it should in any way increase the likelihood of piercing the corporate veil. The potential for liability is increased by the suggested form only if it is assumed that the courts will not understand that the form of organization suggested has not, of itself, resulted in creating any greater disadvantage to the creditors.

Attempting to take a pragmatic view, it must be admitted that if a court desires to find assets with which to compensate a creditor, the use of a thinly capitalized corporate general partner may provide the excuse. However, under like circumstances it seems highly improbable that a court desiring to compensate creditors would be unable to find an excuse to reach the same end had the business simply been incorporated. Stated another way, if the court perceives a manifest injustice, the court will likely find liability regardless of the means employed by the owners to avoid the liability.

To continue in a pragmatic vein, it is difficult to see how the form of organization could affect liability to consensual creditors. If persons extend credit to an organization having knowledge of the arrangements and the opportunity to inquire into the credit worthiness of the partnership and the general partner, it is hard to see that there is a substantial risk such persons would later be able to pierce the corporate veil without some showing of wrongful conduct on the part of the partners. Thus, the practical risk is really that a nonconsensual creditor (*e.g.*, a tort claimant) will seek to pierce the corporate veil in order to seek satisfaction of claims. The risk of personal liability to such persons should be greatly reduced simply by causing the corporate general partner to purchase insurance that is appropriate to the size and scope of the business. It is difficult to argue that there is manifest injustice in not piercing the corporate veil based solely on thin capitalization if the capitalization is augmented by appropriate levels of insurance.[397] Certainly, any court that would pierce the corporate veil notwithstanding adequate capitalization of the partnership and appropriate levels of general partner insurance would not have been deterred from this result if the business had simply incorporated.

397. Insurance is necessary notwithstanding concerns about piercing the corporate veil because no form of organization will protect an active owner who has committed a tortious act. The business liability for tortious acts is vicarious. It arises when an agent of the business has committed a tortious act within the scope of their employment. The fact that the business has vicarious liability does not protect the individual wrongdoer from liability, it simply provides the injured party with another defendant against whom to seek satisfaction of any judgment.

c. Complexity of Suggested Use

Given that the use of limited partnerships should, in most states, permit the parties to establish a relationship that is virtually indistinguishable from the corporate form (but that is not subject to corporate taxation), the only other legitimate objection to the use of this form might be that it will entail greater complexity and more onerous documentation. Hopefully the bar has not reached the point that the complexity of the law forestalls the use of a better form. However, if business finds the form inordinantly complex or burdensome, this would be a legitimate objection.

It seems that the suggested form should not entail any significantly more onerous documentation or create significant confusion for the owners. Of course, the corporate documentation that would have been required had the limited partnership option not been selected will still be required. A limited partnership agreement and a certificate of limited partnership will also be necessary.[398] However, the limited partnership agreement should, in most cases, be of the simplest order. The only matter that should be dealt with in the limited partnership agreement is the sharing of profits, losses, and distributions. These provisions need not be any more complicated and should not differ from those which would have been required if the business had simply incorporated. To illustrate, if the corporation would otherwise have been formed with a single class of stock, the partnership agreement should simply provide for the partnership interests to be represented by units and for all profits, losses, and distributions to be allocated or made in proportion to the units. As the alternative corporate relationship that would have been adopted becomes more complicated, the complexity of the limited partnership form is similarly increased. However, the complexity is the same regardless of which form is adopted. Instead of establishing a preferred class of stock, the same rights and preferences will attach to units of limited partnership interest. The same language is appropriate regardless of the document into which it is inserted.

From the point of view of the business owner, the added complexity is that the same relationship is created with the same terminology but in two documents. The fact that checks to the owners will be in

398. The certificate of limited partnership should not be a problem because the RULPA, since 1985, requires very little substance to be contained in the certificate. *See* RULPA § 201. Most states have now adopted RULPA (1985). *See supra* note 286.

their capacity as limited partners, not as shareholders, does not necessitate any different conduct or the use of any different bank account. Only the accountants and attorneys need to remember that the checks are going to the owners in their capacity as shareholders. On the other hand, the management of the business will be precisely the same. Under either option, the owners are acting as employees, agents, officers, directors, and shareholders of the corporation. So far as management is concerned, the owners should essentially ignore the existence of the limited partnership, the only exception being that they should sign documents and print up letterhead in the name of the partnership.

