The Tax Treatment of Limited Liability Companies: Law in Search of Policy

*By Daniel S. Goldberg**

INTRODUCTION

Classifying an entity for tax purposes as either a partnership or a corporation has received a great deal of attention for many years.[1] What is at stake, first and foremost, is the potential avoidance of entity-level taxation. A partnership is entitled to pass-through treatment. Under this treatment, partnership income is attributed to the partners, who are subject to tax on that income. The partnership itself is not subject to tax.[2]

In addition, and as a corollary to pass-through treatment, losses and tax credits also pass through to the partners.[3] These items need not await partnership income or tax on that income to be of use to the partners.[4]

In contrast, a corporation, other than one electing S corporation status is a taxable entity that must pay tax on its net income.[5] Distributions of that net income, in general, are also taxable to the corporation's shareholders as dividends, which are treated as ordinary income.[6] As a result, a second layer of income tax is imposed on that income. Moreover, corporate losses do not pass through to the shareholders, and therefore cannot be used to offset the shareholders' other income.

Limited Liability Companies (LLCs) are a relatively new form of business entity in the United States, although they do have foreign counterparts of longer standing.[7] An LLC resembles a partnership in some respects and

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1. See *infra* text at notes 29-48, for a brief history of the endeavor.
2. *See* I.R.C. § 701 (1988).
3. *Id.* § 702 (1988 & Supp. V 1993).
4. Note that the limitation on the use of passive activity losses and credits under I.R.C. § 469 is applied at the partner level.
5. I.R.C. § 11 (1988 & Supp. V 1993).
6. *Id.* § 61(a)(7).
7. Limited liability for all members of an association is a characteristic of a number of foreign organizations including for example, the Latin American *limitada* and the German Gesellschaft mit beschrenkter Haftung (GmbH). *See* Michael Wallace Gordon, *Joint Business Ventures in the Central American Market*, 21 VAND. L. REV. 315 (1968).

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a corporation in others. An LLC's tax treatment, therefore, depends upon how the tax law classifies it—as a partnership or as a corporation. Thus, the tax policy issues involved in LLC classification are crucial.

LLCs, under current law, are classified as partnerships for federal income tax purposes if they satisfy the classification test set forth in the Treasury Regulations;[8] LLCs generally do so. As such, they are "pass-through" entities in that the LLC does not pay tax. Instead, taxable income is computed at the LLC level, and each LLC member is charged with a proportionate amount of the LLC's income or losses. In contrast, under current law, if an LLC does not satisfy the classification test, it will be taxed as a corporation, which is a tax-paying entity whose income is subject to a separate level of tax.

Recently, the Department of the Treasury (Treasury) announced that it is considering simplifying the classification regulations to allow taxpayers to treat domestic unincorporated business organizations as partnerships or associations (taxable as corporations)[9] on an elective basis.[10] Under this proposal, therefore, an LLC would be treated as a partnership, unless it elected otherwise, or its classification was determined under another Internal Revenue Code provision. For example, an LLC whose interests were publicly traded would be taxed as a corporation[11] and the proposal would not change that classification.[12] A hearing on the issue is scheduled for July 20, 1995.[13] If the Treasury adopts this elective approach, the limited liability company should become the non-public structure of choice, leaving the closely held corporation as a vehicle for special situations.[14]

The tax treatment of LLCs has broad implications for the federal revenue. To the extent a business can be conducted through an LLC (offering limited liability to its members) instead of through a corporation, an entire

8. Treas. Reg. § 301.7701-2 (as amended 1993); *id.* § 301.7701-3 (1967).

9. *See id.* § 301.7701-2 (as amended in 1993).

10. I.R.S. Notice 95-14, 1995-14 I.R.B. 7.

11. I.R.C. § 7704 (1988).

12. I.R.C. § 7704, in general, treats publicly traded partnerships as corporations. Section 7704(b) defines a publicly traded partnership as a corporation "if (1) interests in such partnership are traded on an established securities market, or (2) interests in such partnership are readily tradable on a secondary market (or the substantial equivalent thereof)." An exception from corporate treatment is made for publicly traded partnerships with passive-type income. *Id.* § 7704(c). All of these terms are or will be further defined and explained in Treasury Regulations promulgated under the section. For the meantime, the IRS has issued guidelines for the administration of the section (*see* I.R.S. Notice 88-75, 1988-2 C.B. 386), and has issued proposed regulations generally following those guidelines with certain modifications. I.R.S. Notice 95-28, 1995-21 I.R.B. 9, instructs taxpayers to rely on the guidelines set forth in the 1988 Notice, until regulations have been issued in final form.

13. I.R.S. Notice 95-14, *supra* note 10.

14. Another generation of limited liability "pass-through" entities has emerged recently. These are known as "Limited Liability Partnerships" or "LLPs." LLPs are tailored for professional service practices but have proliferated, and may continue to proliferate, outside of that sphere.

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level of tax can be avoided. The corporate alternative for accomplishing pass-through treatment, the S Corporation, is inadequate for many business situations. S Corporation qualification is limited with regard to the number and identity of permissible shareholders.[15] In addition, S Corporation corporate structure is inflexible because of the one class of stock requirement.[16] As a result, pass-through treatment is foregone by businesses that require corporate structure and are uncomfortable with the relatively new LLC form.[17] Proliferation of LLCs, therefore, theoretically could cause a substantial reduction in federal revenue collections. It is likely, however, that many firms are already achieving optimal tax treatment through the more cumbersome and costly mechanism of the limited partnership, the S corporation, or the general partnership, or even the C corporation whose operating profits are paid out as salary to its owner-employees. A shift to an elective regime, therefore, may not so much drain the revenue as reduce the costs of obtaining the optimal tax status. In any event, the proliferation of LLCs, in large measure, would accomplish the integration of business and individual taxation. Accordingly, the growth of LLCs poses a very important policy issue for the federal income tax system.

This Article considers alternative methods of classification of LLCs that could improve upon the Treasury's current classification test set forth in the Treasury Regulations. In order to evaluate these alternative methods, one must first understand the entity classification policy issues confronting the Treasury and the current state of the law. Accordingly, this Article will consider those policy issues and the test currently employed in the Treasury Regulations. In this connection, the Article examines the history and application of that test and its shortcomings in adequately dealing with the basic policy issues involved in classification. It then suggests that the Treasury or Congress adopt an alternative method of classification and sets forth and critiques four such alternative methods. The Article concludes that any of these four methods would be preferable to the Treasury's current method, with some substantially more preferable than others, and

15. I.R.C. § 1361(b)(1)(A), (B) & (C) (1988).

16. *Id.* § 1361(b)(1)(D) (1988).

17. While taxpayers currently can use S Corporations to avoid the corporate level tax on operating profits, LLCs offer substantially more flexibility in accomplishing an economic sharing arrangement among equity owners more complicated than a straight pro rata sharing. Whereas S Corporations can only issue a single class of stock (I.R.C. § 1361(b)(1)(D)), LLC members can share profits, losses, and distributions in the same, more complex manner as partners can share such partnership items. In addition, partnership tax treatment is generally preferential to S Corporation tax treatment. For example, partnership tax treatment permits more generous loss pass-through by including entity level debt in the partners' outside basis. Also, S Corporations, under current tax law, sometimes involve double level tax resulting from shareholder transactions. In contrast, partnership taxation treatment that would apply to LLCs allows for avoidance of these problems. *See* I.R.C. §§ 734(b), 743(b) and 754 (1988). Accordingly, LLCs treated as partnerships can avoid double taxation entirely.

