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THE LIMITED LIABILITY COMPANY: A CATALYST EXPOSING THE CORPORATE INTEGRATION QUESTION

*Susan Pace Hamill**

INTRODUCTION

The rise of the domestic limited liability company (LLC)¹ from obscurity to its present position as a viable, mainstream alternative to the corporation or partnership was met with enormous enthusiasm by the business community and the practicing bar.² First introduced by the

* Associate Professor of Law, The University of Alabama School of Law. — Ed. The author gratefully acknowledges Dean Kenneth C. Randall and other faculty colleagues, who have enthusiastically supported the author's research and other projects, including the approval of a new course in the University of Alabama's curriculum focusing on LLCs and LLPs, the University of Alabama Law School Foundation, the Edward Brett Randolph Fund, and the William H. Sadler Fund. Valuable comments were received from Jim Bryce, Norman Stein, Rebecca Rudnick, Bob Peroni, Bill Turnier, Don Turlington, Will Nelson, and George Yin. The author also greatly appreciates the hard work and tireless efforts of her research assistants Leah Panayiotou and Carrie Ellis.

1. The LLC is an unincorporated business organization that contains dissolution, management, and transferability provisions similar to those of a general partnership but that can easily be altered to resemble the limited partnership or to approach the corporate model. A related unincorporated business entity that appeared in 1991, the limited liability partnership (LLP), essentially operates as a general partnership for business purposes, while offering the partners either partial or total limited liability protection. The articles written on LLCs and LLPs are too numerous to cite completely. In 1995 four law reviews dedicated entire issues to LLCs and LLPs. See *F. Hodge O'Neal Corporate and Securities Law Symposium: Limited Liability Companies*, 73 WASH. U. L.Q. 369 (1995); Symposium, *LLCs, LLPs and the Evolving Corporate Form*, 66 U. COLO. L. REV. 855 (1995); *Limited Liability Company Symposium*, 25 STETSON L. REV. 253 (1995); 51 BUS. LAW. 1 (1995) (all articles discuss LLCs or LLPs). For an early article predicting, at a time when only Wyoming and Florida recognized domestic LLCs, that the LLC's popularity would grow once more states passed LLC statutes, see Susan Pace Hamill, *The Limited Liability Company: A Possible Choice for Doing Business?*, 41 U. FLA. L. REV. 721 (1989).

2. See Charles Briggs Davenport, Jr., et al., *LLC Boosters Blitz Passthrough Sessions*, 37 TAX NOTES 1019, 1019 (1992) (“[The LLC] was shown around at this year's Tax Section meeting like a new fighter plane at the Paris Air Show. . . . [T]he hottest thing in S corporations has nothing to do with S corporations; it has to do with the LLC.”); Richard M. Phillips, *From the Editor*, 47 BUS. LAW. at xiii (1992) (“[The LLC is] one of the most important developments in business law today While to date only a handful of states have adopted legislation providing for limited liability companies, the train is out of the station. Years from now, this may be viewed as the

State of Wyoming in 1977³ and recognized by the Internal Revenue Service (IRS) as a partnership for federal income tax purposes in 1988,⁴ the LLC offers for the first time a domestic entity that combines the tax advantages of a partnership with limited liability protection for all members, an advantage commonly associated with corporations.⁵ The advantages of the partnership tax provisions include one level of tax at the owner level, flexible rules to allocate profits and losses among the owners, and the opportunity for owners to deduct losses or receive distributions attributable to the partnership's liabilities.⁶ By contrast, corporations are taxed at both the entity and the shareholder level,⁷ unless they elect subchapter S, which taxes closely held corporations only once — at the owner level — under a set of rules far less favorable and flexible than the partnership provisions.⁸ However, unlike shareholders of corporations who bear no statutory personal liability for the corpora-

dawn of a new era in business entities."); Josephine Marcotty, *State To Allow Business Hybrid That Combines the Advantages of Corporate and Tax Worlds*, STAR TRIB., (Minneapolis-St. Paul) Apr. 30, 1992, at 10 ("[Minnesota's law] slid so smoothly through the House and Senate that . . . one legislator described it as 'a bipartisan love fest.' . . . [The LLC] can be useful to many types of businesses and has little downside."); Daniel B. Moskowitz, *New Way To Organize Business Is Gaining Wider Acceptance*, WASH. POST, Nov. 4, 1991, at F14 ("[The LLC] is exciting lawyers around the country and is likely to grow in importance over the next few years."); Jeffrey A. Tannenbaum, *Forming as a Limited Liability Company Offers Best of Both Worlds*, WALL ST. J., May 14, 1991, at B2 ("LLCs are an easy sell.").

3. See Wyoming Limited Liability Company Act, ch. 158, 1977 Wyo. Sess. Laws 537 (1977) (codified as WYO. STAT. §§ 17-15-101 to -144 (1989 & Supp. 1995)). The very first domestic unincorporated entity to offer limited liability and partnership taxation, the limited partnership association, never gained widespread acceptance by the states and enjoyed no significant use. Unlike LLCs, limited partnership associations were burdened with restrictions requiring either the principal place of business or the principal office to be in the state of organization. Moreover, some of the statutes severely limited the number of owners. See Hamill, *supra* note 1, at 722 n.9.

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

5. The question of whether the LLC offers significant business advantages over the partnership and corporation above and beyond the tax advantage of combining partnership tax treatment with statutory limited liability protection is beyond the scope of this article.

6. For an exhaustive discussion of the detail on how the partnership tax rules work, see WILLIAM S. MCKEE ET AL., *FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS* (2d ed. 1990 & Supp. 1996).

7. For an exhaustive discussion of the tax rules for corporations, see BORIS I. BITTKER & JAMES S. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* (6th ed. 1994); see also *infra* notes 98-111, 134, 136, 140 and accompanying text.

8. See Susan Kalinka, *The Limited Liability Company and Subchapter S: Classification Issues Revisited*, 60 U. CIN. L. REV. 1083 (1992); *infra* text accompanying notes 75-80, 85. See generally JAMES S. EUSTICE & JOEL D. KUNTZ, *FEDERAL INCOME TAXATION OF S CORPORATIONS* (3d ed. 1993); DEBORAH H. SCHENK, *FEDERAL TAXATION OF S CORPORATIONS* (rev. ed. 1992).

tion's debts,⁹ under the partnership statutes, at least one partner must bear personal liability for the debts and obligations of the partnership.¹⁰

By combining the best of both worlds, partnership taxation and limited liability, the LLC revolution can be characterized as tax driven.¹¹ Nevertheless, some commentators believe that it is the LLC's superior business provisions that will cause LLCs to continue to rise in popularity.¹² Although the LLC's business provisions may be characteristic of either partnerships or corporations, in toto they produce a truly unique and new business entity that cannot be aligned categorically with either of the more traditional forms.¹³ For example, the statutory provisions addressing the management and control of the LLC generally vest agency authority and governance rights in all members, as if they were partners in a general partnership. However, LLC members, unlike general partners, can adopt a management structure resembling those of corporations or limited partnerships by appointing managers. The LLC's managers, holding the power to make important policy decisions and to bind the LLC in day-to-day business transactions, take on the roles held both by general partners of limited partnerships and by corporate directors and officers.¹⁴

Regardless of whether the motivation is tax or business related, the use and acceptance of LLCs as a serious alternative to the partnership and the corporation exponentially increased between 1988 and 1995 and will probably grow more each year.¹⁵ Indeed, some commentators believe the LLC will largely replace the partnership and the closely held corporation and emerge as the dominant form of business for nonpublicly traded entities.¹⁶

9. See *infra* section III.B.

10. See *infra* notes 87-91 and accompanying text.

11. See *infra* notes 47-67, 216-27 and accompanying text.

12. "LLCs must be rescued from the grasp of the tax lawyers." *AALS Tax Section Looks at LLCs*, 96 TAX NOTES TODAY 17-H, 17-H (1996) [hereinafter *AALS Tax Section*] (quoting Professor Larry Ribstein) (arguing that LLCs offer independent business advantages).

13. See Robert R. Keatinge et al., *The Limited Liability Company: A Study of the Emerging Entity*, 47 BUS. LAW. 375 (1992).

14. See UNIF. LIMITED LIABILITY COMPANY ACT §§ 301, 404, 6A U.L.A. 425 (1995).

15. "Everything is driven by tax and the rest of the world will accommodate . . ." *AALS Tax Section*, *supra* note 12, at 17-H (quoting Professor Jerry Kurtz's response to Larry Ribstein's assertion that the LLC offers independent business advantages); see *infra* section I.B.

16. See Jerome Kurtz, *The Limited Liability Company and the Future of Business Taxation: A Comment on Professor Berger's Plan*, 47 TAX L. REV. 815, 820 (1992); see also *supra* notes 1-2. Commentators are just starting to speculate on the future popularity of the LLP. Some believe that LLPs will evolve as the business form of choice

The rise of the LLC, however, has not been greeted with uniform zeal. Said one critic: "The federal government has opened up a candy store."¹⁷ This pithy comment metaphorically sums up the underlying and often unarticulated concern hidden in the shadows of the LLC euphoria. Some commentators have expressed concern that the LLC could undermine the policy behind the two-tier tax imposed on corporations and shareholders, or the restrictions under the subchapter S regime, or both.¹⁸

For over fifty years, scholars, practitioners, and legislators have debated whether the tax imposed at both the corporate and shareholder levels represents sound tax policy — whether this two-tier tax should be eliminated or mitigated.¹⁹ This question, commonly referred to as the

for many transactions and may even surpass the LLC. *See generally* Robert R. Keatinge et al., *Limited Liability Partnerships: The Next Step in the Evolution of the Unincorporated Business Organization*, 51 *BUS. LAW.* 147 (1995). Because the rise of the LLP exposes the corporate integration issue as well (both LLCs and LLPs provide one level of taxation under the partnership provisions and limited liability), the analysis in the article is not affected by the choice between LLCs and LLPs.

17. *New York Contemplates Cost of Partnership Treatment for Limited Liability Companies*, 1992 *TAX NOTES TODAY*, 243-10 (quoting from James W. Wetzler, New York State Commissioner of Taxation and Finance).

18. *See* Karen C. Burke, *The Uncertain Future of Limited Liability Companies*, 12 *AM. J. TAX POLY.* 13, 15 (1995); Daniel S. Goldberg, *The Tax Treatment of Limited Liability Companies: Law in Search of Policy*, 50 *BUS. LAW.* 995 (1995); William J. Rands, *Passthrough Entities and Their Unprincipled Differences Under Federal Tax Law*, 49 *SMU L. REV.* 15 (1995).

19. *See, e.g.*, Jennifer Arlen & Deborah M. Weiss, *A Political Theory of Corporate Taxation*, 105 *YALE L.J.* 325 (1995); Glenn E. Coven, *Corporate Tax Policy for the Twenty-First Century: Integration and Redeeming Social Value*, 50 *WASH. & LEE L. REV.* 495 (1993); Joseph M. Dodge, *A Combined Mark-to-Market and Pass-Through Corporate-Shareholder Integration Proposal*, 50 *TAX L. REV.* 265 (1995); Martin D. Ginsburg, *Maintaining Subchapter S in an Integrated Tax World*, 47 *TAX L. REV.* 665 (1992); Jeffrey L. Kwall, *The Uncertain Case Against the Double Taxation of Corporate Income*, 68 *N.C. L. REV.* 613 (1990); Charles E. McLure, Jr., *Integration of Personal and Corporate Income Taxes: The Missing Element in Recent Tax Reform Proposals*, 88 *HARV. L. REV.* 532 (1975); John K. McNulty, *Preserving the Virtues of Subchapter S in an Integrated World*, 47 *TAX L. REV.* 681 (1992); Fred W. Peel, *A Proposal for Eliminating Double Taxation of Corporate Dividends*, 39 *TAX LAW.* 1 (1985); Joseph S. Platt, *Integration and Correlation — The Treasury Proposal*, 3 *TAX L. REV.* 59 (1947); Rebecca S. Rudnick, *Who Should Pay the Corporate Tax in a Flat Tax World?*, 39 *CASE W. RES. L. REV.* 965 (1988-1989); Deborah H. Schenk, *Complete Integration in a Partial Integration World*, 47 *TAX L. REV.* 697 (1992); Michael L. Schler, *Taxing Corporate Income Once (or Hopefully Not at All): A Practitioner's Comparison of the Treasury and ALI Integration Models*, 47 *TAX L. REV.* 509 (1992); Reed H. Shuldiner, *Corporate Integration: Do the Uncertainties Outweigh the Benefits?*, 47 *TAX L. REV.* 653 (1992); Emil M. Sunley, *Corporate Integration: An Economic Perspective*, 47 *TAX L. REV.* 621 (1992); Scott A. Taylor, *Corporate Integration in the Federal Income Tax: Lessons from the Past and a Proposal for the Future*, 10 *VA. TAX REV.* 237 (1990); Alvin C. Warren, *The Relation and Integration of Individual and Cor-*

“corporate integration issue,” arguably represents one of the most important tax policy issues confronting U.S. lawmakers today. Because the corporation historically has been the only domestic entity to offer limited liability protection for all owners, and because the corporate tax regime applies per se to all domestic corporations,²⁰ the question whether, and under what circumstances, limited liability protection should carry the price of the corporate tax must be resolved before one affirmatively answers the corporate integration issue.²¹ Because LLCs offer limited liability by statute and partnership taxation, they appear to offer a new mechanism to achieve corporate integration even though U.S. lawmakers have not yet sanctioned corporate integration in any form.²² This observation has led some commentators to question whether LLCs represent an effort by the states to achieve corporate integration’s benefits inappropriately without the approval of Congress.²³ The LLC’s strongest critics view the LLC as a direct threat to the corporate tax base, arguing that LLCs should either be taxed as corporations or legally limited in some other fashion.²⁴

porate Income Taxes, 94 HARV. L. REV. 717 (1981); George K. Yin, *Corporate Integration and the Search for the Pragmatic Ideal*, 47 TAX L. REV. 431 (1992); Eric M. Zolt, *Corporate Integration After the Tax Reform Act of 1986: A State of Disequilibrium*, 66 N.C. L. REV. 839 (1988).

In response to section 634 of the Tax Reform Act of 1986, Pub. L. 99-514, 1986 U.S.C.A.N. (100 Stat.) 2282, the Department of Treasury issued a comprehensive study on the effect of the corporate tax and the corporate integration question. See REPORT OF THE DEPARTMENT OF THE TREASURY ON INTEGRATION OF THE INDIVIDUAL AND CORPORATE TAX SYSTEMS (Jan. 1992). Later on that year the Department of the Treasury issued a report recommending that corporate integration be adopted, so as to exclude dividends from the shareholder’s income. See DEPARTMENT OF THE TREASURY, A RECOMMENDATION FOR INTEGRATION OF THE INDIVIDUAL AND CORPORATE TAX SYSTEMS (Dec. 1992).

20. See I.R.C. § 7701(a)(2)-(3) (1994) (statutory definitions of corporations and partnership literally do not allow corporations to be taxed as partnerships); see also Gen. Couns. Mem. 37,953 (May 14, 1979) (citing *Dartmouth College v. Woodward*, 17 U.S. (4 Wheat.) 518 (1819)); Priv. Ltr. Rul. 79-21-084 (Feb. 27, 1979); Gen. Couns. Mem. 37,127 (May 18, 1977).

21. See *infra* notes 32-37, 172-80, 185-89 and accompanying text.

22. See *supra* notes 7, 19 and accompanying text.

23. See sources cited *supra* note 18; see also *Use of Limited Liability Companies Seen Not Jeopardizing Corporate Tax Base*, Daily Tax Rep. (BNA) No. 59, at J-1 (Mar. 30, 1993) [hereinafter *Use of Limited Liability Companies*] (stating that the LLC “has opened the floodgates to do-it-yourself integration, and this is not the proper way to approach the question of integrating the corporate tax” (quoting Donald Alexander, former IRS Commissioner, criticizing the increased use of LLCs as an inappropriate way for states to eliminate the two-tier corporate tax)).

24. See Lee A. Sheppard, *The Dark Side of Limited Liability Companies*, 62 TAX NOTES TODAY, 1441 (1992), at 1441; James W. Wetzler, *Federal Tax Policy and the States: Corporate Integration*, 46 NATL. TAX J. 393, 396 (1993); *New York Official Says Corporate Integration Ignores Revenue Impact on States*, 1993 TAX NOTES TO-

This article demonstrates that the rise of the LLC will not materially reduce the corporate tax base, and uses the LLC phenomenon to expose two major problems in current corporate tax law: the intolerable inequities of imposing the corporate tax on small corporations, and the distortions caused by, as well as the conflicting signals within, the corporate tax structure as applied to large corporations. Part I attributes the energy that fuels the LLC's rise to Congress's failure to address the corporate integration question. The number of new state LLC enactments and LLC filings showed minimal activity until the IRS confirmed partnership status for the LLC form, at which point there was explosive growth in new state enactments and LLC filings. This evidence illustrates that the sole attraction of this new business form was the desire to obtain statutory limited liability and flow-through taxation under the partnership regime — the void left open by the corporate integration question. Moreover, as new LLC state filings showed geometric growth, both the IRS and Congress were confronted with the effect of LLCs on the different tax regimes that are accorded partnerships and corporations — another aspect of the corporate integration issue.