Of course, if the parties wish to take advantage of the inherent flexibility of partnerships in order to obtain benefits that would not have been available had the corporate form been employed, additional complexity will arise. This added complexity is not caused by the form of organization chosen, but is made possible by that form.

d. Summary

In summary, as with LLCs, it now appears that limited partnerships can be used in a fashion that will duplicate the corporate relationship in all principal respects without also subjecting the business to corporate tax. The primary restraint on the use of this form is a concern that courts might more readily pierce the corporate veil in such a case, even though there is no theoretical justification for any different treatment.

VIII. The Future of Corporate Income Taxation

If LLCs and limited partnerships now offer the possibility of creating corporate relationships without subjecting the business to corporate income taxation, the conclusion that necessarily follows is that corporate income taxation has become an entirely voluntary obligation for all nonpublic businesses. In a sense this has always been true. It is certainly true for any business which qualifies for the subchapter S election. It has also been true for anyone willing to forego the benefits of the corporate form. What has changed is that avoidance of corporate tax no longer requires either qualifying under subchapter S or foregoing the principal benefits of the corporate relationship.

Recognizing that corporate taxation has or is quickly becoming a voluntary obligation, it is time that Congress address the issue. Congress has two basic alternatives: either it should make the election not to pay corporate income tax expressly available under the Code without regard to the type of entity employed, or it should eliminate the developing election. Whatever Congress' response, it should come promptly.

If corporate income taxation is to be elective, there can be no debate that the proper means for providing this election is by amendment of the Code. Such a change would be easily accomplished merely by amending section 7701(a)(2) to exclude from the definition of a corporation any organization electing to be treated as a partnership. On the other hand, permitting the election to develop along its current course will result in significant unfairness, lack of uniformity, uncertainty, and inefficiency.

Detailing all of the problems that attend the current means by which an elective corporate tax system is developing seems unnecessary. An election not to pay corporate tax ought to be a federal tax election, adopted after due consideration in Congress and uniformly available to all businesses. By making the election dependent on state legislative efforts, the election is not uniform nationally. Further, the election is not realistically available to already established businesses organized at a time before this election became possible.[399]

A very great objection to continuing the current means to the adoption of an elective corporate tax is the tremendous inefficiency of this course. While Congress could provide the election with little change to statutes, the current course will require, ultimately, legislation in all fifty states. In adopting business legislation, the states should be concerned with the proper regulation of the relationship of business to the state and to its creditors and with the relationship between the owners. Its effort should be to deal with these relationships in clear and unequivocal terms. However, because the state legislation must endeavor to permit businesses to establish relationships that wind their way through the highly technical, mostly nonsensical 1960 Regulations, these legitimate state concerns give way. The result is the adoption of statutes that are uncertain and ambiguous and that endeavor to permit and foster relationships which may not be directly established by the legislation.

The inefficiency of the current course is not limited to the state legislatures. The burden of the present course will rest most directly and onerously on the courts and on businesses that will be forced to wrestle daily with the effects of new and uncertain legislation and

399. Conversion from a corporation to a noncorporate form would entail the recognition of gain, whether the corporation is an S corporation or a regular corporation. *See* I.R.C. §§ 331, 336 (1986).

with how such legislation will be treated under the 1960 Regulations. Ultimately, the uncertainty and ambiguity of the present course will produce the downfall of more than one business that has gone too far or attempted too much. There is also little doubt that the bar will expend substantial resources coming to terms with the new solutions to the choice of entity dilemma.

Probably the most objectionable fact of all is that the states, the courts, businesses, and the bar may well be running the Red Queen's Race[400] with the Service. The Service has long been dissatisfied with the consequences of the 1960 Regulations. This dissatisfaction has been reflected in efforts to impose more onerous standards than those present in the 1960 Regulations, both in litigation and in adopting ruling standards. The dissatisfaction is further evidenced by the fact that the Service only recently completed more than ten years of study on the role which limited liability should play in entity characterization. That the substantial expenditure of effort by the states, the courts, businesses, and the bar could be quickly brought to nought by a change in the 1960 Regulations is troubling. That the Service could accomplish largely the same result under a new reading of the 1960 Regulations or a change in ruling policy, in each case combined with the threat of litigation which business can ill-afford, is simply unacceptable.

If corporate tax is to be elective, it should be made expressly so under the Code, and the legislation accomplishing this result should occur quickly to avoid the escalating costs associated with the continuance of the current course.

Quite obviously, adoption of a voluntary corporate tax system should occur only after Congress has reached the political and economic decision that a voluntary system is appropriate. On the other hand, if a voluntary system is not appropriate, there is even greater reason to insist that Congress act to achieve that end. Proceeding quickly is necessary not only to protect whatever revenue might otherwise be lost, but to minimize the expenditures of the states, the courts, businesses, and the bar to attain an end which Congress will eventually prohibit.

