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The Limited Liability Company: A Possible Choice for Doing Business

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THE LIMITED LIABILITY COMPANY: A POSSIBLE CHOICE FOR DOING BUSINESS?

*Susan Pace Hamill**

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I. INTRODUCTION

Recently, in Revenue Ruling 88-76,[1] the Internal Revenue Service (the "Service") classified an unincorporated organization operating

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

under the Wyoming Limited Liability Company Act[2] as a partnership for federal income tax purposes.[3] Under the tests for determining entity classification set out in section 301.7701-2 of the regulations,[4] the limited liability company ("LLC") lacked the corporate characteristics of continuity of life and free transferability of interests.[5] Consequently, the LLC did not possess a majority of corporate characteristics. The Service therefore classified the entity as a partnership, even though it possessed the corporate characteristic of limited liability.[6] This ruling ends the uncertainty[7] that has surrounded LLCs since their statutory creation by Wyoming in 1977[8] and Florida in 1982.[9]

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2. Wyoming Limited Liability Company Act, WYO. STAT. ANN. §§ 17-15-101 to -136 (1977).

3. Rev. Rul. 88-76, 1988-2 C.B. 360, 361.

4. Treas. Reg. § 301.7701-2 (as amended in 1983). Unless otherwise indicated, all references to sections of the "Code" or the "regulations" refer to the Internal Revenue Code of 1986, as amended, and the regulations promulgated thereunder.

5. Rev. Rul. 88-76, 1988-2 C.B. 360, 361.

6. *Id.* at 361.

7. The Service showed initial hostility to LLCs by proposing amendments to the entity classification regulations which would have conclusively treated LLCs as corporations for tax purposes. *See* 45 Fed. Reg. 75,709 (proposed Nov. 17, 1980, later withdrawn). After those proposed regulations were finally withdrawn, see Announcement 83-4, 1983-2 I.R.B. 30 (Jan. 14, 1983), the Service stated it would conduct an extensive study concerning the effect of the limited liability characteristic on entity classification. *Id.* Before the Service published Revenue Ruling 88-76, 1988-2 C.B. 360, § 5.37 of Revenue Procedure 88-3, 1988-1 C.B. 579 included the classification of limited liability companies for federal income tax purposes on the list of areas where the Service will not rule. Revenue Procedure 88-44, 1988-2 C.B. 634 modifies Revenue Procedure 88-3 by deleting § 5.37. *See also* Rev. Proc. 89-3, 1989-3 I.R.B. 29 for the current list of areas where the Service will not rule.

8. *See supra* note 2.

9. Florida Limited Liability Company Act, FLA. STAT. §§ 608.401-.471 (1987). To date, no other state has passed a limited liability company act.

The LLC somewhat resembles, but is far superior to, two other business organizations known as limitadas and limited partnership associations. Limitadas are foreign organizations that grant all members limited liability and can be structured to lack the corporate characteristics of continuity of life and free transferability of interests. *See* Priv. Ltr. Rul. 8,003,072 (Oct. 25, 1979), I.R.S. Let. Rulings Rep. (CCH) No. 152 (Jan. 29, 1980), where the Service classified a Brazilian limitada as a partnership for tax purposes. *Id.* Limitadas have not been extensively used in the United States because of certain restrictions on the amount of capital and other restrictions which generally allow only natural persons to be members. Additionally, some commentators have expressed doubt whether courts would respect the limited liability feature if the limitada were sued in the United States. *See* Burke & Sessions, *Partnerships and Subchapter S*, 54 J. TAX'N 232 (1981); Comment, *The Limited Liability Company Act*, 11 FLA. ST. U.L. REV. 387 (1983). Limited partnership associations, which exist in Michigan, New Jersey, Ohio, and Pennsylvania, also possess the desired feature of limited liability and can be structured

The Service's willingness to bestow partnership status to the LLC legitimizes for the first time an entity combining the tax advantages of a partnership with the limited liability advantages commonly associated with corporations.

Part II of this article discusses the Service's regulations and other authorities for classifying organizations as associations taxable as corporations or partnerships and focuses on the application of these authorities to Revenue Ruling 88-76 and the statutory provisions of the Wyoming and Florida acts.[10] Part III summarizes the powers and requirements of LLCs, as well as possible business problems concerning LLCs.[11] Part IV explores different types of ventures in which businesspersons might consider using an LLC instead of the traditional entity normally chosen for that venture.[12] When compared to a general partnership, the benefits offered by the LLC are probably more perceived than real. However, choosing an LLC in this situation is unlikely to cause problems or pose significant disadvantages.[13] This part then explains why the LLC should never be chosen for certain ventures that traditionally are conducted in larger limited partnerships.[14] Finally, this part of the article compares the LLC to two other business forms — certain smaller limited partnerships and Subchapter S Corporations. Here, the choice of an LCC may provide distinct advantages over those two entities.[15] The last part of the article analyzes the effect of the LLC's absolute limited liability feature on certain operating rules of Subchapter K.[16]

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to lack two of the three remaining corporate characteristics. *See* Priv. Ltr. Rul. 7,505,290,310A (May 29, 1975) (available on WESTLAW) (Michigan partnership association was classified as a partnership for tax purposes providing that its creation and conduct were in "substantial compliance" with all state statutes pertaining to limited partnerships"). These are seldom used because of restrictions requiring either the principal place of business or the principal office to be maintained in the state of organization. *See* MICH. COMP. LAWS ANN. § 449.301 (West 1989); N.J. STAT. ANN. § 42:3-1 (West 1940 & Supp. 1982); OHIO REV. CODE ANN. § 1783.01 (Anderson 1984); PA. STAT. ANN. tit. 59, § 172 (Purdon 1984 & Supp. 1989). Michigan, New Jersey, and Ohio require at least three persons to form a limited partnership association and Ohio limits the number of members to twenty-five. *See* MICH. COMP. LAWS ANN. § 5409.301 (West 1989); N.J. STAT. ANN. § 42:3-1 (West 1940 & Supp. 1982); OHIO REV. CODE ANN. § 1783.01 (Anderson 1984).

10. *See infra* text accompanying notes 17-125.
11. *See infra* text accompanying notes 126-50.
12. *See infra* text accompanying notes 151-244.
13. *See infra* text accompanying notes 151-61.
14. *See infra* text accompanying notes 162-69.
15. *See infra* text accompanying notes 170-244.
16. *See infra* text accompanying notes 245-333.

II. Classification of the LLC as a Partnership or an Association Taxable as a Corporation for Federal Income Tax Purposes

The Service has the power to classify unincorporated[17] organizations and treat them for tax purposes as associations taxable as corporations, partnerships, or trusts based on whether the organization possesses or lacks certain characteristics set out in the regulations.[18] The fact that the organization is treated as a partnership or trust under state law generally does not protect it from being classified as an association taxable as a corporation.[19]

If an unincorporated organization more closely resembles a corporation than a partnership or a trust, the Service treats the organization as an association, and taxes it as a corporation.[20] The regulations

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17. The regulations only address classifying domestic *unincorporated* organizations as associations taxable as corporations. *See* Treas. Reg. § 301.7701-2(a)(3) (as amended in 1983). No example was discovered in which a domestic incorporated entity was not treated as a corporation for tax purposes. Arguably, a corporation always possesses three out of four of the corporate characteristics. A corporation always possesses the corporate characteristic of continuity of life because it continues until it is formally liquidated or otherwise dissolved. *See* REVISED MODEL BUSINESS CORP. ACT §§ 2.03(a), 14.02, .20, .30 (1985). A corporation always possesses the corporate characteristic of limited liability because shareholders are not liable for corporate liabilities unless the corporate veil is pierced. *See id.* § 6.22. All corporations must either have a formal board of directors or set forth in the articles of incorporation who will informally perform the duties of the Board. *See id.* § 8.01. Consequently, one could argue corporations always possess centralized management. This argument becomes weaker when the corporation is closely held or has a single shareholder where in fact all the shareholders are actually managing the business. Generally, shares of stock are freely transferable. Shareholders can and often do impose restrictions on transferability through the articles of incorporation, the by-laws or otherwise by a separate shareholders' agreement. *See id.* § 6.27. *But see* Rev. Rul. 88-8, 1988-1 C.B. 403 (all entities organized or incorporated under foreign law must have at least three of the four corporate characteristics to be treated as an association taxable as a corporation for U.S. purposes). In other words, the Service will treat foreign corporations as partnerships for U.S. purposes if they lack two of the four corporate characteristics.

18. Treas. Reg. § 301.7701-1(c) (as amended in 1977).

19. *Id.* However, the last sentence of Treasury Regulation § 301.7701-1(c) makes it clear that local law will determine whether an organization possesses or lacks a particular characteristic. *Id.*

20. Treas. Reg. § 301.7701-2(a)(3) (as amended in 1983). An unexpected determination of corporate status can have disastrous tax consequences. For example, losses flow through partnerships but do not flow through corporations. *See* I.R.C. § 11 (West Supp. 1989); I.R.C. §§ 701, 702(a) (1986). The Code taxes corporations (except Subchapter S Corporations which are discussed at *infra* notes 211-44) at the corporate level and the shareholder level, while only the partners of a partnership are subject to tax. *See* I.R.C. §§ 11, 301 (West Supp. 1989); I.R.C. §§ 701, 702(a) (1986). Partnerships, but not corporations, are entitled to certain inside basis adjustments. *See* I.R.C. §§ 734, 743(b) (1986). Both the partnership and the partner can generally

identify six characteristics indicative of corporate status: (1) associates, (2) an objective to carry on business and divide the gains, (3) continuity of life, (4) centralization of management, (5) limited liability, and (6) free transferability of interests.[21] Whether a particular organization possesses or lacks these characteristics is a facts-and-circumstances test.[22] The Service treats an unincorporated organization as a corporation for tax purposes if it has more corporate characteristics than partnership or trust characteristics.[23]

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defer unrealized gain when distributing appreciated property. *See id.* §§ 731, 732, 733. Corporations, however, must recognize gain when appreciated property is distributed and shareholders generally have a taxable dividend equal to the fair market value of the property received. *See* I.R.C. §§ 301, 311 (West. Supp. 1989). Additionally, corporations are subject to the alternative minimum tax if book income is higher than taxable income; the book income preference, however, does not apply to partnerships. *See id.* § 56(f). Income allocated from a partnership will sometimes qualify as passive income while dividends are always treated as portfolio income. *See id.* §§ 469(e), (h); Temp. Treas. Reg. §§ 1.469 2T(c)(3) and 1.469-2T(e), 53 Fed. Reg. 15,494 (1988).

21. Treas. Reg. § 301.7701-2(a)(1) (as amended in 1983).

22. *Id.* The Service may consider other factors not listed in the regulations in determining if a particular organization is a corporation, a partnership, or a trust. *Id.* For a list of items that the Service will not consider as "other factors" in classifying an organization as a limited partnership or an association taxable as a corporation, see Rev. Rul. 79-106, 1979-1 C.B. 448,

23. Treas. Reg. § 301.7701-2(a)(1) (as amended in 1983); *see also* Morrissey v. Commissioner, 296 U.S. 344 (1935). In *Morrissey*, the taxpayers created a trust under local law, to develop a golf course for profit. *Id.* at 360-61. The trustee had broad management powers, the beneficial interests were freely transferable, liability was limited to the trust's assets, and the death of a trustee or a beneficiary did not terminate the trust. *Id.* The Supreme Court held that this trust was an association taxable as a corporation long before the Service promulgated the entity classification regulations.

Treasury Regulations discuss when an organization will be classified as a trust rather than an association or a partnership. Treas. Reg. § 301.7701-2 (as amended in 1983); Treas. Reg. § 301.7701-4 (as amended in 1986). The very essence of a trust is to take property for the purpose of protecting it or conserving it for the beneficiaries. The Service will classify trusts which fail to possess either the corporate characteristic of associates or an objective to carry on business and divide the gains as trusts for tax purposes. If the trust has associates, and an objective to carry on business and divide the gains, the Service will treat it as an association taxable as a corporation or a partnership for tax purposes. A trust that has these two characteristics will be characterized as a corporation if it possesses at least three of the four remaining corporate characteristics. Otherwise, the Service will classify it as a partnership. *Id. See also* Rev. Rul. 88-79, 1988-2 C.B. 361 (trust formed under Missouri law for the purpose of buying, holding and selling oil and gas royalty interests classified as a partnership because it had associates and a business objective but lacked at least two of the remaining four corporate characteristics); W. MCKEE, W. NELSON & R. WHITMIRE, FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS, ¶ 3.09 (1977) [hereinafter TAXATION OF PARTNERSHIPS] (citing several examples of cases and rulings where trusts were reclassified as partnerships or corporations for federal income tax purposes).

In determining whether an organization possesses a greater number of corporate versus noncorporate characteristics, the Service does not consider characteristics common to both types of the organizations being compared.[24] For example, in determining corporate versus partnership status, the Service does not consider the characteristic of associates, and the characteristic of a business objective and the division of gains because both partnerships and corporations possess these characteristics.[25] Thus, an organization seeking partnership classification need only lack two of the remaining four corporate characteristics to qualify as a partnership. In other words, the regulations treat an organization as a partnership for federal income tax purposes, even though it possesses two of the four characteristics indigenous to corporations.[26]

A. *Continuity of Life*

As noted, continuity of life is a characteristic uniquely indicative of corporate status. Continuity of life exists when the organization does not cease merely because one or more of its original owners dies, retires, resigns, or suffers insanity, bankruptcy, or expulsion.[27] Continuity of life is a corporate characteristic because an incorporated entity continues to survive until formal liquidation. This is so even in

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24. Treas. Reg. § 301.7701-2(a)(3) (as amended in 1983).

25. *Id.*

26. *Id.* Under § 301.7701-3 of the Treasury Regulations, an organization, collective group, or other relationship (such as employer/employee or independent contractor, landlord/tenant, co-owners of property and lender/borrower) which is not a partnership for state law purposes can be classified as a partnership for tax purposes. *Id.* § 301.7701-3 (1967). A relationship will rise to the level of a partnership where the parties have joined together to earn a profit. *Id.* Merely sharing expenses or co-owning property does rise to the level of a partnership. *See* Treas. Reg. § 1.761-1(a) (as amended in 1972); *see also* Farley Realty Corp. v. Commissioner, 279 F.2d 701 (2d Cir. 1960) (participating loan held to be a partnership interest); Bussing v. Commissioner, 88 T.C. 449 (1987) (purported lease held to be a partnership arrangement); Wheeler v. Commissioner, 37 T.C.M. (CCH) 883 (1978) (service provider held to be a partner even though the other partner bore all the losses and no partnership tax returns were filed); Rev. Rul. 75-374, 1975-2 C.B. 261 (discussing how co-owners can avoid being partners). For an exhaustive discussion and numerous examples and citations concerning how partnerships are distinguished from these other relationships, see TAXATION OF PARTNERSHIPS, *supra* note 23, at ¶¶ 3.01-.04.

The Code and the regulations allow certain unincorporated organizations to elect to be excluded from all or certain portions of Subchapter K if certain requirements are met. I.R.C. § 761(a) (1988); Treas. Reg. § 1.761-2(b) (as amended in 1972). For an extensive discussion of the procedure for making this election and the requirements that must be met, see TAXATION OF PARTNERSHIPS, *supra* note 23, ¶ 3.05.

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

cases of death, retirement, resignation, insanity, bankruptcy, or expulsion of one of the original owners.[28] If the organization dissolves due to one of these events, it lacks continuity of life.[29]

Taxpayers have always found it easy to create a partnership lacking continuity of life. The regulations recognize that partnerships organized under the Uniform Partnership Act ("UPA"),[30] the model act for organizing general partnerships, and the Revised Uniform Limited Partnership Act including the 1985 amendments ("RULPA"),[31] the model act for organizing limited partnerships, automatically lack continuity of life.[32] Many prospective joint venturers who seek partnership classification simply arrange to form the partnership in a jurisdiction where the state's partnership laws correspond to the UPA or RULPA. The partnership still can lack continuity of life if the taxpayers do not organize in a UPA or RULPA jurisdiction. If such partnership is a general partnership, the operative documents must require the partnership to dissolve if one of these dissolution events occurs with respect to any partner, unless all remaining partners agree to continue the business.[33] If such partnership is a limited partnership, the operative documents must require the partnership to dissolve if one of these dissolution events occurs with respect to a general partner unless all remaining general partners agree to continue the business.[34]

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28. *See* REVISED MODEL BUSINESS CORP. ACT §§ 2.03(a), 14.02, 14.20, 14.30 (1985).