Part II examines the critical question of whether the increased use of LLCs amounts to an unsanctioned backdoor to corporate integration, and concludes that it does not. Even before the LLC developed, small businesses who could afford the necessary transaction costs were able to achieve limited liability and one level of taxation. Part II notes that LLCs cannot threaten tax revenues collected from publicly traded corporations, because the tax law forces all publicly traded entities to bear the corporate tax. Part II further illustrates that LLCs theoretically challenge tax revenues collected from larger, nonpublicly traded corporations, where the asset base and level of ownership has expanded beyond the closely held range. Part II concludes, however, that this theoretical ability to undermine the corporate tax will not materialize because certain practical constraints, mainly the unwillingness of tax-exempt and foreign investors to purchase noncorporate equity, will prevent larger nonpublic businesses from using LLCs to avoid the corporate tax.

Part III explores the impact of the increased use of the LLC form on the substantive resolution of the corporate integration issue, by focusing separately on closely held corporations with a relatively modest

DAY, 102-3 (“[LLCs] will create a significant federal revenue loss because privately held C corporations pay significant corporate income taxes” (quoting James W. Wetzler, Commissioner of Taxation and Finance, New York State)); *Tax Revenues Will Suffer, but Limited Liability Companies May Be Here To Stay*, 62 TAX NOTES TODAY, 233-34 (1992) (asserting that LLCs will cause “big holes in the federal corporate tax base” (quoting Lee A. Sheppard, Contributing Editor, *Tax Notes*)).

asset base and on larger corporations where the asset base and ownership level has extended beyond the closely held range. Careful tax planning always allowed closely held businesses the opportunity to obtain limited liability and one level of tax. However, because the LLC offers these benefits with minimal transaction costs, closely held businesses will continue to choose the LLC over the corporation form in large numbers without examining the LLC's business benefits or detriments. Thus, it is impossible to tell whether or not the LLC offers material business advantages over the close corporation. This preference for the LLC exposes the inequities of applying the corporate tax to small incorporated businesses as compared to the more favorable and flexible partnership tax provisions enjoyed by LLCs. Consequently, by exposing these inequities, the increased use of LLCs has demonstrated the demand for some form of corporate integration, at least for closely held corporations.

Part III recognizes that, because LLCs do not pose a threat to the taxation of larger corporations, lawmakers could leave LLCs alone and maintain the corporate tax in its current form without affecting the number of larger businesses needing to incorporate. Part III argues, however, that as LLCs continue to multiply, their sheer numbers, combined with their theoretical challenge to the corporate tax revenues paid by these larger corporations, will make it increasingly difficult for lawmakers to avoid the corporate integration issue. The LLC's ability to provide limited liability combined with one level of tax under the partnership provisions brings to the surface the question of what role limited liability should play when imposing the corporate tax. Moreover, the practical reasons that prevent LLCs from being a real threat to the corporate tax paid by larger corporations help expose certain fundamental problems within the corporate tax structure: the distortions in investment decisions caused by the distinctions drawn between taxable and tax-exempt and foreign investors, as well as the disparate treatment between debt and equity.

I. THE RISE OF THE LLC AND THE CORPORATE INTEGRATION ISSUE

A. *LLCs Before the Recognition of Partnership Status*

The LLC's very creation is linked to the corporate integration issue. After a failed attempt in Alaska, the Hamilton Oil Company, on behalf of certain foreign oil and gas clients, lobbied the Wyoming legis-

lature to create a domestic business entity that mirrored the *limitada*.²⁵ Unlike the U.S. entities available at that time, the *limitada* provided direct limited liability for all owners coupled with the ability to comply with partnership classification regulations for U.S. income tax purposes. On March 4, 1977, the Wyoming Legislature responded to these lobbying efforts by passing the Wyoming Limited Liability Company Act.²⁶

U.S. law generally forces all corporations (the only domestic entity providing for direct statutory limited liability protection) to be taxed under the two-tier tax regime and all partnerships to expose at least one partner to personal liability for the partnership's debts. Due to the high risk and speculative nature of their investments, Hamilton Oil Company's foreign clients needed a flow-through entity to provide one level of tax and limited liability. Because the tax law forbids foreign shareholders from owning stock in an S corporation, they could not obtain limited liability and one level of tax using the corporate form.²⁷ Despite the establishment of statutory limited liability protection for all members, the Wyoming LLC clearly met the standards to obtain partnership classification, because the Wyoming statute required the LLC to lack both continuity of life and free transferability of interests — two out of the four corporate characteristics unincorporated entities must lack to secure partnership classification — regardless of the members' operating agreement.²⁸ After experiencing some resistance from the IRS,²⁹ the Wyoming Secretary of State's Office obtained a private letter ruling³⁰ that classified the Wyoming LLC as a partnership for tax purposes.³¹

25. A *limitada* is a foreign business entity that offers the ability to combine limited liability with other business characteristics normally associated with U.S. partnerships. These foreign entities were able to secure one level of tax for U.S. purposes under the partnership provisions. See *infra* note 42. Certain administrative difficulties and other difficulties related to the foreign law had made it impractical to continue to use these foreign *limitadas*. See William J. Carney, *Limited Liability Companies: Origins and Antecedents*, 66 U. COLO. L. REV. 855 (1995); Thomas N. Long, *The Wyoming Limited Liability Company* (Feb. 15, 1989) (unpublished manuscript, on file with author).

26. See WYO. STAT. ANN. §§ 17-15-101 to -136 (1989).

27. See Letter from A.J. Miller to Walter Urbigkit, Chief Justice Wyoming Supreme Court (June 5, 1992); Open letter by Frank Burke (Mar. 25, 1993) (describing early history of LLCs).

28. See WYO. STAT. ANN. §§ 17-15-123 to -123 (1989). For a detailed description of the classification regulations as applied to the Wyoming LLC Act, see Hamill, *supra* note 1.

29. See sources cited *supra* note 25.

30. Because private letter rulings only provide authority to the individual taxpayer requesting it, the Wyoming private letter ruling could not have launched the LLC movement on a wide scale.

31. See Priv. Ltr. Rul. 81-060-82 (Nov. 18, 1980).

On the eve of the private letter ruling's release,³² the IRS issued proposed amendments to the state's entity classification regulations that would automatically treat all limited liability companies as associations taxable as corporations.³³ Although undoubtedly offended by the special-interest motivation behind the Wyoming LLC legislation,³⁴ the IRS may also have viewed the newly invented domestic LLC as a potential threat that, if allowed to spread, would precipitously undermine the tax revenues collected from corporations.

By defining a "limited liability company" as any organization in which all owners enjoy limited liability protection under local law, the IRS's proposed regulations ignored all other similar business arrangements (for example, a minimally capitalized corporate general partner) that also provide limited liability protection.³⁵ The proposed regulations, therefore, would have failed to establish limited liability³⁶ as a meaningful criterion for imposing the corporate tax.³⁷ Many state law partnerships would have continued to enjoy limited liability in substance by using corporations as intermediaries between the partnership and the real partner.³⁸ Moreover, closely held corporations could continue to avoid the corporate tax by paying out most, if not all, of their net profits in deductible items.³⁹

Although clearly devastating to the Wyoming LLC, the proposed regulations received the strongest criticism from representatives of equipment-leasing trusts and U.S. persons participating in foreign enterprises.⁴⁰ Before the IRS issued these proposed regulations,⁴¹ *limitadas*, as well as other foreign entities that enjoyed limited liability protection by statute, were often classified as partnerships and, in some cases, re-

32. See sources cited *supra* note 25.

33. See 45 Fed. Reg. 75,709 (1980).

34. This represents pure speculation on the author's part based on knowledge of how the government works and certain comments made by government employees long after the proposed regulations were issued and withdrawn.

35. The preamble to these proposed regulations explicitly states that limited partnerships organized in a state with statutory default provisions materially corresponding to the Revised Uniform Limited Partnership Act and general partnerships governed by state law similarly adopting the provisions of the Uniform Partnership Act will not be subject to per se association treatment regardless of any substantive arrangements by the general partners to limit their liability exposure. See 45 Fed. Reg. 75,709 (1980).

36. See *infra* notes 185-88 and accompanying text.

37. See *infra* section III.A.

38. See *infra* notes 87-91, 185-87 and accompanying text.

39. See *infra* section II.A.

40. See I.R.S. News Release IR-82-145 (Dec. 16, 1982).

41. See *supra* notes 32-37 and accompanying text.

ceived favorable partnership classification in private letter rulings.⁴² Like the Wyoming LLC, these foreign entities would automatically have been taxed as corporations under the proposed regulations.⁴³ The IRS later withdrew its proposal and stated that it would conduct an extensive study concerning the effects of the limited liability characteristic on entity classification.⁴⁴

Both the LLC's creation and its viability as a serious business form can be directly linked to the failure of lawmakers to resolve the corporate integration issue affirmatively. The nearly ten-year duration of the IRS's study, during which little activity occurred with respect to LLCs, suggests that the IRS was reluctant to allow a domestic limited liability entity to enjoy the benefits of the partnership tax regime. Before Wyoming passed the first statute allowing for domestic LLCs, no other unincorporated domestic business form had ever combined corporate limited liability and partnership taxation while providing business provisions offering a serious possibility of widespread use. By providing limited liability and one level of tax under the partnership provisions, the LLC created a direct route for small business to fill the void left open by the partnership and corporate tax regimes. If the tax system provided for corporate integration, the LLC probably would not have been born and without the critical partnership classification, the LLC had no chance of expanding throughout the country.

Although in 1982 Florida enacted an LLC statute, presumably to lure capital into the state,⁴⁵ no other states recognized the LLC while its tax status remained in limbo. Thus, the LLC remained imprisoned as a tax hostage until the IRS resolved the partnership classification issue. During this period, predictably few businesses chose to become LLCs. Less than one hundred groups became LLCs before the entity finally received partnership status.⁴⁶

42. See Priv. Ltr. Rul. 81-06-082 (Nov. 18, 1980); Priv. Ltr. Rul. 80-19-112 (Feb. 15, 1980); Priv. Ltr. Rul. 80-07-029 (Nov. 21, 1979); Priv. Ltr. Rul. 80-07-029 (Nov. 2, 1979); Priv. Ltr. Rul. 80-04-140 (Nov. 2, 1979); Priv. Ltr. Rul. 78-41-047 (July 14, 1978); Priv. Ltr. Rul. 78-41-042 (July 14, 1978); Priv. Ltr. Rul. 77-37-049 (June 17, 1977). The language of these private letter rulings strongly indicates that the limited liability protection enjoyed by the owners of the foreign entity comes directly from the foreign law and was not created contractually by the owners.

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

44. See Announcement 83-4, 1983-2 I.R.B. 30 (Jan. 14, 1983); *supra* notes 33, 35.

45. See FLA. STAT. §§ 608.401-.514 (1995); Richard Johnson, Comment, *The Limited Liability Company Act*, 11 FLA. ST. U. L. REV. 387, 387 (1983).

46. Approximately 44 LLCs formed in Wyoming before the IRS issued Revenue Ruling 88-76. See Telephone Interview with Sharon Cochran, Office of the Wyoming Secretary of State (Jan. 31, 1996) [hereinafter Cochran Interview]. The 44 LLC filings in Wyoming had to be estimated, because the IRS issued Revenue Ruling 88-76 on Sep-

B. *LLCs After the Recognition of Partnership Status*

As a result of its study, the IRS issued Revenue Ruling 88-76 in 1988,⁴⁷ which permitted the LLC to secure partnership classification despite the presence of limited liability. After this long-awaited ruling, LLCs leapt from obscurity to become a well known and accepted form in less than ten years. In 1990 Colorado and Kansas both passed LLC statutes, and in 1991 four more states (Nevada, Texas, Utah and Virginia) joined them.⁴⁸ Then, in 1992 and 1993, LLC legislation swept the country. In 1992 ten more states, including Delaware, passed LLC statutes,⁴⁹ and the National Conference of Commissioners on Uniform State Laws formed a drafting committee to produce a Uniform Limited Liability Company Act.⁵⁰ In 1993 eighteen more states, the largest number

tember 2, 1988 and the Wyoming Secretary of State's Office keeps records on a calendar-year basis. As of December 31, 1987, a total of 40 business ventures had filed to become LLCs. The estimated number of LLC filings between January 1, 1988, and the release of Revenue Ruling 88-76 was determined by adding the average number of new LLC filings per year from 1977 through 1987, 4, to 40. Although 12 new LLCs were formed in 1988, it is reasonable to conclude that the number formed between January 1, 1988, and September 2, 1988, was commensurate with the average of four filings per year for the 10 years before Revenue Ruling 88-76. Accordingly, this estimate assumes that eight new LLCs registered between the issue date of Revenue Ruling 88-76 and December 31, 1988 — the difference between 12, the total number of LLC filings in 1988, and 4.

Although the Florida Secretary of State's Office only calculates total current LLCs registered in the state without breaking down the number of filings year by year, based upon the Wyoming filing data, it is reasonable to assume that the number of pre-Revenue Ruling 88-76 Florida LLCs was similarly modest. As of December 31, 1995, Florida had 2709 active LLCs and 903 inactive LLCs (presumably entities existing as shells not actively engaging in businesses), indicating that Florida currently has on record 3612 existing LLCs. Telephone Interview with Diane Cushing, Office of the Florida Secretary of State (Jan. 17, 1996) [hereinafter Cushing Interview]. Comparing the 3612 Florida LLCs with the total number of Wyoming filings from 1977 to 1995, 4631, it appears unlikely that the number of pre-Revenue Ruling 88-76 LLC filings in Florida exceeded that in Wyoming.

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

48. See COLO. REV. STAT. §§ 7-80-101 to -1101 (1995); KAN. STAT. ANN. §§ 17-7601 to -7656 (1995); NEV. REV. STAT. ANN. §§ 86.010 to 86.571 (Michie 1991); TEX. REV. CIV. STAT. ANN. art. 1528n, arts. 1.01-11.07 (West 1991); UTAH CODE ANN. §§ 48-26-101 to 48-26-157 (1991), VA. CODE ANN. §§ 13.1-1000 to 13.1-1123 (Michie 1991).

49. See ARIZ. REV. STAT. ANN. §§ 29-601 to -857 (Supp. 1995); DEL. CODE ANN. tit. 6, §§ 18-101 to 1107 (1995 & Supp. 1996); ILL. COMP. STAT. ch. 805, para. 180/1-1 to 180/60-1 (1995 & Supp. 1996); IOWA CODE §§ 490A.100 to .1601 (1995); LA. REV. STAT. ANN. 12:1301 to :1369 (West 1994); MD. CORPS. & ASSNS. CODE ANN. §§ 4A-101 to -1103 (1993 & Supp. 1995); MINN. STAT. §§ 322B.01 to .960 (1996); OKLA. STAT. ANN. tit. 18, §§ 2000-2060 (West Supp. 1996); R.I. GEN. LAWS §§ 7-16-1 to -75 (1992 & Supp. 1995); W. VA. CODE §§ 31B-1-101 to 13-13-6 (1996).

50. Letter from Edith O. Davies, Executive Secretary, National Conference of Commissioners on Uniform State Laws (on file with author) (Sept. 4, 1992); Letter

to enact LLC legislation in any single year, passed statutes.⁵¹ By the fall of 1996, eight years after the IRS issued Revenue Ruling 88-76, all fifty states and the District of Columbia recognized LLCs.⁵² In 1995 the National Conference of Commissioners on Uniform State Laws approved the final version of the Uniform Limited Liability Company Act.⁵³

The number of business ventures filing as LLCs mirrored the meteoric pace of state enactment of LLC statutes.⁵⁴ Between September 2, 1988, the eve of the IRS's release of Revenue Ruling 88-76 (when the U.S. had less than 100 LLC filings) and December 31, 1995, over 210,000 business ventures filed to become LLCs, a pace that can only be explained by the LLC's ability to secure limited liability and partnership taxation, a combination lying at the heart of the corporate integration issue.⁵⁵

For some perspective it is necessary to compare the growth in LLC filings to U.S. corporation and partnership data. In 1988 approximately

from Edward I. Cutler, Chair of Uniform Limited Liability Company Act Drafting Committee to Susan Pace Hamill (Aug. 19, 1992) (on file with author).

51. See ALA. CODE §§ 10-12-1 to -61 (1994); ARK. CODE ANN. §§ 4-32-107 to -1316 (Michie 1996), CONN. GEN. STAT. ANN. §§ 34-100 to -242 (West Supp. 1996); GA. CODE ANN. §§ 14-11-100 to -1109 (1994 & Supp. 1996); IDAHO CODE §§ 53-601 to -672 (1994 & Supp. 1996); IND. CODE ANN. §§ 23-18-1-1 to -13-1 (West 1994 & Supp. 1996); MICH. COMP. LAWS ANN. §§ 450.4101 to .5200 (West Supp. 1996); MO. REV. STAT. §§ 347.010 to .187 (1994); MONT. CODE ANN. §§ 35-8-101 to -1307 (1995); NEB. REV. STAT. §§ 21-2601 to -2653 (Supp. 1994); N.H. REV. STAT. ANN. §§ 304C:1 to :85 (1995); N.J. REV. STAT. §§ 42:2b-1 to -70 (1995); N.M. STAT. ANN. §§ 53-19-1 to -74 (Michie Supp. 1996); N.C. GEN. STAT. §§ 57C-1-01 to -10-07 (Supp. 1995); N.D. CENT. CODE §§ 10-32-01 to -155 (Supp. 1995); OR. REV. STAT. §§ 63.001 to .990 (1995); S.D. CODIFIED LAWS ANN. §§ 47-34-1 to -59 (Supp. 1996); WIS. STAT. §§ 183.0102 to .1206 (1996).