Should Congress decide to continue a mandatory tax on the income of nonpublic companies, it will find that there are no simple

400. This term was used by Martin Ginsberg in the course of discussions about the 1986 proposal to amend I.R.C. § 382. The precise reference of this allusion is unknown though it rings mightily of Lewis Carroll. It nevertheless so elegantly conjures up the image of a race in which the finish line changes each and every time it is approached as to make its use irresistible. It is truly an apt description of efforts to address the choice of entity dilemma if the Service is left with the ability to control entity characterization through novel interpretations of the 1960 Regulations or, worse, through a raised eyebrow announced in a revenue procedure that simply ignores the unambiguous provisions of the 1960 Regulations.

means to such end. The difficulty is that there is no necessarily inherent basis for distinguishing between corporate and noncorporate forms. The problem faced is similar to that addressed in 1987 when Congress felt it necessary to impose corporate taxation on all public companies. With respect to such companies, Congress did not attempt to redefine the term "corporation." Instead, Congress came to the conclusion that it was proper to impose the corporate income tax on any publicly traded business regardless of the nature of the organization used. In a real sense, Congress recognized that entity characterization should have little to do with the tax burden of publicly traded companies and therefore drew a new line. Precisely the same issue is arising again. Entity characterization simply does not serve to adequately distinguish companies that should pay corporate tax from those who need not do so. Unfortunately, there is no single factor which can serve as a line of demarcation for private companies.

Congress could choose to require that the 1960 Regulations be revised so as to determine the presence of the attributes in a more realistic fashion. It could additionally give disproportionate weight to the various factors. It is certainly possible for Congress to revise or direct the revision of the 1960 Regulations in a manner that would be more substantive. For example, a better system might include the following concepts. First, limited liability, determined in a realistic fashion, could be made a condition to the imposition of corporate tax. Second, if limited liability and a potentially perpetual existence were both present, corporate tax would be imposed. Third, if continuity of life is not present in any realistic fashion, corporate tax could still be imposed if the organization has both centralized management and free transferability. Finally, if either free transferability or centralized management, but not both, are combined with limited liability, other factors could be made relevant, including the extent to which arrangements exist that suggest that the other corporate factors will be achieved by arrangements of the parties.

It seems clear that any system devised should be relatively certain. Taxpayers must be put in a position that they can reasonably predict the tax consequences of their activities. Further, the question is not one that can be left to the courts to address on a case-by-case basis. Certainly, the Service should not be left with discretion to determine who should or should not pay corporate tax. The difficulty then becomes that any reasonably definite rules for entity characterization will be little more than a challenge to the bar and to business to find the forms that will again address the choice of entity dilemma. Beyond the difficulty of finding a means to properly classify organizations as corporations for tax purposes, there is the further question of just why some of these characteristics should be relevant. It is difficult to find a cogent explanation for why the ability to make transfers or the creation of a representational management structure should result in the imposition of a more onerous tax. If two factories stand side-by-side and produce the same product and eventually the same income, how does the fact that the owners of one can transfer their interests freely while the owners of the other must get the consent of the other owners justify the imposition of a different tax burden?

The real difficulty in this area stems from the fact that the corporate income tax is justifiable only by a conclusion that certain business profits ought to be taxed more onerously than other types of income, and the effort to impose this more onerous tax by reference to the nature of the entity in which they are earned will always result in the failure to reach the proper tax base. The only question is whether to error on the side of over or under inclusion. In all probability, the errors will probably occur on both sides.

Possibly it is time to recognize that the corporate tax is not the only means available for imposition of a more onerous tax on certain business profits. The most obvious alternative is to simply identify the profits to be taxed more onerously and impose a surtax on them. The same result could be achieved by an increase in the basic rate of tax, but then giving a preference to other types of income similar to the maximum tax system that recently existed for earned income.[401] Preferred income could obviously include income from the performance of services, dividends from businesses which are paying corporate tax, interest income, and any other income which Congress determines to prefer. With such arrangements for a surtax of business profits, the corporate tax, at least for non-public companies, could then be either abolished or made voluntary.

CONCLUSION

Recent developments in both tax law and state law indicate that forms of organization are rapidly developing which permit the corporate relationship to be created without corporate taxation. Given these developments, it is incumbent on Congress to act promptly to either expressly permit a voluntary corporate tax system or to avoid it.

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401. *See* I.R.C. § 1348 (1969), *repealed by* Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, Title I, § 101(c)(1), 95 Stat. 183 (1981).