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considers the policy implications of the Treasury's unwillingness, so far, to abandon its current classification test.

ENTITY CLASSIFICATION

THE SHIFTING POLICY FOCUS

The underlying policy issue involved with regard to entity classification is whether business entities should be taxed as separate entities or should be permitted pass-through treatment or some other form of integration treatment so that income will be taxed at only one level. If integration is rejected and some business entities are to be taxed at the entity level, then policymakers must decide which entities are to be subject to that extra level of tax. That decision should be grounded on some policy objective, that is, to achieve some economic goal or simply to achieve fairness. Current policy achieves neither.

From the inception of the Internal Revenue Code (Code), a two-tier structure of taxation has been in force for corporations.[18] Yet the Code generally treated partnerships, even before the enactment of subchapter K in 1954,[19] as aggregations of their partners and therefore not as separate taxable entities.[20] This treatment made sense, particularly with respect to general partnerships, which were the prevailing form of partnership in existence prior to the latter part of the 1960s (although the limited partnership structure has a very long history in the United States, dating back to the first half of the nineteenth century), because the partners maintained almost unlimited control over the business and each remained liable for all of the businesses' obligations. In a very real sense, each partner had ownership of, control over, and responsibility for the business, and through contributions and the agreement for sharing of profits and losses, essentially owned an undivided pro rata share of the business.

18. *See* BORIS I. BITTKER & JAMES S. EUSTICE, THE FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 1.01 (6th ed. 1994); JAMES S. EUSTICE ET AL., THE TAX REFORM ACT OF 1986: ANALYSIS AND COMMENTARY ¶ 2.02 (1987) (discussing history of corporate tax rates); Marjorie E. Kornhauser, *Corporate Regulation and the Origins of the Corporate Income Tax*, 66 IND. L.J. 53 (1990); Robert Charles Clark, *The Morphogenesis of Subchapter C: An Essay in Statutory Evolution and Reform*, 87 YALE L.J. 90 (1977).

19. Act of Aug. 16, 1954, ch. 736, 68A Stat. 250.

20. *See* ARTHUR B. WILLIS, HANDBOOK OF PARTNERSHIP TAXATION 11-12, 129-30 (1957), indicating that prior to the 1954 Code, the tax treatment of a partnership and its constituent partners depended upon whether, under applicable state law, it was an aggregate of partners undertaking joint effort, or an entity, separate and distinct from its members. The pure aggregate theory of partnership taxation treats the partnership as a conduit through which the partners own interests in both the partnership's income as well as in the partnership's property. This theory does not treat the partnership as a separate entity, but rather as a means for the centralized reporting of tax information. The 1954 Code adopted both aggregate and entity features. *See* Kimberly K. Francev, *The Fate of the Fully-Divested Lower-Tier Partnership: Does the IRS Recognize the Body?*, 6 DEPAUL BUS. L.J. 201 (1994); Donald J. Weidner, *A Perspective to Reconsider Partnership Law*, 16 FLA. ST. U. L. REV. 1 (1988).

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The proliferation of limited partnerships beginning in the late 1960s brought partnerships somewhat closer to corporations in their character.[21] Under applicable state limited partnership laws, a limited partner theoretically can exercise only limited control over the partnership and no day-to-day control over its business.[22] In that sense, a limited partner's relationship to the partnership is much closer to the shareholder's relationship to a corporation than it is to the general partner's relationship to a partnership. Nevertheless, a limited partnership is generally treated as a partnership under the tax law so long as at least two of the four corporate characteristic criteria are not present.[23]

The final step in this progression of entity creation is that of LLCs, which, as outlined earlier, bear an even stronger resemblance to corporations than do limited partnerships. Unlike a limited partnership, in which a general partner has personal liability to third parties for the recourse debts of the partnership,[24] an LLC has no such member who bears that responsibility for LLC debts.[25] As such, all LLC members can view the operations of the LLC as not affecting their personal assets other than those invested in the LLC. Accordingly, LLC members are able to view their membership interest more passively, and relate to the LLC in a fashion more similar to the way shareholders relate to a corporation than to the way general partners, in the traditional model, relate to a partnership.

With this continuum in mind, the issue confronting the government in classifying an organization as either a two-level tax organization or a one-level tax organization is an important one with significant economic consequences, but yet a difficult one. This Article proposes that the classification issue should not be resolved by counting of corporate characteristics, the artificial mechanism employed under the current and longstanding Treasury Regulations,[26] but rather should be resolved by

21. *See* ALAN R. BROMBERG & LARRY E. RIBSTEIN, BROMBERG AND RIBSTEIN ON PARTNERSHIP §§ 11.01(f), 11.02(a) & (b) (1993 & Supp. 1994). For example, limited partnership laws were adopted in New York and Connecticutt in 1822, and in Pennsylvania in 1836. The Uniform Limited Partnership Act (ULPA) was drafted in 1916, two years after the Uniform Partnership Act (UPA), and was adopted first in Illinois and Pennsylvania in 1917, in New York in 1922, and by the 1970s, throughout the United States. *Id.* § 11.02(b). In 1976, it was replaced by the Revised Uniform Partnership Act, and by an amended version in 1985. *Id.*

22. During the 1970s and 1980s, limited partnerships became the principal vehicle for tax shelter investors. *Id.* § 11.01(f). REVISED UNIF. LTD. PARTNERSHIP ACT § 303 (1985).

23. Treas. Reg. § 301.7701-2(a)(3), -3(b)(1); Larson v. Commissioner, 66 T.C. 159 (1976), *acq.* 1979-2 C.B.2. In *Larson*, the court held that an entity organized as a limited partnership that possessed the corporate characteristics of centralized management and free transferability of interests, but lacked continuity of life and limited liability, was taxable as a partnership. *Id.* at 185-86.

24. *See* REV. UNIF. LTD. PARTNERSHIP ACT § 303.

25. *See, e.g.*, MD. CODE ANN., CORPS. & ASS'NS § 4A-301 (1993 & Supp. 1994); N.J. STAT. ANN. § 42:2B-23 (West Supp. 1994).

26. Treas. Reg. § 301.7701-2(a) (as amended in 1993).

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determining what policy objective is achieved by permitting either integration treatment or two-tier taxation.

In other words, the classification issue should be resolved by reference to the policy objective. Classification might be accomplished by identifying the benefits associated with conducting business in corporate form that justify an entity-level of taxation that do not exist in the case of a business conducted in partnership form, which enjoys a single level of taxation. It might also be answered by reference to fiscal or economic policy objectives in maintaining or abrogating a two-tier corporate income tax structure.