52. See ALASKA STAT. § 10.50.010 - .995 (Supp. 1995); CAL. CORP. CODE §§ 17000-17705 (West Supp. 1990); D.C. CODE ANN. §§ 41-101 to -148 (Supp. 1996); KY. REV. STAT. ANN. §§ 275.001-455 (Michie/Bobbs-Merrill Supp. 1994); ME. REV. STAT. ANN. tit. 31, §§ 601-762 (West 1996); MASS. GEN. L. ch. 156C, § 1-68 (Supp. 1995); MISS. CODE ANN. §§ 79-29-101 to -1201 (Supp. 1995); OHIO REV. CODE ANN. §§ 1705.01 to .58 (Anderson Supp. 1995); PA. CONS. STAT. §§ 890108998 (1995); S.C. CODE ANN. §§ 33-43-101 to -1409 (La. Co-op. Supp. 1995); TENN. PUB. CODE ANN. §§ 48-201-101 to -248-606 (1995); VT. STAT. ANN. tit. 11, §§ 3001-3162 (Michie Supp. 1996); WASH. REV. CODE §§ 25.15.005 to .902 (1994); HAWAII 1995 HI S.B. 2723 (signed June 7, 1996, effective Apr. 1, 1997).

53. See also Advisors Report on the Uniform Limited Liability Company Act (Mar. 13, 1995), reprinted in RIBSTEIN & KEATINGE ON LIMITED LIABILITY COMPANIES (1995).

54. For a complete year-by-year and state-by-state breakdown of LLC filings from September 2, 1988 to December 31, 1995, see Appendix.

55. Undoubtedly some of these new filings are shells on shelves and, therefore, we cannot estimate to what extent these filings represent true going concerns.

3.56 million corporations⁵⁶ and 1.65 million partnerships⁵⁷ filed income tax returns. By 1992, the latest year *Statistics of Income* makes income tax return information available, approximately 3.87 million corporations filed returns, representing an increase of 8.6% over the 1988 returns, while approximately 1.48 million partnerships filed returns, representing a decrease by 9.2% when compared to the 1988 returns.⁵⁸ The number of LLC filings, which totaled approximately 210,000 by 1995, looks modest by comparison, but the explosive percentage increase in LLCs compared with the small percentage increase in corporations and decrease in partnerships, clearly reflects a rapidly growing trend of new businesses choosing LLCs. The percentage increase of LLCs between 1992 and 1995 was well over 1600% (comparing the 7000 new LLC filings in 1992 with the 115,000 new LLC filings in 1995), assuredly a far greater increase than the 1995 corporate and partnership income tax returns will likely show when those statistics become available.⁵⁹

Although the LLC still trails the corporation in total number of existing entities and new filings, the tremendous rise in new LLC filings on a percentage basis from 1990 through 1995 indicates that the LLC has at the very least become a serious choice for doing business and may in fact become the entity of choice in the future. Moreover, leading

56. See STATISTICS OF INCOME DIV., INTERNAL REVENUE SERV., STATISTICS OF INCOME: 1988 CORPORATIONS INCOME TAX RETURNS 8 [hereinafter STATISTICS OF INCOME, CORPORATIONS 1988].

57. See STATISTICS OF INCOME DIV., INTERNAL REVENUE SERV., STATISTICS OF INCOME: 1988 PARTNERSHIP INCOME TAX RETURNS (this number includes filings for both general and limited partnerships). General partnership returns equaled 1.37 million, and limited partnership returns equaled 285,000. *Id.*

58. STATISTICS OF INCOME DIV., INTERNAL REVENUE SERV., STATISTICS OF INCOME: 1992 CORPORATION INCOME TAX RETURNS [hereinafter STATISTICS OF INCOME, CORPORATIONS, 1992]; STATISTICS OF INCOME DIV., INTERNAL REVENUE SERV., STATISTICS OF INCOME: 1992 PARTNERSHIP INCOME TAX RETURNS.

59. See *infra* notes 215-27 and accompanying text. New LLC filings at the state level and corporate and partnership income tax return filings provide comparable, but not perfectly equivalent information. The income tax return filings represent the number of existing corporations or partnerships, regardless of when they were formed, while the LLC filings generally measure new filings each year.

Comparing new LLC filings to new corporate filings in a particular state, Delaware, similarly shows the corporation in the lead when focusing on gross numbers, with the LLC showing much more growth potential on a percentage basis. In Delaware, the number of new corporations filed in 1994 and 1995 totaled 44,762 and 47,851 respectively, representing an increase of 6.9%. In those years, new Delaware LLC filings grew from 2795 in 1994 to 6483 in 1995, an increase of 132%. Facsimile from Pauline Fry, Office of Delaware Department of State (Feb. 13, 1996) (on file with author). Moreover, the gross number of new corporate filings, which include existing businesses that must incorporate in order to enter the capital equity markets, is distortively high when attempting to measure the trend of new businesses choosing either the corporate or LLC forms. See *infra* notes 149-71.

business states, such as New York, California, and Delaware, have taken the lead in LLC formation, notwithstanding their relatively late enactments of LLC statutes. By securing enormous acceptance in these states, LLCs have become an accepted mainstream form for doing business. The stagnation of LLCs before Revenue Ruling 88-76, contrasted with their tremendous growth after that ruling, shows that the energy fueling the LLC's rise is the LLC's ability to directly combine the tax advantages of a partnership with the statutory limited liability previously only enjoyed by corporations — the void left open by lawmakers' failure to solve the corporate integration issue.

As the LLC rose in prominence, the IRS and other branches of government were forced to deal with both the presence of LLCs and their effect on the tax system.⁶⁰ From 1990 to 1995, the IRS spent an enormous amount of time solving certain technical tax issues created by LLCs.⁶¹ Taxpayers and the bar focused on questions concerning how the partnership classification regulations applied to LLCs. Before 1995 the partnership classification regulations effectively prevented larger, widely held businesses from using the LLC form, because it was not clear whether LLC managers could be analogized to the general partners of limited partnerships when applying the technical rules of the partnership classification regulations.⁶² In early 1995, the IRS virtually destroyed all of the remaining tax handicaps that held LLCs back by allowing them to largely treat LLC managers as general partners and otherwise apply the partnership classification regulations in the same flexible manner applied to limited partnerships.⁶³ Shortly thereafter, the IRS proposed amendments to the classification regulations allowing unincorporated businesses to choose partnership or corporate taxation regardless of their business characteristics.⁶⁴ Because LLCs have been freed

60. See *supra* text accompanying notes 53-71.

61. See Susan Pace Hamill, *The Taxation of Domestic Limited Liability Companies and Limited Partnerships: A Case for Eliminating the Partnership Classification Regulations*, 73 WASH. U. L.Q. 565, 589-98 (1995) (describing in detail the technical problems confronted by the Service from 1990 until it issued Revenue Procedure 95-10).

62. See *id.*

63. See Rev. Proc. 95-10, 1995-1 C.B. 501.

64. See Prop. Treas. Reg. §§ 301.7701-1 to 7701-3, 61 Fed. Reg. 21989 (1996), previously discussed in I.R.S. Notice 95-14, 1995-1 C.B. 297. The question of whether pass-through entities should receive the benefits and flexibility offered by the partnership tax provisions is beyond the scope of this article. The recent promulgation of the anti-abuse regulation, see Treas. Reg. § 1.701-2 (as amended in 1995), suggests that the Treasury believes at least some partnerships are being used inappropriately. Many have criticized the partnership tax rules. See Curtis J. Berger, *W(h)ither Partnership Taxation?*, 47 TAX L. REV. 105 (1991); Mark P. Gergen, *Reforming Subchapter K: Special Allocations*, 46 TAX L. REV. 1 (1990). For a defense of the policy behind the funda-

from the restrictions of the classification regulations that once caused many businesses to favor limited partnerships,⁶⁵ the LLC form can now compete with all forms of partnership, including widely held limited partnerships, on their business merits alone — indeed, the LLC may be judged superior.⁶⁶ Moreover, the ability of widely held businesses to choose the LLC form without regard to the classification regulations allows LLCs to enjoy at least a theoretical tax advantage over all nonpublicly traded corporations.⁶⁷

The ability of businesses to choose the LLC form instead of the corporation clearly added an additional dimension to the already controversial corporate integration issue, and lawmakers predictably were interested in exploring the rise of LLCs. In early 1993, the House Ways and Means Select Revenue Measure Subcommittee announced a plan to hold hearings addressing a number of topics, including the corporate integration question generally and the increased use of LLCs.⁶⁸ Although the Chairman, Charles Rangel (D-NY), identified no official concerns with LLCs,⁶⁹ unofficial sources indicate that lawmakers were interested in examining whether LLCs resulted in any revenue loss and if a better means existed to distinguish partnerships from corporations.⁷⁰ As discussed later in this article, the concern of an LLC-created revenue loss will prove groundless.⁷¹ However, Congress's interest in seeking a better way to distinguish partnerships and corporations suggests that lawmakers may realize that the current system for imposing the corporate tax is inequitable and inconsistent.⁷² Regardless, both of these issues are significant, as they lie at the center of the corporate integration debate.⁷³

By mid-1993, both lawmakers and the bar evinced intense interest in relaxing the restrictions faced by S corporations.⁷⁴ This culminated in

mental partnership taxation rules, see Rebecca S. Rudnick, *Enforcing the Fundamental Premises of Partnership Taxation*, 22 HOFSTRA L. REV. 229 (1993).

65. See Hamill, *supra* note 61, at 589-92.

66. See *id.* at 607.

67. See *infra* notes 140-48 and accompanying text.

68. See HIGHLIGHTS & DOCUMENTS, Feb. 3, 1993, p. 2109.

69. See *Use of Limited Liability Companies*, *supra* note 23, at J-1.

70. See *supra* note 68; *Congress May Examine IRS Position on LLCs in Future*, Daily Tax Rep. (BNA) No. 72, at G-7 (Apr. 15, 1994).

71. See *infra* sections II.A.-B.

72. *But cf. supra* notes 131-39 and accompanying text.

73. See *supra* note 19.

74. An S corporation is a closely held corporation (no more than 35 shareholders (75 after effective date of 1996 legislation)) that has elected to be taxed under a special set of rules that allows one level of tax at the shareholder level with many restrictions not applicable to partnerships. A significant restriction that contributed greatly to the

the proposal of the S Corporation Reform Act of 1995 and the relaxation of certain S corporation restrictions as part of the Small Business Job Protection Act of 1996, signed on August 20, 1996.⁷⁵ The committee responsible for the S Corporation Reform Act proposal identified the rise of the LLC as one of the most important reasons for passing the legislation.⁷⁶ Commentators asserted that without reform S corporations would be unable to compete for capital with LLCs.⁷⁷ At least from the perspective of closely held businesses the 1995 proposal and the Small Business Job Protection Act of 1996 appear to address the relationship between the increased use of LLCs and the corporate integration question by mitigating certain inequities among partnerships, LLCs, and S corporations.⁷⁸ Although the 1995 proposal and the 1996 legislation loosen up the limitations imposed on the number and the kinds of persons that can be S corporation shareholders and make other changes,⁷⁹ the improvements at best nip at the margin of the inequities between incorporated and unincorporated business forms.⁸⁰ Consequently, regardless of whether or not Congress further relaxes the S corporation restrictions as contemplated by the proposed S Corporation Reform Act

first LLC statutory enactment is the rule denying S corporation eligibility to any corporation with a foreign shareholder. *See supra* note 8.

75. *See Hearing on S.327, S.758, and H.R.1215 Before the Subcomm. on Taxation & IRS Oversight of the Sen. Comm. on Finance, 104th Cong. (1995) [hereinafter Senate S Hearing]; see also Finance Members Consider Whether LLCs Trump S Corp. Reform, TAX NOTES 1711 (1995).*

The Small Business Job Protection Act of 1996 allows S corporations to have 75 shareholders instead of 35, relaxes the rules related to certain trusts permitted as shareholders, allows financial institutions to hold safe harbor debt, allows S corporations to hold subsidiaries, allows certain tax-exempt organizations to be shareholders, and makes other changes. *See H.R. 3448, 142 CONG. REC. H9568, H9574-77 (1996) (enacted) (provisions of Small Business Job Protection Act relating to S corporations); see also Clinton Signs Health Insurance and Small Business Bills, 72 TAX NOTES 1079 (1996).*

76. *See Senate S Hearing, supra* note 75, at 4 (statement of Glen A. Kohl, Tax Legislative Counsel, Dept. of Treasury); *see also* STAFF, JOINT COMM. ON TAXATION, PRESENT LAW AND PROPOSALS RELATING TO SUBCHAPTER S CORPORATIONS AND HOME OFFICE DEDUCTIONS 5-6 (Comm. Print 1995) [hereinafter S CORP. PROPOSALS].

77. *See* Robert J. Wells, *S Corp. Simplification Bill To Be Introduced Soon, Senate Aides Say*, 93 TAX NOTES TODAY, 160-62 (1993).

78. *Cf.* S CORP. PROPOSALS, *supra* note 76, at 5 (noting that until rise of LLCs, S corporations represented the only domestic business entity directly providing for one level of tax and limited liability treatment under local law).

79. *See id.* at 2-3; *supra* note 75.

80. *See Senate S Hearing, supra* note 75, at 30-39 (interchange between senators and witnesses, including author); *id.* at 50-54 (statement of Susan Hamill); *supra* note 75. The major advantages partnerships enjoy over S corporations — the ability to make special allocations and to include shares of the entity's third party debt in the owner's basis and the right to have any owner, including foreign persons — are not provided for in either the 1995 proposal or the 1996 legislation. *Id.*

of 1995, new businesses will continue to choose the LLC in order to receive the benefits of limited liability and one level of tax without having to deal with the restrictions of subchapter S or the complications associated with paying out corporate profits in deductible items. Thus, the corporate integration question with respect to smaller corporations will not be answered by legislation that largely leaves the inequities between S corporations and partnerships in place.⁸¹

Shortly after the hearing on S corporation reform, the Treasury Assistant Secretary for Tax Policy suggested that the Senate Finance Committee propose legislation allowing S corporations to convert to LLC status without incurring the corporate tax, or allow S corporations to elect partnership taxation while retaining their corporate status under state law.⁸² It is likely that most S corporations would choose to become LLCs if allowed to do so tax free.⁸³ Moreover, many eligible C corporations would quickly elect subchapter S and convert to LLC status.⁸⁴ A mass conversion to LLC status led by tax considerations alone would further expose the tax inequities suffered by corporations caused by the failure of lawmakers to address the corporate integration question.⁸⁵ If lawmakers allow all S corporations to be taxed as partnerships without giving up the corporate form, at least for closely held corporations eligi-

81. See also *infra* notes 110-25 and accompanying text.

82. Letter from Leslie B. Samuels, Assistant Secretary for Tax Policy, Treasury Dept., to Orrin G. Hatch, Senator (July 25, 1995), reprinted in *Treasury Expresses Conditional Support for S Corp. Reform Bill*, 95 TAX NOTES TODAY, 150-25 (Aug. 2, 1995). The 1996 legislation contains no provision allowing S corporations to convert to partnerships or LLCs tax free or the general freedom to use the partnership tax provisions. See *supra* note 75.

83. See Wells, *supra* note 77, at 100-02 (statement of Jerald August) (conceding that businesses would opt for the LLC rather than the S corporation form if given a choice and no transaction costs).

Total S corporations filing income tax returns equaled 1,785,371 in 1992. See *S Corporation Returns*, STAT. OF INCOME BULL., Spring 1995, at 73. Thus, a more favorable tax rule would cause a mass migration to the LLC form. See also EMPIRICAL FOUNDATIONS OF HOUSEHOLD TAXATION (Martin Feldstein & James M. Poterba eds., (1996); JOEL SLEMRUD, HIGH-INCOME FAMILIES AND THE TAX CHARGES OF THE 1980S: THE ANATOMY OF BEHAVIORAL RESPONSE ¶ 6.4.1 (1996) (noting that choice of S corporations rose substantially after the Tax Reform Act of 1986).

84. C corporations, which are subject to tax at the corporate level and again at the shareholder level when the corporation pays dividends (the two-tier tax), include all corporations that have not elected (or are ineligible to elect) to be S corporations. Because S corporations can only have 35 shareholders (75 shareholders after the effective date of the Small Business Protection Act of 1996) and face numerous other restrictions, most of the corporations in the United States of significant size will be C corporations. See *supra* notes 7-8.