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

30. UNIF. PARTNERSHIP ACT (1914).

31. REVISED UNIF. LTD. PARTNERSHIP ACT (1985).

32. Treas. Reg. § 301.7701-2(b)(3) (as amended in 1983). The Uniform Limited Partnership Act was first codified in 1916. Substantial changes were made in the Revised Uniform Limited Partnership Act, codified first in 1976 and then amended in 1985. References in this article to the Revised Uniform Limited Partnership Act will refer to the latest version, with the 1985 amendments, unless explicitly stated otherwise. The UPA provides that dissolution results from the death, retirement, resignation, insanity, bankruptcy or expulsion of any of the partners unless all remaining partners agree to continue the business. UNIF. PARTNERSHIP ACT §§ 29-32, 38(2)(b) (1914). RULPA provides that dissolution results if one of these events occurs with respect to a general partner unless the certificate provides that the remaining general partners can agree to continue the business. REVISED UNIF. LTD. PARTNERSHIP ACT § 801 (1985). If one of these events occurs with respect to the sole general partner then all remaining limited partners must consent to the substitution of a new general partner to avoid dissolution of the partnership. *Id.*

33. Treas. Reg. §§ 301-7701-2(b)(1), (3) (as amended in 1983).

34. *Id.* If there is only one general partner, then all remaining limited partners must consent to substitute a new general partner. General partnerships and limited partnerships with only one general partner may take steps to avoid dissolution by having all the partners contractually agree to continue the business, in the case of a general partnership, or substitute a new general partner, in the case of a limited partnership. If a partner breaches this contract, thereby causing

The continuity of life issue is affected by Revenue Procedure 89-12,[35] which the Service released shortly after it released Revenue Ruling 88-76. Revenue Procedure 89-12 redefines[36] the requirements an organization must satisfy to obtain a partnership classification ruling. The provisions of this new revenue procedure merely relate to obtaining a ruling from the Service and do not represent substantive rules for the determination of partnership status as a matter of law.[37] Revenue Procedure 89-12 covers all organizations in which any member has limited liability for the organization's debts and other obligations.[38] If the organization is not a limited partnership under state law, the references in this revenue procedure to "limited partner" and "general partner" apply to comparable members. Specifically, "general partners" for purposes of this revenue procedure are those members with significant management authority relative to other members.[39]

Under Revenue Procedure 89-12, limited partnerships[40] seeking a ruling must provide in the partnership agreement that no less than a majority[41] of the limited partners will elect a new general partner to continue the partnership if a general partner is removed[42] from the

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the partnership to dissolve, that partner will be liable for damages. Moreover, the partnership agreement can also provide that if a majority of the partners agree upon the occurrence of one of the dissolution events to follow the contract, then the other partners are deemed to also agree unless they affirmatively disagree. Under this scenario, a general partnership or a limited partnership with only one general partner arguably still lacks continuity of life because one partner can still cause the partnership to dissolve by refusing to follow the contract.

35. Rev. Proc. 89-12, 1989-7 I.R.B. 22.

36. *See infra* note 180 (discussing the requirements to obtain a partnership classification ruling before Revenue Procedure 89-12 was released).

37. *See* Rev. Proc. 89-12, 1989-7 I.R.B. 22, § 1.03.

38. *See id.* § 1.02.

39. *Id.*

40. General partnerships need not be concerned with any of the requirements of Revenue Procedure 89-12. This revenue procedure only applies if at least one member's liability for the organization's debts are limited to a determinable amount. *See id.* All partners in a general partnership are jointly and severally liable for the partnership's debts. See UNIF. PARTNERSHIP ACT §§ 13-15 (1914). Creditors, however, can only hold limited partners liable for a limited partnership's debts to the extent the limited partners have actually made or promised to make contributions to the partnership's capital. *See* REVISED UNIF. LTD. PARTNERSHIP ACT § 303.

41. Majority presumably means more than 50%. *See* BLACK'S LAW DICTIONARY 1107 (5th ed. 1979).

42. By referring to "removal" of a general partner, the Service apparently only intended to cover the situation where a general partner is involuntarily ousted from the partnership for some sort of wrongdoing. If there were more than one general partner and one of them merely withdrew (due to bankruptcy, for example), the other general partners presumably still would be able to continue the business without the vote of the limited partners, and the partnership could still be eligible for a ruling that it lacked continuity of life.

partnership; otherwise, the Service will not rule that the partnership lacks continuity of life.[43] The Service may still issue a partnership classification ruling, however, if the organization lacks two of the three remaining corporate characteristics.[44]

The Service concluded in Revenue Ruling 88-76 that the LLC organized under the Wyoming Limited Liability Company Act lacked continuity of life.[45] The Wyoming Act[46] provides that an LLC dissolves at the *earlier* of: (1) expiration of the period fixed for its duration,[47] (2) the unanimous agreement of the members to terminate, or (3) the death, retirement, resignation, insanity, bankruptcy or expulsion of a member, *unless* all remaining members consent to continue the business.[48] Wyoming LLCs will always lack continuity of life because the dissolution provisions in the Wyoming Act are almost identical to the dissolution provisions in the UPA.[49]

The dissolution provisions in the Florida Limited Liability Company Act are worded somewhat differently. Under the Florida Act, if the articles of organization provide a right to continue the business, then the LLC will not dissolve upon the death, retirement, resignation, insanity, bankruptcy, or expulsion of a member, even if all the remaining members refuse to consent to continue the business.[50] If the articles

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43. *See* Rev. Proc. 89-12, 1989-7 I.R.B. 22, § 4.05.

44. *Id.* § 4 (introduction).

45. *See* Rev. Rul. 88-76, 1988-2 C.B. 360-61.

46. WYO. STAT. ANN. § 17-15-123 (1977).

47. Both Wyoming and Florida LLCs can fix a duration period of up to 30 years. *See* FLA. STAT. ANN. § 608.407(1)(b) (1987); WYO. STAT. ANN. § 17-15 107(a)(ii) (1977).

48. WYO. STAT. ANN. § 17-15-123 (1977). This right must be stated in the articles of organization. *See id.* § 17-15-107(a)(viii). The Wyoming dissolution provisions result in business problems similar to those found in general partnerships and limited partnerships with only one general partner. For example, members may not want the LLC to dissolve merely because one member dies or goes bankrupt. The LLC can mitigate this problem by contractually binding every member to agree to continue the business and providing for members to be deemed to agree once a majority actually agrees. *See supra* note 34 and accompanying text. These steps do not eliminate the problem; one member can still refuse to continue the business, causing a dissolution, and the other members' only remedy would be to sue for damages under the contract. *Id.*

49. *See supra* note 32.

50. FLA. STAT. § 608.441(c) (1987). The language in the Florida Act explicitly provides that the LLC will dissolve if one of these dissolution events occurs with respect to any member "unless the business of the limited liability company is continued by the consent of all the remaining members *or* under a right to continue stated in the articles of organization of the limited liability company." *Id.* (emphasis added). In other words, the Florida Act explicitly allows members of a Florida LLC the option of circumventing the requirement that all members consent to continue the business.

do not state this right to continue, then, like the dissolution provision in the Wyoming Act, the Florida Act requires all members to consent to continue the business if one of these dissolution events occurs with respect to any member.[51] When the articles of organization do contain the right to continue, thereby alleviating the business problems associated with an unexpected dissolution,[52] the Service may well view a Florida LLC as possessing the corporate characteristic of continuity of life. The right to continue in this instance would deprive each member of the power to dissolve the LLC as a matter of law.[53]

All requirements of Revenue Procedure 89-12, including the requirement, discussed earlier, dealing with continuity of life and relating to the removal of a general partner, appear to apply to LLCs seeking a partnership classification ruling.[54] If a designated manager runs the LLC, this revenue procedure would presumably require a majority of the members to concur in removing the manager.[55] If the LLC does not designate a manager and no member has significantly more man-

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51. *Id.*

52. *See supra* notes 34, 48 and accompanying text.

53. Treas. Reg. § 301.7701-2(b)(3) (as amended in 1983); *see also* Comment, *The Limited Liability Company Act*, *supra* note 9, at 396 n.67 (where this concern has been expressed); Seemann, *The Florida Limited Liability Company*, 57 FLA. B.J. 536, 537 (1983) (implying that Florida LLCs lack continuity of life even if the right to continue is stated in the articles). The legislative history of the Florida Act indicates that Florida LLCs were designed to be classified as partnerships. This implies that Florida LLCs were intended to lack continuity of life because the committee acknowledged that a Florida LLC would always possess limited liability and may or may not possess centralized management. *See* STAFF REPORT TO COMMITTEE OF INSURANCE OF FLORIDA ON H.B. 43 (1982), *reprinted in* 1982 FLA. LAWS 82-177. *But see* Priv. Ltr. Rul. 8,937,010 (June 16, 1989), where the Service ruled that a Florida LLC is classified as a partnership because it lacks continuity of life and free transferability of interests. The Service explicitly states that continuity of life is lacking because no right to continue the business is stated in the articles of organization. *Id.* Consequently, all members must consent to continue the business if any member ceases to be a member. This ruling strongly implies that Florida LLCs containing this right to continue the business in its articles of organization will be treated by the Service as possessing continuity of life. A Florida LLC can substantially reduce its risk of possessing continuity of life by not providing for an absolute right to continue the business, by contractually binding all the members to vote to continue the business, and by deeming all members to have constructively agreed once a majority of members have agreed. *See supra* notes 34, 48 and accompanying text.

54. In an LLC, no member has unlimited liability for the LLC's debts. *See infra* notes 93-94 and accompanying text. Revenue Procedure 89-12 explicitly states that "general partner" refers to those with significant management power and "limited partner" refers to those without management power if the entity is not organized under a formal state limited partnership act. *See* Rev. Proc. 89-12, 1989-7 I.R.B. 22, § 1.02.

55. *Id.* § 4.05. LLCs can explicitly provide for designated managers to run the business. *See infra* text accompanying notes 71-74.

agement rights than the others,[56] arguably Revenue Procedure 89-12 does not apply at all.[57] Moreover, it seems unnecessary to apply a management removal requirement to an LLC seeking a ruling that continuity of life is lacking. This is because, unlike limited partners in limited partnerships,[58] and like general partnerships in UPA jurisdictions, LLCs dissolve on the death, retirement, resignation, insanity, bankruptcy, or expulsion of *any* member unless all remaining members agree to continue the business.[59] An LLC seeking a partnership classification ruling should be able to rely solely on the similarity of its dissolution provisions to those of the UPA to establish that it lacks continuity of life.[60]

B. *Centralized Management*

Also indicative of corporate status is centralized management. An organization possesses centralized management if designated persons have the exclusive authority to make business decisions without consulting the owners.[61] By its nature, a corporation possesses centralized management via a board of directors or the equivalent which runs the business and makes management decisions for the true owners — the shareholders.[62] For unincorporated organizations, however, centralized management is less readily discernible. The regulation section at 301.7701-2(c) treat an unincorporated organization as having centralized management if any person or group that does not include all of the owners has the exclusive authority to make the business and management decisions.[63] General partnerships organized in states with

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56. Generally, LLCs vest management authority in all members in proportion to their capital contributions. *See infra* text accompanying note 73. If one member contributed significantly more capital than the others, that member would have significantly more management rights than the others even if no manager was designated. *Id.*

57. If no member has significantly more management rights than the others, they are all "general partners" and consequently there are no "limited partners" by analogy. *See* Rev. Proc. 89-12, 1989-7 I.R.B. 22, § 1.02.

58. If one of these dissolution events occurs with respect to a limited partner, the partnership is never dissolved. *See* REVISED UNIF. LTD. PARTNERSHIP ACT § 801 (1985); *supra* note 32 and accompanying text.

59. *See supra* text accompanying notes 46-53.

60. *See* Rev. Rul. 88-76, 1988-2 C.B. 360, 361; *see also supra* note 49 and accompanying text.

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

62. *See id. But see* MODEL BUSINESS CORP. ACT § 8.01(c) (1985) (corporation having 50 or fewer shareholders may dispense with a board of directors).

63. Treas. Reg. § 301.7701-2(c)(1) (as amended in 1983). Such persons that possess the exclusive authority to manage the business can either be designated owners of the organization or outsiders retained solely to manage the business. *See id.* § 301.7701-2(c)(2). Centralized management can exist either when the managers are elected to office from time to time or when the position of running the business is self-perpetuating. *See id.*

general partnership acts corresponding to the UPA automatically will lack centralized management because all partners have equal rights to manage the partnership and conduct its business.[64] Regulations also provide that limited partnerships organized in states with limited partnership acts corresponding to RULPA lack centralized management *unless* the limited partners own substantially all the interests in the partnership.[65]

Under Revenue Procedure 89-12, the Service will not rule that a limited partnership lacks centralized management unless the limited partners in the aggregate own no more than eighty percent of the total interests in the partnership.[66] In other words, the general partners must own at least twenty percent of the partnership interest or the Service will treat the partnership as possessing centralized management.[67] Again, failure to meet this standard only means the Service will not rule that the partnership lacks centralized manage-

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64. Treas. Reg. § 301.7701-2(c)(4) (as amended in 1983); *see also* UNIF. PARTNERSHIP ACT § 18(e) (1914). Partners in general partnerships can agree among themselves to vest management rights in a select few. *See, e.g.*, Endsley v. Game-Show Placements, Ltd., 401 N.E.2d 768, 770-1 (Ind. App. 3d Dist. 1980); *In re* Lester, 87 Misc. 2d 717, 386 N.Y.S.2d 509, 513 (1976). Even if such agreement exists, normally the act of any partner within the scope of partnership business binds all partners because these agreements are ineffective against outsiders who have no notice. *See* Treas. Reg. § 301.7701-2(c)(4) (as amended in 1983).

65. Treas. Reg. § 301.7701-2(c)(4) (as amended in 1983). The regulations do not clearly define how much the limited partners can own before they will be treated as owning "substantially all" the interests in the partnership. The regulations contain examples where centralized management was found to exist when the general partners owned only 5.7% and 2.9% of the partnership interests. *See id.* § 301.7701-2(c)(4)-3(b)(2) exs. 1 & 2 (as amended in 1967). One could interpret the regulations and Revenue Procedure 89-12 to mean that it is possible to lack centralized management if the general partners own more than 5.7%, even if they own less than 20% of the partnership interests. Obviously, relying on this interpretation would not provide certainty for the organization, particularly if lacking centralized management was crucial to the organization's classification as a partnership. The Tax Court has stated that centralized management does not exist if the general partner has a "meaningful proprietary interest" in the partnership. *See* Larson v. Commissioner, 66 T.C. 159, 177 (1976), *acq.*, 1979-1 C.B. 1. (discussed *infra* notes 88, 111). This statement does not provide much certainty either. The regulations also provide that if all or a group of limited partners may remove a general partner, for reasons other than wrong doings such as gross negligence, self-dealing, or embezzelment, then all the facts and circumstances must be taken into account to determine whether the partnership possesses centralized management, see Treas. Reg. § 301.7701-2(c)(4) (as amended in 1983).

66. *See* Rev. Proc. 89-12, 1989-7 I.R.B. 22, § 4.06. Limited partnership interests owned by general partners are excluded from the 80% calculation. The Service states that it will carefully examine all facts and circumstances to make sure that the limited partners do not control the general partner. *Id.*

67. *See id.* The requirement that the general partner own at least 20% of the partnership is for ruling purposes only. *Id.* § 1.03.

ment: the partnership still can obtain a partnership classification ruling if it can show that it lacks two of the three remaining corporate characteristics.[68]

The Service apparently focuses on the percentage of the partnership owned by the limited partners when determining centralized management because state law prohibits limited partners from participating in the management of the limited partnership. If limited partners participate in the control of the business on behalf of other partners, the courts will not respect their status as limited partners and will expose them to unlimited liability.[69] The regulations seem to presume that centralized management must exist if the limited partners own substantially all of the partnership interests because the general partner must be managing the business primarily for the true owners — the limited partners.[70] If the general partner owns a meaningful interest in the limited partnership, however, centralized management does not exist. In this situation, the Service presumably views the general partner as managing the business primarily for itself as a true owner and only secondarily for the limited partners.

Both the Wyoming[71] and Florida acts[72] offer flexible alternatives for managing an LLC. Generally, the power to manage the LLC vests in the members in proportion to their capital contributions; consequently, LLCs generally lack centralized management.[73] If the articles of organization so provide, however, the shareholders may elect a manager or managers in the manner provided in the operating agreement.[74] In Revenue Ruling 88-76, designated managers ran the Wyom-

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68. *See id.* § 4 (introduction).

69. *See* REVISED UNIF. LTD. PARTNERSHIP ACT § 303 (1985). Certain activities are listed in § 303(b) that limited partners can engage in without being treated as participating in the control of the business. Such activities include: being an employee or agent of, or contractor for, the limited partnership or the general partner; consulting with or advising the general partner concerning the partnership's business; acting as a surety for the limited partnership; approving or disapproving an amendment to the partnership agreement; and voting on certain listed extraordinary matters. *Id.* § 303(b).

70. RULPA provides that the general partner of a limited partnership has the same management rights and is exposed to the same liabilities as all partners in general partnerships. *Id.* § 403. In other words, for state law purposes the general partners are the only partners intended to manage the business.

71. WYO. STAT. ANN. § 17-15-116 (1977).

72. FLA. STAT. § 608.422 (1987).

73. *Id.* at § 608.422; WYO. STAT. ANN. § 17-15 116 (1977). These provisions strongly resemble a similar provision in the UPA. If the members manage the business according to their capital contributions, then by definition, the organization lacks centralized management because no person is making decisions on behalf of the true owners. *See supra* text accompanying notes 61-64.