THE TREASURY REGULATIONS' "CORPORATE CHARACTERISTICS"

The Treasury Regulations, in their current form, use four factors or characteristics to distinguish entities (partnerships or LLCs) treated as partnerships for federal income tax purposes from entities treated as associations taxable as corporations. Those factors are the following: (i) continuity of life; (ii) centralized management; (iii) limited liability; and (iv) free transferability of interests.[27] In order to be classified as a partnership, the entity must lack at least two of these characteristics.[28]

History

The history of this four factor test underscores the policy myopia inherent in the test. That history began with the case of *Morrissey v. Commissioner*.[29] *Morrissey* involved the federal income tax classification of an organization formed as a trust under state law. Based upon the facts of that case, including freely transferable "share certificates" issued by the trust, the United States Supreme Court concluded that the trust resembled a corporation and therefore should be classified as an association taxable as a corporation.[30] The opinion discussed the various characteristics that distinguish associations taxable as corporations from trusts and partnerships, and made tax classification turn on the facial resemblance of the subject entity to one of those structures rather than to any policy goal that might be accomplished by the classification.[31] Treasury regulations issued in 1953 further carried out this classification scheme, creating a bias toward corporate classification.

In *United States v. Kintner*,[32] however, the taxpayer sought association classification. In *Kintner*, the taxpayer was a physician who, together with other physicians, formed an association that, under state law, apparently

27. *Id.*
28. *Id.* § 301.7701-2 (as amended in 1993).
29. 296 U.S. 344 (1935).
30. *Id.* at 360.
31. *Id.*
32. 216 F.2d 418 (9th Cir. 1954).

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constituted a general partnership. In contrast to the *Morrissey* case, the taxpayer sought association classification so the entity would be taxable as a corporation. This classification would enable the organization to establish a qualified corporate pension plan for the benefit of its employees. The United States Court of Appeals for the Ninth Circuit sided with the taxpayer, holding the organization had sufficient corporate characteristics to qualify as an association taxable as a corporation.[33] It therefore could adopt a qualified corporate pension plan.

In response to *Kintner*, the Treasury proposed new regulations in 1959,[34] which were adopted with certain changes in 1960 as final regulations.[35] The new regulations, which are essentially the current regulations, represented an attempt to stop non-corporate entities from obtaining the corporate pension plan advantages of corporations, which was particularly important with regard to professionals who, at the time of *Kintner*, generally could not incorporate under state corporate laws.[36] The regulations sought to accomplish this result by shifting the regulatory bias toward partnership classification.

As a result of this bias shift, however, large, syndicated tax-shelter limited partnerships began to form.[37] In these limited partnerships, most of the equity participants enjoyed limited liability, the protection generally afforded corporate shareholders.[38] The limited partnerships generally obtained favorable pass-through treatment of income, gains, and losses by avoiding association classification under the new regulations. The regulations designed to restrain access to corporate pension plan advantages therefore had the unintended effect of making it fairly easy for a noncorporate entity formed as a limited partnership under state law to qualify as a partnership for federal tax purposes.

In response to the growth of tax-shelter limited partnerships, the Treasury again sought to modify its regulations to accomplish its goal of the moment, which was then to limit the scope of organizations that could be considered partnerships for tax purposes. It did this by proposing regulations in 1977 that would have retained the classification approach based upon factors of resemblance, but inserted certain secondary corporate characteristics against which the entity would have to be evaluated.[39] The Treasury, however, promptly withdrew these regulations.[40]

33. *Id.* at 428.

34. Prop. Treas. Reg. § 301.7701, 24 Fed. Reg. 10,450 (1959).

35. T.D. 6503, 1960-2 C.B. 409.

36. In Montana, the practice of medicine was considered personal and a medical practice was prohibited from incorporating under the state law. MONT. CODE ANN. § 5902 (1935).

37. For a discussion of the creation of the limited partnership association, see Edward R. Schwartz, *The Limited Partnership Association—An Alternative to the Corporation for the Small Business with "Control" Problems?*, 20 RUTGERS L. REV. 29 (1965).

38. REVISED UNIF. LTD. PARTNERSHIP ACT § 303.

39. Prop. Treas. Reg. §§ 301.7701-1 to -3, 42 Fed. Reg. 1038 (1977).

40. 42 Fed. Reg. 1489 (1977).

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After an abortive legislative attempt in 1978 to restrict partnership classification by statute to limited partnerships with no more than fifteen limited partners,[41] the Treasury flirted once again with the use of its regulatory authority to attack the problem. This attack was accomplished through the issuance, in 1980, of another set of proposed regulations elevating unlimited liability to a status of a necessary, but not sufficient, condition for partnership classification.[42] The Treasury eventually withdrew these proposed regulations in 1982.[43] Following withdrawal of these regulations, the Internal Revenue Service (IRS or Service) shifted emphasis to minimum capitalization requirements, which had been set forth in Revenue Procedure 72-13[44] and were reiterated in Revenue Procedure 89-12.[45]

Congress finally dealt with an aspect of the problem in 1987 with the enactment of section 7704 of the Code.[46] Congress's goal was to restrain the proliferation of publicly traded limited partnerships as a means of vastly increasing the number of investors eligible to benefit from pass-through tax treatment of business entities. Section 7704 disposed of the problem by simply classifying most publicly traded limited partnerships as corporations for tax purposes.[47] It is interesting that Congress achieved this result virtually by fiat, without any important use of the facial resemblance of the Treasury regulations.[48]

Analysis of LLCs Under the Current Regulations

The Treasury's method of counting corporate characteristics for classification purposes values form more than substance. With the complicity of the IRS, a non-corporate entity can secure optimal tax treatment by avoiding a majority of corporate characteristics. It can do so, however, only by incurring legal expenses and other transactional costs, and wasting time (an opportunity cost).

In general, LLCs will possess limited liability because no member is generally liable for the entity's debts.[49] Accordingly, to be classified as a partnership, an LLC will have to lack at least two of the remaining three

41. *See* WILLIAM S. MCKEE ET AL., FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS ¶ 3.06[1] (2d ed. 1990).

42. Prop. Treas. Reg. §§ 301.7701-2(a)(2) to -2(a)(4), -2(g) ex. (1), 45 Fed. Reg. 70,909 (1980).

43. I.R.S. News Release I.R. 82-145 (Dec. 16, 1982).

44. Rev. Proc. 72-13, 1972-1 C.B. 735.

45. Rev. Proc. 89-12, 1989-1 C.B. 798.

46. H.R. REP. NO. 495, 100th Cong., 1st Sess. 950 (1987).

47. *See supra* notes 11-12 and accompanying text.

48. For a more complete rendition of the history of the classification regulations, see MCKEE, *supra* note 41, ¶ 3.06.

49. *See, e.g.*, MD. CODE ANN., CORPS. & ASS'NS § 4A-301 (1993 & Supp. 1994); N.J. STAT. ANN. § 42:2B-23 (West Supp. 1994).

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corporate characteristics: centralized management, continuity of life, and free transferability of interests.

Centralized Management

An LLC run by managers who are elected by the members generally will possess centralized management.[50] Many LLC participants, however, will desire centralized management for nontax reasons, because it allows for the more efficient management of the business that normally results from giving managers authority over business decisions.

Member-managed LLCs, on the other hand, generally lack centralized management.[51] In addition, under some circumstances, a member-managed LLC whose manager must be a member can avoid possessing the corporate characteristics of centralized management.[52]

Free Transferability of Interests

Free transferability of interests exists if each of the members of the organization (or members owning "substantially all" of the interests) has the power, without the consent of other members, to transfer the membership interest in a manner that substitutes the transferee for the member.[53] That characteristic is lacking if transfers are restricted in a meaningful way. An LLC can be organized to lack this corporate characteristic with little difficulty.