85. Cf. *Senate S Hearings*, *supra* note 75, at 24, 29 (statement of Martin Ginsburg, Professor, Georgetown University Law Ctr.) (stating that S corporation reform is needed to help existing corporations that cannot convert to an LLC).

ble to elect subchapter S, the tax inequities demanding corporate integration would disappear, and these businesses could choose between the corporate and LLC forms for business reasons alone.⁸⁶

II. LLCs AND CORPORATE INTEGRATION

A. *Partnerships and Closely Held Corporations Enjoy One-Level Taxation and Limited Liability*

Long before the LLC emerged, some businesses sought to combine the advantages of limited liability for all owners with one level of taxation by forming a partnership with corporate intermediaries between the ultimate partner and the partnership. Individual partners of general partnerships that produce taxable income often use S corporations to bear the personal liability for the partnership's obligations.⁸⁷ The partnership's income flows through to the S corporation and then again to the ultimate partner who thereby avoids bearing personal liability for the partnership's debts.⁸⁸

Over the years it has also become standard industry practice for limited partnerships to acquire limited liability by using minimally capitalized corporate general partners.⁸⁹ As long as the partner seeking to avoid personal liability takes precautions to ensure that no grounds exist to pierce the corporate veil⁹⁰ or otherwise disregard the corporation,⁹¹ the partnership effectively provides limited liability protection and one level of tax. From the perspective of both general and limited partnerships acquiring limited liability by using corporate partners, LLCs pro-

86. This would directly provide for corporate integration for the defined group of corporations eligible to elect Subchapter S under a pure pass through to shareholders modeled exactly like the partnership rules.

87. In 1992, 49.34% of the S corporations had only one shareholder. *See S Corporation Returns*, *supra* note 83, at 73.

88. *See supra* notes 6, 8.

89. *See* Hamill, *supra* note 61, at 585-87, 604-07.

90. *See* Robert B. Thompson, *Piercing the Corporate Veil: An Empirical Study*, 76 CORNELL L. REV. 1036 (1991) (extensive study of over 1500 cases outlining the factors various courts use to pierce the corporate veil). Professor Thompson notes that no cases were found involving a widely held or publicly traded corporation's veil being disregarded. *Id.* at 1047.

91. *See, e.g.*, Delaney v. Fidelity Lease Ltd., 526 S.W.2d 543, 546 (Tex. 1975) (concluding that corporation was a mere fiction because its sole purpose was to manage and control limited partnership); *cf.* Frigidaire Sales Corp. v. Union Properties, Inc. 562 P.2d 244, 247 (Wash. 1977) (concluding that 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); *see also* Alan L. Feld, *The "Control" Test for Limited Partnerships*, 82 HARV. L. REV. 1471 (1969); Michael S. McNeely, 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).

vide no new opportunities to enjoy limited liability. Rather, the LLC allows these businesses to enjoy limited liability without going through the expense and effort of setting up intermediary corporations.

Many active closely held businesses that essentially operated like general partnerships have chosen to incorporate directly rather than use intermediary corporate partners in order to obtain limited liability protection.⁹² Because the shareholders of these close corporations act, as a business matter, more like general partners, problems arise when trying to resolve disputes among the shareholders using strict corporate law. Minority shareholders involved in disputes with the majority shareholders face the possibility that their capital investment will grant no immediate return. Under the protection of the business judgment rule, corporate law grants majority shareholders, as the controlling members of the board of directors, wide discretion to withhold dividends and deny the minority shareholders salary payments as employees. Unlike partners in partnerships, shareholders of corporations generally have no right to force the corporation or the other shareholders to buy back their shares.⁹³

Initially, courts rigidly applied the traditional corporate law and denied minority shareholders relief.⁹⁴ Over time, courts⁹⁵ and legislatures⁹⁶

92. See *infra* note 97 and accompanying text.

93. See generally 2 F. HODGE O'NEAL & ROBERT B. THOMPSON, O'NEAL'S OPPRESSION OF MINORITY SHAREHOLDERS § 7.02 (2d ed. 1985).

94. See 2 F. HODGE O'NEAL & ROBERT B. THOMPSON, O'NEAL'S CLOSE CORPORATIONS §§ 8.13 and 8.14 (3d ed. 1990); see also *Benintendi v. Kenton Hotel, Inc.*, 60 N.E.2d 829 (N.Y. 1945); *Clark v. Dodge*, 199 N.E. 641 (N.Y. 1936); *McQuade v. Stoneham*, 189 N.E. 234 (N.Y. 1934).

95. See *Rexford Rand Corp. v. Ancel*, 58 F.3d 1215 (7th Cir. 1995) (recognizing fiduciary duties in close corporations under Illinois law); *Evans v. Certified Engg. & Testing Co.*, 834 F. Supp. 488 (D. Mass. 1993) (denying defendants motion for summary judgment in part); *Cramer v. Devon Group, Inc.*, 774 F. Supp. 176 (S.D.N.Y. 1991); *Alaska Plastics, Inc. v. Coppock*, 621 P.2d 270 (Alaska 1980) (remanding for a factual determination of whether the remedy is appropriate); *Van Schaack v. Van Schaack Holdings, Ltd.*, 856 P.2d 15 (Colo. Ct. App. 1992); *Marshall v. W.E. Marshall Co.*, 376 S.E.2d 393 (Ga. Ct. App. 1988); *W&W Equip. Co., v. Mink*, 568 N.E.2d 564 (Ind. Ct. App. 1991); *Zimmerman v. Bogoff*, 524 N.E.2d 849 (Mass. 1988); *Wilkes v. Springside Nursing Home, Inc.*, 353 N.E.2d 657 (Mass. 1976); *Donahue v. Rodd Electrotype Co. of New England*, 328 N.E.2d 505 (Mass. 1975); *Donahue v. Draper*, 491 N.E.2d 260 (Mass. App. Ct. 1986) (remanding for a new trial on the issue of appropriate damages); *Hallahan v. Haltom Corp.*, 385 N.E.2d 1033 (Mass. App. Ct. 1979); *Westgor v. Grimm*, 318 N.W.2d 56 (Minn. 1982) (remanding to determine if the actions taken by the majority shareholders were in the interest of the corporation); *Harris v. Mardan Business Sys., Inc.*, 421 N.W.2d 350 (Minn. Ct. App. 1988) (recognizing fiduciary duties, but finding that these parties are not co-shareholders bound by fiduciary duties); *Fix v. Fix Material Co.*, 538 S.W.2d 351 (Mo. Ct. App. 1976) (recognizing fiduciary duties in a close corporation context, but denying minority shareholder relief based on failure of minority shareholder to sustain her burden of proof); *Russell v. First York*

recognized the business differences between close corporations and widely held corporations and started to fashion remedies for minority shareholders in close corporations. The combination of state corporation codes that allow opportunities to plan around close corporation problems and the courts' recognition of special fiduciary duties owed to minority shareholders, allowed the corporate form to become a serious alternative for the closely held business.⁹⁷

Sav. Co., 352 N.W.2d 871 (Neb. 1984) (per curiam) (recognizing fiduciary duties, but the action was barred by statute of limitations), *overruled on other grounds by* Van Pelt v. Greenhouse, 364 N.W.2d 14 (Neb. 1985); Yackel v. Kay, 642 N.E.2d 1107 (Ohio 1994); Frank Lerner and Assocs., v. Vassy, 599 N.E.2d 734 (Ohio 1991); Crosby v. Beam, 47 Ohio St. 548 N.E.2d 217 (Ohio 1989); Thompson v. Central Ohio Cellular Inc., 639 N.E.2d 462 (Ohio Ct. App. 1994); Koos v. Central Ohio Cellular, Inc., 641 N.E.2d 265 (Ohio Ct. App. 1994) (recognizing fiduciary duties in the close corporation context, but holding that defendants did not breach their fiduciary duties to minority shareholders under these specific facts); Gigax v. Repka, 615 N.E.2d 644 (Ohio Ct. App. 1992); Masinter v. WEBCO Co., 262 S.E.2d 433 (W. Va. 1980) (reversing summary judgment and remanding for factual findings to determine if majority shareholder conduct was oppressive).

96. Many states adopted close corporation supplements while others explicitly recognized in their general corporate statute the right to enter into shareholder agreements and petition the court for dissolution or buy-out due to oppression. See REVISED MODEL BUSINESS CORP. ACT §§ 7.32, 14.30 (1984); MODEL STATUTORY CLOSE CORP. SUPP. §§ 1-55 (1988), *reprinted in* MODEL BUSINESS CORPORATION ACT ANNOTATED (3d ed. 1985); see also CAL. CORP. CODE § 1800 (West 1990); DEL. CODE ANN. tit. 8, § 262 (1991).

97. During the period in which close corporation law developed, roughly the late 1970s through the mid-1980s, the number of general partnerships and corporations with assets ranging from \$1 to \$1 million (small-asset corporations) increased. Each year from 1977 until 1985, the number of general partnerships filing income tax returns equaled 1,058,220; 1,115,247; 1,163,481; 1,209,318; 1,252,298; 1,288,326; 1,308,000; 1,386,417; and 1,433,725, respectively. See *Partnership Returns, 1978-82*, STAT. OF INCOME BULL., Spring 1986, at 71; Partick Piet, *Partnership Returns, 1983*, STAT. OF INCOME BULL., Summer 1985, at 55; Alan Zempel, *Partnership Returns, 1984*, at STAT. OF INCOME BULL., Summer 1986 at 37; Alan Zempel, *Partnership Returns, 1985*, STAT. OF INCOME BULL., Summer 1987, at 33. From 1977 until 1985, the number of small-asset corporations filing income tax returns equaled 2,008,305; 2,112,167; 2,273,302; 2,405,227; 2,459,353; 2,570,557; 2,629,788; 2,757,179; and 2,844,212, respectively. See STATISTICS OF INCOME DIV., INTERNAL REVENUE SERV., STATISTICS OF INCOME: 1977-1985 CORPORATION INCOME TAX RETURNS (each year in separate books).

After 1985 the number of general partnerships filing returns steadily declined. From 1986 until 1993, general partnerships totaled 1,429,876; 1,385,824; 1,369,093; 1,341,527; 1,267,760; 1,244,665; 1,214,004; and 1,175,189, respectively. See Alan Zempel, *Partnership Returns, 1986*, STAT. OF INCOME BULL., Summer 1988, at 29, 31 fig. D; Joseph H. Middough, *Partnership Returns, 1987*, STAT. OF INCOME BULL., Winter 1989-1990, at 5, 7 fig. B; Gail Moglen, *Partnership Returns 1988*, STAT. OF INCOME BULL., Summer 1990, at 5, 5 fig. A. Except for a tiny decline in filings from 1987 to 1988, small-asset corporations increased every year from 1985 to 1992 (showing 2,844,212; 2,916,891; 3,016,254; 3,012,174; 3,064,603; 3,152,534; 3,228,881; and 3,258,995 corporations filing income tax returns in those years, respectively). See STA-

These closely held corporations, while developing their own partnership-flavored corporate law, have been able largely to avoid the corporate tax.⁹⁸ During the period between 1970 and 1986, the year Congress enacted the Tax Reform Act of 1986, closely held corporations,⁹⁹ on a percentage basis, paid a negligible amount of corporate tax when compared to the total receipts realized by corporations.¹⁰⁰ For example, in 1976 corporations with assets of less than \$1 million (small-asset corporations) earned 17.8% of the total receipts realized by all corporations but paid only 4.86% of the total corporate tax paid by all corporations.¹⁰¹

The percentage of corporate tax paid appears even more insignificant when focusing only on the small-asset corporations with the lowest asset base. For example, in 1976 corporations with assets of less than \$100,000 paid only 0.57% of the total corporate tax while realizing 3.83% of the total receipts.¹⁰² In 1986, these small-asset corporations paid slightly more tax but hardly shouldered a share commensurate with

STATISTICS OF INCOME DIV., INTERNAL REVENUE SERV., STATISTICS OF INCOME: 1985-1992 CORPORATION INCOME TAX RETURNS (each year in separate books). These trends suggest that, by the mid-1980s, existing smaller businesses were incorporating and new smaller businesses were more often choosing to be corporations rather than general partnerships.

98. See *supra* notes 92-97 and *infra* notes 99-125 and accompanying text.

99. Because the *Statistics of Income on Corporations* reflects a corporation's size by the value of its assets (on a gross rather than net basis, see *infra* note 122) rather than the number of shareholders, it is assumed that small-asset corporations roughly encompasses corporations with relatively few shareholders. See STATISTICS OF INCOME DIV., INTERNAL REVENUE SERV., STATISTICS OF INCOME: 1970-1991 CORPORATION INCOME TAX RETURNS (each year in separate books); STAT. OF INCOME BULL. Fall & Spring 1995; see also *infra* note 110 (describing the tiny number of small-asset corporations that list as publicly traded on the over the counter markets).

100. Smaller firms in competitive industries generally have a lower rate of return than larger firms, monopolies, and oligopolies. While some of the lower tax to total receipts ratio for smaller firms might be explained by the lower rates of return generally earned by smaller firms, undoubtedly a large part of the discrepancy is due to the smaller firms' methods of avoiding the corporate tax. See *infra* notes 110-26 and accompanying text.

101. See STATISTICS OF INCOME DIV., INTERNAL REVENUE SERV., STATISTICS OF INCOME: 1976 CORPORATION INCOME TAX RETURNS [hereinafter STATISTICS OF INCOME, CORPORATIONS, 1976]. These figures assume that the corporations have at least \$1 of assets.

Corporations with assets of \$1 million or more but less than \$5 million, a group with assets too large to fit comfortably in the small-asset group, likewise managed to avoid a large amount of corporate tax, although their contribution to the total corporate revenues cannot be categorically classified as insignificant or negligible. In 1976 these in between corporations paid 6.72% of the corporate tax while realizing 12.19% of the total receipts. *Id.*

102. See *id.* This assumes that the corporations in question have at least \$1 of assets.

their earnings. In that year, these corporations realized 14.26% of gross receipts but paid only 4.65% of the corporate tax.¹⁰³ In 1986 small-asset corporations with assets below \$100,000 realized 3.31% of total receipts but paid only 0.70% of the corporate tax.¹⁰⁴

Since 1987 small-asset corporations on the whole decreased their share of the corporate tax every year.¹⁰⁵ In 1987 small-asset corporations realized 13.52% of total receipts and paid only 3.68% of the corporate tax;¹⁰⁶ small-asset corporations with assets below \$100,000 realized 3.18% of the total receipts and paid 0.51% of the corporate tax.¹⁰⁷ By 1992 small-asset corporations realized 11.94% of total receipts and paid only 2.0% of the corporate tax;¹⁰⁸ small-asset corporations with

103. STATISTICS OF INCOME DIV., INTERNAL REVENUE SERV., STATISTICS OF INCOME: 1986 CORPORATION INCOME TAX RETURNS [hereinafter STATISTICS OF INCOME, CORPORATIONS, 1986]. These figures assume that the corporations have at least \$1 of assets. Corporations with assets of \$1 million to \$5 million likewise managed to avoid a large amount of corporate tax, although their contribution to the total corporate revenues cannot be categorically classified as insignificant or negligible. In 1986 these corporations paid 5.93% of the corporate tax while realizing 11.37% of the total receipts. *Id.*

104. *See id.* These figures assume that the corporations have at least \$1 of assets.

105. Small-asset corporations in 1987 bore less corporate tax than they did in 1986. The gap between the percentage of total receipts and percentage of corporate tax paid in 1986 equaled 9.61% (2.61% when focusing only on the corporations with assets of less than \$100,000), while this spread totaled 9.84% in 1987 (2.67% when focusing only on the corporations with assets of less than \$100,000). Comparing the 1986 and 1987 figures, the increased differential suggests that small-asset corporations more successfully avoided the corporate tax in 1987. *Id.*; STATISTICS OF INCOME DIV., INTERNAL REVENUE SERV., STATISTICS OF INCOME: 1987 CORPORATION INCOME TAX RETURNS [hereinafter STATISTICS OF INCOME, CORPORATIONS, 1987].

From 1988 all the way through 1992, small-asset corporations paid a steadily decreasing share of the corporate tax when focusing on the percentage of their total receipts compared to the percentage of their total corporate tax paid. In 1988 these corporations realized 12.85% of total receipts and paid 2.59% of the corporate tax; in 1989 they realized 12.15% of total receipts and paid 2.55% of the corporate tax; in 1990 they realized 12.15% of total receipts and paid 2.27% of the corporate tax; in 1991 they realized 12.08% of total receipts and paid 2.20% of the corporate tax; in 1992 they realized 11.94% of total receipts and paid 2.0% of the corporate tax. *See id.*; STATISTICS OF INCOME DIV., INTERNAL REVENUE SERV., STATISTICS OF INCOME: 1988-1992 CORPORATION INCOME TAX RETURNS (each year in separate volumes).

The latest year in which statistics on corporate income tax returns were published is 1992. *See supra* note 99; *infra* note 109.

106. STATISTICS OF INCOME, CORPORATIONS, 1987, *supra* note 105. These figures assume that the corporations have at least \$1 of assets.

In between corporations with assets of \$1 million or more but less than \$5 million managed to avoid a large amount of corporate tax, although their contribution to the total corporate revenues cannot be categorically classified as insignificant or negligible. In 1987 these corporations paid 4.47% of the corporate tax while realizing 10.80% of the total receipts. *See id.*

107. *See id.*

108. These figures assume that the corporations have at least \$1 of assets.

less than \$100,000 of assets realized 3.10% of total receipts but paid only 0.28% of the corporate tax.¹⁰⁹

To avoid the entity-level tax, closely held corporations frequently extract the profits out of corporate solution by directly or indirectly making deductible payments to shareholders.¹¹⁰ The IRS has often attacked this technique and attempted to recoup the corporate tax by recharacterizing these payments as dividends. Although since the mid-1930s the IRS has sought to reclassify a variety of payments (such as compensation, rent, and interest as dividends) in nearly 400 cases,¹¹¹ it

In between corporations with assets of \$1 million to \$5 million managed to avoid a large amount of corporate tax, although their contribution to the total corporate revenues cannot be categorically classified as insignificant or negligible. In 1992, these corporations paid 2.82% of the corporate tax while realizing 10.30% of the total receipts. STAT. OF INCOME BULL., Fall/Spring 1995, 7-25 (coverage includes corporate return statistics). Like small-asset corporations, these in between corporations were paying noticeably less corporate tax by 1992 than they paid in the previous years, indicating that they were finding more deductible expenses at the corporate level. See *supra* notes 101, 103, 106.