74. FLA. STAT. § 608.422 (1987); WYO. STAT. ANN. § 17-16-116 (1977).

ing LLC and the Service treated the entity as possessing the corporate characteristic of centralized management.[75]

The Service will probably treat LLCs that have designated managers as lacking centralized management if the designated managers own enough of an interest in the LLC.[76] Revenue Procedure 89-12 considers the managers as "general partners" and the nonmanagers as "limited partners" by analogy when applying the percentage ownership tests.[77] If the managers own at least twenty percent of the LLC, the Service should rule that the LLC lacks centralized management.[78] Moreover, if the managers own a meaningful proprietary interest in the LLC, the LLC should lack centralized management as a matter of substantive law.[79]

The designated managers in Revenue Ruling 88-76 were three of the LLC shareholders.[80] The Service did not reveal how much of the LLC the managers owned when it held that the Wyoming LLC possessed centralized management.[81]

C. *Limited Liability*

A major advantage of doing business in corporate form is the privilege of having liability for debts and obligations of the business limited to the actual and promised contributions to the business; creditors cannot proceed against the owner's personal assets such as houses and automobiles.[82] An organization possesses the corporate characteristic of limited liability if no member is personally liable for the debts or claims against the organization. Simply put, a creditor cannot proceed against any member's personal assets if the organiza-

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75. *See* Rev. Rul. 88-76, 1988-2 C.B. 360, 361.

76. *See* Rev. Proc. 89-12, 1989-7 I.R.B. 22, § 4.

77. *Id.* §§ 1.02, 4.06. If the designated managers are not members of the LLC, *see infra* note 156 and accompanying text, the LLC will always possess centralized management because the members, as "limited partners" by analogy, will be treated as owning all the interests in the LLC. Rev. Proc. 89-12, 1989-7 I.R.B. 22, §§ 1.02, 4.06.

78. *See* Rev. Proc. 89-12, 1989-7 I.R.B. 22, §§ 1.02, 4.06. If the LLC had no designated managers it would always lack centralized management under the rule of Revenue Procedure 89-12 because the "general partners" would own 100% of the interests. *See id.*

79. *See supra* note 65.

80. *See* Rev. Rul. 88-76, 1988-2 C.B. 360.

81. *See id.* at 361.

82. *See* REVISED MODEL BUSINESS CORP. ACT § 6.22 (1988). Commentators have identified the limited liability feature as the primary business advantage for choosing the corporate form. *See* Berle, *The Theory of Enterprise Entity*, 47 COLUM. L. REV. 343 (1947). *But see infra* text accompanying notes 189-95 (discussing when shareholders may be liable for corporate debts under the doctrine of piercing the corporate veil).

tion's assets are insufficient to satisfy the claim.[83] If an organization is to lack limited liability, at least one member must have unlimited liability for all the organization's debts.[84]

All partners in a general partnership organized under state laws corresponding to the UPA are jointly and severally liable for all claims against the partnership.[85] Consequently, a general partnership organized in a UPA jurisdiction always lacks the corporate characteristic of limited liability.[86] General partners of a limited partnership organized in a RULPA jurisdiction are also jointly and severally liable for all claims against the partnership.[87] The regulations treat a partnership organized under state laws corresponding to the RULPA as lacking the corporate characteristic of limited liability *unless* the general partner is merely a dummy agent for the limited partners and has no substantial assets that the partnership's creditors can reach.[88]

Limited partnerships seeking to minimize the general partner's liability for debts of the partnership often will arrange to have a corporation serve as the general partner. Revenue Procedure 89-12 provides a safe harbor for establishing that a limited partnership with one or more corporate general partners lacks limited liability.[89] The Service automatically will rule that the partnership lacks limited liability if the net worth of the corporate general partners equals at least ten percent of the total contributions to the partnership and is expected to continue at such level throughout the life of the partnership.[90] If the partnership cannot meet that standard, it must demonstrate that

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

84. *Id.*

85. *See id.*; UNIF. PARTNERSHIP ACT §§ 13-15 (1914).

86. *See* Treas. Reg. § 301.7701-2(d) (as amended in 1983).

87. *See* REVISED UNIF. LTD. PARTNERSHIP ACT § 403(b) (1985).

88. Treas. Reg. § 301.7701-2(d)(2) (as amended in 1983). The Tax Court has held that the general partner will be treated as having unlimited liability for the partnerships debts if it *either* has substantial assets *or* it is not a mere dummy agent of the limited partners. Larson v. Commissioner, 66 T.C. 159 (1976), *acq.*, 1979-1 C.B. 1. In *Larson*, the court treated the general partner as having unlimited liability because it was involved substantially in the partnership's business affairs. *Id.* The court specifically noted that, although it was doubtful this general partner had substantial assets, the presence of substantial assets is not necessary if the general partner is not a mere dummy agent. *Id.* at 180-81.

89. *See* Rev. Proc. 89-12, 1989-7 I.R.B. 22, § 4.

90. *Id.* § 4.07. *See also* Gen. Couns. Mem. 39,798 (Oct. 18, 1989) (stating that contributions do not include deemed contributions for a partners share of partnership liabilities under § 752(a) and "net worth" does not include the value of the limited partnership; if the corporation is a general partner in more than one limited partnership, details are provided to prevent double counting of the corporation's assets).

either the general partners collectively have "substantial assets" or the general partners will act independently of the limited partners.[91] Although the language of Revenue Procedure 89-12 is somewhat confusing, failure to meet one of these standards will not result in the denial of a partnership classification ruling if the partnership can show it lacks two of the three remaining corporate characteristics. A limited partnership still can obtain a partnership classification ruling if it possesses the corporate characteristic of limited liability.[92]

Both the Wyoming[93] and Florida acts[94] provide that no member or manager of the LLC is liable for the LLC's debts; creditors can only force members and managers to pay what they have agreed to contribute to the LLC's capital. It is therefore not surprising that the Service found, in Revenue Ruling 88-76, that the Wyoming LLC possessed the corporate characteristic of limited liability.[95]

The Service should always treat an LLC as possessing the corporate characteristic of limited liability, and the tests for determining limited liability set out in Revenue Procedure 89-12 should be irrelevant to an LLC seeking a partnership classification ruling.[96] If members

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91. *Id.* The Service will closely scrutinize the parties' arrangement to determine whether one of these two alternatives are met. *Id.* A recent General Counsel Memorandum states that general partners seeking to prove independence from the limited partners usually must show (1) there is insignificant influence or control by the limited partners; (2) the general partner's contributions are much larger than is required by §§ 4.03 or 4.04 of Rev. Proc. 89-12; (3) the general partner is allocated a much larger profits interest than is required by §§ 4.01 or 4.02 of Rev. Proc. 89-12; and (4) the general partner has "significant" net worth. Gen. Couns. Mem. 39,798 (Oct. 18, 1989).

92. The introduction to § 4 of Revenue Procedure 89-12 provides that a taxpayer must satisfy all conditions of § 4 to obtain a partnership classification ruling. *Id.* § 4 (introduction). It then states that §§ 4.05 and 4.06, relating to continuity of life and centralized management, respectively, refer solely to those characteristics. *Id.* Failure to meet them will not preclude a partnership classification ruling overall. *Id.* Next, it vaguely states that § 4.07 provides a safe harbor generally to limited partnerships with at least one corporate general partner. *Id. See also* Gen. Couns. Mem. 39,798 (Oct. 18, 1989) (Service states that failure to obtain ruling that limited liability is lacking does not preclude a partnership classification ruling if it can be shown that the organization lacks two of the remaining four corporate characteristics). For a discussion of the Service's ruling requirements before the issuance of Rev. Proc. 89-12, see *infra* text accompanying notes 179-81.

93. WYO. STAT. ANN. § 17-15-113 (1977).

94. FLA. STAT. § 608.436 (1987).

95. *See* Rev. Rul. 88-76, 1988-2 C.B. 360, 361. As a matter of state law, LLCs will always possess limited liability. Consequently, for tax purposes, even if the members contractually assume or guarantee every claim incurred by the LLC, the LLC will still possess the corporate characteristic of limited liability. It is impossible to negate the limited liability characteristic.

96. Revenue Procedure 89-12's reference to "general partners" as those with significant management authority relative to other members raises the possibility of applying this test to a corporate manager. *See* Rev. Proc. 89-12, 1989-7 I.R.B. 22, § 1.02.

with significant management rights or designated managers of the LLC are individuals, the standards for determining limited liability in this revenue procedure do not apply.[97] If a member with significant management rights or the designated manager constitute a corporation, the language of this revenue procedure literally allows those persons to meet the net-worth or the independent-action tests and at the same time argue that the LLC lacks limited liability.[98] The Service could not have intended this result when it drafted Revenue Procedure 89-12. Unlike general partners in limited partnerships,[99] state law provides that no member of an LLC has unlimited liability.[100] The Service later clarified Revenue Procedure 89-12 and made the portion dealing with limited liability inapplicable to LLCs, presumably because it makes no sense to apply any version of a limited liability test to LLCs.[101]

D. *Free Transferability of Interests*

The final corporate characteristic discussed in the entity classification regulations is free transferability of interests. For the entity to possess the corporate characteristic of free transferability of interests, substantially all of the owners must have the power to transfer, without the consent of any other owner, *all* attributes of ownership in the organization to a person not a member of the organization.[102] An unlimited right to assign only the interest in profits without a right to participate in management and otherwise exercise full rights of ownership does not constitute free transferability of interests.[103] General partnerships organized in UPA jurisdictions always lack free transferability of interests because no person can become a member of the partnership without the consent of all partners.[104]

The RULPA contemplates the inclusion of transferability restrictions in the limited partnership certificate.[105] Such restrictions can be

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97. Section 4.07 of Rev. Proc. 89-12 only applies if one or more of the "general partners" (the managers, by analogy) are corporations. *See id.*

98. *Id.*

99. General partners always have unlimited liability for state law purposes regardless of how they are treated for tax purposes. *See supra* text accompanying notes 87-88.

100. *See supra* notes 93-94 and accompanying text.

101. *See* Gen. Couns. Mem. 39,798 n.3 (Oct. 18, 1989), which explicitly states that § 4.07 of Rev. Proc. 89-12, the section dealing with obtaining a ruling that limited liability is lacking, does not apply to state law limited liability companies.

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

103. *Id.*

104. *See* UNIF. PARTNERSHIP ACT § 18(g) (1914). The transferor can transfer only the right to share in partnership profits and losses if this consent is not granted. *See id.* § 27(1).

105. *See* REVISED UNIF. LTD. PARTNERSHIP ACT §§ 702, 704(b) (1985).

likened to the power of corporate shareholders to include restrictions on stock transfers in corporate articles or bylaws.[106] Unlike the UPA, the RULPA does not impose restrictions on transferability as a matter of law.[107] If the limited partnership certificate or agreement does not impose restrictions on transferability, the partners are free to transfer all aspects of ownership, including full membership without the consent of any other partner.[108] Revenue Procedure 89-12 does not provide standards for avoiding the corporate characteristic of free transferability of interests for purposes of obtaining a partnership classification ruling.[109]

Limited partnerships trying to negate the existence of free transferability of interests, while still allowing the limited partners maximum freedom to dispose of their interests, often make all transfers of a full interest in the partnership (rather than merely the economic rights to share in partnership profits and losses) subject to the general partner's approval. Under the regulations, the power of the general partner to "veto" any transfer of a complete partnership interest causes the partnership to lack free transferability of interests.[110] The Tax Court has held, however, that if the general partner is prohibited from unreasonably withholding consent, the court will treat the partnership as possessing the corporate characteristic of free transferability of interests if no reason exists for the general partner to block the transfer.[111]

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106. *See* REVISED MODEL BUSINESS CORP. ACT § 6.27 (1985).

107. *See* REVISED UNIF. LTD. PARTNERSHIP ACT §§ 702, 704(b) (1985).

108. *Id.*

109. *See* Rev. Proc. 89-12, 1989-7 I.R.B. § 22.

110. *See* Treas. Reg. § 301.7701-3(b)(2) Ex. 1 (as amended in 1967). As a practical matter, it sometimes makes very little difference to a transferee limited partner if the general partner refuses to consent to the transfer. *See infra* notes 111, 165, 168 and accompanying text. The Service has held that limited partners that possess only the economic rights still report their share of the partnership's income and losses for tax purposes in the same manner as they would had a complete interest been transferred. *See* Rev. Rul. 77-137, 1977-1 C.B. 178.

111. *See* Larson v. Commissioner, 66 T.C. 159, 183 (1976), *acq.*, 1979-1 C.B. 1 (discussed *supra* at notes 65 and 88). Commentators have expressed the view that it is relatively easy for limited partnerships to avoid possessing free transferability of interests by merely allowing the general partner to arbitrarily withhold consent for transfers of all attributes of ownership (not transfers of the economic rights only) in situations where such veto would, as a practical matter, never be invoked. *See* TAXATION OF PARTNERSHIPS, *supra* note 23, ¶ 3.06[4][(d)]. Others have cautioned practitioners not to rely on this technical distinction between the regulations and *Larson* to provide certainty that free transferability does not exist at least when the partnership at issue is a master limited partnership. For a discussion of this issue, see *infra* note 169. *See* R. Turlington & R. Beeson, Master Limited Partnerships: Current Issues, Techniques and Strategies 11 n.21 (Feb. 23, 1987) (unpublished paper). The authors presumably believe that

Both the Wyoming[112] and Florida acts[113] by definition produce an entity that lacks the corporate characteristic of free transferability of interests. Although members have some flexibility to include provisions concerning transferability in the operating agreement, under no circumstances will the transferee have the right to participate in the business affairs or otherwise be a full member in the LLC unless *all* members consent to the transfer.[114]

Revenue Procedure 89-12 contains additional requirements to obtain a partnership classification ruling not directly tied to the four corporate characteristics discussed above. Usually,[115] the general partners must have in the aggregate a one percent or greater interest in all material items of partnership income, gain, loss, deduction, or credit.[116] The Service will tolerate deviation from this one-percent standard under only limited circumstances.[117] The general partners also must *either*: (1) maintain a minimum capital account balance [118] of one percent of all positive capital account balances or $500,000, whichever is less[119] or (2) contribute substantial services where pay-

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the larger and more like a corporation the limited partnership is, the less likely the Service will respect the technical right of the general partner to arbitrarily prevent a full transfer as grounds to hold that the partnership lacks free transferability. This is particularly true with larger transactions such as offerings of master limited partnership interests where the documents will usually imply that there are no restrictions on transferability. These concerns become very compelling when one considers that a limited partner in a large limited partnership who merely possesses the economic rights is in virtually the same position as a limited partner with all attributes of ownership. Both types of limited partners are really mere investors; consequently, only the economic rights are important. *See supra* note 110 and *infra* note 165.

112. WYO. STAT. ANN. § 17-15-122 (1977).

113. FLA. STAT. § 608.432 (1987).

114. *Id.*; WYO. STAT. ANN. § 17-15-122 (1977).

115. In larger limited partnerships, where the total contributions exceed $50 million, the general partners are not required to have a 1% interest in all the partnership's material items. The general partner's interest only is required to equal a percentage, equal to one percent divided by the ratio of total contributions to $50 million. *See* Rev. Proc. 89-12, 1989-7 I.R.B. 22, § 4.02.

116. *Id.* § 4.01.

117. *Id.* Temporary allocations required by §§ 704(b) and 704(c) will justify deviating from the one-percent requirement. The Service will view all other deviations as violations of the requirement unless the limited partnership demonstrates that the general partners have a material interest in net profits and losses over the anticipated life of the partnership. *Id.*

118. For a discussion of the definition of a partner's capital account balance, see *infra* note 309.

119. Rev. Proc. 89-12, 1989-7 I.R.B. 22, § 4.03. Under certain circumstances, general partners must make additional capital contributions when limited partners make additional capital contributions. *Id.*

ment for these services will come from allocations of partnership income rather than guaranteed payments.[120]

Like several other aspects of Revenue Procedure 89-12,[121] the analysis is awkward when one attempts to apply these additional requirements to LLCs. The "general partners" required to meet these standards are presumably the designated managers or those members with significant management rights by virtue of their contributions to the LLC capital.[122] If the designated managers are not members,[123] apparently the LLC cannot obtain a partnership classification ruling.[124] If no designated managers or members with proportionately greater management exist, the Service could interpret this revenue procedure to require each member to meet the additional requirements. Alternatively, the Service could disregard this revenue procedure in its entirety because, by analogy, no "limited partners" exist.[125]

III. OTHER CHARACTERISTICS OF LLCs

A. *Purpose and Registered Offices*

Like most entities, taxpayers can organize LLCs for almost any lawful purpose.[126] The powers of an LLC are very broad.[127] More

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120. *Id.* § 4.04. If the general partners are contributing substantial services they must agree to contribute on termination or dissolution of the partnership the lesser of: any deficit in their capital account or the excess of 1.01% of the total capital contributed by the limited partners over capital previously contributed by the general partners'. *Id.* These extra requirements in Rev. Proc. 89-12 that are not directly tied to one of the four corporate characteristics are presumably to ensure that the general partner has undertaken a minimum participation in the risks and rewards of the business rather than being merely an outside manager.

121. *See supra* notes 54-58, 96-101 and accompanying text.

122. *See* Rev. Proc. 89-12, 1989-7 I.R.B. 22, § 1.02.

123. No prohibition apparently exists forbidding nonmembers from being the designated managers. *See infra* text accompanying note 156.

124. If the manager or "general partner" is not a member, the LLC will not meet the one percent or the capital contribution requirements. *See supra* notes 115-20 and accompanying text.

125. Revenue Procedure 89-12 only applies where liability of any member is limited, and at least one member exists analogous to a "general partner" who possesses significant management authority relative to the other members. *See* Rev. Proc. 89-12, 1989-7 I.R.B. 22, § 4.02.