A potential problem, however, arises with regard to the corporate characteristic of free transferability of interests when the members of the LLC who own non-freely transferable interests are related either by blood or common ownership. It is possible that a close relationship among the members could preclude the LLC from lacking the corporate characteristic of free transferability of interests because the relationship of the members negates the effect of any transfer restrictions or the substance of any requirement that the members consent before any interest can be transferred.[54] This is particularly problematic when the membership interests of a limited liability company are owned entirely by a single economic

50. *See* Treas. Reg. § 301.7701-2(c).

51. Rev. Proc. 95-10, § 5.03(1), 1995-3 I.R.B. 20, 23.

52. *See id.* This could occur under the Treasury's regulations and IRS ruling guidelines if the member-managers in the aggregate own at least 20% of the total interests in the LLC so that, in theory, they are regarded as looking after their own interests when they manage the company rather than merely representing others' interests. See Treas. Reg. § 301.7704-2(c)(4) (relating to limited partnerships) and Rev. Proc. 95-10, § 5.03(2), supra note 51, which contains certain other ruling requirements for LLCs as well.

53. Treas. Regs. § 301.7704-2(e).

54. Free transferability of interests will be lacking if such a transfer requires consent of a majority of nontransferring members. *See* Rev. Proc. 95-10, § 5.02, 1995-3 I.R.B. 20 and Rev. Proc. 92-33, 1992-1 C.B. 782.

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interest, such as an individual and the individual's wholly-owned corporation.

In Revenue Ruling 77-214,[55] the IRS concluded that a German GmbH, an LLC-like foreign entity, possessed the corporate characteristic of free transferability of interests because its members were two wholly-owned domestic subsidiaries of a single parent corporation.[56] In that situation, the IRS reasoned, the parent corporation could make all the transfer decisions for its wholly-owned subsidiaries, despite any provision in the memorandum of association that might indicate otherwise.[57]

Several years later, in Revenue Ruling 93-4,[58] the Service reiterated much of the Revenue Ruling 77-124 conclusion, noting that a provision requiring consent of the members was meaningless when all of the members were commonly controlled, and that such a requirement thus could not cause the entity to lack free transferability of interest.[59] The Service also indicated, however, that free transferability could still be avoided, even if the members are commonly controlled, if the entity's organizational documents either (i) flatly prohibit transfers of interest, or (ii) provide that a transfer triggers dissolution.[60] Based upon this statement, commentators have suggested that if all the owners are to be commonly controlled and free transferability of interest is to be avoided, the documents must be drafted so that transfers are flatly prohibited or that dissolution occurs upon any transfer.[61]

The absence of these special restrictive provisions could prove fatal to partnership classification.[62] Of course, on closer examination, these suggestions are without much substance, because all of the commonly controlled members can agree to amend the organizational documents to allow transfers. Nevertheless, it appears that by issuing Revenue Ruling 93-4, the IRS has provided a formalistic way out of what could be an intractable problem. Caution would suggest that the organizational documents provide both of the safeguards, namely (i) that no member may transfer a membership interest in the LLC and any such transfer shall be void and not effective, and (ii) that any attempted transfer shall result in dissolution of the LLC. Further, the operating agreement should provide that it may be amended only by vote of all of the members of the organization. Yet,

55. Rev. Rul. 77-214, 1977-1 C.B. 408.

56. *Id.* at 409.

57. *Id.*

58. Rev. Rul. 93-4, 1993-1 C.B. 225.

59. *Id.* at 226.

60. *Id.*

61. CARTER G. BISHOP & DANIEL S. KLEINBERGER, LIMITED LIABILITY COMPANIES—TAX AND BUSINESS LAW ¶ 2.07[5] (1994).

62. *See, e.g.*, Priv. Ltr. Rul. 9433008 (May 6, 1994), in which the IRS ruled that a limited liability company whose members consisted of an individual and his wholly-owned S corporation should be classified as an association taxable as a corporation rather than a partnership where the operating agreement lacked these provisions.

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because all LLC documents can be amended, these suggestions are without substantive effect. They do illustrate, however, the elective nature of this corporate characteristic.

Continuity of Life

An LLC will lack the corporate characteristic of continuity of life if it is dissolved upon the bankruptcy, death, dissolution, expulsion, incapacity, or withdrawal of any member, notwithstanding any vote to the contrary by all or any portion of the remaining members.[63] To avoid the corporate characteristic of continuity of life, the LLC operating agreement, articles of organization, or both, or the operative state LLC law must contain a provision that the foregoing events will cause dissolution of the LLC, without further action of the members.[64] While the foregoing generally appears to be the rule in most states,[65] even absent such a provision in the operating agreement or articles of organization, some states, such as New York, permit variations.[66] An explicit provision best assures that an LLC controlled by a single person or entity, in a jurisdiction such as New York, will lack continuity of life.[67]

The continuity of life characteristic analysis should not be affected if the interests of the LLC are commonly controlled. This should be the case even if reformation of the LLC after dissolution (e.g., because of one member's bankruptcy or dissolution) is assured, as a practical matter. Under the IRS's later pronouncement on this subject, the presence or absence of separate interests (i.e., common control of the members) apparently is not relevant to the determination of whether an entity possesses continuity of life.[68]

More Than a Single Member

The IRS has indicated that in order for an LLC to be classified as a partnership for federal tax purposes, it must have at least two members.[69] It is a relatively minor matter to cause an LLC to have two members by using a wholly-owned corporation as the second member. In this connection, one should note that in other contexts, the IRS has recognized a partner as a partner for federal income tax purposes only if the partner has at least a one percent interest in all material items of profit, gain, loss,

63. Treas. Reg. § 301.7701-2(b).

64. *Id.*

65. *E.g.*, MINN. STAT. ANN. § 322B.80(5) (West Supp. 1995).

66. The New York Limited Liability Company Law allows for the managers to continue the limited liability company by vote of the majority of interests remaining, absent such a prohibition. 1994 N.Y. Laws 576 § 701 (1994).

67. *See* Rev. Proc. 95-10, § 5.01, 1995-3 I.R.B. 20.

68. Rev. Rul. 93-4, 1993-1 C.B. 225.

69. *See* Rev. Proc. 95-10 § 4.01, 1995-3 I.R.B. 21.

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cash distributions, and other allocations.[70] In fact, in a recently issued revenue procedure issued on December 28, 1994, the Service specifically stated as a requirement for receiving an advance letter ruling that in order for an LLC to lack continuity of life or free transferability of interests, "the member-managers in the aggregate must own, pursuant to the express terms of the operating agreement, at least a one percent interest in each material item of the LLC's income, gain, loss, deduction, or credit during the entire existence of the LLC."[71] Allowance is made, however, for so-called regulatory allocations required under either section 704(b) or section 704(c) and corresponding income tax regulations thereunder.[72] Caution suggests adhering to this guideline, which should not be difficult in most cases once the inconvenience and expense of the second member entity has already been suffered and the second entity has been formed.

Thus, with regard to its proposal to abandon the classification regulations, the Treasury's preliminary conclusion that there is considerable flexibility under the current rules to choose the tax classification of an organization appears well taken.[73] It well behooves the Treasury, therefore, to search for another criterion for making the classification determination.