109. See STATISTICS OF INCOME, CORPORATION INCOME TAX RETURNS, 1992, *supra* note 58. The gap between small-asset corporations' percentage of total receipts and percentage of corporate tax paid in 1992 equaled 9.94% (2.82% when focusing only on the corporations with assets of less than \$100,000). Comparing the 1992 figures with the 1986 figures, 9.61% (2.61% for the less than \$100,000 corporations), and the 1987 figures, 9.84% (2.67% for the less than \$100,000 corporations), clearly proves that small-asset corporations steadily increased their ability to avoid the corporate tax by 1992. See also STATISTICS OF INCOME, CORPORATIONS, 1986, *supra* note 103, at 8; STATISTICS OF INCOME, CORPORATIONS, 1987, *supra* note 105, at 8.

110. Most of the corporations in the small-asset group are probably closely held. However a few of these corporations do trade publicly. In 1992, 3,258,995 small-asset corporations filed income tax returns. See STATISTICS OF INCOME, CORPORATIONS, 1992, *supra* note 58. Currently 8079 corporations in this asset range are publicly traded. Search of LEXIS, Compny library, UPSPUB file (Mar. 21, 1996) (search = total - assets (< \$1,000,000)). Although the number of corporations currently trading is not a perfect comparison to the total returns in 1992, it roughly indicates that a very limited number of small-asset corporations publicly trade. The publicly traded corporations in this group are most likely post bankruptcy shells of what once was a profitable company. These companies have outstanding stock, little assets, no income, and probably substantial net operating losses. More than likely these companies pay no corporate taxes.

111. Search of LEXIS, Genfed library, MEGA file (Oct. 24, 1995) (search = corporation and (stockholder! or shareholder! or (control! /5 corporation)) and (deduct! /5 salar! or rent or interest or compensation) and ((disguis! or constructiv!) /5 dividend!) and (23 or 162 or 163 or 1.162 or 1.163 or (ordinary or necessary /5 business expens!)) (599 cases found); Search of LEXIS, Taxria library, CASES file (Oct. 24, 1995) (same search parameters) (575 cases found); Search of Westlaw, Allcases and FTX-CS databases (Oct. 25, 1995) (same search parameters) (531 and 533 cases found, respectively). After overlapping cases were eliminated, these combined searches produced a total of 610 net cases of which 381 involved payments potentially being recharacterized as dividends. Of the 381 cases, the Service entirely prevailed in 123 cases, entirely lost 95 cases, and was able to partially, but not completely, recharacterize the deductible payment as a dividend in 163 cases. See also Hamill, *supra* note 61, at 603 n.171 (a

won only 123 of them.¹¹² In all the other cases, the corporation was able to keep its deduction at least partially, and often completely, thus effectively eliminating the corporate tax.¹¹³ During the 1970s through the mid-1980s, the IRS litigated 179 cases and won only 30 percent of the time.¹¹⁴ By the end of the 1970s, the IRS publicly announced that it would no longer seek to recharacterize compensation payments as dividends, even if the corporation paid virtually no dividends, if the compensation payments met the standard for reasonableness.¹¹⁵ From 1985 through 1995, the IRS cut down the number of cases litigated and improved its success record, prevailing in 45% of 81 cases.¹¹⁶

The IRS's inability to effectively prevent closely held corporations from avoiding the corporate tax becomes even more obvious after examining the cases when the IRS either completely or partially compelled a dividend. In many of these cases, the corporation could have preserved the deduction entirely or largely had it been better advised. For example, better planning (advising the shareholder to actually perform meaningful services and keep good records) could have altered the result in cases in which the IRS invalidated a salary deduction, because the shareholder either performed inadequate services for the corporation¹¹⁷ or none at all.¹¹⁸ Moreover, the IRS successfully disallowed other

more limited search in the Taxria library produced 260 annotated cases, with the Service completely prevailing in 72 cases, entirely losing in 138 cases, and partially recharacterizing dividends in 50 cases).

112. See *supra* note 111 and *infra* notes 116-20, 124 and accompanying text. The IRS undoubtedly audited and settled many more cases, the number of which is impossible to estimate.

113. See *supra* note 111.

114. See *supra* note 111. From 1970 to 1984, of the 179 litigated cases, the IRS won 51 cases, lost 49 cases, and had partial success in 79 cases.

115. See Rev. Rul. 79-8, 1979-1 C.B. 92. In *Charles McCandless Tile Serv. v. United States*, 422 F.2d 1336 (Ct. Cl. 1970), the court ordered a constructive dividend reflecting 15% of the corporation's profit even though the salary paid by the corporation fell within the standard of reasonableness. After several other courts disagreed with this reasoning, the Service retreated from the Court of Claims' position.

116. See *supra* note 111. Of the 122 early cases (from 1935 to 1965), the IRS only won 29% of the time (35 cases). From 1985 to 1995, of the 81 litigated cases, the Service won 37 cases, lost 15 cases, and enjoyed partial success in 29 cases.

117. Of the 286 cases in which the IRS was either partially or completely successful, 48 involved situations in which the shareholder's salary was too large when considering the work done and therefore failed to meet the standards of reasonableness. See *supra* note 111. For example, in order for the salary paid to the shareholder to be entirely deductible, it had to be reasonable in comparison to other salaries paid in the industry for comparable positions. Courts also considered the shareholder's contribution (or lack thereof) to the corporation's success. See *supra* note 111.

118. See *Hardin v. United States*, 461 F.2d 865 (5th Cir. 1972); *Union Stock Farms v. Commissioner*, 265 F.2d 712 (9th Cir. 1959); *Fink v. Wallace (In re Fink)*, No. CV 185-51 (S.D. Ga. Nov. 10, 1986); *S.A. Manohara, M.D., Inc. v. Commissioner*, 68

salary and rent deductions, because the shareholders failed to adequately document the business nature of the expense — a mistake clearly avoidable with competent advice.¹¹⁹ In other cases, the IRS successfully denied the corporate interest deduction because the shareholders failed to adequately document the debtor-creditor relationship with the corporation.¹²⁰

Both the statistics on corporate income tax filings¹²¹ and the cases in which the IRS attempted to recharacterize deductible payments as dividends illustrate that closely held corporations were able to avoid the corporate tax almost completely. Small-asset corporations did indeed pay a negligible amount of corporate tax — certainly not enough to make a positive impact on corporate revenues.¹²² Although over time

T.C.M. (CCH) 142 (1994); *Alexander Shokai, Inc. v. Commissioner*, 63 T.C.M. (CCH) 1870 (1992); *Greenwood v. Commissioner*, 57 T.C.M. (CCH) 1058 (1989); *Frankland Racing Equip., Inc. v. Commissioner*, 53 T.C.M. (CCH) 658 (1987); *Estate of Marcello v. Commissioner*, 36 T.C.M. (CCH) 1408 (1977); *American Lithofold Corp. v. Commissioner*, 55 T.C. 904 (1971), *acq.*, 1971-2 C.B.1; *Miles Prod. Co. v. Commissioner*, 28 T.C.M. (CCH) 1387 (1969); *Mulder Bros. v. Commissioner*, 26 T.C.M. (CCH) 217 (1967); *Glasgow Village Dev. Corp. v. Commissioner*, 36 T.C. 691 (1961), *acq.*, 1961-2 C.B. 4, *and acq.*, 1962-2 C.B.6; *Wilson v. Commissioner*, 20 T.C.M. (CCH) 676 (1961) (13 total cases).

119. Of the 286 cases, 52 of them involved corporations that could have largely salvaged the deduction had the shareholders documented the business nature and other details of the expense. *See supra* note 111.

120. Of the 286 cases in which the IRS enjoyed partial or total success, 12 could have preserved the interest deduction had the shareholders simply bothered to set forth a note with an interest rate. *See supra* note 111.

121. *See supra* notes 99-109 and accompanying text.

122. *See supra* notes 98-109 and accompanying text. In 1976, small-asset corporations paid \$4,047,500,000 in corporate tax revenues compared to \$70,503,361,000 of tax paid by larger corporations. By 1986, the small-asset corporate tax bill had risen to \$5,157,474,000 with the larger corporations picking up \$102,682,896,000 in corporate tax revenues. In 1987 the small-asset corporations' total tax paid dropped to \$4,349,478,000 while the larger corporations continued to pay more, \$112,354,765,000 that year. By 1992, small-asset corporate tax revenues further decreased to \$2,638,015,000, while larger corporations' tax revenue continued to grow to \$127,218,877,000 that year. *See STATISTICS OF INCOME, CORPORATIONS, 1976, 1986, 1987, 1992 supra* notes 101, 103, 105, 58, respectively. Because the asset size measures gross rather than net assets, the corporate tax paid by truly small corporations probably appears to be more than it is actually. Some corporations, by virtue of having less liabilities on a percentage basis when compared to other corporations, appear (when measuring gross assets) to be smaller than they are. If it were possible to group all corporations by size according to their net assets, corporations with less liabilities will appear in a larger sized group. It is impossible to tell how many of the small-asset corporations in the less than \$1 million gross asset group have proportionally less liabilities and therefore should be in a larger asset group. One can speculate that the bulk of the small-asset corporations paying the corporate tax are lean with little leverage and therefore would appear in a larger asset group if the corporations could be grouped according to net rather than gross assets. *See infra* notes 131 and 145.

the IRS improved its chances of recouping some tax through litigation, at best its total success rate rose to just under 50% — not enough to justify litigation costs when compared to the corporate tax recouped.¹²³ Moreover, in more than half of the cases where the IRS enjoyed partial or complete success, the corporation again could have largely preserved its deduction had the shareholders sought competent advice.¹²⁴ Furthermore, the corporate income tax return filings from 1987 to 1992 (the period during which the IRS's record improved) show that closely held corporations further reduced their share of the corporate tax.¹²⁵ Because closely held corporations of a relatively modest asset size never were and never will be a serious source of corporate tax revenues,¹²⁶ the increased use of the LLC form rather than the closely held corporation imposes little or no threat to corporate tax revenues and, therefore, does not represent an unsanctioned backdoor to corporate integration.

B. *Is There an LLC Challenge to Larger Corporations?*

As corporations grow beyond a closely held group of shareholders, it becomes increasingly difficult for a variety of reasons to eliminate the corporate tax. For example, once the number of shareholders grows beyond a closely held group, the board of directors faces business pres-

123. See *supra* note 111 and accompanying text. Arguably, a tough litigating position by the IRS might discourage more abusive corporate deductible payments that are disguised as dividends. However, a well-advised closely held corporation can still largely avoid the corporate tax without prompting an IRS attack.

124. See *supra* note 111. Of the 286 cases in which the IRS enjoyed partial or total success, in 180 the IRS's victory can be best viewed as the result of a shareholder's blunder, either from poor planning or from outright illegal or fraudulent activity. See *supra* notes 117-20.

125. See *supra* notes 98-109 and accompanying text.

126. Over the last 10 to 20 years, the mix of corporate income earned has shifted away from capital-intensive businesses that will show a greater value in assets (particularly when the measurement focuses on gross rather than net assets, see *supra* note 122 and *infra* note 131) toward more service-oriented, highly technical businesses — Silicon Valley, for example — that will show a much smaller value when measuring assets. In these service companies, the stock value will be a more accurate valuation of the company than the total assets and if it were possible to group all corporations by size according to stock value, these technical service oriented corporations would appear in a larger-sized group. Undoubtedly a good portion of the corporate tax paid by the smaller companies, when measuring size based on assets, comes from these service corporations that appear in a smaller-sized group than they should. If in the future the amount of corporate tax paid by smaller (measuring assets) corporations increases, that increase can probably be largely attributed to further growth in these highly technological, service oriented industries that in fact should be treated as larger corporations. The presence of these new service-oriented corporations in no way undermines the ability of traditional closely held corporations, in fact truly small corporations, to avoid the corporate tax by paying out corporate earnings in deductible items.

tures to declare at least some dividends.¹²⁷ Moreover, once a corporation's assets and total receipts grow beyond a certain range, it becomes increasingly difficult to eliminate its taxable income with legitimate business deductions. The main tool to mitigate the corporate tax that is available to corporations beyond the closely held range involves using debt to raise capital (which creates deductible interest) rather than building equity (which creates nondeductible dividends).¹²⁸ The IRS has sometimes challenged the interest or other corporate deductions of larger corporations but has enjoyed no more success in preserving the corporate tax than it did in its attempts to disallow deductions of closely held corporations.¹²⁹

Despite the opportunity to mitigate the corporate tax by creating corporate debt, the largest corporations, representing the greatest concentration of publicly traded corporations, pay the lion's share of the corporate tax¹³⁰ on a percentage basis when compared to their total re-

127. See O'NEAL & THOMPSON, *supra* note 93, at § 1.02.

128. Section 163(a) generally allows corporations to deduct interest on indebtedness. See I.R.C. § 163(a) (1994). Because dividends paid on stock are not deductible, corporations will often prefer to issue debt instead of equity when raising capital. Although § 279 might appear to disallow interest deductions on certain debt incurred to acquire another corporation, see I.R.C. § 279 (1994), a closer look reveals a number of easy opportunities to avoid the limitations. Consequently, corporations could generally deduct all interest on debt needed to finance the takeover boom in the 1980s. After an aborted attempt in 1987 to cut back the corporate interest deduction, see H.R. 3545, 100th Cong. §§ 10138, 10144 (1987), in 1989 Congress finally passed some limitations narrowly targeted to cover very specific abuses, see Revenue Reconciliation Act of 1989, Pub. L. No. 101-239, §§ 7202(a)-(b), 7211(a)-(b), 101 Stat. 2301, 2330-32, 2342-45 (codified as amended at I.R.C. §§ 163(e)(5), (i), 172(b)(1)(E), (h) (1994)). Although these changes represent a start toward limiting the benefits of corporate leverage, the current tax system still significantly favors corporate debt over corporate equity. See BITTKER & EUSTICE, *supra* note 7, ¶¶ 4.01[2] and 4.26 (1995).

A comprehensive discussion of the disparate treatment of corporate interest and dividend payments and how it complicates the corporate integration issue is beyond the scope of this article. See generally Cheryl D. Block, *The Trouble with Interest: Reflections on Interest Deductions After the Tax Reform Act of 1986*, 40 U. FLA. L. REV. 689 (1988); Michael S. Knoll, *Taxing Prometheus: How the Corporate Interest Deduction Discourages Innovation and Risk-Taking*, 38 VILL. L. REV. 1461 (1993); Alvin C. Warren, Jr., *The Corporate Interest Deduction: A Policy Evaluation*, 83 YALE L.J. 1585 (1984).

129. See *supra* note 111. The facts in approximately 69 cases strongly suggested that the corporation was not closely held. In most of the 52 cases in this group in which the IRS enjoyed partial or total success, the corporation had attempted to deduct personal or other nonbusiness expenses.

130. The tax revenues collected from corporations as a percentage of total federal revenues collected from all taxpayers has been falling. In 1943 the corporate tax made up 39.8% of all federal revenues while by 1991 corporations shouldered just under 9% of all federal revenues. See BITTKER & EUSTICE, *supra* note 7, ¶ 1.01. To the extent that corporations steadily contribute less on a percentage basis to federal revenue as a

ceipts.¹³¹ In 1976 corporations with assets of \$250 million or more (large-asset corporations) realized 46.18% of total receipts while paying 66.94% of the total corporate tax.¹³² In 1986 large-asset corporations slightly reduced their percentage share of the corporate tax, realizing 50.49% of total receipts while paying 64.48% of the corporate tax.¹³³ Since 1987 the percentage of corporate tax paid by large-asset corporations representing the bulk of the publicly traded corporations has grown consistently each year;¹³⁴ in that year, large-asset corporations earned 51.94% of the total receipts but paid 71.63% of the corporate

whole, the LLC's possible impact on the corporate tax and the corporate integration question generally becomes less controversial.

131. Because the *Statistics of Income* breaks down corporations only by asset size, this analysis assumes that the corporations with assets of \$250 million or more (large-asset corporations) tend to be publicly traded. The measurement of a corporation's asset size focuses on gross rather than net assets, which is the figure used to group corporations for SOI purposes. Because gross asset size includes liabilities, highly leveraged corporations will appear to be larger than they are in actuality. Because earnings and taxes are related more closely to net assets, the grouping of corporations by gross assets produces a larger margin of error.

In 1992, 6269 large-asset corporations filed income tax returns. See STATISTICS OF INCOME, CORPORATIONS, 1992, *supra* note 58. Currently, 3634 large-asset corporations are publicly traded. See Search of LEXIS, Compny library, US PUB file, (Mar. 21, 1996) (search = total - assets (> \$249,999,999)). Although the current number of publicly traded corporations and the total 1992 income tax return filings is not a perfect comparison, together they roughly indicate that more than 50% of the largest corporations are publicly traded, a percentage far greater than any other asset range of corporations. Although the percentage of publicly traded large-asset corporations seems low, one can assume that the nonpublicly traded corporations in the large-asset group are highly leveraged. From a perspective of measuring gross assets these companies appear larger than they are because of a high number of liabilities and would likely appear in the medium-asset corporate group if it were possible to group the corporations according to size on a net asset basis. See *supra* note 110; *infra* note 145.