126. Wyoming LLCs cannot be organized for the purpose of banking or insurance. *See* WYO. STAT. ANN. § 17-15-103 (1977). Florida LLCs cannot be used for businesses where special statutes control that type of business and are in conflict with the LLC provisions. FLA. STAT. § 608.403 (1987).

127. A Wyoming LLC may, for example: (1) sue or be sued in its own name; (2) purchase, lease or otherwise deal with real and personal property; (3) sell, lease, or otherwise dispose of any of its assets or property; (4) lend money to or otherwise assist its members; (5) purchase, mortgage, vote, dispose of, or otherwise deal with any security or interest in another LLC, corporation, or partnership; (6) contract for, guarantee, or incur liabilities or issue its own notes;

importantly, LLCs can do business anywhere.[128] Consequently, venture capitalists and business persons seeking to take advantage of the limited liability feature while having their entity classified as a partnership with absolute certainty can form a Wyoming or Florida LLC and do business anywhere, even if they conduct no business in Wyoming or Florida.[129] However, both Wyoming and Florida require that the LLC maintain a registered office and registered agent in the chosen jurisdiction.[130] The registered agent must be an individual who resides in the state, a domestic corporation, or a foreign corporation qualified to do business in the state.[131] The registered office need not be the same as the LLC's place of business, but such office must be identical to the registered agent's business office.[132] Persons seeking to form an LLC without doing business in Wyoming or Florida would need to find a person in the state, a corporate service company, for example, to serve as its agent and business office, presumably for a fee.

B. *Persons and Contributions*

Two or more persons may form an LLC.[133] In both Wyoming and Florida a person includes virtually any type of entity.[134] Contributions

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(7) elect or appoint managers or agents; (8) become a member of a general or limited partnership, joint venture or any other limited liability company. WYO. STAT. ANN., § 17-15-104 (1977). The powers of Florida LLCs are similarly broad. *See* FLA. STAT. § 608.404 (1987).

128. Wyoming allows an LLC the power to "[c]onduct its business, carry on its operations and have and exercise the powers granted by this act in any state, territory, district or possession of the United States, or in any foreign country . . . ." WYO. STAT. ANN. § 17-15-104(a)(viii) (1977). Similarly, a Florida LLC may "[c]onduct its business, carry on its operations and have offices, and exercise the powers granted by this chapter within or without this state." FLA. STAT. § 608.404(7) (1987).

129. One of the purposes behind the enactment of the Florida Act was to attract foreign investment and encourage businesses to move to Florida. *See* Comment, *supra* note 9, at 387 88 nn.3 & 5, (citing tape recordings of proceedings in the Florida legislature at the time the Florida Act was discussed and passed). One commentary has claimed that the reason for enacting the Wyoming Act was to provide an attractive vehicle for conducting business ventures and real estate transactions all over the United States through Wyoming LLCs. The legislature anticipated that Wyoming would benefit from the revenues of filing fees and business activities to maintain nominal places of business and registered agents in Wyoming, much like the State of Delaware benefits from out-of-state businesses incorporating under its laws. *See* Burke & Sessions, *supra* note 9, at 235.

130. FLA. STAT. § 608.415 (1987); WYO. STAT. ANN. § 17-15-110 (1977).

131. FLA. STAT. § 608.415 (1987); WYO. STAT. ANN. § 17-15-110 (1977).

132. FLA. STAT. § 608.415 (1987); WYO. STAT. ANN. § 17-15-110 (1977).

133. FLA. STAT. § 608.405 (1987); WYO. STAT. ANN. § 17-15-106 (1977). An LLC must have at least two members; no limitations exist on how many members above two. FLA. STAT. § 608.405 (1987); WYO. STAT. ANN. § 17-15-106 (1977).

134. FLA. STAT. §§ 608.402(4); 1.01(3) ("person" includes "individuals, children, firms, associations, joint adventures, partnerships, estates, trusts, business trusts, syndicates, fiduciaries,

to capital of the LCC by a member can only consist of cash or other property. Members cannot contribute services to the LLC for a capital interest.[135] No comparable restriction exists, however, preventing an LLC member from contributing services for an interest in profits.[136] A possible reason for not allowing LLC members to contribute services for a capital interest is to prevent a member from claiming credit in its capital account for services of questionable value or for services the member may not have performed at all.[137]

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corporations, and all other groups or combinations"); WYO. STAT. ANN. § 17-15-102(a)(iv) (1977) ("person" includes "individuals, general partnerships, limited partnerships, limited liability companies, corporations, trusts, business trusts, real estate investments, trusts, estates and other associations").

135. FLA. STAT. § 608.4211 (1987); WYO. STAT. ANN. § 17-15-115 (1977). It is not always clear whether property or services are being contributed. Partners receiving an interest in partnership capital will always argue that they have contributed property rather than services, because of the undesirable tax consequences which result if services are contributed. *See infra* note 137. It may be considered reasonable to rely on the authorities in the partnership area when deciding if an LLC member contributed property or services for an interest in the LLC's capital. *See* United States v. Stafford, 727 F.2d 1043, 1052 (11th Cir. 1984) (letter of intent was property because it was analogous to goodwill which had been always treated as property); Stafford v. United States, 611 F.2d 990, 995-96 n.6 (5th Cir. 1980) (letter of intent held not property because the contract was not binding); United States v. Frazell, 335 F.2d 487, 490 (5th Cir. 1964), *cert. denied*, 380 U.S. 961 (1965) (maps showing where oil could be found held to be property).

136. *See* FLA. STAT. § 608.4211 (1987); WYO. STAT. ANN. § 17-15-115 (1977).

137. Partners, however, are permitted to contribute services to their partnerships in exchange for an interest in partnership capital. *See* UNIF. PARTNERSHIP ACT § 18(a) and REVISED UNIF. LTD. PARTNERSHIP ACT § 501 (containing no language that would prohibit partners from contributing services for an interest in partnership capital). Partners generally do not elect to do so because of the undesirable tax consequences. Section 721 and the regulations will not shield the partner from recognizing gain when services are contributed for a capital interest. Consequently, the service-providing partner will often recognize immediate ordinary income under § 61. *See* Treas. Reg. § 1.721-1(b)(1) (1960). If the partner contributes services and the receipt of the capital interest is contingent or otherwise subject to a substantial risk of forfeiture then the timing of service-providing partner's income will be determined under the rules of § 83. *See* § 83(a) and Treas. Reg. § 1.83-1(a) (1978) (provides generally that a service provider is not taxed on property received for such services until such property is no longer subject to a substantial risk of forfeiture or is freely transferable); *see also* I.R.C. § 351(d)(1) (West Supp. 1989) (nonrecognition rules for contributions to corporations in exchange for the corporation's stock do not apply if services are contributed).

A service-contributing partner is not taxed under §§ 61 and 83 if a mere interest in partnership profits is received. *See* Treas. Reg. § 1.721-1(b)(1) (1960) (parenthetical language suggests that the rule requiring income recognition if services are contributed for a capital interest does not apply if a share in partnership profits is received); Gen. Couns. Mem. 36,346 (July 23, 1975) (suggesting that if, in fact, the interest received is a pure profits interest rather than a hidden interest in partnership capital then the receipt of the profits interest will not be taxable on receipt even if it can be readily valued); *see also* National Oil Co. v. Commissioner, 52 T.C.M.

C. *Division of Profits and Losses*

Both Wyoming and Florida acts explicitly permit the members to divide the LLC's profits and losses any way they see fit.[138] Consequently, these laws allow members of LLCs the same flexibility that partners in partnerships enjoy to allocate income and losses for tax purposes.[139] For example, an LLC could provide in the articles of organization for certain members to contribute major parts of the capital, while other members contribute services for an interest in the LLC's profits. Once the capital contributing members recover their capital, the LLC can allocate a disproportionate share of the profits to the service contributing members.[140]

D. *Other Considerations*

Except for the dissolution provisions,[141] the language in the Wyoming and Florida acts is very similar and substantively produces almost identical entities.[142] Organizing the LLC in Florida versus Wyoming does raise different state tax considerations. Wyoming imposes no state income tax on individuals and apparently does not tax LLCs at the entity level.[143] The Florida Act, however, explicitly taxes Florida LLCs as corporations for state tax purposes and classifies distributions to its members as dividends for state tax purposes.[144]

(CCH) 1223 (1986); Kenroy, Inc. v. Commissioner, 47 T.C.M. (CCH) 1749 (1984); Wheeler v. Commissioner, 37 T.C.M. (CCH) 883 (1978) (language or facts suggest that services contributed for a profits interest will not be taxed on receipt). In Diamond v. Commissioner, 492 F.2d 286 (7th Cir. 1974), however, a partner contributed services allegedly for a profits interest and shortly thereafter sold his partnership interest and recognized substantial gain. *Id.* at 286-87. The court held that the gain was ordinary compensation income from the receipt of the profits interest rather than capital gain from the sale of the partnership interest. *Id.* at 291. While the result in *Diamond* is correct, the reasoning unfortunately causes concern any time a partner contributes services for a profits interest. A holding that the taxpayer in *Diamond*, actually received a hidden capital interest would have produced more consistent law in this area.

138. FLA. STAT. §§ 608.407(j), .423, .426 (1987); WYO. STAT. §§ 17-15-119, 17-15-107(a)(x) (1977).

139. *See infra* notes 273-86, 319-33 and accompanying text (discussing the limitations on special allocations for tax purposes of the partnership's income and losses).

140. *Id.*

141. *See supra* notes 46-53 and accompanying text.

142. *See supra* notes 71-75, 93-95, 112-14, 126-40 and accompanying text.

143. *Cf.* WYO. STAT. ANN. §§ 17-2-101 to -2-104 (1977) (franchise tax imposed on corporations).

144. FLA. STAT. §§ 608.426, .471 (1987). Florida imposes a corporate tax at a rate of 5.5%. *See id.* § 220.11(2). For businesses conducted outside the State of Florida, the state imposes the tax on only the net income apportioned in Florida, (*i.e.*, Florida source income). *See id.* § 220.16. Even if the LLC has no Florida tax because none of its income is apportioned in Florida,

The lack of precedent surrounding LLCs may cause some to hesitate before utilizing them. At least one writer has expressed concern because the law is uncertain as to the circumstances under which members may dissolve an LLC if a particular member wants to withdraw its capital contribution.[145] The extent that a member may bind the LLC and the scope of an outside party's duty to determine that member's authority are also unclear.[146] More importantly, there is some question as to whether all states will respect the LLC's limited liability feature.[147] Courts will refuse to recognize the presumption of comity if the state affirmatively expresses that the LLC is against its public policy.[148] Consequently, business persons considering the use of an LLC should review the laws and decisions of the states where the LLC is doing business to ensure that limited liability for unincorporated associations is not against the public policy of those states.[149] Moreover, the courts have yet to define the extent to which the common law doctrine of piercing the corporate veil will apply to LLCs.[150] Although the LLC is an unincorporated entity, if it proves a viable choice for doing business, courts likely will develop doctrines over time defining the proper circumstances for disregarding the limited liability.

IV. Business Situations in Which Use of an LLC Might be Considered

A. *Situations in Which Benefits of LLC Formation Are More Preceived than Real*

As noted above, an LLC can always be structured to be a partnership for federal income tax purposes because it always lacks continuity of life, free transferability of interests,[151] and, depending on how it is

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it still must file a Florida corporate income tax return. *See id.* § 220.22(1). This could be administratively cumbersome since the LLC will be filing partnership information returns and the Form K-1 for federal income tax purposes. Like Wyoming, Florida has no income tax on natural persons; therefore only corporate members need be concerned about receiving dividends for state tax purposes. *See id.* §§ 608.426, .471.

145. *See* Comment, *supra* note 9, at 398-400.

146. *Id.* at 400-01.

147. *Id.* at 401.

148. *Id.*

149. *Id.* at 401-02.

150. For a discussion of the doctrine of piercing the corporate veil, see *infra* text accompanying notes 190-97.

151. *See supra* text accompanying notes 45-49, 112-14. *But cf. supra* notes 50-53 (discussing when Florida LLCs may be viewed as possessing continuity of life).

structured, centralized management.[152] The Service also treats general partnerships organized in UPA jurisdictions as partnerships as the classic general partnership lacks all four of the characteristics indigenous to corporations alone.[153] Initially, the LLC may appear to provide a more flexible form to conduct a business or venture when a general partnership would traditionally be chosen. Unlike a general partnership, the members of an LLC always have limited liability unless, as a business matter, they agree to expose themselves to unlimited liability with respect to certain debts by either assuming or guaranteeing these obligations.[154] Moreover, LLCs offer more flexible alternatives managing the business. General partners by law have equal management rights,[155] while LLC members can vest management rights in a select few. Moreover, the Wyoming and Florida acts do not appear to require those select few to be members of the LLC.[156]

The perceived benefits of an LLC over a general partnership diminish when one considers that general partners always have been able to obtain limited liability and centralized management in substance. General partners who are natural persons need only set up a wholly-owned S corporation and have the S corporation be the partner. Under the rules described in Subchapter S, the partnership's tax items will flow first to the S corporation and then to the ultimate partner. Only the S corporation, however, will have unlimited liability for the partnership's debts.[157] Corporate partners can be insulated from the

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152. *See supra* text accompanying notes 71-81. A Florida LLC that could be viewed as possessing continuity of life should be structured to lack centralized management.

153. *See supra* notes 32, 64, 85, 104 and accompanying text.

154. *See infra* notes 247, 287 and accompanying text.

155. *See supra* note 64 and accompanying text.

156. *But see supra* text accompanying notes 121-25 (indicating Revenue Procedure 89-12 may preclude a classification ruling if the manager is not a member). Both the Wyoming and Florida acts explicitly provide that management may be vested in the person or persons that have been elected by the members pursuant to the LLC's operating agreement. Such elections must be held annually. FLA. STAT. § 608.422 (1987); WYO. STAT. ANN. § 17-15-116 (1977). If only members were intended to be managers it seems that the statutes would either so provide or refer to the "managers" as members that have been elected to manage the LLC. *See also* FLA. STAT. § 608.422 (1987) (providing for the election of managers by the LLC's articles of organization, as opposed to vesting management in the members by law); WYO. STAT. ANN. § 17-15-113 (1977); FLA. STAT. § 608.436 (1987) (providing that "[n]either the members . . . nor the managers" have unlimited liability for claims against the LLC). The fact that the statutes explicitly provide for managers implies that there can be managers that are not members of LLC. Under the facts of Rev. Rul. 88-76, however, the designated managers were members. *See* Rev. Rul. 88-76, 1988-2 C.B. 360, 360.

157. *See infra* text accompanying notes 211-44 (discussing S corporations). Partners seeking to insulate liability by interposing a corporation must consider the common law doctrine of piercing the corporate veil. *See infra* text accompanying notes 189-95. The threat of having the

partnership's liabilities by interposing a wholly-owned special purpose subsidiary between it and the partnership. The subsidiary's losses or income, which flow through from the partnership, can be used to offset the corporate partner's income or losses by the filing of a consolidated return with the subsidiary.[158] Moreover, general partners are free to contract among themselves concerning management of the partnership.[159] These agreements are ineffective, however, against outsiders without notice.[160] LLCs are probably better viewed as a less complicated alternative[161] to general partnerships in circumstances in which parties desire features of limited liability or centralized management.

B. *Situations in Which an LLC Should Not Be Chosen*

The LLC should never be chosen for ventures traditionally conducted in large limited partnerships in which the business includes many limited partners that do not meet or communicate regularly and in some cases are unaware of each other's identity. In such situations, the limited partners usually will require as much freedom as possible to dispose of their interests in the partnership. LLCs require consent of all members before a member may transfer all the attributes of

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corporate shield disregarded is not likely to be as great in the context of a general partnership, as opposed to a limited partnership, for several reasons. Disregarding the corporate entity is equitable in nature and varies depending on the circumstances of each case. *See* Hackney & Benson, *Shareholder Liability for Inadequate Capital*, 43 U. PITT. L. REV. 837, 844 (1982). Consequently, the use of the corporate form to insulate liability among general partners when all of them are jointly and severally liable often will not be as great an abuse of the corporate entity as using a corporation to insulate the only general partner in a limited partnership. Moreover, the general partners in the aggregate are more likely to produce an adequately capitalized pool of resources for the creditors to proceed against than a sole corporate general partner in a limited partnership. *Id.* at 885.

158. *See* Treas. Reg. §§ 1.1502-11, -21 (as amended in 1980). The possibility of special purpose subsidiaries, used to insulate corporate partners from partnership liabilities, being disregarded should also not be as risky when used in the general partnership context. *See supra* note 157. It has been noted, however, that courts are more willing to disregard the separate corporateness of a subsidiary, particularly when the parent and the subsidiary are viewed as having one enterprise. *See* Berle, *supra* note 82, at 350; *see also* Easterbrook & Fishel, *Limited Liability and the Corporation*, 52 U. CHI. L. REV. 89, 99 (1985). Corporate partners in a general partnership using a special purpose subsidiary should be especially careful to keep the subsidiary's business of being a partner separated from the parent. The parent also might consider capitalizing the subsidiary more generously than the individual counterpart seeking the same goals by using an S corporation. *See* Hackney & Benson, *supra* note 157, at 866.