CHOOSING AN ALTERNATIVE METHOD OF CLASSIFICATION

The four characteristic test is often difficult to apply, in particular because the counting of equally weighted factors fails to define the importance of some factors relative to others. More importantly, the test is a failure because it does not express any policy objective for making the classification determination in the first place. Allowing a tax issue as important as entity-level taxation to turn on whether the entity possesses a majority of easily manipulatable corporate characteristics represents the antithesis of rational tax policy. In adopting its four characteristic test, the Treasury made no attempt to accomplish a policy objective other than precluding professional associations from qualifying as corporations[74] and obtaining retirement tax benefits available only to corporations.[75]

This portion of the Article considers and critiques four classification methods as alternatives to the counting of corporate characteristic methods employed in the current regulations. They are the following: (i) large versus small, (ii) public versus private, (iii) limited liability versus unlimited liability, and (iv) a limited number of "non-pass-through shareholders," a

70. *See id.* § 4.02. The IRS has taken the position, for ruling purposes, that this rule is subject to certain exceptions. *Id.* §§ 4.02, 4.03.

71. Rev. Proc. 95-10, § 4.02, 1995-3 I.R.B. 20, 22.

72. *Id.*

73. *See* I.R.S. Notice 95-14, 1995-14 I.R.B. 7.

74. *See supra* text accompanying notes 32-36.

75. *See supra* text accompanying notes 32-36.

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criterion similar to the principal requirement under the current S Corporation rules.

LARGE VERSUS SMALL

Professor Curtis Berger has suggested that the distinction should be between large entities, which should be subject to a two-tier tax applicable to corporations, and small entities, which should be entitled to the pass-through treatment generally accorded to partnerships.[76] Thus, large business entities, whether they are structured as corporations or partnerships, would be subject to the two-level tax. Size would be determined by the enterprise's gross revenues. In contrast, all small businesses, whether organized in partnership or corporate form, would enjoy conduit treatment.[77] Entities would not be subject to two-level tax until their gross revenues exceed an unspecified level, and even then, the two-level tax would apply only if the entity's gross revenues remained at that level for several years.[78]

If a two-level tax is the norm for business taxation, then Professor Berger's proposal would confer a subsidy upon small businesses. In contrast, if a single level tax were the norm (corporate tax integration), then Professor Berger's view would impose a penalty on large businesses and therefore, perhaps, efficiency. Yet, Professor Berger has not sought to justify this subsidy or penalty on any policy grounds. Additional shortcomings of this approach have been identified by Professor Jerome Kurtz in connection with his alternative classification proposal.[79]

PUBLIC VERSUS PRIVATE

In General

Professor Jerome Kurtz suggests that the distinction for according single-level or dual-level taxation should be made between publicly traded entities and private entities. Publicly traded entities would be subject to a two-tier tax, but privately held entities in partnership form or LLCs would only be subject to a one-tier tax.[80] Professor Kurtz foresees as inevitable that eventually most small entities will be formed as LLCs.[81] He applauds this trend.[82]

Professor Kurtz views the public/private test as superior to one based on gross sales for five distinct reasons. First, the public/private distinction

76. Curtis J. Berger, *W(h)ither Partnership Taxation*, 47 TAX. L. REV. 105 (1992).

77. *See id.* at 106.

78. *See id.* at 107.

79. *See* Jerome Kurtz, *The Limited Liability Company and the Future of Business Taxation: A Comment on Professor Berger's Plan*, 47 TAX L. REV. 815 (1992).

80. *See id.* at 824.

81. *See id.* at 820.

82. *See id.*

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already has been made in the Code[83] and, in his view, appears to be working well.[84] This is in contrast to the large/small distinction based on sales, which is subject to manipulation through the formation of multiple business entities.

Second, the public/private distinction allows tax-free creation with appreciated property in situations in which the transferor has not essentially changed economic position.[85] In contrast, when the transferor of property receives publicly traded and therefore marketable securities, whether corporate stock or a partnership interest, the transferor has experienced a significant change of position. In this case, Professor Kurtz sees the imposition of a tax as entirely appropriate.[86]

Third, the public/private distinction will reduce the problems of distinguishing interest and compensation from dividends.[87] A private company normally experiences the ongoing controversy over whether its owner/employees are receiving compensation for their services, which would be deductible by the corporation, or are receiving distributions of earnings (i.e., dividends), which would not be deductible by the entity. This problem generally does not exist in public companies, in which there is a lack of identity between stockholders and debt-holders and between employees and controlling shareholders, thereby making it much easier to distinguish amounts received as compensation for services from earnings distributions.

Fourth, the administrative difficulty of allocating income among entity owners, whether real or perceived, when there are a large number of shareholders, and there are frequent transfers of those shares or other securities, afflicts publicly traded companies to a far higher degree than privately held ones.[88] Professor Kurtz believes that flow-through treatment for non-publicly traded entities for whom the administrative burdens are most easily overcome, achieves the fairest and most appropriate method of taxation for them.[89] This approach leaves publicly traded entities, which suffer the greatest administrative difficulties under flow-through treatment, to the two-tier taxation regime.

Fifth, foreseeing full integration of the corporate and individual income tax at some time in the future, similar to what most other countries have done in one form or another, a distinction between publicly traded entities and private entities will best allow for the transition.[90] Private entities can be treated under the flow-through regime, whereas publicly traded entities

83. *See* I.R.C. § 7704.
84. *See* Kurtz, *supra* note 79, at 824.
85. *See id.*
86. See *id.*
87. *See id.* at 824-25.
88. *See id.* at 825.
89. *See id.*
90. *See id.* at 825-26.

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can accomplish integration through an imputation credit system.[91] During the interim, before full integration is achieved, an appropriate line can be drawn between private and public based upon the number of shareholders and perhaps the volume of transfers.

Elective Treatment

The Treasury may be close to reaching this same conclusion. Recognizing that classification as a pass-through entity is largely elective (although complicated and costly) under current law, the Treasury announced it is considering a proposal to abandon the classification factors entirely and permit nonpublicly traded LLCs pass-through treatment at will.[92] Under the proposal, if a nonpublicly traded LLC desires corporate treatment, it could make an affirmative election to obtain that treatment.[93]

The proposal under consideration by the Treasury recognizes the absurdity of classifying organizations in accordance with formal characteristics and the expense to which such organizations are put to get assurance from their tax advisors that at least two of the corporate characteristics are absent so that partnership classification is achieved.[94] In addition, the proposal also recognizes that it would eliminate the expense incurred by the IRS to verify the non-corporate classification of those entities.[95] Verification requires examination of a variety of documents, relationships, and events, a time-consuming process, to the end of determining whether the subject entity has fallen into one of the many traps for the unwary.

The confluence of provisions in the Tax Reform Act of 1986,[96] the provisions of the Omnibus Budget Reconciliation Act of 1987,[97] and the IRS's own concession in 1988 that a Wyoming LLC could qualify as a partnership,[98] make the proposed approach possible. The Wyoming LLC concession, the most important element, spawned the enactment of LLC

91. Under an imputation credit system, the corporate tax is viewed as a withholding tax on shareholders' income. When the corporation makes an actual or constructive distribution of income, the shareholders are treated as receiving both the distributed earnings and the corporate tax paid on those earnings. *See id.*

92. I.R.S. Notice 95-14, 1995-14 I.R.B. 7. Elective treatment would be specifically precluded for LLCs governed by I.R.C. § 7704.