132. The total tax paid by these corporations equaled \$55,758,037,000. STATISTICS OF INCOME, CORPORATIONS, 1976, *supra* note 101.

133. See STATISTICS OF INCOME, CORPORATIONS, 1986, *supra* note 103. The total tax paid by large-asset corporations equaled \$71,660,623,000.

134. See *supra* note 131. Large-asset corporations in 1987 appeared to bear more corporate tax than they did in 1986. The gap between the percentage of corporate tax paid and the percentage of total receipts in 1986 equaled 13.90%, while this gap rose to 19.69% in 1987. Comparing the 1986 and 1987 figures, the increased differential indicates that large-asset corporations, presumably publicly traded, increasingly shouldered a greater share of the corporate tax. See STATISTICS OF INCOME, CORPORATIONS, 1987, *supra* note 105; see also STATISTICS OF INCOME, CORPORATIONS, 1986, *supra* note 103. Moreover, large-asset corporations in 1992 bear even more corporate tax than they did in 1987. The gap between the percentage of corporate tax paid and the percentage of total receipts in 1987 equaled 19.69%, while this gap rose to 23.24% in 1992. Comparing the 1987 and 1992 figures, the increased differential proves that the bulk of the corporate tax is paid by, and will continue to be paid by, large-asset corporations. See *id.*; STATISTICS OF INCOME, CORPORATIONS, 1987, *supra* note 105.

tax.¹³⁵ By 1992 they realized 55.22% of the total receipts and paid 78.46% of the corporate tax.¹³⁶ Because the tax law requires all publicly traded partnerships,¹³⁷ which include publicly traded LLCs, to bear the corporate tax, publicly traded LLCs cannot possibly undermine the corporate tax base.¹³⁸ Consequently, the increased use of LLCs does not directly force lawmakers to decide the important policy question of whether publicly traded corporations should enjoy some form of corporate integration.¹³⁹

Corporations with assets well above the range of small-asset corporations but not reaching the size of large-asset corporations¹⁴⁰ consist-

135. See STATISTICS OF INCOME, CORPORATIONS, 1987, *supra* note 105. The total tax paid equaled \$84,871,153,000.

136. The total tax paid equaled \$103,006,310,000. See STATISTICS OF INCOME, CORPORATIONS, 1992, *supra* note 58. The large-asset corporations paid slightly less tax in 1989 when compared to 1988. (In 1988 they paid 76.45% of the corporate tax and they realized 52.36% of the total receipts; in 1989 they paid 76.02% of the corporate tax and realized 53.34% of the total receipts; the drop in tax paid from 1988 to 1989 was an insignificant less than one-half of one percent). After 1989 the large-asset corporations paid a slightly increasing share of the corporate tax each year. In 1990 they paid 77.58% of the corporate tax and realized 54.12% of the total receipts; in 1991 they paid 77.69% of the corporate tax and realized 54.82% of the total receipts; in 1992 they paid 78.46% of the corporate tax and realized 55.22% of the total receipts.

137. See I.R.C. § 7704(b) (1994); Treas. Reg. § 1.7704-1 (1995). Publicly traded partnerships include any partnership interest traded on an established market, a secondary market, or the equivalent. The regulations contain safe harbors deeming certain sales of partnership interests that constitute private transfers or private placements, sales pursuant to certain redemption and repurchase agreements, and sales pursuant to certain qualified matching services to fall outside the definition of public trading. See Treas. Reg. § 1.7704-1 (1995).

138. Theoretically, LLCs could undermine the corporate tax paid by the large-asset corporations that are not publicly traded. On a practical level, under the current income tax system LLCs possess no more ability to replace nonpublicly traded large-asset corporations than they do in the \$10 million to \$250 million asset range (medium-asset corporations). Because LLCs pose no practical threat to the corporate tax raised by the nonpublicly traded corporations in the medium-asset range, LLCs cannot possibly threaten the corporate tax paid by the large-asset nonpublicly traded corporations. See *infra* notes 148-70 and accompanying text.

139. See *supra* note 19; see also RICHARD GOODE, THE CORPORATION INCOME TAX (1951); RICHARD B. GOODE, THE POSTWAR CORPORATION TAX STRUCTURE (1946); CHARLES E. McLURE, JR., MUST CORPORATE INCOME BE TAXED TWICE? (1979). The question whether LLCs would have the ability to undermine the corporate tax if the tax law allowed them to publicly trade while enjoying partnership taxation (as was indeed permitted before Congress enacted § 7704 in 1987 taxing publicly traded partnerships as corporations) is beyond the scope of this article. The debate relevant to publicly traded LLCs would be identical to the debate on whether publicly traded partnerships could undermine the corporate tax. See *infra* notes 166-71 and accompanying text.

140. The data examining the corporate tax paid by corporations in the in between asset group of \$5 million to just under \$10 million (too large to fit in the small-asset group but too small to fit comfortably in the medium-asset group), show significantly

ently pay roughly their share of the corporate tax on a percentage basis. For example, in 1976 corporations with assets of \$10 million to just under \$250 million (medium-asset corporations) realized 16.98% of total receipts and paid 14.32% of the corporate tax,¹⁴¹ and in 1986 these corporations realized 17.33% of total receipts and paid 18.87% of the corporate tax.¹⁴² In 1987 data indicate a shift in favor of slightly less corporate tax on a percentage basis, showing medium-asset corporations realizing 17.10% of total receipts while paying 16.28% of the corporate tax;¹⁴³ and by 1992 this gap had widened slightly more, with medium-asset corporations realizing 16.90% of total receipts and paying 14.02% of the corporate tax.¹⁴⁴ Unlike large-asset corporations, which pay a significantly higher percentage of the corporate tax when compared to their percentage of the total receipts, medium-asset corporations pay close to the same percentage of corporate taxes.¹⁴⁵ Although starting in

less total receipts and corporate tax paid than the data for the medium-asset and large-asset corporations; nevertheless in the earlier years they roughly paid their share of the corporate tax. In 1976, corporations with \$5 million to just under \$10 million of assets paid 3.21% of the corporate tax while realizing 4.19% of the total receipts. *See STATISTICS OF INCOME, CORPORATIONS, 1976, supra* note 101. In 1986, these corporations paid 3.11% of the corporate tax while realizing 4.56% of the total receipts. *See STATISTICS OF INCOME, CORPORATIONS, 1986, supra* note 103.

By 1987, these in between corporations did a better job improving their corporate tax position on a percentage basis than the corporations in the medium-asset range. In 1987 corporations with \$5 million to just under \$10 million of assets paid 2.45% of the corporate tax while realizing 4.69% of the total receipts. *See STATISTICS OF INCOME, CORPORATIONS, 1987, supra* note 105. By 1992 these corporations paid 1.60% of the corporate tax while realizing 4.39% of the total receipts. *See STATISTICS OF INCOME, CORPORATION INCOME TAX RETURNS, 1992, supra* note 58. Although these in between corporations falling just below the medium-asset range generate far less total receipts and corporate tax than medium-asset corporations and on a percentage basis do a better job avoiding the corporate tax, their contribution to the total corporate revenues cannot be categorically classified as insignificant or negligible. *See supra* notes 101, 103, 106 and 108.

141. Total tax paid equaled \$14,745,324,000. *See STATISTICS OF INCOME, CORPORATIONS, 1976, supra* note 101.

142. Total tax paid equaled \$20,977,655,000. *See STATISTICS OF INCOME, CORPORATIONS, 1986, supra* note 103.

143. Total tax paid equaled \$19,282,358,000. *See STATISTICS OF INCOME, CORPORATIONS, 1987, supra* note 105.

144. Total tax paid equaled \$18,411,714,000. *See STATISTICS OF INCOME, CORPORATION INCOME TAX RETURNS, 1992, supra* note 58.

145. The number of publicly traded medium-asset corporations is far fewer than the number of the publicly traded large-asset corporations. In 1992, 49,644 corporations in the medium-asset range filed income tax returns. *See STATISTICS OF INCOME, CORPORATIONS, 1992, supra* note 58. Currently, 5,275 medium-asset corporations are publicly traded. This is approximately 10.6% of the total 1992 corporations in the medium-asset range. *See Search of LEXIS, Compny library, US PUB file (Mar. 21, 1996) (search = total -assets (< \$250,000,000 and > \$9,999,999))*. Although the information on currently publicly traded corporations is not a perfect comparison with that contained in

1987 medium-asset corporations, like the smaller corporations, demonstrated an ability to improve their corporate tax position, medium-asset corporations always have and, assuming no integration, probably always will constitute an important source of revenue generated by the corporate tax.

Unlike large-asset corporations, which represent the greatest concentration of publicly traded activity, medium-asset corporations fall into a variety of groups. Undoubtedly some of these corporations, particularly those at the high end of the asset range, trade on the over-the-counter markets.¹⁴⁶ The presence of the LLC as an alternative form cannot undermine the corporate tax raised by the publicly traded corporations in this, or any, asset base because a publicly traded LLC will be taxed as a corporation regardless of whether or not it technically qualifies for partnership classification.¹⁴⁷ However, to the extent that medium-asset corporations fall outside the definition of "publicly traded," the option of using the LLC form theoretically could undermine a significant source of corporate tax.¹⁴⁸

For purely practical reasons, however, the LLC option poses no real threat to tax revenue generated by nonpublicly traded corporations. These corporations, like all others, are locked into the corporate form. Existing corporations cannot liquidate and reform as LLCs, because the corporate tax structure, as amended by the Tax Reform Act of 1986, imposes a corporate tax on all gains from liquidation and separately taxes the shareholders on their receipt of the liquidation proceeds.¹⁴⁹ The high cost of converting to the LLC form effectively locks all existing corporations into paying the corporate tax, allowing larger corpo-

the total income tax filings in 1992 for the medium-asset range, it roughly indicates that the medium-asset corporations on a percentage basis publicly trade far less often than the large-asset corporations. One can assume that the medium-asset corporations that do publicly trade are probably less leveraged than the average corporation in that group. Consequently, if the asset size could be grouped according to net rather than gross assets, at least some of these corporations would probably be in the large-asset category. See *supra* notes 122, 126 and 131.

146. See *supra* note 145.

147. See *supra* note 137.

148. To the extent that the large-asset corporations are not publicly traded, the option of using an LLC could theoretically undermine the corporate tax collected from these corporations. See *supra* note 131. The option of using a limited partnership can also theoretically undermine the corporate tax. See *infra* notes 162-65. Whether the LLC or limited partnership would be chosen is largely a business issue and beyond the scope of this article.

149. See *supra* text accompanying note 7; see also JOINT COMM. ON TAXN., 99TH CONG., 1ST SESS., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, at 328-54 (Comm. Print 1987) [hereinafter 1986 REFORM EXPLANATION].

rations only the ability to mitigate the tax by, for example, raising capital with debt instead of equity or by retaining earnings.¹⁵⁰

Arguably, though, the existence of the LLC could erode the future corporate tax of businesses that begin as small partnerships or LLCs and subsequently enter the capital markets in order to grow rapidly. Once these businesses reach a size commensurate with the nonpublicly traded corporations currently paying significant corporate tax,¹⁵¹ they could simply choose not to convert into corporate form and could thereby continue enjoying one level of tax under the partnership provisions. If the majority of these businesses do indeed avoid the corporate tax by failing to convert to the corporate form once the size of the business shows promise for significant growth, the availability of the LLC form over the long term would in fact contribute to an erosion of the corporate tax base.¹⁵²

However, the business tax system itself contains a practical backstop that will force such businesses to enter into the corporate form before they grow to a significant size. Once a small business reaches a high growth stage, it becomes necessary to issue equity in substantial amounts in order to raise capital. Because at this stage of a business' development, management will want to reinvest excess cash in the business rather than pay immediate investment returns, the business will want to issue equity (in which case management has sole discretion to decide when returns are paid) rather than debt (which typically requires regular interest payments).¹⁵³ Currently, tax-exempt and foreign inves-

150. See *id.* at 328-55. The high tax cost of liquidating a corporation also prevented publicly traded corporations from converting the entire business to a publicly traded partnership. See generally *Master Limited Partnerships: Hearings Before the Subcomm. on Select Revenue Measures of the House Comm. on Ways and Means*, 100th Cong. (1987) [hereinafter *MLP Hearings*].

151. An initial public offering of equity will cause the LLC to be taxed as a corporation under the publicly traded partnership rules. See *supra* note 137 and accompanying text. However, growing businesses can and often do tap the capital markets through private placements.

152. A small business starting out unincorporated currently can use the limited partnership instead of the LLC once it reaches a level of growth where capital must be raised in the market. If the LLC poses a threat to the corporate tax paid by these businesses avoiding the corporate form, the limited partnership poses the same threat. The same practical problems that will confine the LLC to a mere theoretical threat to this corporate tax also prevents limited partnerships from undermining the corporate tax. See *infra* notes 153-65 and accompanying text.

153. See WILLIAM A. KLEIN & JOHN C. COFFEE, JR., *BUSINESS ORGANIZATION AND FINANCE* 365-80 (6th ed., 1996) for a discussion of considerations when management adopts dividend policies; *id.* at 323-65 for a general discussion of leverage and the choice of capital structure; *id.* at 235-55 for a discussion of the characteristics of corporate debt. It is possible to issue corporate debt that does not require regular interest payments, the zero coupon bond, a debt instrument with an issue price signifi-

tors represent a large share of the equity capital markets — any business needing to raise capital by issuing substantial equity must look to these investors as potential purchasers.¹⁵⁴ However, because of the current tax rules, these investors generally will not purchase equity in an LLC or any other partnership form.¹⁵⁵ As the tax law now stands, distributive shares of an LLC's income will be taxed at the regular rates as unrelated business income taxable to the tax-exempt investor¹⁵⁶ and as income effectively connected with a U.S. trade or business to the foreign investor.¹⁵⁷ Dividends on corporate stock, however, are not taxable at all to the tax-exempt investor,¹⁵⁸ and foreign investors generally receive dividends at significantly lower tax rates under various treaties into which the United States has entered with its major trading partners.¹⁵⁹ Consequently, growing businesses that find it necessary to raise significant capital from the equity markets for the first time will be forced to use the corporate form in order to reach the tax-exempt and foreign investors.¹⁶⁰

cantly below the amount paid at maturity with no interest payments in between, for example. The interest element for these bonds is paid at the time of maturity. *See id.*

154. *See MLP Hearings, supra* note 150.

155. *See, e.g., id.* at 112-13 (statement of William S. McKee and Mark A. Kuller, attorneys, King & Spalding); 135-36 (statement of Barksdale Hortenstine, attorney, Andrews & Kurth); 143-44 (statement of R. Donald Turlington, Attorney and Adjunct Law Professor). If business contemplates raising capital by issuing equity in a private placement, neither the LLC nor the limited partnership can be used if the investors include tax-exempt or foreign persons. These investors will insist on purchasing corporate stock in order to receive the dividends tax free (for tax-exempt investors) or at the favorable rate provided by the applicable treaty (for foreign investors).

156. *See* I.R.C. §§ 512-513; *see also MLP Hearings, supra* note 150, at 107-67.

157. *See* I.R.C. §§ 871(b), 872, 875; *see also MLP Hearings, supra* note 150, at 107-67.

158. *See* I.R.C. §§ 512-513; *MLP Hearings, supra* note 150, at 107-67.

159. *See* I.R.C. § 871(a) (imposing a withholding tax of 30%). For a general discussion of tax treaties, *see* BITTKER & EUSTICE, *supra* note 7, ¶ 15.02[4]; *see also* 2 U.S. Intl. Taxn. (Warren Gorham & Lamont) ¶ C4.07 (1994 & Supp. 1995).

160. If the corporate income tax rate rose to a level significantly higher than that of the individual rate, nonpublicly traded businesses not already in corporate form probably would struggle to remain unincorporated and perhaps find ways to use the LLC and the limited partnership to undermine the corporate tax. A closely held active business of a modest size that starts out as an LLC and grows to a significant asset size, without needing to increase the level of ownership or raise capital by issuing equity to tax exempt and foreign investors, will simply remain an LLC in order to avoid the corporate tax. These future businesses remaining as LLCs could represent the corporations with assets out of the range of being classified as small, but not large enough to reach the medium-asset range. As already noted, the contributions made to the corporate tax by these corporations cannot be categorized as insignificant or negligible. *See supra* notes 101, 103, 106, 108 and 140. The number of small businesses able to grow without substantially increasing the equity owners and tapping the tax-exempt and foreign equity markets is likely small. *See MLP Hearings, supra* note 150. Moreover, if it were

Moreover, once the number of owners of an active business becomes so large that the individual tax situation for each owner inevitably shows significant diversity, it will become very difficult for management to adopt policies at the entity level to optimize the tax consequences for all of them. Because owners of the LLC's equity must report each year their distributive share of all the LLC's income and losses with the peculiar tax character of each item being preserved, management will face impossible pressure to choose courses of action that fit all the members' circumstances. Management also will dislike the increased pressure to distribute the earnings that the LLC inevitably will face due to the flow through of the taxable income and will find burdensome the disclosure of all the business decisions in the annual partnership filings that must be provided to each member.¹⁶¹

An examination of the business uses of limited partnerships, another potential unincorporated alternative for the larger business seeking to avoid the corporate form, further illustrates that the LLC's threat to the corporate tax is merely theoretical. Although the choice of using an LLC represents a fairly new development, growing active businesses starting out as partnerships have had for quite some time the option of using the limited partnership form to avoid paying the corporate tax. Consequently, the past and current uses of these limited partnerships provide clues as to the future direction of nonpublicly traded, larger LLCs. Most nonpublicly traded limited partnerships have been used for real estate and other investment ventures showing net losses rather than positive taxable income.¹⁶² When compared to larger, mostly nonpublicly traded corporations exceeding the small-asset range, the corporations, while showing fewer actual numbers in terms of the number of

possible for corporations in the in between sizes (\$1 million to just under \$10 million) to use flow-throughs, at least some of them would have used limited partnerships. See *infra* notes 162-65.