159. UNIF. PARTNERSHIP ACT §§ 9, 18(e) (1914); *see supra* note 64 and accompanying text; Treas. Reg. § 301.7701 2(c)(4) (as amended in 1983).

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

161. *But see supra* text accompanying notes 145-50 (discussing certain corporate problems with LLCs).

membership in the LLC.[162] Partners can structure a limited partnership, however, with no restrictions on transferability and still retain partnership status, provided the entity lacks two of the three remaining corporate characteristics.[163]

One should note that an LLC's articles can provide that economic rights, as distinguished from all the attributes of membership, are transferable without any consent.[164] At the same time, limited partnerships can lack free transferability of interests without imposing any limitations on transfers of the economic rights merely by providing that transfers of all attributes of ownership are subject to the arbitrary veto of the general partner.[165]

When the business involves multiple owners desiring to freely transfer interests, the right to freely transfer economic rights of LLC ownership should not encourage use of the LLC form for at least two practical reasons. First, the limited partners may want the flexibility of freely transferring all rights of ownership. With an LLC such freedom is impossible.[166] In contrast, in a limited partnership, partners directly can allow this right by omitting restrictions on transferability from the partnership certificate or agreement.[167] More importantly, in situations where many owners exist and the right to freely dispose of the interests is crucial to the business deal, counsel may be uncomfortable relying on an entity technically lacking free transferability if this characteristic is essential to securing partnership status.[168] Tra-

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162. *See supra* text accompanying notes 112-14.

163. *See supra* text accompanying notes 24-26.

164. *See supra* text accompanying notes 112-14.

165. *See supra* note 110. In larger limited partnerships, the limited partners are usually passive investors. Consequently, merely imposing limitations on transfers of all attributes of ownership, while allowing free transferability of the economic rights, will not likely produce a sound argument that free transferability is lacking in substance. The economic rights in the partnership confer partner status for tax purposes and limited partners investing in large limited partnerships will not care about receiving the management rights associated with full membership. *Id.*

166. *See supra* text accompanying note 114.

167. *See supra* text accompanying notes 105-08.

168. In a larger transaction with many members that are essentially investors, the LLC would have to appoint a designated manager who typically would own a small percentage of the LLC, thus causing the LLC to possess centralized management. Because the LLC would also possess limited liability, it would have to lack free transferability of interests to ensure partnership status. Under the facts of the Rev. Rul. 88-76, the Wyoming LLC had twenty-five members and three of those members were the designated managers. *See* Rev. Rul. 88-76, 1988-2 C.B. 360, 360. Although there were no restrictions in the LLC's articles on the transfer of the economic rights in the LLC, a transferee could not be a full member in the LLC without the consent of all members. This LLC was held to be a partnership because it lacked continuity of life and free transferability of interests. *Id.* at 361. Arguably, different considerations would

ditionally, such entities have ensured their status as partnerships by establishing that they lack continuity of life and limited liability.[169]

C. *The LLC as an Attractive Alternative in Select Business Situations*

Business planners may view the LLC as an attractive alternative[170] to small, limited partnerships in some circumstances. The LLC particularly suits potential partners that do not need the ability to freely transfer all attributes of ownership. With such LLCs, transferability restrictions on transfers of all attributes of ownership can be included

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arise if an LLC had significantly more than twenty-five members and was managed by a member with a small interest or by a manager that was not a member. Under this fact pattern, the members could be viewed more as passive investors, much like limited partners in larger limited partnerships. *See supra* notes 110, 165. Consequently, the right to freely transfer the economic rights in the LLC could be substantively viewed as free transferability of interests. Therefore, if the LLC has significantly more than twenty-five members and the absence of free transferability is essential to partnership status, Rev. Rul. 88-76 may not provide adequate assurance of partnership status.

169. *See supra* note 111 and accompanying text. Congress illustrated its hostility toward freely traded partnership interests by its statutory treatment of "publicly traded partnerships," (often referred to as master limited partnerships), as corporations, notwithstanding their lacking two (usually continuity of life and limited liability) of the four corporate characteristics. *See* I.R.C. § 7704 (West Supp. 1989). Partnerships are treated as publicly traded if the interests are traded on an established securities market, or are readily tradeable on a secondary market (or the substantial equivalent). *Id.* § 7704(b). See the Conference Committee Report on the Revenue Act of 1987 for details on when the free transferability of partnership interests rises to public trading. H.R. CONF. REP. NO. 100-495, 100th Cong., 1st Sess. 943-53, *reprinted in* 1987 U.S. CODE CONG. & ADMIN. NEWS 2313-45, 2313-1689 to -1699. Certain publicly traded partnerships are permitted to retain their status as partnerships if they otherwise lack two of the four corporate characteristics. These are partnerships in which 90% or more of gross income is "qualifying income." I.R.C. § 7704(c)(2) (West Supp. 1989). Qualifying income generally consists of interest, dividends, rents on real property, gains from disposing of real property, income from certain natural resource ventures, and gains from dealing in commodities, futures, options or forward contracts where the partnership's principal activity is buying and selling those items. *Id.* § 7704(d)(1). Given the obvious hostility toward publicly traded partnerships, counsel representing large partnerships, with interests that are freely transferable in substance but which are not treated as publicly traded under § 7704, will not rely on the partnership technically lacking free transferability of interests to ensure partnership status. Instead, they will insist that the partnership lacks continuity of life and limited liability. Although it is no longer necessary for the corporate general partner to have a minimum net worth, *see* Rev. Proc. 89-12, 1989-7 I.R.B. 22, § 4.07, as a business matter, the corporate general partner is likely to have net worth which could be viewed as substantial and is likely to contribute capital which could be viewed as significant. Limited partners are simply more likely to invest if the general partner is perceived as risking some of its own money.

170. *But see supra* text accompanying notes 145-50 (discussing problems associated with LLCs).

and still result in meaningful consequences even when there are no restrictions on transfering the economic rights of membership. Because of these restrictions, the LLC will always substantively lack free transferability of interests and can therefore always be structured to avoid corporate classification.[171] Ventures that can benefit from such an arrangement include high-risk real estate and natural resource ventures that may be heavily leveraged with a limited number of participants.[172] Before the Service issued Revenue Ruling 88-76, the Subchapter S Corporation was the only form that offered such ventures both limited liability for all members and the flowthrough of taxable income and losses to the owners, without a separate tax to the entity.[173] For these business arrangements, the LLC offers the following: the certainty of partnership status[174] without the problems associated with the general partner seeking to mitigate its unlimited liability; flexibility in managing the business without jeopardizing any member's limited liability status;[175] and the feature of limited liability for all members for state law purposes without the limitations under Subchapter S.[176]

As noted previously, limited partnerships formed to conduct high-risk ventures ordinarily will have a corporation serve as the general partner in an attempt to minimize exposure to the risks of the business.[177] Sometimes the shareholders of the general partner are also limited partners;[178] other times the shareholders are unrelated to the

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171. *See supra* notes 166-69 and accompanying text.

172. *See* F. BURKE & A. BOWHAY, FEDERAL INCOME TAXATION OF NATURAL RESOURCES ¶ 9.24; Burke & Meyer, *Federal Income Tax Classification of Natural Resource Ventures: Co-Ownership, Partnership, or Association?*, 37 Sw. L.J. 859, 860, 887-89 (1984); Burke & Sessions, *supra* note 9, at 235; Seemann, *supra* note 53, at 536-37. Ownership interests in these types of deals will usually not be readily tradeable. Consequently, the ability to freely dispose of one's interest, as a business matter, is not as an important factor as in larger ventures. *See supra* notes 166-69 and accompanying text. Moreover, an ability to only dispose of the economic interest without consent of all members will cause the entity to lack free transferability of interests because in this context full membership has some meaning even if there is centralized management. *See supra* notes 71-74 and accompanying text. The new member will probably want to vote on the management.

173. *See infra* notes 211-44 and accompanying text which discusses S corporations. Because of their restrictions, these deals normally were not conducted through S corporations.

174. *See infra* text accompanying notes 46-53, 112-14. Florida LLCs should either avoid stating a right to continue in the articles while mitigating an unexpected dissolution through contractual measures, or be structured so that centralized management does not exist. *See supra* text accompanying notes 50-53, 71-75.

175. *See infra* notes 198-201 and accompanying text.

176. *See infra* text accompanying notes 211-44.

177. *See supra* text accompanying notes 89-92.

178. *See* MCA v. United States, 685 F.2d 1099 (9th Cir. 1982) (limited partners and general partner can be affiliated and still have a valid limited partnership).

limited partners. The Service will not rule that a limited partnership lacks limited liability unless the partnership meets certain guidelines with respect to the corporate general partner.[179] These guidelines eliminate the prior requirement that the general partner have a minimum net worth.[180] As noted above, however, the corporate general partner still must prove that it is a genuine partner for tax purposes by receiving at least one percent of every partnership item and by contributing certain amounts of cash, property or substantial services to the partnership.[181]

At times, meeting these guidelines may be impossible or undesirable under the terms of the business agreement. While failure to meet the guidelines does not preclude the entity from ultimately being treated as a partnership,[182] the LLC offers more certainty of partnership status[183] and avoids concern as to how far one may deviate from these guidelines.[184]

Regardless of how a limited partnership obtains classification as a partnership for tax purposes, state law still requires that at least one general partner have unlimited liability for all claims against the partnership.[185] A corporate general partner will not always insulate the shareholders from unlimited liability for the partnership's debts. In certain situations, courts have held officers, directors, and shareholders of a sole corporate general partner liable as general partners on the grounds that the corporation was a mere shell through which the limited partners exercised control over the partnership.[186]

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179. *See* Rev. Proc. 89-12, 1989-7 I.R.B. 22, § 4.01 to .04, 4.07.

180. The Service formerly required (as a condition to a partnership classification ruling) that the sole corporate general partner have a net worth equal to at least 10% or 15% (depending on the size of the partnership) of the total capital contributed to the partnership. *See* Rev. Proc. 72-13, 1972-1 C.B. 735, § 2.01. Limited partners could not own more than 20% of the general partner's stock. *Id.* § 2.02.

181. *See supra* text accompanying notes 115-20.

182. These guidelines are for ruling purposes only. *See* Rev. Proc. 89-12, 1989-7 I.R.B. 22, § 1.03.

183. *See supra* notes 45-53, 111-14 and accompanying text.

184. *Id.*

185. REVISED UNIF. LTD. PARTNERSHIP ACT, § 403 (1985).

186. *See* Delaney v. Fidelity Lease Ltd., 526 S.W.2d 543 (Tex. 1975) (corporation was a mere fiction because its sole purpose was to manage and control limited partnership); *cf.* Frigidaire Sales Corp. v. Union Properties, Inc., 88 Wash. 2d 400, 562 P.2d 244 (Wash. 1977) (because creditors relied on the corporate partner as the party with general liability, limited partners who were also officers, directors, or shareholders were not personally liable). For a further discussion of when officers, directors, and shareholders of a sole corporate general partner have been held personally liable as general partners, see Feld, *The Control Test For Limited Partnerships*, 82 HARV. L. REV. 1471 (1968); Note, *Liability of a Limited Partner Who is an Officer, Director and Shareholder of a Corporate Sole General Partner*, 31 OKLA. L. REV. 997 (1978).

The danger of courts holding such persons personally liable for the partnership's debts solely because they control the partnership through the corporate general partner is somewhat diminished under the 1985 amendments of RULPA.[187] Those amendments only expose a limited partner who controls the partnership to unlimited liability to the extent that creditors mistakenly relied on that limited partner having the status of a general partner.[188] When such control is coupled with other factors, however, a court could be more willing to disregard the corporate entity under the common law doctrine of piercing the corporate veil.[189]

A court potentially can disregard any corporation if sufficient assets do not exist to pay corporate liabilities. A complete discussion of all details considered in the doctrine of piercing the corporate veil is beyond the scope of this article. Only the salient points relevant to sole corporate general partners in limited partnerships will be discussed here. Commentators have noted the difficulty in predicting when courts will pierce the corporate veil and hold shareholders liable for creditors' claims.[190] Inadequate capitalization seems to be one of the most important factors courts consider when deciding whether to impose liability on shareholders for corporate obligations.[191] Normally, inadequate capitalization itself will not be enough to disregard the corporation.[192] Other objective factors indicating misuse of the corporate form usually must exist, including mismanagement, comingling of assets, explicit or implied financial misrepresentation, failure to maintain records or corporate formalities, and direct intervention or participation by the controlling shareholder in the management of the corporation.[193] Finally, courts are more likely to pierce the corporate veil when the creditor is an "involuntary creditor" such as a tort victim or a contract claimant with little or no bargaining power, or when the

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187. REVISED UNIF. LTD. PARTNERSHIP ACT § 303 (1985).

188. *See id.*

189. *See infra* text accompanying notes 190-97.

190. "Like lightning, it is rare, severe, and unprincipled." *See* Easterbrook & Fischel, *supra* note 158, at 106. *See generally* Hamilton, *The Corporate Entity*, 49 TEX. L. REV. 979 (1971); Stone, *The Place of Enterprise Liability in the Control of Corporate Conduct*, 90 YALE L.J. 1 (1980).

191. *See* Hackney & Benson, *supra* note 157, at 859.

192. *See id.* at 859-60. The definition of what is adequate capital is very obscure. Courts generally consider the corporation's business. *See id.* at 891-94. Presumably, corporate general partners of limited partnerships engaging in risky businesses would be required to be more generously capitalized.

193. *Id.* at 850-51.

corporation is a subsidiary of another solvent corporation, than in other situations.[194]

While all corporations risk the possibility that a court will disregard the corporate entity, a sole corporate general partner with insufficient capital is especially vulnerable, particularly when the corporate shareholders really are managing the limited partnership.[195] Moreover, unlike the traditional corporation, limited partnerships formed under state law are supposed to provide creditors with at least one general partner who has unlimited liability.[196] The arrangement looks particularly abusive when the only partner with unlimited liability is a corporation with few assets, especially when the controlling shareholders are running the partnership.[197] Consequently, participants should be careful to ensure that the sole corporate general partner is adequately capitalized. In other words, investors should place some amount of capital other than the contributions to the partnership at risk in the business.

One could view an LLC as a more attractive alternative[198] because for state law purposes no member has personal liability for the company's debts, yet the LLC still has all the advantages of partnerships for tax purposes.[199] The LLC allows members more flexibility in structuring the unlimited liability features than exists with the smaller limited partnerships. If certain creditors insisted on unlimited liability to secure their claims, designated members could assume or guarantee those debts.[200] This preserves the unlimited liability feature for all members as to all other claims. Under the LLC form, there would be no need to have any member exposed to unlimited liability for unexpected claims such as damages in tort actions.[201]

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194. *See* Berle, *supra* note 82, at 350; Easterbrook & Fischel, *supra* note 158, at 99-100; Hackney & Benson, *supra* note 157, at 864-69.

195. *See* Hackney & Benson, *supra* note 157, at 864 n.122 (citing *In re* First Nat'l Bank, 23 F. Supp. 255 (E.D. Ill. 1938) (court disregarded corporation with inadequate capital when the sole shareholder dominated the affairs of the business)).

196. *See* REVISED UNIF. LTD. PARTNERSHIP ACT §§ 101(7), 403 (1985).

197. However, this concern is present regardless of whether or not the controlling shareholders who are running the partnership are also limited partners. The case for piercing the corporate veil seemingly is stronger if they are limited partners.

198. An LLC is likely over time to be subject to some form of the doctrine of piercing the corporate veil. Unlike the limited partnership, however, the LLC is not structured so that creditors can expect any member to have unlimited liability. Consequently, the abuses concerning limited partnerships are not present with LLCs. *See supra* text accompanying notes 194-95.

199. *See* Rev. Rul. 88-76, 1988-2 C.B. 360.

200. For a discussion of the effect this would have on the operating provisions of Subchapter K, see *infra* text accompanying notes 287-333.

201. *But see supra* text accompanying note 150.

Moreover, the LLC form offers more flexibility to the members in managing the business than the smaller limited partnership. With a limited partnership, the power to control the partnership's business is vested in the general partner.[202] Regardless of whether an LLC or limited partnership is chosen, the participants often desire a central manager and at the same time, flexibility to participate in certain aspects of the business. As noted, LLCs are free either to allow members full and equal management rights or to vest management in a select group.[203] Either way, each member's limited liability is unaffected.[204] Limited partners, however, have to distance themselves from the partnership's business affairs, or courts will not respect their limited liability status.[205]

LLCs also provide a useful mechanism for Subchapter S Corporations to segregate different aspects or branches of its business for limited liability purposes while still maintaining control.[206] S corporations are not permitted to be members of an affiliated group.[207] Consequently, an S corporation that owns a number of separate divisions or operates its business at a number of different locations cannot segregate each division in a wholly-owned subsidiary.[208] An LLC, however, is not a corporation.[209] Therefore, an S corporation could segregate each division or location in a different LLC, owning almost all of the interests[210] in each while avoiding membership in an affiliated group.

In situations where the LLC offers a viable choice over a partnership, it offers even clearer advantages over an S corporation. Congress designed Subchapter S to create an entity that serves as a tax conduit

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202. *See* REVISED UNIF. LTD. PARTNERSHIP ACT § 403 (1985).

203. *See supra* text accompanying notes 71-75.