93. Indeed, the Treasury is also considering expanding this elective approach to corporate entities as well. *See Treasury Not Locked into Approach Taken in Business Status Proposal, Official Says*, DAILY TAX REP., May 12, 1995, at G-3.

94. *Id.*

95. *Id.*

96. H.R. 3838, 99th Cong., 2d Sess., 100 Stat. 2085 (1986).

97. H.R. 3545, 100th Cong., 1st Sess., 101 Stat. 1330 (1987).

98. Rev. Rul. 88-76, 1988-2 C.B. 360. *See supra* note 13

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statutes in virtually every state in the ensuing few years[99] and permitted entrepreneurs to obtain the most significant benefits of incorporation and yet enjoy the pass-through and flexible tax benefits of partnership status.

In addition, the enactment of section 469 (Passive Activity Loss Rules) under the Tax Reform Act of 1986 significantly limited tax shelter benefits.[100] It thereby substantially reduced the revenue losses that could result from more freely available loss pass-through attributes of partnerships.

Thereafter, in 1987, Congress created a category of "publicly traded partnerships" that are generally treated like C Corporations.[101] This legislation was intended to accomplish several objectives: assure the application of corporate level tax to publicly owned business entities in order to protect the corporate tax revenue base, deny tax shelter benefits to publicly traded tax shelter partnerships,[102] and deter conversion of corporate business entities to partnerships after individual income tax rates had been reduced to a level below corporate tax rates by the 1986 Act.

These developments over the last decade have permitted the Treasury to consider the complete abandonment of the four characteristic test of partnership classification with little risk of sacrificing a great deal of rev-

99. ALA. CODE §§ 10-12-1 to -61 (1994); ARIZ. REV. STAT. ANN. §§ 29-601 to -857 (Supp. 1994); ARK. CODE ANN. §§ 4-32-101 to -1316 (Michie Supp. 1994); COLO. REV. STAT. ANN. §§ 7-80-101 to -913 (West Supp. 1994); 1993 Conn. Pub. Acts 267 (West); DEL. CODE ANN. tit. 6, §§ 18-101 to -1107 (Supp. 1994); FLA. STAT. ANN. §§ 608.401-.514 (West Supp. 1995); GA. CODE ANN. §§ 14-11-100 to -1109 (1994); IDAHO CODE §§ 53-601 to -672 (1994); ILL. COMP. STAT. ANN. ch. 805, paras. 180/1-1 to 60-1 (Smith-Hurd Supp. 1995); IND. CODE ANN. §§ 23-18-1-1 to -13-1 (Burns 1995); IOWA CODE ANN. §§ 490A.100-.1601 (Supp. 1994); KAN. STAT. ANN. §§ 17-7601 to -7652 (Supp. 1994); 1994 Ky. S.B. 184; LA. REV. STAT. ANN. §§ 12:1301-1369 (West 1994); ME. REV. STAT. ANN. tit. 31, §§ 601-751 (West 1994); MD. CODE ANN., CORPS. & ASS'NS §§ 4A-101 to -1103 (1993 & Supp. 1994); MICH. COMP. LAWS ANN. §§ 450.4101-.5200 (West Supp. 1994); MINN. STAT. ANN. §§ 322B.01-.960 (West 1995); MISS. CODE ANN. §§ 79-29-101 to -1201 (Supp. 1994); MO. ANN. STAT. §§ 347.010-.740 (Vernon Supp. 1995); MONT. CODE ANN. §§ 35-8-101 to -1307 (1994); NEB. REV. STAT. §§ 21-2601 to -2645 (Supp. 1993); NEV. REV. STAT. ANN. §§ 86.010-.571 (Michie 1994); N.H. REV. STAT. ANN. §§ 304-C:1 to :85 (Supp. 1994); N.J. STAT. ANN. §§ 42:2B-1 to -70 (West Supp. 1994); N.M. STAT. ANN. §§ 53-19-1 to -74 (Michie Supp. 1994); N.C. GEN. STAT. §§ 57C-1-01 to -10-07 (1993); N.D. CENT. CODE §§ 10-32-01 to -155 (Supp. 1994); OHIO REV. CODE ANN. §§ 1705.01-.58 (Anderson Supp. 1994); OKLA. STAT. ANN. tit. 18, §§ 2000-2060 (West Supp. 1995); OR. REV. STAT. §§ 63.001-.990 (Supp. 1994); R.I. GEN. LAWS §§ 7-16-1 to -75 (1992 & Supp. 1994); S.D. CODIFIED LAWS ANN. §§ 47-34-1 to -59 (Supp. 1994); TENN. CODE ANN. §§ 48-201-101 to -248-606 (Supp. 1994); TEX. REV. CIV. STAT. ANN. art. 1528n (West Supp. 1995); UTAH CODE ANN. §§ 48-2b-101 to -157 (1994 & Supp. 1994); VA. CODE ANN. §§ 13.1-1000 to -1073 (Michie 1993 & Supp. 1994); WASH. REV. CODE ANN. §§ 25.15.005-.902 (West Supp. 1995); W. VA. CODE §§ 31-1A-1 to -69 (Supp. 1994); WIS. STAT. §§ 183.0102-.1305 (West Supp. 1994); WYO. STAT. §§ 17-15-101 to -143 (1989 and Supp. 1994).

100. I.R.C. § 469 (1988 & Supp. V 1993).

101. *See id.* § 7704.

102. Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647 § 2004, 1988-3 L.B 473 (1988); Omnibus Budget Reconciliation Act of 1987, H.R. 3545, 100th Cong., 1st Sess. (1987).

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enue. Indeed, the Treasury does not believe its proposal will result in any revenue loss whatever,[103] although that belief appears to some observers to be somewhat optimistic.

On balance, the Treasury's consideration of the public/private dichotomy and an elective approach appears to be very realistic and would accomplish a great deal of tax simplification, to be welcomed by taxpayers, if not the tax lawyers who worried about and planned around the classification factors at their normal hourly rates.

A Caution

While Professor Kurtz has set forth several compelling practical reasons for adopting the public/private dichotomy for entity classification,[104] it nevertheless appears that basing tax treatment on this dichotomy creates some negative and unfortunate tax incentives. Adoption of this dividing line would create a tax incentive for a business to remain private, thereby impeding the free and efficient flow of capital to the business. Whereas capital could flow to the business in the form of debt, there would be a significant penalty in the form of an extra layer of income tax, imposed at the entity level on all of the entity's income, if the entity were to seek its capital from prospective equity-holders in the public market. Privately held companies would have a competitive advantage over publicly held companies, an advantage that cannot be justified on any grounds other than the administrative convenience to which Professor Kurtz points.[105]

LIMITED LIABILITY

The single distinguishing feature between a corporation and a sole proprietorship may be the existence of limited liability accorded the corporation. This corporate feature is what isolates the responsibility for corporate actions to the assets of the corporation and not the separate assets of the owners of the corporation, and therefore forces the commercial world to view the corporation as a person, separate and apart from its owners, whose assets are protected from the liabilities of the corporation. This aspect also allows corporations to attract other owners, whose risk of loss is limited by the amount of capital contributed to the corporation.