161. See *id.* at 116, 129. Even before LLCs became a viable option, nonpublicly traded limited partnerships were not used for growing active businesses; rather they were investment vehicles mostly producing losses. If growing active businesses never chose to use limited partnerships it is highly unlikely that they will use LLCs. See *infra* notes 162-65 and accompanying text; see also *Treasury Dept. Study, Widely Held Partnerships: Compliance and Administration Issues: A Report to Congress* (Mar. 30, 1990), reprinted in 64 *Daily Tax Rep. (BNA)*, Apr. 3, 1990, at L-1.

162. See *MLP Hearings, supra* note 150, at 168-74. Because of the enactment of the passive loss limitations in the Tax Reform Act of 1986, which severely limit the ability of many limited partners to currently deduct the partnership's losses, the popularity of the limited partnership predictably waned. Because existing limited partnerships exhaust their losses and eventually produce income, limited partnerships as a whole should start to show positive income in the future, because new limited partnerships producing initial losses are simply not being formed to the same degree.

returns filed, produce significant taxable income,¹⁶³ while limited partnerships consistently show a net deficit.¹⁶⁴ Clearly corporations are primarily engaged in active, profitable business, but limited partnerships have on balance been investment-oriented arrangements designed to produce, when the economics of the investment interface with the tax rules, tax losses. Before the LLC ever became an option, the data illustrate that growing active businesses found it necessary to incorporate rather than use the limited partnership form.¹⁶⁵ Therefore, it seems highly unlikely that a significant number of active businesses reaching a

163. From 1980 to 1992, medium-asset corporations (and the in between corporations with assets of at least \$5 million to just under \$10 million) filed returns numbering 55,072 (\$51,369,818,000 taxable income); 58,242 (\$50,899,467,000 taxable income); 60,138 (\$44,245,016,000 taxable income); 62,263 (\$46,222,390,000 taxable income); 68,591 (\$52,282,238,000 taxable income); 71,487 (\$54,161,137,000 taxable income); 73,374 (\$55,814,190,000 taxable income); 79,119 (\$56,277,962,000 taxable income); 83,403 (\$58,740,086,000 taxable income); 86,707 (\$56,408,956,000 taxable income); 87,971 (\$57,536,426,000 taxable income); 87,133 (\$54,539,446,000 taxable income); and 87,820 (\$58,142,107,000 taxable income), respectively. See INTERNAL REVENUE SERV., STATISTICS OF INCOME: 1980-1992 CORPORATION INCOME TAX RETURNS, 1980-1992 (separate volume for each year).

164. See *id.* From 1980 until 1992, limited partnerships numbered 170,336 (producing a net deficit of \$9,392,799,000); 208,204 (producing a net deficit of \$15,691,486,000); 225,886 (producing a net deficit of \$17,488,028,000); 234,000 (producing a net deficit of \$18,700,000,000); 257,164 (producing a net deficit of \$22,633,300,000); 279,878 (producing a net deficit of \$26,893,300,000); 273,076 (producing a net deficit of \$35,517,100,000); 262,210 (producing a net deficit of \$28,169,000,000); 285,152 (producing a net deficit of \$24,010,710,000); 293,637 (producing a net deficit of \$21,560,743,000); 285,769 (producing a net deficit of \$21,161,231,000); 270,681 (producing a net deficit of \$16,702,278,000); and 270,748 (producing a net deficit of \$3,277,692,000). See STAT. OF INCOME BULL., Spring 1986, Partnership Returns 1978-82, STAT. OF INCOME BULL., Summer 1985, Partnership Returns 1983, STAT. OF INCOME BULL., Summer 1986, Partnership Returns 1984 and STAT. OF INCOME BULL., Summer 1987, Partnership Returns, 1985; STAT. OF INCOME BULL., Summer 1988, Partnership Returns, 1986; STAT. OF INCOME BULL., Winter 1989-1990, Partnership Returns 1987; STAT. OF INCOME BULL., Summer 1990, Partnership Returns, 1988; STAT. OF INCOME BULL., Fall 1991, Partnership Returns, 1989; STAT. OF INCOME BULL., Summer 1993, Partnership Returns, 1990, STAT. OF INCOME BULL., Fall 1993, Partnership Returns, 1991, STAT. OF INCOME BULL., Fall 1994, Partnership Returns 1992; STAT. OF INCOME BULL., Fall 1995, Partnership Returns, 1993. See also SLEMROD, *supra* note 83, ¶ 6.4.2 (noting that the passive activity loss limitations caused a decrease in the use of partnerships and decreased the size of the global partnership deficit).

165. See *supra* notes 162-64 and accompanying text. Although the number of corporate filings consistently ran less than the number of limited partnerships, those corporations consistently reported over \$50 billion of taxable income each year. As a group, these corporations which numbered from 50,000 to 100,000 filings per year were clearly engaged in profitable, active businesses. On the other hand, the limited partnerships numbered over 200,000 each year but consistently reported significant deficits (reaching over \$35 billion in one year) evidencing real-estate and other shelter-oriented investments rather than active, profitable business. See *id.*

high-growth, profitable stage can avoid corporate status by using the LLC form if they were unable to accomplish the same result by using a limited partnership.

The LLC is not the only unincorporated business entity to have posed a challenge to revenues collected from the corporate tax. Starting in the early 1980s, publicly traded limited partnerships appeared on the market, offering at least a theoretical ability to threaten the future corporate tax paid by growing active businesses reaching the initial public offering stage.¹⁶⁶ In 1987, however, the fear of a mass disincorporation of American businesses prompted Congress to enact section 7704 of the Internal Revenue Code to tax all publicly traded partnerships as corporations.¹⁶⁷

During the hearings, the potential revenue drain caused by publicly traded partnerships was hotly debated.¹⁶⁸ Although government officials argued strongly to the contrary, a significant amount of compelling testimony and data indicated that the threat of the publicly traded limited partnership to the corporate tax was more theoretical than real. The rules in the business tax system that discourage tax-exempt and foreign investors from investing in partnership equity were at the core of the arguments supporting publicly traded partnerships. Many different experts testified that small businesses reaching a high growth stage simply could not exist as publicly traded partnerships. These businesses, unable to raise capital with debt due to the pressure to pay regular interest, would be forced to incorporate in order to fully reach the entire capital equity market, a large portion constituting tax-exempt and foreign investors.¹⁶⁹ Thus, the very backstop that prevents growing, nonpublicly traded LLCs from threatening the corporate tax thematically links the current debate over LLCs and corporate integration with the publicly traded partnership controversy fought in the 1980s.

During the hearings, the supporters of publicly traded partnerships pointed to the favored tax treatment of corporate debt over corporate

166. See *MLP Hearings*, *supra* note 150, at 29 (listing existing publicly traded partnerships by year starting in 1981).

167. See *id.* at 7-38 (statement and testimony of J. Roger Mentz, Assistant Secretary of Tax Policy); see also H.R. REP. NO. 100-495, at 943-53 (1987), reprinted in 1987 U.S.C.C.A.N. 2313-1245, 2313-1689 to -1699; H.R. REP. NO. 100-391, at 1065 (1987), reprinted in 1987 U.S.C.C.A.N. 2313-680 to -681.

168. See *MLP Hearings*, *supra* note 150, at 62-403.

169. Before the changes in the tax law under the 1986 Act, it was possible for existing mature businesses to liquidate and reform as publicly traded partnerships. After the 1986 Act, this course of action would be too expensive thus confining the theoretical threat to the corporate tax by publicly traded partnerships to future businesses. See *MLP Hearings*, *supra* note 150, at 135, 160, 396.

equity as another feature of the business tax system preventing publicly traded partnerships from undermining the corporate tax. The experts testified that the investors currently purchasing interests in publicly traded partnerships generally pay tax at the regular rates and insist on predictable cash flow returns, similar to interest payments on corporate debt, and in fact would invest in corporate debt if publicly traded partnership interests were not available. Consequently, publicly traded partnerships likely would evolve as a substitute for corporate debt issued by mature businesses willing and able to pay a regular return.¹⁷⁰ Because corporations enjoy a deduction for interest payments on debt, corporate income used to pay interest generally bears only one level of tax — at the investor level. Although the return on interest in a publicly traded partnership clearly bears no tax at the entity level, the investors will pay tax on their shares of the partnership's income at their regular rates. Consequently, according to these experts, the publicly traded partnership posed no real threat to corporate tax revenues, because mature businesses needing to raise capital would simply issue corporate debt if denied the opportunity to use a publicly traded partnership.¹⁷¹

III. THE INCREASED USE OF LLCs AND THE CORPORATE INTEGRATION ISSUE

A. *LLCs and the Integration of Closely Held Corporations*

The current system for imposing the corporate tax on nonpublicly traded businesses employs a double standard based on whether the business has incorporated under state law. Regardless of how modest the asset base or how closely held the ownership level, incorporated businesses that choose not to follow the S corporation restrictions face the corporate tax.¹⁷² Because the corporate tax is largely insignificant for businesses that remain closely held and small enough to pay out their earnings in deductible items, the increased use of the LLC cannot possibly undermine a serious¹⁷³ source of corporate tax revenue.¹⁷⁴ Newly or-

170. From a business point of view issuing partnership equity was superior, because if cash flow suddenly became tight, management could forgo a distribution on equity without consequences. With corporate debt, a missed interest payment often triggered a default. See *MLP Hearings, supra* note 150, at 62-403.

171. See sources cited *supra* notes 166-70.

172. See *supra* note 8.

173. See *supra* notes 98-109, 145 and accompanying text.

174. The only way to ensure that close corporations as a group bear significant corporate tax is to require a stated percentage of payments to shareholders to be classified as dividends even if, for example, the payments represent reasonable salary. The IRS abandoned that position, possibly because it would discriminate between reasonable

ganizing, closely held businesses¹⁷⁵ now have the option to obtain the benefits of limited liability and one level of tax under the flexible partnership tax provisions without incurring the transaction costs necessary to achieve one of these benefits indirectly.¹⁷⁶

Furthermore, the increased use of LLCs actually improves the overall fairness of the business tax system. The increased use of LLCs levels the playing field between sophisticated, well-advised small businesses, and unsophisticated small businesses. Before the LLC became available, closely held businesses that could afford to either eliminate the corporate tax by paying out all of the earnings in deductible items or to create limited liability in a partnership enjoyed the benefits of limited liability combined with one level of tax.¹⁷⁷ On the other hand, unsophisticated businesses were forced to make a choice between the two advantages. If the business wanted corporate limited liability, it was forced either to live with the restrictions of subchapter S or pay a significant corporate tax that only negligibly increased total corporate tax revenues.¹⁷⁸

deductible payments made to shareholder employees and reasonable deductible payments made to third-party employees. *See supra* note 115.

175. Businesses *currently* being operated as general or limited partnerships can generally convert to an LLC without adverse tax consequences. Closely held businesses operating in corporate form usually cannot convert to LLC form because of the prohibitively expensive tax imposed at both the corporate and the shareholder level from the liquidation. *See supra* text accompanying notes 6-8 (discussing corporate "double" tax burden compared with partnership and S corporation burdens); *supra* text accompanying notes 149-52 (discussing penalty occurring on switching to LLC form).

176. *See supra* notes 87-91, 165 and accompanying text.

177. *See supra* notes 87-91, 165 and accompanying text.

178. *See supra* notes 105-09, 121-22 and accompanying text. As previously noted, the tax paid by the small-asset corporations ranged from just over \$5 billion in 1986 to just over \$2.5 billion in 1992. *See supra* note 122. Although this number seems large, it represents a relatively small portion of the total corporate tax paid. When focusing on the 1992 figures, the smallest corporations pay only 2% of the entire revenues from the corporate tax. *See supra* notes 122, 136, 144. The cost of leveling the playing field appears to be a bit higher if you add the corporate tax paid by the corporations in between the small- and medium-asset ranges. In 1992 corporations in the \$1 million to just under \$5 million asset range paid \$3,702,027,000 in corporate taxes while the \$5 million to just under \$10 million corporations paid \$2,098,826,000 in corporate taxes. *See supra* notes 108, 140. As already noted the LLC will not likely pose a threat to these corporate taxes for a variety of reasons. First due to the distortions from measuring asset size by gross rather than net figures, some of these corporations belong in a larger-size group. Moreover some of these corporations are probably technological, service-oriented corporations that would be in a larger group, using a stock valuation. *See supra* notes 122, 126. Moreover because the limited partnership has always been available, one can assume the same barriers (the inability to grow by issuing equity to tax-exempt and foreign investors) that in fact prevented these businesses in the past from using limited partnerships will prevent these businesses in the future from using LLCs. *See supra* notes 153-65 and accompanying text.

If tax policymakers eliminate the use of LLCs by taxing all businesses that provide limited liability protection as corporations, the business tax system, as applied to small businesses, will revert to the same unfair conditions that existed before the rise of the LLC: those businesses able to incur the necessary transaction costs would be able to enjoy one level of tax and limited liability, while other businesses would be forced to choose between these two benefits. Moreover, unsophisticated businesses that otherwise could avoid the corporate tax by using the LLC form¹⁷⁹ would at best produce only a small increase in corporate tax revenues¹⁸⁰ with that marginal increase primarily coming from those businesses unable to secure competent advice.¹⁸¹ Therefore, eliminating LLCs by instituting a limited liability-based corporate tax would, by unfairly favoring sophisticated businesses able to incur transaction costs over similar¹⁸² businesses lacking the means to obtain limited liability and one level of tax indirectly,¹⁸³ violate fundamental principals of horizontal equity.¹⁸⁴

Most importantly, by exposing the inequities built into the taxation of closely held incorporated and unincorporated business, the increased use of LLCs reveals the inexcusably poor policy of taxing small business more than once. Regardless of the form chosen under local law, closely held small business owners tend to participate actively in their businesses and use a decentralized management structure with significant limitations on their ability to withdraw their capital from the busi-

179. See Hamill, *supra* note 61, at 601-04.

180. In order for a limited liability based corporate tax to be remotely fair and consistent it would be necessary to impose the corporate tax on businesses providing substantive protection rather than confining the rule to statutory protection. For closely held businesses, this would require scrutiny of partnerships using intermediary corporate partners to create substantive limited liability. Because the trend has clearly been to favor obtaining direct limited liability by using the corporate form, policing these partnerships under a limited liability based corporate tax would likely produce little revenue. See *supra* notes 166-74 and accompanying text. Moreover, it would also be necessary to enforce the corporate tax against existing closely held corporations by policing their ability to pay out disguised dividends in deductible items, a goal unlikely to be achieved. See *supra* notes 110-25 and accompanying text.

181. See *supra* notes 117-20 and accompanying text. Also, a portion of the corporate income tax paid by these corporations undoubtedly comes from service-oriented corporations that appear smaller than they are when measuring size based on assets. See *supra* note 126.

182. See generally, 1 O'NEAL & THOMPSON, *supra* note 94, §§ 1.05, 1.07 n.2 (describing various situations under which closely held corporations may arise).

183. See *supra* notes 98-125 and accompanying text.

184. Although these corporations contribute a negligible amount to corporate revenues, see *supra* notes 98-109, the impact of the tax on the individual closely held corporation is probably far from negligible.

ness.¹⁸⁵ Applying a significantly different taxation regime (the corporate or the partnership) to a closely held business solely because of the inconsequential act of incorporating (or remaining unincorporated) also treats similar taxpayers differently and therefore violates the fundamental principals of horizontal equity. Consequently, even before the LLC became available, no valid policy reason existed to support the corporate tax as applied to closely held small businesses.¹⁸⁶

Finally, by bringing the inequities between the incorporated and unincorporated forms out of the closet, the rise of the LLC form should compel lawmakers to integrate small closely held businesses as quickly as possible.¹⁸⁷ Only after closely held corporations achieve integration will the tax system treat similar small businesses similarly.¹⁸⁸ Moreover, as long as closely held corporations remain subject to the corporate tax, small businesses will continue to choose LLCs over corporations in

185. See 1 O'NEAL & THOMPSON, *supra* note 94, § 1.08; see also Armando Gomez, *Rationalizing the Taxation of Business Entities*, 49 TAX LAW. 285, 289 (1996); Harry J. Haynsworth, *The Need for a Unified Small Business Structure*, 33 BUS. LAW. 849, 854-56 (1978).

186. See Haynsworth, *supra* note 185, at 861-69; cf. Gomez, *supra* note 185, at 300-02 (describing difficulty of formulating workable judicial definition of "corporation").