204. *Id.* Moreover, there is nothing in the Florida or Wyoming acts that would expose a member not designated as a manager to unlimited liability for participating in the business. FLA. STAT. § 608.436 (1987); WYO. STAT. § 17-15-113 (1977).

205. *See supra* note 69 and accompanying text.

206. *But see supra* text accompanying notes 190-97 (discussing the possibility of piercing the corporate veil).

207. *See* I.R.C. § 1361(b)(2)(A) (1986). An affiliated group is defined as a chain of corporations where the common parent owns at least 80% of the vote and value of the stock of at least one subsidiary. *See id.* § 1504(a). In other words, an S corporation cannot own 80% or more of another corporation's stock.

208. *See supra* note 207 and accompanying text.

209. *See* Rev. Rul. 88-76, 1988-2 C.B. 360.

210. *See id.* Because LLCs require two or more members, the S corporation will have to find another person, presumably one of its officers or shareholders, to serve as a nominal member of the LLC.

for small businesses, similar to a partnership, while allowing the owners to enjoy the corporate characteristic of limited liability.[211] A purported purpose behind the Subchapter S Revision Act of 1982 was to more closely align the treatment of S corporations and partnerships.[212] Numerous commentators have discussed the differences between S corporations and partnerships, concluding that in most instances the partnership is the superior form.[213] An examination of every significant difference between the S corporation and partnership forms is beyond the scope of this article.[214] This section focuses on the differences between Subchapter K and Subchapter S that are most important to transactions in which an LLC may prove to be a superior alternative over the small limited partnership: high-risk, leveraged real estate or natural resource ventures.

In some respects the rules of Subchapter S and Subchapter K are very similar. Under both, undistributed income as well as losses flow through from the entity, retaining the character, and are reported by the owners.[215] The Code only permits the owners to deduct losses flowing through to the extent of their basis in the entity.[216] The owners do not pay tax again when receiving distributions attributable to taxable income that flowed through from the entity. Such income originally increased their basis; the distribution will then cause a decrease in basis.[217]

Eligibility restrictions that burden S corporations do not apply to LLCs governed by Subchapter K. An S corporation can have no more

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211. *See* Kaplan & Ritter, *Partnerships and S Corporations: Has the Tax Gap Been Bridged?*, 1 J. PARTNERSHIP TAX'N 3 n.1 (1984). *But see supra* text accompanying notes 190-97.

212. *See* Eustice, *Subchapter S Corporations and Partnerships: A Search for the Pass Through Paradigm (Some Preliminary Proposals)*, 39 TAX L. REV. 345, 346 (1984).

213. *See* August & Silow, *S Corporation vs. Partnership for Real Estate Ventures*, 1 J. TAX'N INVESTMENTS 91 (1983); Kaplan & Ritter, *supra* note 211; Liveson, *Partnership vs. S Corporations: A Comparative Analysis in Light of Legislative Developments*, 5 J. PARTNERSHIP TAX'N 142 (1989); Massoglia & Choate, *Using an S Corporation for Oil and Gas Operations: More Flexible but Still Restrictive*, 59 J. TAX'N 102 (1983); Mullaney & Blau, *An Analytic Comparison of Partnerships and S Corporations as Vehicles for Leveraged Investments*, 59 J. TAX'N 142 (1983).

214. For a particularly exhaustive analysis as well as an extensive policy discussion with suggestions for change, see Eustice, *supra* note 212.

215. *See* I.R.C. § 702 (1986); I.R.C. § 1366 (West Supp. 1989).

216. *See* I.R.C. § 704(d) (1986); I.R.C. §1366(a)(1) (West Supp. 1989). *But see infra* note 250 which describes other limitations on the deductibility of losses flowing through from a pass-through entity.

217. *See* I.R.C. §§ 705, 1367 (1986).

than thirty five shareholders.[218] Moreover, only United States citizens, resident aliens, and certain trusts can be shareholders.[219] In contrast, virtually all types of persons, including partnerships and corporations, are eligible for LLC membership.[220] Corporations must make an affirmative election, with the consent of all shareholders, to secure Subchapter S status.[221] The rules of Subchapter K automatically apply if the LLC lacks two of the four corporate characteristics.[222]

The Code only allows S corporations to have one class of stock.[223] This limitation effectively prohibits shareholders of S corporations from making special allocations of the corporation's income and losses, a privilege highly regarded by partnerships and now LLCs.[224] The single class of stock requirement can cause concern when the S corporation issues debt and other instruments such as warrants and options to outsiders. If the Service treats these outsiders as shareholders, the Subchapter S election may terminate.[225]

Probably the most important advantage of Subchapter K over Subchapter S is Subchapter K's treatment of the entity's liabilities for basis purposes.[226] Under the rules of Subchapter K, an LLC member's basis in its interest will increase for its share of the LLC's liabilities.[227]

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218. *See* I.R.C. § 1361(b)(1)(a) (West Supp. 1989).

219. *See id.* § 1361(b)(1). Restrictive buy/sell agreements are necessary to make sure the Subchapter S election is not terminated by the sale of the stock to an ineligible shareholder.

220. *See supra* note 134 and accompanying text.

221. *See* I.R.C. § 1362 (1986). Commentators have different opinions concerning the desirability of the election requirement for S corporations. *Compare* Eustice, *supra* note 212, at 368 (affirmative election presents opportunity for taxpayer blunders) *with* August & Silow, *supra* note 213, at 116 (election procedure provides more certainty that entity will get conduit treatment). For details concerning the Subchapter S election, see I.R.C. § 1362 (West Supp. 1989); Temp. Treas. Reg. §§ 1.1362-1 to -2, *reprinted in* 8 FED. TAXES (P-H) ¶ 33,366 to -66-E.

222. An LLC presumably would become taxable under the partnership rules as soon as it filed its articles with the Secretary of State.

223. *See* I.R.C. § 1361(b)(1)(D) (West Supp. 1989).

224. *See* August & Silow, *supra* note 213, at 110; Eustice, *supra* note 212, at 395; Kaplan & Ritter, *supra* note 211, at 16; Liveson, *supra* note 213, at 149.

225. *See* I.R.C. § 1362(d)(2)(A) (West Supp. 1989). Although the straight debt safe harbor, *see id.* § 1361(c)(5), provides some certainty that certain debt will not be treated as stock, this concern still arises if the safe harbor cannot be met. For example, the corporation may issue the debt to a creditor that could not be a shareholder in an S corporation. *See* Eustice & Kuntz, *Federal Income Taxation of S Corporations* ¶ 3.07[3](b) (1985). Although warrants and options are generally not treated as stock for Subchapter S purposes, arguably, they could be treated as stock if sufficient certainty of exercise exists. *See* Bravenec, *Federal Taxation of S Corporations and Shareholders* ¶ 7.3.4.5 (1988).

226. *See* August & Silow, *supra* note 213, at 119; Eustice, *supra* note 212, at 397; Kaplan & Ritter, *supra* note 211, at 15; Liveson, *supra* note 213, at 145-46.

227. *See* I.R.C. § 752(a) (1986). For a detailed discussion of how debt is allocated for basis purposes, see *infra* text accompanying notes 257-71, 288-305.

Shareholders of S corporations receive no comparable basis increase for the corporation's debts unless the shareholder is the lender.[228] Consequently, LLC members have an opportunity to deduct losses attributable to borrowed funds.[229] For years, this feature alone caused many venturers to operate as a partnership rather than an S corporation.[230]

Subchapter K provides a mechanism, unavailable in Subchapter S, for adjusting the basis of partnership assets if a partnership interest is sold, exchanged, or passed by inheritance.[231] If a section 754 election[232] is in effect, a transferee partner acquiring an interest in a partnership with appreciated assets will receive a positive basis adjustment in the partnership's assets equal to the amount paid for the partnership interest minus the transferor partner's share of the partnership's asset basis.[233] This election usually prevents an incoming partner from later having to recognize taxable gain due to appreciation that occurred before it became a partner.[234] This feature can be very important in preserving the value of a partnership interest where the assets are expected to appreciate or at least decline in value more slowly than the depreciation rate for tax purposes.[235]

Subchapter K contains another mechanism, not present in Subchapter S which ensures that built-in gain or loss in contributed property is allocated back to the contributing partner.[236] Section 704(c) of the Code requires that allocations of the partnership's items of income, gain, loss, and deduction attributable to contributed property take into account the variation between the partnership's basis in the property and its fair market value at the time of contribution.[237] The concepts embodied in section 704(c) can best be illustrated by a simple

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228. *See* I.R.C. § 1367(b)(2) (1986).

229. *See infra* text accompanying notes 257-87.

230. *See supra* note 213 and accompanying text.

231. *See* I.R.C. § 743(b) (1986).

232. Adjustments to the basis of assets inside the partnership will also result if a distribution to a partner results in recognized gain or loss or the partner receives a higher or lower basis in the asset that the partnership had. *See id.* § 734(b).

233. *See id.* § 743(b). If the assets inside the partnership have declined in value, the partner's share of the partnership's inside basis will decrease by the transferor's share of the partnership's inside basis minus the amount paid for the partnership interest; *see also id.* § 755 (code section and regulations promulgated thereunder explain how to apportion the basis increase or decrease among the partnership's assets).

234. *Id.* § 743(b).

235. *See* Liveson, *supra* note 213, at 151.

236. *See* I.R.C. § 704(c) (1986).

237. *Id.*

example: Assume that one person contributes cash of $100 and the other contributes an asset worth $100 with a $50 basis, and each owns one half of the entity. If later the asset was sold for $100, an S corporation would have to allocate $25 of gain to each person.[238] This allocation would force the cash contributor to recognize gain from appreciation that accrued before the venture was formed. Section 704(c) requires a partnership to allocate all $50 of the gain to the partner who contributed the property.[239] Unlike the allocation provisions in Subchapter S, section 704(c) ensure that distortions[240] like this do not occur in partnerships.

Finally, in the context of high-risk real estate or natural resource ventures, certain participants may only want to contribute services in exchange for a larger share of the profits later, when the deal becomes profitable. As already noted, Subchapter K will allow an LLC to make special allocations reflecting this business arrangement as long as the allocations have substantial economic effect.[241] All items of the S corporation's income, gains, losses, and deductions, however, must be allocated pro rata, based on stock ownership, to each shareholder at the end of the S corporation's taxable year.[242] In other words, the S corporation cannot allocate a larger share of the profits to one shareholder at a specified time if such allocation does not represent that shareholder's pro rata share of the profits. Moreover, with an S corporation, shareholders may not contribute services for stock without recognizing immediate gain.[243] The rules of Subchapter K, however, permit LLC members to contribute services for an interest in profits without recognizing income until the entity actually earns profits.[244]

V. THE EFFECT OF THE LLC FORM ON THE OPERATING RULES OF SUBCHAPTER K

As noted above, LLCs can be structured to qualify as partnerships for federal income tax purposes.[245] With partnerships, state law re-

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238. I.R.C. § 1366 (West Supp. 1989).

239. I.R.C. § 704(c) (1986).

240. *But see* Treas. Reg. § 1.704-1(c)(2) (as amended in 1987) (limiting the total amount of gain or loss that can be allocated to any partner equal to the amount of gain or loss realized by the partnership). To the extent this "ceiling rule" applies, § 704(c) will not cure the distortions.

241. *See supra* text accompanying notes 138-40; *infra* text accompanying notes 306-20.

242. *See* I.R.C. § 1366 (West Supp. 1989).

243. *See* I.R.C. § 351(d) (West Supp. 1989) (applying to corporations generally).

244. *See supra* text accompanying notes 135-40.

245. *But see supra* text accompanying notes 50-53 (discussing the right to continue business option available to Florida LLCs).

quires that at least one partner have unlimited liability for all claims against the partnership.[246] With LLCs, however, no member has unlimited liability for any of the LLC's debt, unless a member specifically agrees to assume or guarantee specific debts.[247] In this respect, an LLC resembles a limited partnership that has no general partner. The absolute limited liability granted to all members of an LLC directly affects certain rules in Subchapter K — specifically, the provisions allowing members to share the LLC's debt for purposes of increasing the basis of each member's[248] interest in the entity and the rules governing how the LLC's losses and deductions can be allocated to the members.

The adjusted basis of a partner's interest in a partnership, also referred to as the partner's "outside basis," is important for a number of reasons.[249] As noted, a partner may only deduct allocations of the partnership's losses and deductions against other income to the extent that such partner has enough outside basis at the end of the partnership's taxable year to absorb the loss flowing out.[250] If the partner's

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246. *See supra* text accompanying notes 85-88.

247. An "assumption" occurs when someone agrees to replace the original borrower and consequently has no rights to proceed against the original borrower. *See* BLACK'S LAW DICTIONARY 157 (4th ed. 1968). In contrast, guarantors "step into the shoes" of the creditor and inherit the creditor's rights to proceed against the borrower. *See id.* at 833. *See also infra* note 287 and accompanying text.

248. For purposes of this article, unless the context requires otherwise, the discussion of the rules of Subchapter K, as applied to both partnerships and LLCs, refers to the entity as a "partnership" and its owners as "partners." When this article focuses primarily on LLCs, the entity will be referred to as an "LLC" and its owners will be referred to as "members." A member's or partner's basis in the LLC or partnership is sometimes referred to as "outside basis."

249. If a partner sells his or her interest, the gain or loss equals the amount realized over the partner's adjusted basis at the time of the sale. *See* I.R.C. § 741 (1986). Such gain or loss will be capital unless the sale is attributable to certain unrealized receivables and inventory items inside the partnership. *See id.* §§ 751(a), (c)-(d). Distributions of money are only tax-free to the extent the partner has outside basis to cover the distribution. *See id.* §§ 731, 733.

250. *See* I.R.C. § 704(d) (1986). At the end of the partnership's taxable year, each partner's outside basis is first increased by allocations of partnership taxable income and partnership tax-exempt income. *See id.* § 705(a)(1). Then outside basis is decreased, first by distributions to the partner and finally by allocations of partnership losses and deductions. In no event is outside basis ever reduced below zero. *See id.* § 705(a)(2); Rev. Rul. 66-94, 1966-1 C.B. 166. *See also* Treas. Reg. § 1.731-1(a)(1)(ii) (1966) (ordinary distributions take place on the last day of partnership's taxable year, regardless of when the distribution actually took place).

If the partner is an individual or a closely held C corporation, it can only deduct the losses flowing through from the partnership to the extent of its economic exposure or "at-risk" amount in the venture. *See* I.R.C. § 465(a)(1) (West Supp. 1989); Prop. Treas. Reg. § 1.465-24(a)(2). Generally, a partner is treated as being at-risk to the extent of the money and the adjusted basis of property it contributed to the partnership. I.R.C. § 465(b) (West Supp. 1989). A partner

outside basis is insufficient to cover the loss, such loss will be suspended until the partner has enough outside basis to absorb it.[251]

A partner's outside basis increases by the amount of money and the adjusted basis of property it contributes to the partnership.[252] A partner's outside basis will also increase by its share[253] of partnership liabilities because the Code treats such share as a constructive contribution of money by the partner to the partnership.[254] Partnership

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is also at-risk for its share of the partnership recourse liabilities from an unrelated party. Prop. Treas. Reg. § 1.465-24(a)(2). Nonrecourse debt at the partnership level will not produce usable deductions unless the amounts borrowed are considered "qualified nonrecourse financing," within the meaning of § 465(b)(6). *See* I.R.C. § 465(b)(6) (West Supp. 1989); Prop. Treas. Reg. § 1.465-25. If the borrowed amounts are treated as "qualified nonrecourse financing" which generally means the loan is from a bona fide lending institution for the purpose of holding real property, *see* I.R.C. § 465(b)(6)(B) (West Supp. 1989), then the partners are deemed to be at-risk. *Id.* § 465(b)(6)(A). The at-risk amount would then be apportioned among the members based on the profit sharing ratio. *See* I.R.C. § 465(b)(6)(C). The at-risk amount determined by the temporary regulations under § 752 are not intended to provide any correlation for determining at-risk for purposes of § 465.

Section 469 states other limitations on the extent a partner can deduct losses that have flowed through from the partnership. *See id.* § 469. Generally, unless the partner materially participates in the partnership's activity, *see id.* § 469(c)(1)(B), section 469 will deny the deduction of these "passive losses" unless the partner has passive income from other sources. It is generally presumed that limited partners do not materially participate in the partnership's activities. *See id.* § 469(h)(2).

251. *See* I.R.C. § 704(d) (1986). If the losses are of different characters and the partner only has enough losses to cover part of them, the regulations require the losses to flow out pro rata. *See* Treas. Reg. § 1.704-1(d)(2) (as amended in 1987).

252. *See* I.R.C. § 722 (1986). If a partner purchases the partnership interest from another partner, the partner's initial outside basis will be the amount of cash and the fair market value of any property tendered to the selling partner plus the partner's share of the partnership's liabilities. *See id.* §§ 742, 752(d); Treas. Reg. § 1.742-1 (1960).

253. Increasing outside basis for a share of partnership liabilities reflects the theory of treating partnerships like an aggregate group of partners rather than an entity. Because borrowed funds are not generally taxed, as the Service assumes those amounts will be paid back, the Service allows this increase so the partnership could distribute those funds without having the partners recognize income from the distribution.