In 1980, the Treasury proposed regulations that would have elevated limited liability to a determining factor.[106] The proposed regulations provided as follows: "[T]he term 'partnership' can apply only to an organization some member of which is personally liable for debts of the orga-

103. *Treasury Officials Discuss Entity Choice of Tax Status*, 133 CONG. REC. H 11967 (Dec. 21, 1987).

104. *See* Kurtz, *supra* note 79.

105. *See id.*

106. Prop. Treas. Reg. § 301.7701-2, 45 Fed. Reg. 75,709 (1980).

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nization. Because a limited liability company does not satisfy this condition, it cannot be classified as a partnership."[107] After receiving significant comments in opposition to the proposed regulation, including questions regarding whether the Treasury had the authority to promulgate such a regulation, the Treasury withdrew its proposed regulations in 1982, contemporaneously announcing the beginning of a study project to review whether partnership taxation applied to entities in which no member is personally liable.[108] It concluded that study in 1988 with the issuance of the Wyoming LLC revenue ruling,[109] in which the IRS ruled that limited liability was simply one of four factors, no more or less important than any of the other three factors.[110] The IRS concluded that an LLC, organized in Wyoming under a statute authorizing the creation of a new form of business organization known as the limited liability company,[111] could be classified as a partnership even though no member was liable for any of the entity's debts, because the organization lacked two of the other three factors.[112]

The current Treasury regulations continue to recognize the importance of limited liability as a classification factor in distinguishing between partnerships and associations, which are taxable as corporations, but make it only one of four equally weighted factors, together with continuity of life, centralized management, and free transferability of interest.[113] Under the current Treasury regulations, an organization that lacks any two of these factors, even if it has limited liability, will be classified as a partnership rather than as an association.[114]

The goal of tax policy relating to integration or two-level tax should be tax neutrality, that is, to minimize the effect on the economy of the tax decision involved in classification. Arguably, there should be complete integration for all businesses, including sole proprietorships, partnerships, limited liability companies, and corporations. The state does, however, bestow a special benefit that some of these entities enjoy, giving them a competitive advantage in the market for capital. Corporations, LLCs, and limited partnerships enjoy this special benefit: limited liability. These forms of companies are able to take greater risks because their owners are insulated from those risks. Limited liability is a function of the legal fiction that corporations and corporation-like entities are persons, separate and apart from their true owners. A separate tax on entities that enjoy limited liability might be viewed as equalizing the relative government-bestowed

107. *Id.*
108. *See supra* note 43.
109. Rev. Rul. 88-76, 1988-2 C.B. 360.
110. *Id.* at 361.
111. WYO. STAT. §§ 17-15-101 to -136 (1977).
112. *Id.* The entity lacked continuity of life and free transferability of interest.
113. Rev. Proc. 95-10, 1995-3 I.R.B. 20.
114. *Id.*

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benefits and detriments among these entities. Accordingly, so long as corporations are subject to entity level taxation, non-corporate entities that possess their market advantages, namely limited liability, arguably should also be subject to that treatment.

On the other hand, there are difficulties with using limited liability as the single determinant. First, S Corporations, which enjoy limited liability, are generally subject to only shareholder level taxation.[115] Subjecting LLCs to entity-level taxation because of their limited liability, while excusing S Corporations from that tax, appears to be inconsistent. Perhaps the distinction can be viewed as a matter of legislative grace to so-called "Small Corporations." But, why should that grace not be extended to "Small LLCs" as well?

Second, sometimes the characteristic of limited liability is achieved in practical terms, even though the entity form is technically not one that provides limited liability protection. In those situations, the limited liability characteristic may be an inappropriate determinant of the entity's tax treatment. This inappropriateness is more troubling in the context of the pass-through of losses than the avoidance of entity-level taxation of income. In transactions in which loss pass-through is an important objective, the treatment of liabilities is frequently a determinant of the taxpayer's choice of entity among the pure pass-through partnership, the modified pass-through S Corporation, and non-pass-through C Corporation. Inclusion of partnership nonrecourse liabilities in outside as well as inside basis essentially allows partners to deduct amounts in excess of amounts contributed or promised to the activity.[116] Justified as merely equating a partner's treatment to a co-owner's treatment of the activity, nonrecourse liabilities allow partners to achieve loss pass-through treatment and yet enjoy limited liability.

Put differently, if *Crane v. Commissioner*[117] had been decided differently and the United States Supreme Court had held that nonrecourse liabilities assumed or taken subject to in the acquisition of property were not includable in the property's basis, then the controversy over limited liability in the area of entity classification would be of much less import. Pass-through loss deductions would be limited to actual cash invested or promised for which a taxpayer has personal liability. This would correspond to the entity's own basis inclusion for liabilities. In substance, this change

115. I.R.C. §§ 1361-1377 (1988 & Supp. V 1993). Section 1366 allows for pass-through of income to the shareholder in proportion to the shareholder's ownership interest. The income retains the character it had when received by the entity. *Id.* § 1366.

116. I.R.C. § 752; Treas. Regs. §§ 1.752-1 to -5.

117. 331 U.S. 1 (1947). In *Crane*, the Court held that a person who acquires depreciable property subject to an unassumed mortgage, and later sells the property still encumbered, realizes gain on the sale that includes the liability. *Id.* at 14.

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would have reduced the tax differences between partnership treatment and S Corporation treatment (and, of course, C Corporation treatment).[118]

The point is that an entity that does not possess the protection of limited liability under law can effectively obtain much of that protection by providing for nonrecourse treatment with its creditors. Although this may not be likely with trade creditors and potential tort plaintiffs (although adequate insurance likely would be available), it can often be achieved with regard to loans secured by real estate or other property. Nevertheless, the areas in which liability protection cannot be achieved may very well be sufficient to impose significant risks on owners of the entity to fairly characterize them as not being protected by limited liability.

This suggestion of drawing the one-level/two-level tax distinction based upon limited liability is not consistent with the direction that the courts in decisions,[119] the Treasury in regulations,[120] and the IRS in revenue rulings have taken.[121] Indeed, to attempt to draw this distinction at this point in tax history, as indicated, would require a substantial amount of back-peddling. It would also not be without administrative difficulty because an entity such as a limited partnership, which has a general partner with unlimited liability, might have to be treated partly as a pass-through entity and partly as a taxable entity. But this complication results from the historical creation of limited partnerships to take advantage of pass-through treatment even where limited liability exists. The partial entity treatment described would be more of a problem for existing limited partnerships than for future limited partnerships which, in all likelihood, would be few and far between under this regime. Absent tax considerations, most of the limited partnership's limited partners likely would prefer to own corporate stock than limited partnership interests, or senior LLC membership interests.

If, however, limited liability is not to be the determining factor in entity classification, then why should corporations be entitled to that same treatment regardless of whether they satisfy S corporation requirements?[122] Limited liability, after all, is the most important non-tax reason for incorporating.