254. *See* I.R.C. § 752(a) (1986); Temp. Treas. Reg. 1.752-1T(a), 53 Fed. Reg. 53,140, 53,143 (1988). The Service treats any decrease in a partner's share of the partnership's liabilities as a constructive distribution of money and will therefore decrease outside basis. *See* I.R.C. § 752(b) (1989); Temp. Treas. Reg. § 1.752-1T(c), 53 Fed. Reg. 53140, 53145 (1988). These decreases occur, for example, when the partnership sells or distributes property subject to a partnership liability or when the partnership makes principal payments on its liabilities. If the partnership assumes a partner's individual liability, the Service treats this assumption as a constructive distribution of money and producing a corresponding decrease to the partner's outside basis for the entire amount assumed. *See* Temp. Treas. Reg. § 1.752-1T(f)(2)(i), 53 Fed. Reg. 53,140, 53,150 (1988).

liabilities[255] are crucial to any venture in which the partners expect to receive allocations of partnership losses and deductions in excess of other amounts of money and the adjusted basis of property they have contributed.[256]

Computation of each partner's share depends on whether the partnership liability is recourse or nonrecourse.[257] Under the temporary regulations promulgated under section 752,[258] the Service will consider a partnership's liability recourse to the extent that *any* partner bears the risk of loss if the partnership is unable to pay the liability.[259]

The partnership provisions in Subchapter K will apply to LLCs and their members.[260] Consequently, members of LLCs will compute their outside bases using the same rules to which partners are subject. Likewise, LLC members will be subject to the same limitations on the deductibility of losses flowing through from the LLC.[261]

Unlike the traditional general or limited partnership, state law dictates that no member of an LLC has unlimited liability for the LLC's debts.[262] Consequently, unless a particular member assumes or guarantees the LLC's debt[263] or the LLC borrows the funds from a member or a person related to the member,[264] LLC liabilities are always nonrecourse.[265] In such cases, the members of an LLC automat-

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255. An obligation is treated as a partnership liability only to the extent such liability gives rise to the creation or increase of the basis of any property held by the partnership; a deduction for the partnership; or an expenditure not deductible in computing the partnership's taxable income or properly chargeable to capital. *See* Temp. Treas. Reg. § 1.752-1T(g), 53 Fed. Reg. 53,140, 53,150 (1988). *See also* Temp. Treas. Reg. § 1.752-1T(k) ex.2, 53 Fed. Reg. 53,140, 53,152 (1988) (example of an obligation that is not treated as a partnership liability).

256. *But see supra* note 250 (discussing other limitations on the use of the partnership's losses).

257. Temp. Treas. Reg. § 1.752-1T(a), 53 Fed. Reg. 53,140, 53,143 (1988).

258. Congress mandated the Treasury to revise the regulations under § 752 in the Tax Reform Act of 1984. *See* GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984, H.R. DOC. No. 4170, 98th Cong., 2d Sess. 250-52 (1984) (discussing history behind these temporary regulations).

259. *See* Temp. Treas. Reg. § 1.752-1T(a)(1), 53 Fed. Reg. 53,140, 53,143 (1988)

260. *See* Treas. Reg. §§ 301.7701-2(a)(1), (3) (as amended in 1983) (unincorporated organization will be classified as a partnership if it lacks at least two of the four corporate characteristics); *see also supra* note 222.

261. *Id.*

262. *See supra* text accompanying notes 93-95.

263. *See supra* note 247; *infra* text accompanying note 287.

264. *See infra* text accompanying notes 290, 328-33.

265. *See* Temp. Treas. Reg. § 1.752-1T(d)(3)(ii)(B)(4)(ii)(B), 53 Fed. Reg. 53,140 53,146 (1988) (if entity is treated as a partnership for tax purposes, but none of its members have un-

ically share the LLC's liabilities for purposes of increasing their outside basis under the more favorable rules for nonrecourse debt. Also, the LLC may allocate the losses arising from the nonrecourse debt to its members under the safe harbor rule for allocating nonrecourse deductions, which does not require members to meet the substantial economic effect standard.[266]

If the partnership's debt is nonrecourse,[267] then the partners share the liability for purposes of increasing their outside bases based on three factors which are applied consecutively. Partnership nonrecourse debt is first allocated to those partners according to their share of the partnership's "minimum gain"[268] if any; any remaining nonrecourse debt is then allocated to those partners according to certain required income allocations under section 704(c) and section 1.704-1(b)(4)(i) of the regulations.[269] Finally, any remaining nonrecourse debt is allocated to all partners according to how they have agreed to share gains and profits.[270] The profit-sharing ratio ultimately controls even though cre-

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limited liability, then all liabilities are treated as if creditors' rights are limited to the assets of the partnership, i.e., nonrecourse liabilities). If any member had an unpaid capital contribution obligation, similar to a limited partner's, the LLC's liabilities should be recourse to that extent with that member bearing the risk of loss.

266. *See* Temp. Treas. Reg. § 1.704-1T(b), 53 Fed. Reg. 53,161 (1988) and *infra* text accompanying notes 267-86.

267. The Service considers liability of a partnership nonrecourse if no partner bears the risk of loss. *See* Temp. Treas. Reg. § 1.752-1T(e)(2), 53 Fed. Reg. 53,140, 53,150 (1988).

268. For a discussion of the concept of minimum gain and its relevance, see *infra* text accompanying notes 277-82.

269. *See supra* text accompanying notes 236-40. The Service requires income allocations under § 1.704-1(b)(4)(i) of the regulations when a new partner being admitted contributes cash to the partnership and the other partners "book up" their capital accounts to reflect the appreciation in the partnership's assets. *See* Treas. Reg. §§ 1.704-1(b)(2)(iv)(h), 1.704-1(b)(4)(i) (as amended in 1987). Gain representing appreciation that occurred before the new partner was admitted from the sale of these assets must be allocated back to the partners that booked up their capital accounts. *Id. See infra* note 309 (explaining a partner's capital account).

Nonrecourse liabilities will be added first to the partners' outside bases in proportion to how they would recognize "minimum gain," and then according to how they would recognize § 704(c) gain, and gain under § 1.704-1(b)(4)(i) of the regulations, if the partnership hypothetically disposed of all property subject to nonrecourse liabilities for no consideration other than the relief of these liabilities. *See* Temp. Treas. Reg. § 1.752 1T(e)(1), 53 Fed. Reg. 53,140, 53,150 (1988).

270. The Service's allocation of nonrecourse liabilities among partners, first, according to the minimum gain and, then, according to required gain allocations under I.R.C. § 704(c) (1986) and Treas Reg. § 1.704-1(b)(4)(i) (as amended in 1987), is an attempt to coordinate the increases to outside bases under § 752 with the treatment of nonrecourse liabilities under § 704(b). *See* 53 Fed. Reg. 53, 140 (1988) (to be codified at 26 C.F.R. § 1,602). Previously, the Service allocated nonrecourse debt for outside basis purposes by the profit sharing ratio only. *See* Treas. Reg. § 1.752-1(e) (as amended in 1960). The partnership can state each partner's interest in

ditors cannot force any partner to actually pay the debt. Outside basis increases for nonrecourse liabilities are not based on how the partners bear risk of loss.[271]

Having nonrecourse debt at the partnership level is very advantageous from a tax standpoint, particularly if the organization's membership consists of limited partners or LLC members with little or no unpaid capital contribution obligations. If the partnership's debt is nonrecourse, all partners are eligible to receive increases to their outside bases even though they bear no risk of loss. The partnership can therefore allocate deductible[272] losses under the favorable rules for allocating nonrecourse deductions or make cash distributions to such partners without requiring them to agree to make actual payments or contributions to pay the liability back.

Generally, partners can agree to allocate partnership items of income, gain, loss, deduction, or credit for tax purposes any way they see fit as long as the allocations have substantial economic effect.[273] Losses and deductions arising from nonrecourse debt[274] cannot have economic effect because no partner bears the risk of loss. The creditor alone bears the risk that the property securing the debt will decline in value below the principal amount of the loan.[275] If the partnership

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partnership profits in the agreement and have it respected if it corresponds to a significant allocation of partnership income or gain which has substantial economic effect. *See* Temp. Treas. Reg. § 1.752 1T(e)(3)(ii)(C), 53 Fed. Reg. 53,140, 53,150 (1988).

271. *Id.* The theory behind using the profit sharing ratio is that the partnership has to earn a profit either from operations or use proceeds from the sale of assets to pay the debt. If the partnership loses money and the partnership's assets decline in value, the lender bears the loss. If the partnership earns profits, the lender can insist that the loan be paid out of such profits and the partners will pay tax on those profits even if there are no cash distributions. *See also* I.R.C. § 752(c) (1986) (providing that a nonrecourse liability can increase the partners' outside bases only to the extent of the underlying property's fair market value).

272. *See supra* note 250 (discussing other limitations on the deductibility of the losses). Although the regulations dealing with the application of the at-risk limitations and the passive loss limitations only refer to partnerships, the same concepts would presumably apply to losses flowing from LLCs. *See* Prop. Treas. Reg. §§ 1.465-6(b), -7(a), *reprinted in* 5 FED. TAXES (P-H) ¶¶ 20,648.36, .37 (1979); Temp. Treas. Reg. § 1.469-2T(e), 53 Fed. Reg. 5686, 5718 (1988).

273. *See infra* notes 288-320 and accompanying text.

274. Generally, the regulations treat losses or deductions as nonrecourse deductions to the extent that such losses or deductions reduce the basis of the property securing the nonrecourse debt below the principal amount of the nonrecourse note. Such increase in nonrecourse deductions is known as the net increase in partnership minimum gain during the taxable year. *See* Temp. Treas. Reg. § 1.704-1T(b)(4)(iv)(b), (c), 53 Fed. Reg. 53,161 (1988).

275. For purposes of testing loss allocations attributable to recourse or nonrecourse debt the regulations assume that the property's fair market value equals the property's adjusted basis. *See* Treas. Reg. § 1.704-1(b)(2)(iii)(c)(2) (as amended in 1987). Thus, once the property's adjusted basis is reduced below the principal amount of the note (by depreciation, for example) the

meets the requirements in the regulations, the regulations view allocations of nonrecourse deductions to be in accord with the partner's interest in the partnership even though no economic effect is present.[276]

For nonrecourse deductions to come within the safe harbor, the partnership agreement, among other requirements,[277] must have a "minimum gain chargeback."[278] A minimum gain chargeback requires the partnership to allocate income to the partner claiming the nonrecourse deductions to the extent such partner's minimum gain (represented generally by allocations of losses, deductions, or distributions of loan proceeds attributable to nonrecourse debt) is decreased on a net basis.[279]

For example, minimum gain will decrease, thus forcing an income allocation, if the partnership pays principal on the nonrecourse loan or if the property securing the nonrecourse loan is sold, abandoned, foreclosed, or otherwise disposed of.[280] If the partnership abandoned the property, for example, even if it was worthless, the partnership would have an amount realized equal to the debt relief, causing "phantom gain" to the extent the debt exceeded the property's basis.[281] Under the nonrecourse debt allocation rules, the partnership would have to allocate, that phantom gain to the partners in proportion to how they claimed the nonrecourse deductions or received distributions of proceeds from nonrecourse debt.[282] These required income allocations for net decreases of minimum gain often produce income allocations without cash flow. Unlike the deficit restoration obligations, which are required under the economic effect test in allocations of losses attributable to recourse debt,[283] minimum gain chargebacks never force partners to actually contribute cash. Obviously, partners would rather have the partnership allocate them taxable income even without corresponding cash flow, than be forced to contribute cash.

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regulations assume that the property's sale will not produce enough cash to pay off the loan. That "spread," or the difference between the property's adjusted basis and the principal of the nonrecourse note, is a nonrecourse deduction. *See* Temp. Treas. Reg. § 1.704-1T(b)(4)(iv)(c), 53 Fed. Reg. 53,161 (1988).

276. Temp. Treas. Reg. § 1.704-1T(b)(4)(iv)(a), 53 Fed. Reg. 53,616 (1988).

277. The partnership agreement must maintain capital accounts and follow positive capital accounts at liquidation. Temp. Treas. Reg. § 1.704-1T(b)(4)(iv)(d)(1), 53 Fed. Reg. 53,161 (1988).

278. *Id.* § 1.704-1T(b)(4)(iv)(e), 53 Fed. Reg. 53,161, 53,163 (1988).

279. *Id.* §§ 1.704-1T(b)(4)(iv)(e), (f), 53 Fed. Reg. 53,161, 53,163 (1988).

280. *See id.*

281. *See* Commissioner v. Tufts, 461 U.S. 300 (1983) (citing Crane v. Commissioner, 331 U.S. 1 (1947)).

282. Temp. Treas. Reg. § 1.704-1T(b)(4)(iv)(e)-(f), 53 Fed. Reg. 53,161, 53,163 (1988).

283. *See infra* notes 311-18 and accompanying text.

The nonrecourse debt allocation rules also require the partnership agreement to allocate the losses and deductions attributable to nonrecourse deductions in a manner reasonably consistent with some other allocation that has substantial economic effect.[284] Generally, the partners can allocate these losses and deductions according to how they share economic losses, how they share economic profits, or any median between these two figures, and still satisfy the requirement.[285] This requirement of "reasonable consistency" provides more flexibility for allocating nonrecourse deductions. The economic effect test, required for all allocations of deductions attributable to recourse debt, basically requires the partnership to allocate the losses according to how the partners technically bear the risk of loss.[286]

Often, as a business matter, the creditor will not make a loan to the LLC if no member has personal liability. In these cases, a designated member can contractually assume or guarantee the loan. An assumption or guarantee of a nonrecourse liability effectively changes it to a recourse liability to the extent that a member assumes or guarantees it.[287] Consequently, if a member assumes or guarantees an obligation of the LLC, the rules for recourse liabilities govern the increases in outside bases and the allocation of losses for tax purposes.

Partners share partnership recourse liabilities for purposes of increasing their outside bases according to how each individually bears the risk of loss, taking into account all arrangements between the partners, the partnership, and persons related to the partners.[288] The

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284. Temp. Treas. Reg. § 1.704-1T(b)(4)(iv)(d)(2), 53 Fed. Reg. 53,161, 53,163 (1988).

285. *Id.* In order to use the loss sharing ratio to support the "reasonably consistent" requirement, the partner whose allocation of nonrecourse deductions is being supported by its loss sharing ratio must have made material capital contributions to the partnership as compared with the amount of nonrecourse debt financing. *Id.* For example, if the partnership is 100% leveraged with nonrecourse debt, then the loss sharing ratio can not be used to allocate nonrecourse deductions. Generally, if the nonrecourse debt does not exceed 90% of the property's financing (that is, the partners contribute or are personally liable for 10% of the property's value) then the regulations will deem the capital contributions to be material and the partners can divide the nonrecourse deductions based on the loss sharing ratio. *See id.* § 1.704-1T(b)(5) ex. 20.

286. *See infra* notes 306-18 and accompanying text.

287. Assumptions of nonrecourse liabilities produce personal liability for the assuming member (with a corresponding increase to outside basis) because, like assumptions of recourse liabilities, the assuming member agrees to discharge the LLC's indebtedness as it comes due. Guarantees of nonrecourse loans also cause the guarantor or member to have personal liability. Although the guarantor inherits the creditor's rights to proceed against the LLC, with guaranteed nonrecourse debt of an LLC, no rights exist against any member personally for the guarantor to inherit. *See* Temp. Treas. Reg. §§ 1.752-1T(d)(3)(ii)(A), (d)(3)(iv), (f), 53 Fed. Reg. 53,140, 53,148 (1988); *see also* Abramson v. Commissioner, 86 T.C. 360 (1986); Smith v. Commissioner, 84 T.C. 889 (1985).

288. Temp. Treas. Reg. § 1.752-1T(a)(1), 53 Fed. Reg. 53,140, 53,143 (1988).

regulations provide two ways for a partner to be treated as bearing the economic risk of loss with respect to partnership recourse liabilities. A partner's outside basis will be increased to the extent that *either*:[289] (1) the partner or persons related to such partner[290] are obligated to make a net payment to a creditor or another person ("Net Payment Obligations");[291] or (2) such partner is obligated to make a net contribution to the partnership ("Net Contribution Obligations")[292] if the partnership "constructively liquidated."[293] Constructive liquidation generally means the partnership is unable to pay the liability because all of its assets are deemed to have become worthless.

The Net Payment Obligation generally is designed to increase the outside basis of those partners who have either directly agreed or had a related person agree to assume or guarantee certain partnership debts.[294] Any reimbursements to which the partner or the related person is entitled will offset the partner's increase in outside basis.[295] The Net Contribution Obligation looks to the relative amount each partner would have to contribute to the partnership. This evaluation takes into account the manner in which all the partners have agreed

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289. *See* Temp. Treas. Reg. § 1.752-1T(d)(3)(ii)(B)(1), 53 Fed. Reg. 53,140, 53,146 (1988) (partner will be treated as having a Net Contribution Obligation only to the extent the obligation is not treated as a Net Payment Obligation); Temp. Treas. Reg. § 1.752-1T(d), 53 Fed. Reg. 53,140, 53,145 (1988).

290. Persons related to a partner is defined in Temp. Treas. Reg. § 1.752-1T(h), 53 Fed. Reg. 53,140, 53,151 (1988), to include, generally, certain members of a partner's family and corporations that are in the same affiliated group as the partner. This section prevents partners from deflecting outside basis increases to other partners by having a related person obligated to make the payment.

291. Temp. Treas. Reg. § 1.752-1T(d)(3)(ii)(A), 53 Fed. Reg. 53,140, 53,145 (1988).

292. *Id.* § 1.752-1T(d)(3)(ii)(B), 53 Fed. Reg. 53,140, 53,146 (1988).

293. *See id.* § 1.752-1T(d)(3)(iii), 53 Fed. Reg. 53,140, 53,146 (1988). The concept of constructive liquidation is a mechanism to test who would bear the risk of loss if the absolute worst events occurred economically. A partnership is deemed to constructively liquidate if: (1) all the partnership's assets became worthless; (2) all the liabilities became due and payable; (3) the partnership disposed of all partnership property for no consideration other than the relief of the liabilities; and (4) all items of income, gain, loss, deduction, or credit are allocated on the date of liquidation in accordance with the partnership agreement.

294. *See id.* § 1.752-1T(d)(3)(ii)(A)(2)(i)(B), 53 Fed. Reg. 53,140, 53,146 (1988). Increasing the partner's outside basis for guarantees and assumptions made by related partners prevents a partner from arbitrarily shifting outside basis over to another partner by having a related person make the agreement. If a person related to a partner agrees to make a contribution to the partnership with respect to a liability, the regulations treat the agreement as a Net Payment Obligation of the partner's. *Id.*

295. Temp. Treas. Reg. §§ 1.752-1T(d)(3)(ii)(A)(1)(ii), (d)(3)(ii)(C), 53 Fed. Reg. 53,140, 53,145 (1988).

to bear losses, as well as additional amounts any individual partner agreed to contribute, and any rights to reimbursement which result from such contributions.[296]

So, for example, when a general partnership incurs recourse debt, absent other side agreements, the partners will share the debt, for purposes of increasing their outside bases, in the manner they have agreed to bear losses.[297] If one partner assumes the whole obligation, that partner's outside basis increases by the entire liability. By assuming the entire obligation, that partner would be forced to pay the entire amount as a Net Payment Obligation and such partner could not seek reimbursement from the other partners based on the loss sharing ratio.[298] With a general partnership incurring recourse debt, however, if one partner merely guarantees the partnership's liability, all still share the liability, for purposes of increasing the partners' outside bases, according to the loss sharing ratio.[299] If creditors forced the guarantor partner to pay the entire liability, such partner could proceed against the other partners according to the loss sharing ratio because the guarantor's rights are subrogated to all rights that the original creditor had.[300]

If a limited partnership incurs recourse debt, the limited partners will never have a Net Contribution Obligation with respect to partnership recourse liabilities in excess of their individual *unpaid* capital contribution obligations. A limited partner's unpaid capital contribution obligation represents the amount the limited partner promised to contribute to the partnership's capital, but has not yet contributed.[301] Under state law a limited partner can only be forced to contribute its unpaid capital contribution obligation to the partnership.[302] Con-

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296. Temp. Treas. Reg. § 1.752-1T(d)(3)(ii)(B), 53 Fed. Reg. 53,140, 53,146 (1988).

297. *Id.* If the partnership constructively liquidated and all assets were deemed to become worthless, each partner would have an obligation to contribute a pro rata share to pay the debt equal to the loss sharing ratio. Even if the creditor forced one partner to pay the entire debt, that partner could proceed against the others based on the loss sharing ratio. *See id.*

298. *See* Temp. Treas. Reg. § 1.752-1T(d)(3)(ii)(A), 53 Fed. Reg. 53,140, 53,145 (1988). Because the assuming partner has agreed to replace the original debtor, i.e., the partnership, the partner inherits no additional rights to proceed against the other parties from the creditor. *See supra* note 220. Under the temporary regulations in order to receive a full basis allocation, the assuming partner must be subjected to personal liability and the creditor must be aware of the assumption and have a direct action against the assuming partner. *See* Temp. Treas. Reg. § 1.752-1T(f), 53 Fed. Reg. 53,140, 53,150 (1988).

299. *See* Temp. Treas. Reg. §§ 1.752-1T(d)(3)(ii)(A)(1)(ii), (B)(2), (C), 53 Fed. Reg. 53,140, 53,145 (1988).

300. *See id*; *see supra* note 247.

301. *See* REVISED UNIF. LTD. PARTNERSHIP ACT § 542 (1985).

302. *Id.*

sequently, unless the limited partner assumes all or a portion of the liability, the unpaid capital contribution obligation serves as a ceiling on the amount the limited partner's outside basis can increase for its share of partnership recourse debt.[303] This is true regardless of how the partners have agreed to allocate losses for tax purposes.[304] The general partner or partners are ultimately liable for all partnership recourse debt. Therefore, amounts that limited partners cannot add to their outside bases will be added to the general partners' outside bases in proportion to their loss sharing ratio, absent other side agreements such as an assumption.[305]

Allocations of losses and deductions attributable to recourse debt must have substantial economic effect.[306] Allocations which do not have substantial economic effect are reallocated among the partners in accord with the partner's interest in the partnership.[307] The economic

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303. *See* Temp. Treas. Reg. § 1.752-1T(d)(3)(ii)(B)(2), 53 Fed. Reg. 53,140, 53,146 (1988).

304. *Id.*

305. *Id.*

306. Treas. Reg. § 1.704-1(b)(2)(i) (as amended in 1987). Several exceptions exist in which allocations will be valid without meeting the substantial economic effect tests. The most important exception is an allocation attributable to a nonrecourse deduction. *See supra* text accompanying notes 267-86.

Other provisions dictate exactly how the partnership's items will be allocated for tax purposes. These include: (1) allocations where there is a book-tax disparity due to contributed property or otherwise, see I.R.C. § 704(c) (1986) (discussed *supra* at text accompanying notes 236-40); and (2) allocations where the partner's interests in the partnership have shifted during the taxable year, see I.R.C. § 706(d) (West Supp. 1989). A detailed discussion of these provisions is beyond the scope of this article.

To determine if an allocation has substantial economic effect, the partnership must conduct a two-part analysis at the end of its taxable year to which the allocation related. Such allocation must have economic effect and must be substantial. *See* Treas. Reg. § 1.704-1(b)(2)(i) (as amended in 1987).

A complete discussion of substantiality is beyond the scope of this article. Generally, an allocation will be reallocated in accord with the partners' interest in the partnership on the grounds of not being substantial if the tax consequences result in at least one partner being enhanced (in present value terms) by the allocation as compared to what the tax consequences would have been if the allocation were not contained in the partnership agreement and a "strong likelihood" exists that the after-tax consequences in present value terms will be substantially diminished for no partner as compared with the after-tax consequences had the allocation not been included in the partnership agreement. *See* Treas. Reg. § 1.704(b)(2)(iii) (as amended in 1987). In other words, by looking at the partners as a group, one can determine the likely tax effect of the allocation; if the tax savings is likely to be large and the economic impact on the partners is likely to be small, then the allocation will not be substantial.

307. Treas. Reg. § 1.704-1(b)(1)(i) (as amended in 1987). The determination of the partners' interests in the partnership involves a facts-and-circumstances test to determine the overall economic arrangement in the partnership. The factors considered include: (1) the partners' relative contributions to the partnership; (2) the interests of the partners in economic profits and losses if different than their interest in taxable income or loss; (3) the interest of the partners

effect requirement of the substantial economic effect test attempts to ensure that if there is an economic benefit or burden, the tax allocation of income or deductions will correspond to the economic allocations of the benefits or burdens.[308] The basic safe harbor for economic effect requires: (1) that in accordance with the partnership agreement, the partnership maintain capital accounts[309] under the rules set out in section 1.704-1(b)(2)(iv) of the regulations; (2) that liquidation of the partnership must entitle the partners to liquidating distributions according to their positive book capital account balances;[310] and (3) that if a partner's capital account is negative,[311] the partnership must unconditionally obligate that partner to restore this deficit by making actual contributions to the partnership.[312] The partner must make these contributions on or before the date of the partnership's liquidation or within ninety days thereafter.[313]

Partners that are allocated substantial losses are often uncomfortable with agreeing to an unlimited restoration obligation. When a partner's obligation to restore a negative capital account is limited or nonexistent, the regulations provide an alternate test to meet the economic effect prong.[314] The first two requirements for the alternative test are identical to the first two requirements in the basic economic effect test. The partnership agreement must maintain capital accounts

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in cash flow and other nonliquidating distributions; and (4) the rights of the partners to distributions of capital upon liquidation. *See id.* § 1.704-1(b)(3).

308. *Id.* § 1.704-1(b)(2)(ii)(a). In other words, the partner who reports taxable income and gain ultimately should receive that economic benefit, and the partner who is allocated tax losses and deductions ultimately should bear that economic burden.

309. A partner's capital account represents a share of the partnership's economic net worth. Capital account maintenance is based on economic rather than tax concepts; consequently, the rules for increasing and decreasing capital accounts do not always coincide with the outside basis rules. Capital accounts will be increased by the cash and the fair market value (net of liabilities) of property contributed by the partners as well as allocations of partnership income. Capital accounts will not be increased for a partner's share of partnership liabilities because liabilities do not increase the partnership's positive net worth. *See* Treas. Reg. § 1.704-1(b)(2)(iv) (as amended in 1987). Capital accounts are decreased by distributions and losses allocated from the partnership. *Id.*

310. *See id.* § 1.704-1(b)(2)(ii)(b)(2).

311. A partner's capital account, unlike outside basis, can be reduced below zero. This usually occurs when the partnership has substantial liabilities and losses or distributions attributable to those liabilities have been allocated to the partners. Outside bases but not capital accounts, will be increased by those liabilities. *Id.* § 1.704-1(b)(2)(iv).

312. *Id.* § 1.704-1(b)(2)(ii)(b)(2).

313. *Id.*

314. *Id.* § 1.704-1(b)(2)(ii)(d).

and follow positive account balances at liquidation.[315] Generally, if a number of other requirements are met,[316] the partnership can allocate losses to a partner, allowing the partner's capital account to go negative to the extent of such partner's limited restoration obligation.[317] A limited restoration obligation requires the partner to contribute a limited amount to the partnership on or before the date of the partnership's liquidation or within ninety days thereafter.[318]

Partnership losses arising from recourse deductions must meet either the basic economic effect test or the alternate test. If the losses fail to meet either test, the partnership must reallocate the losses in accordance with each partner's interest in the partnership.[319] Consequently, partners that are allocated losses that create a negative balance in their capital account face the possibility of having to make cash contributions to the partnership at some time in the future.[320]

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315. *Id.*

316. For purposes of determining how negative the partner's capital account is, which in turn dictates how large the limited restoration obligation must be to cover the allocated loss, the partner's capital account is reduced up front for expected distributions of cash flow, with no income allocations and expected allocations of losses and deductions under I.R.C. § 704(e)(2) (1986) and I.R.C. § 706(d) (West Supp. 1989). The theory behind this requirement is to ensure that partners with limited restoration obligations actually bear the losses allocated to them. *See* Treas. Reg. § 1.704-1(b)(2)(ii)(d)(4)-(6) (as amended in 1987). For example, if a partner had a limited restoration obligation and was allocated losses which brought its capital account negative by that amount, cash flow in excess of income would drive its capital account below the limited restoration obligation, preventing the partner from bearing the loss. If the capital account is reduced up front for those expected cash flows in excess of taxable income, losses cannot be allocated to the partner unless the limited restoration obligation is large enough to cover the up-front reduction as well. The partnership agreement must also have a "qualified income offset." This requires that if the capital account of a partner is unexpectedly reduced below the limited restoration obligation (e.g., by an unexpected distribution of cash flow without income), then the partnership must allocate income, including gross income, to that partner so as to eliminate any deficit as quickly as possible. *See id.* § 1.704 1(b)(2)(ii)(d)(3). Since the capital account cannot be reduced up front for unexpected cash flow in excess of income, requiring income allocations to eliminate such disparity helps ensure that the partner will bear the loss. *Id.*

317. Treas. Reg. § 1.704-1(b)(2)(ii)(d)(3) (as amended in 1987).

318. *Id.* § 1.704-1(b)(2)(ii)(c).

319. *See supra* note 307.

320. *See supra* test accompanying notes 312, 314, 317-18. One way to avoid having to restore a negative capital account with actual cash contributions is to allocate income to the partners with negative capital accounts as soon as the partnership has income. Such income allocations run the risk of being reallocated on the grounds of insubstantiality, if there is not sufficient risk that the partnership will never have income to allocate. *See* Treas. Reg. § 1.704-1(b)(2)(iii)(c) (as amended in 1987). Safe harbors exist which will deem allocations of income to partners with negative capital accounts to be substantial without regard to how risky the business is. If the later income allocation is limited to income from the sale of the property,

When attempting to analyze the recourse debt rules in the context of LLCs, it is useful to analogize all members to limited partners. This is because under state law, LLC members are not personally liable for the LLC's debts, and creditors cannot force members to contribute more than their unpaid capital contribution obligations to pay such debts.[321] Like limited partners, LLC members with no unpaid capital contribution obligation cannot be forced to contribute capital and therefore have no risk of loss directly or indirectly for the LLC's debts unless they contractually assume or guarantee the debt.[322] Consequently, the LLC may not allocate increases to the member's outside bases for Net Contribution Obligations in excess of their unpaid capital contribution obligations.[323]

If a member either assumes or guarantees the LLC's obligation, the member will have a Net Payment Obligation equal to the entire amount assumed or guaranteed.[324] The member's outside basis will also receive a corresponding increase equal to the amount of the entire obligation.[325] The regulations treat the debt as recourse to the extent of the assumption or guarantee.[326] Consequently, LLC losses arising from liabilities which a member has assumed or guaranteed must have substantial economic effect. Because of this, the LLC must generally allocate such losses to the member that assumed or guaranteed the obligation, assuming the allocation is substantial.[327]

If a member or a person related to a member[328] makes a loan[329] to the LLC, the regulations treat that member as bearing the entire risk of loss with respect to that loan. Accordingly, that member's outside basis is increased for the entire loan.[330] To the extent the

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which produced the losses (e.g., through depreciation), then the allocations will always be substantial. Moreover, if the income allocations restoring the negative capital accounts are delayed for at least five years then all later allocations of income, even operating income, will be deemed to be substantial. *Id.*

321. WYO. STAT. §§ 17-15-113, -121(a); FLA. STAT. ANN § 608.435, .436.

322. *See supra* notes 93-95 and accompanying text.

323. *See supra* text accompanying notes 301-02.

324. *See supra* notes 247, 287.

325. Temp. Treas. Reg. § 1.752-1T(d)(3)(ii)(A), 53 Fed. Reg. 53,140, 53,145 (1988). An assumption or guarantee will produce the same result. *See supra* note 287.

326. *See supra* notes 247, 287.

327. *See supra* text accompanying notes 306-18.

328. *See supra* note 290 (defining a "related person").

329. All loans made to the LLC by members will be nonrecourse. *See supra* note 265 and accompanying text.

330. *See* Temp. Treas. Reg. § 1.752-1T(d)(3)(i)(B), 53 Fed. Reg. 53,140, 53,145 (1988). *But see* Temp. Treas. Reg. § 1.752 1T(d)(3)(vii), 53 Fed. Reg. 53,140, 53,150 (1988) (providing a *de minimis* rule which allows partners owning 10% or less of the partnership to make nonrecourse

property, which the LLC acquired from the debt proceeds, generates losses reducing the property's basis below the principal of the debt, such losses are nonrecourse deductions.[331] But, because the nonrecourse deductions are from "partner nonrecourse debt," the LLC must allocate all of the losses to the member that made the loan to the LLC.[332] If in a later year the LLC pays off all or part of the loan, or the creditor otherwise discharges the loan through foreclosure, the LLC must allocate income to the lending member to the extent such member's economic risk is eliminated.[333]

VI. CONCLUSION

Because the Service has recognized the LLC's status as a partnership, prospective partners and joint venturers should have far less hesitation when considering the LLC as a possible vehicle for conducting business. The LLC seems to be the first entity that has all the advantages of a partnership for tax purposes while, at the same time, provides all members with the same limited liability enjoyed by corporate shareholders. When considering use of an LLC, one should carefully examine the characteristics of the proposed business and the advantages that the LLC offers over more traditional forms available for operating that business. The LLC is not a panacea that offers substantial advantages for all types of businesses. With certain ventures that are traditionally conducted in large limited partnerships with limited partners that are essentially passive investors, the LLC offers no significant advantages and jeopardizes the certainty of partnership status. In other situations, however, particularly those with a limited number of participants and a high degree of leverage and risk, the LLC's absolute limited liability feature under state law combined with its status as a partnership for tax purposes may offer material advantages over a smaller limited partnership or S corporation. Only time will tell whether the advantages ultimately will outweigh some of the current corporate uncertainties of the LLC form. These uncertainties have arisen because of the LLC's limited use up to this time and the lack of legal precedents to guide planners. As time passes and more LLCs are formed, these uncertainties should dissipate. Additionally, if more states adopt limited liability company acts, the LLC's popularity will likely flourish.

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loans to the partnership and not be treated as bearing the entire risk of loss if such loan is qualified nonrecourse financing within the meaning of I.R.C. § 465).

331. Temp. Treas. Reg. § 1.704-1T(b)(4)(iv)(h), 53 Fed. Reg. 53,161, 53,163 (1988).

332. *Id.*

333. Treas. Reg. § 1.704-1(b)(5) ex. 15 (as amended in 1987).