The Treasury's most recent willingness to consider the adoption of the public/private dichotomy for LLCs, while it should be applauded as a clear

118. It would also have eliminated the need for the at-risk rules of I.R.C. § 465 (generally limited losses to amounts invested by the taxpayer for which the taxpayer bears the economic risk of loss) and a large portion of the passive activity loss rules of I.R.C. § 469 (generally deferring losses from passive activities until a taxpayer has passive income or disposes of the activity).

119. *See, e.g.*, Larson v. Commissioner, 66 T.C. 159 (1976), *acq.* 1979-2 C.B. 2.

120. Treas. Reg. § 301.7701-2 (as amended in 1993).

121. *See, e.g.*, Rev. Rul. 88-76, 1988-2 C.B. 360.

122. See Treasury's most recent suggestion referenced *supra* note 93. The Treasury also pointed out, however, that two level tax applicable to corporations is statutory. *Id.*

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improvement over its current four characteristic test, leads one to question why a similar dichotomy should not be adopted for corporations as well. Indeed, if limited liability, the single significant advantage afforded corporate shareholders, is not a determinant factor in imposing entity level taxation on LLCs, then it would seem that nonpublicly held corporations also should be permitted single level, partnership taxation for precisely the same policy reasons as LLCs, without regard to the current S corporation requirements. This change would have to be effected legislatively. If such a statutory change were made, however, then choice of entity could be made for purely business reasons, rather than tax considerations.

S CORPORATION CRITERIA: THE NUMBER OF OWNERS

Another alternative for distinguishing between single tax entities and double tax entities is the number of owners. This factor is one of the most important features used in subchapter S of the Internal Revenue Code to distinguish essentially single tax S Corporations from double tax C Corporations.[123]

When the Treasury originally established the limit of ten S Corporation shareholders in 1958,[124] the design was intended for small businesses, and simplicity was an important goal. A limitation on the number of shareholders achieved administrative simplicity because the corporation's treatment of items of income or deduction (and IRS auditing of that treatment) could affect no more than ten tax returns.[125] Amendments to the statute to allow additional shareholders, ultimately up to thirty-five under the 1982 amendment,[126] compromised that simplicity somewhat. Nevertheless, a limitation based on the number of owners does provide a clear dividing line (although circumvention is possible by stacking entities) in subchapter S. The possibility of manipulation in this manner in the S Corporation context is precluded by requiring that only individuals (and certain trusts and estates)[127] can be shareholders.[128] A similar requirement could be imposed on LLCs, although that would now require a major change in state LLC laws. Alternatively, LLC ownership could be limited to a fixed number of non-pass-through owners such as individuals and C Corporations. Under this rule, the number of taxpayers whose tax liabilities could be affected

123. *See* I.R.C. § 1361 (limiting the number of shareholders in an S Corporation to 35). Under S Corporation eligibility, the shareholders must be individuals who are not nonresident aliens. *Id.* § 1361(b)(1).

124. *Id.* § 1371(a)(1) (1958).

125. JAMES S. EUSTICE & JOEL D. KUNTZ, FEDERAL INCOME TAXATION OF S CORPORATIONS ¶ 1.03[2][b] (3d. ed. 1993).

126. H.R. REP. No. 6055, 97th Cong., 2d Sess. (1982).

127. I.R.C. § 1361(b)(1)(B), (c)(2), (c)(3), (d).

128. S Corporations, however, can be partners in a larger partnership.

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by the LLC's taxable income would be limited to the fixed number, which is one of the principal goals of setting a maximum number of permissible owners.

CONCLUSION

Each of the four alternatives, (i) large versus small, (ii) public versus private, (iii) limited liability versus unlimited liability, and (iv) large number of owners versus small number of owners has some appeal to policy objectives in the tax law. In this sense, any one of the alternatives is preferable to the current four-factor test employed by the Treasury Regulations. Moreover, the choice of any alternative would obviate the need to create a brand new institution known as "limited liability companies" in fifty different states plus the District of Columbia. Any of these alternative tests, arguably, could be adopted and arguments could be made in its favor. Instead, the Treasury for many years chose to retain its four-factor test, for which no substantial arguments can be made. Moreover, Congress was also unwilling to adopt any of these alternative tests.

More recently, however, the Treasury and the IRS appear willing to permit taxpayers to choose the kind of treatment they desire: pass-through or two-level taxation. They first indicated their flexibility when the IRS, publishing a revenue ruling permitting classification of LLCs as partnerships (and therefore pass-through entities),[129] even though the Treasury's own classification regulations could have been amended to provide otherwise, and most recently, in the Treasury's consideration of elective treatment for non-publicly traded LLCs. Congress has thus far remained silent on this decision.

This new flexibility, however, has spawned an essentially new entity, the LLC, in virtually every state,[130] thereby necessitating the creation of a whole new body of law with all the resulting uncertainty that entails. This has happened almost by accident, and not as part of a purposeful effort to accomplish some social or economic goal that could not have been achieved through corporations, whose law has been developed with great sophistication for generations, if not centuries. A long-term failure of Congress, the Treasury, and the IRS to define and articulate in the tax law the basic policies implicit in business taxation has forced state law makers to adapt to a wholly formalistic means of determining tax status. The net result is the LLC, an ingenious invention that allows partners to achieve both pass-through status and limited liability. It does so, however, by forcing a turn away from the well-established jurisprudence of corporate and partnership law, and to devise a pastiche of law for a new entity that exists only because the classification rules are so absurd.

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

130. *See supra* note 99 (listing states that have adopted LLC statutes).

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The conclusions and observations in this Article are that policymakers have allowed the tax tail to wag the economic dog. Certainty and predictability are important objectives of law. These generally exist when the corporate form is used because of the long history of case law interpreting corporate provisions and rights and responsibilities of officers, directors, and shareholders. Certainty and predictability are sacrificed by the creation of tax incentives for the new and uncertain entity form known as the limited liability company. No one looking at the entire picture, tax and non-tax, would have suggested replacement of corporations with LLCs as a rational policy direction. Yet, it is occurring, and, until recently, much of the academic writing about it concentrated on the kind of trees that should be planted and not whether the new forest is desirable.

It may be asked whether the confusion of policy described in this Article has not only confused tax law, but also spawned undesirably complex and costly legal innovation. Certainty and predictability are important objectives of law. These historically have existed when the corporate or partnership forms are used because of the long history of statutory and case law interpreting the rights and responsibilities of officers, directors, shareholdhers, and partners. Certainty and predictability have been threatened by the creation of tax incentives for the new and uncertain entity form known as the limited liability company. If one had stood back, before the proliferation of LLCs, to take a look at the question of how businesses should be taxed, it is doubtful that one would have proposed the solution of wholesale replacement of traditional entities by a novel hybrid through a state-by-state free-for-all.

On the other hand, the law develops untidily, and it can be argued that the free-for-all among the states in their competition to produce the most attractive and functional LLC statute shows the market for law, which has propelled the LLC to prominence, operating efficiently. Indeed, the timing of the IRS's recent proposal suggests that the LLC phenomenon may have forced legal change that ultimately may result in a tax regime that expressly serves some coherent policy goal, and in the development of a new and highly adaptable form of entity whose present uncertainty may simply be a transitional cost. Indeed, the LLC may simply be a stepping stone to a more widely used form of partnership, the limited liability partnership. Judgment will have to be reserved, however, until both the immediate fate and the long-term effects of the changes are known.

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