187. Focusing on the corporate tax paid by the smallest corporations, the revenue cost for integrating small-asset corporations would likely be between \$2 billion and \$3 billion. See *supra* note 122. If Congress chooses to only integrate small-asset corporations, the line would be difficult to draw. One could then attempt to draw the line on the basis of asset size, shareholder number, or other considerations. See generally DIVISION OF TAX RESEARCH, TREASURY DEPT., TAXATION OF SMALL BUSINESS (Oct. 1947); Berger, *supra* note 64; William A. Klein & Eric M. Zolt, *Business Form, Limited Liability and Tax Regimes: Lurching Toward a Coherent Outcome?*, 66 U. COLO. L. REV. 1001, 1014-15 (1995); Joseph A. Snoe, *The Entity Tax and Corporate Integration: An Agency Cost Analysis and a Call for a Deferred Distributions Tax*, 48 U. MIAMI L. REV. 1 (1993). As already noted, grouping corporations according to true value would be difficult because true value cannot be measured in all corporations using the same valuation method. See *supra* notes 122, 126.

188. In 1992, the Treasury Department reported on prototypes, dividend exclusion, shareholder allocation, the Comprehensive Business Income Tax (CBIT), the imputation credit prototype, and the dividend deduction alternative as a means to achieve corporate integration. All of these methods except the CBIT, the method least likely to be adopted in the near future, would leave in place differences between the incorporated and unincorporated business tax regimes. See U.S. DEPT. OF THE TREASURY, REPORT ON INTEGRATION OF THE INDIVIDUAL AND CORPORATE TAX SYSTEMS: TAXING BUSINESS INCOME ONCE (Jan. 1992). The Treasury subsequently recommended the dividend exclusion prototype. See U.S. DEPT. OF THE TREASURY, A RECOMMENDATION FOR INTEGRATION OF THE INDIVIDUAL AND CORPORATE TAX SYSTEMS (Dec. 1992); see also AMERICAN LAW INST., FEDERAL INCOME TAX PROJECT, INTEGRATION OF THE CORPORATE AND INDIVIDUAL INCOME TAXES (1993) (Alvin Warren, Reporter). Regardless of which method Congress adopts, the planning opportunities left in place between the incorporated and unincorporated worlds will likely be minor and therefore should not discourage the adoption of integration generally.

greater numbers in order to achieve the benefits of partnership taxation directly, rather than be subject to the S corporation restrictions or incur the transaction costs of paying out all earnings in deductible items. Only after lawmakers integrate close corporations, thus removing the tax advantage LLCs currently enjoy, can new businesses choose between the LLC and the closely held corporation without regard to tax consequences; and only then will it be possible to determine if the LLC's business provisions truly offer a superior combination of the corporate and partnership forms.

B. *LLCs and the Question of Integrating Larger Corporations*

Because under the current system LLCs have no practical ability to undermine the corporate tax paid by larger corporations, the increased use of the LLC form does not compel tax policy makers to affirmatively deal with the corporate integration question.¹⁸⁹ However, despite the LLC's inability to affect the corporate tax imposed on larger businesses, the LLC's theoretical ability to allow larger businesses to combine statutory limited liability with one level of tax under the partnership provisions may tempt tax policymakers to re-examine what role limited liability should play when imposing the corporate tax. Because businesses engaged in active profit-making activities reaching a certain size and growth level cannot use LLCs, a limited liability-based corporate tax will not affect the type of entity chosen by those businesses — they will continue to operate as corporations. Nevertheless, from the perspective of businesses, that traditionally have used limited partnerships, a proposed change in the law (modeled after the proposed regulations in 1980), imposing the corporate tax on all entities offering statutory limited liability protection should be summarily rejected as merely elevating form over substance.¹⁹⁰ A limited liability-based corporate tax would still allow limited partnerships that offer the same degree of substantive limited liability protection as LLCs to continue enjoying one level of taxation under the partnership provisions.¹⁹¹ Because in the larger-business range, LLCs only offer a practical alternative to limited

189. See *supra* notes 149-61 and accompanying text. See *supra* note 178 (LLCs have no ability to undermine corporate tax paid by corporations above the small-asset but below the medium-asset range).

190. In addition to all the protest that accompanied the 1980 proposed regulations, the LLC bar would predictably criticize the proposal as well. See *supra* notes 40-44 and accompanying text. Given the already widespread state enactment and current use of LLCs, the scope and number of LLC proponents would be significantly broader and greater than the publicly traded partnership proponents in 1987.

191. See Hamill, *supra* note 61, at 581-89; see *supra* notes 32-44 and accompanying text.

partnerships a limited liability based corporate tax will not increase the corporate tax revenues.¹⁹²

A corporate tax imposed on all businesses offering statutory or substantive limited liability¹⁹³ would, by sweeping within the realm of the corporate tax all LLCs, as well as many partnerships providing substantive limited liability, represent far more than a cosmetic elevation of form over substance.¹⁹⁴ Ignoring the administrative complexities of defining when an entity enjoys substantive limited liability,¹⁹⁵ this rule would go beyond merely maintaining the corporate tax in its present form and would represent a strong policy statement in favor of expanding the corporate tax.¹⁹⁶ Arguably, however, an extension of the corporate tax using substantive limited liability would be unwise for at least two reasons. First, it would severely disrupt the current business climate and would call into question the status of many partnerships.¹⁹⁷ Second, the provisions surrounding the structure of the corporate tax contain many opportunities to mitigate its effect, which arguably sends a policy signal against any further expansion of the corporate tax beyond the corporate form.¹⁹⁸

More importantly, the LLC's presence, rapid growth, and (in many ways) similarity to the corporate form helps reveal the conflicting signals within the system for taxing business organizations. The reasons why the LLC's threat to the corporate tax will remain theoretical can be traced directly to the conflicts within the corporate tax itself, which exist because the different tax regimes of the incorporated and unincorporated worlds often do not work well together. Assuming the global tax policy goal seeks to ensure that business earnings used to pay returns on equity bear at least one level of tax, the law must require tax-exempt and foreign investors owning partnership equity to recognize unrelated

192. See *supra* notes 149-71 and accompanying text.

193. See *supra* notes 32-37 and accompanying text.

194. See *supra* notes 87-91 and accompanying text.

195. Drawing an administrative line in order to determine when a partnership has achieved substantive limited liability protection would be difficult but arguably no more difficult than establishing the line for public trading for purposes of the publicly traded partnership provisions.

196. Whether the corporate tax should be expanded by attempting to tax all entities with substantive limited liability as corporations is beyond the scope of this article. Most authorities, when discussing the corporate tax, favor integration or elimination of the inconsistencies in the current system — with the disparate treatment of debt and equity being the worst example. Virtually no commentator has advocated a radical extension of the corporate tax based on substantive limited liability. See sources cited *supra* note 19.

197. See *supra* notes 33-40 and accompanying text.

198. See *infra* notes 199-214 and accompanying text.

business taxable income and income effectively connected with a U.S. trade or business in order to ensure that this income, not subject to tax at the partnership level, bears at least one level of tax.¹⁹⁹ Because corporations must pay tax on income used to pay dividends, the tax law can allow tax-exempt and foreign investors to maintain their favored tax status when receiving dividends because the income still bears one level of U.S. tax.²⁰⁰

When compared to the tax consequences imposed generally on equity investors paying tax at the regular rates, the rules denying tax-exempt and foreign investors their favored tax treatment for partnership equity helps reveal distortions in investment behavior caused by the corporate tax system. Income earned by a corporation to pay dividends to a taxable investor will be subject to the two-tier tax (once at the corporate level and then again at the shareholder level) while the same income earned by a partnership suffers one level of tax — at the investor level. Because the relief from the entity-level tax potentially allows the partnership to pay a higher rate of return, the two-tier corporate tax creates a bias against investments in corporate equity. As noted above, the bias against investments in corporate equity does not exist for tax-exempt and foreign investors, because the law imposes one level of tax on earnings, used to pay equity returns to these investors, in both the corporate and unincorporated forms. However, tax law, which imposes tax at the investor level for partnership equity and at the entity level for corporate equity, creates a bias in the opposite direction: tax-exempt and foreign investors will choose corporate equity over partnership equity in order to maintain their favored tax treatment.²⁰¹

Unlike publicly traded partnerships before the law taxed them as corporations, LLCs currently offer no new material alternatives to issuing corporate debt to raise capital. Consequently, the rise of the LLC does not directly expose the most controversial aspect of the corporate tax structure — the disparate treatment between corporate debt and equity. The rise of the LLC, however, arguably helps reveal the distortions caused by the corporate debt-equity distinction because the favorable treatment granted to tax-exempt and foreign investors, the very backstops that prevent the LLC from becoming a practical threat, create a heavy incentive in favor of issuing debt to tax-exempt and foreign in-

199. See *supra* notes 153-57 and accompanying text.

200. See *supra* notes 158-60 and accompanying text.

201. See *MLP Hearings*, *supra* note 150. Although, from the global perspective, income earned for returns on partnership and corporate equity roughly bears the same tax, once at some level, the tax-exempt and foreign investors will choose corporate equity because that one level of tax will be borne by the corporation. See *id.*

vestors. The tax system encourages all investors to purchase corporate debt instead of corporate equity.²⁰² Because of the corporate interest deduction, the corporation bears no tax on the income used to pay the interest, which generally allows the investor to enjoy a higher rate of return on interest rather than dividends, the return on corporate equity.²⁰³ The tax system further favors tax-exempt and foreign investors by allowing their receipt of interest to remain tax free.²⁰⁴ Thus when examining the taxation of income earned to pay interest on debt from the entity's perspective, the corporate and noncorporate forms generally enjoy no distinct advantages over each other because in both instances the income used to pay interest escapes tax at the entity level. However by requiring taxable investors to pay tax on interest at the regular rates while tax-exempt or foreign investors receive interest tax free, the tax system encourages all larger businesses willing and able to pay regular returns to raise capital by issuing debt to tax-exempt and foreign investors. Because earnings used to pay interest to these investors escapes U.S. tax entirely, the investment can yield the highest after-tax rate of return.²⁰⁵

Because of the practical inability of larger businesses to use the LLC structure, their presence will have no effect on the real corporate tax collected as modified by provisions that allow the tax to be mitigated. However, the addition of the LLC to the overall business landscape and its theoretical possibility of being chosen over larger nonpublic corporations helps expose the conflicting signals within the entire system for taxing business organizations. On the one hand, the system clearly allows businesses to mitigate the corporate tax in a variety of ways;²⁰⁶ on the other hand the system refuses to give up all the revenues the corporate tax brings.²⁰⁷ The competing desires to mitigate the corporate tax and at the same time preserve some portion of the corporate tax revenues has resulted in a number of economic distortions in investment decisions, the decision to issue corporate debt over equity

202. See *MLP Hearings*, *supra* note 150; Treasury Study on Integration, *infra* note 208.

203. See *id.* But see I.R.C. § 163(f) (corporate interest deduction denied if recipient bears no tax and the amount deemed excessive under the provision). See also Jerome Kurtz, *The Interest Deduction Under Our Hybrid Tax System: Muddling Toward Accommodation*, 50 TAX L. REV. 153 (1995).

204. See I.R.C. §§ 512, 871(h).

205. See *supra* notes 153-60 and accompanying text.

206. See *supra* section II.A.

207. See *MLP Hearings*, *supra* note 150, at 115 (statement of William S. McKee & Mark A. Kuller, Partners, King & Spalding) ("In short, everyone seems to agree that the corporate tax is a bad tax, but that nothing much can be done about it because we need the money.").

being the most obvious and arguably the most economically harmful example.²⁰⁸

In the early 1980s when publicly traded partnerships first emerged on the market, they similarly revealed the same distortions in the corporate tax system.²⁰⁹ The very market that publicly traded partnerships had tapped into — taxable investors expecting regular returns, who otherwise would purchase corporate debt — was made possible by the disparate treatment between corporate equity and debt. Corporations in mature, active businesses that sought to raise capital from investors paying tax at the regular rates had a choice of issuing interests in publicly traded partnerships bearing one level of tax at the investor level rather than corporate debt which also bore only one level of tax to regular taxpayers.²¹⁰ Moreover, the same forces that will prevent LLCs from becoming a real threat to the corporate tax arguably would have prevented publicly traded partnerships from causing a massive revenue drain on the corporate tax. According to the experts who support publicly traded partnerships, growing, active businesses that needed to raise large amounts of capital with equity, not expected to pay regular returns, had to incorporate in order to market equity to tax-exempt and foreign investors.²¹¹

By taxing publicly traded partnerships as corporations, lawmakers arguably killed the messenger that brought the bad news — the inconsistent and inequitable provisions within the corporate tax itself. The 1987 publicly traded partnership legislation allowed tax policymakers to avoid deciding the more difficult issue of whether corporations should be integrated or whether the distortions weakening the corporate tax should be eliminated. The presence of the LLC offers a similar theoretical threat as the publicly traded partnership did before 1987, albeit in a less dramatic form because of the inability of LLCs to cross over into the publicly traded market.²¹² In order to create the illusion of consistency and harmony in the business tax system, lawmakers could elimi-

208. See *supra* note 128. For an extensive discussion of the economic distortions caused by the corporate tax, see REPORT OF THE DEPARTMENT OF TREASURY ON INTEGRATION OF THE INDIVIDUAL AND CORPORATE TAX SYSTEMS (Jan. 1992) reprinted in HIGHLIGHTS & DOCUMENTS, Jan. 7, 1992, at 3-11; see also Peter Cannellos, *The Over-Leveraged Acquisition*, 39 TAX LAW. 91 (1985).

209. See generally *MLP Hearings*, *supra* note 150.

210. See I.R.C. § 7704 (1994); *MLP Hearings*, *supra* note 150, at 114-15.

211. See generally *MLP Hearings*, *supra* note 150, at 62-403.

212. Technically, publicly traded corporations are subject to the corporate tax provisions due to corporate status, see I.R.C. § 11 (1994), while I.R.C. § 7704 (1994) imposes per se corporate taxation on publicly traded partnerships. However, if the public corporation theoretically chose to operate as a limited partnership or LLC, § 7704 would mandate corporate taxation. Section 7704 effectively establishes one line based

nate the LLC by imposing the corporate tax on all entities offering statutory limited liability protection. As already noted, this course of action would result in no significant corporate revenues and would leave the current distortions that plague the taxation of business organizations in place.²¹³ Hopefully the presence of the LLC will instead encourage further progress toward a careful and well considered solution to the corporate integration question.²¹⁴

CONCLUSION

The motives behind the very creation of the LLC form, to provide foreign clients with a business structure option offering limited liability and one level of taxation, can be traced to the lack of a consistent system for taxing business organizations. Because the LLC's sole function initially revolved around filling the void left open by the corporate integration question — should corporations, the only U.S. entity offering direct limited liability, be subject to a two-tier tax — the LLC stood no chance of gaining widespread acceptance as a serious alternative for doing business until it secured the right to receive one level of tax under the partnership provisions. Once the LLC achieved partnership status for tax purposes, the market, consisting of the individual states and the businesses operating in those states, predictably embraced the LLC with open arms and quickly enacted statutes and chose to use LLCs.

From the perspective of closely held businesses, the increased use of LLCs represents a positive development as it levels the playing field between sophisticated businesses that have always obtained the LLC's benefits indirectly and other businesses that have been compromised into either paying some level of corporate tax or incurring personal liability exposure. The LLC offers both groups an easy way to obtain statutory limited liability protection for all owners and one level of tax under the partnership provisions. Moreover, the LLC's rapid rise among small businesses exposes the tax handicaps suffered by closely held corporations and the absurdity of having two radically different tax regimes, the corporate or the partnership, apply to substantively identical businesses. At a minimum, Congress should adopt some form of integration for small, closely held corporations as quickly as possible, and

on public trading in which all businesses are subject to the corporate tax regardless of the form chosen under local law.

213. See *supra* notes 121-25, 144-52.

214. See sources cited *supra* note 19. For a thoughtful discussion attributing the slow progress toward resolution of the integration on the preference of corporate management and other political forces to mitigate the corporate tax indirectly through other mechanisms, see Arlen & Weiss, *supra* note 19.

allow small business to choose an entity structure based on business considerations alone. At that time, the LLC will either show its mettle as the truly superior form on the business merits or it will die away, because the tax advantages it now enjoys over the corporate form will have largely disappeared.

From the perspective of the taxation of larger businesses, the increased use of LLCs adds more distractions into a tax system that is already a maze. Because the current business tax system allows any nonpublicly traded business to use the partnership or the LLC form, the increased use of LLCs theoretically undermines the corporate tax paid by the larger nonpublicly traded corporations. However, other provisions within the business tax structure that effectively discourage tax-exempt and foreign investors from purchasing noncorporate equity will prevent the LLC, as it has prevented the limited partnership in the past, from posing any serious practical challenge to the corporate tax paid by these larger corporations. Consequently, if lawmakers simply leave LLCs alone, the corporate tax revenues will not be reduced by the increased use of LLCs.

The theoretical challenge to the corporate tax posed by LLCs helps to reveal the serious imperfections of the business tax system. The central reason why the LLC and the limited partnership pose a mere theoretical threat to the corporate tax — their inability to tap the tax-exempt and foreign equity markets — exists because of the radically different structure of the corporate and partnership tax regimes. The provisions that fully tax tax-exempt and foreign investors on returns from partnership equity serve as a backstop to the flow-through treatment of partnerships, and prevent that income from completely or almost completely escaping the U.S. tax system. The entity level tax on corporate income used to pay dividends ensures one level of tax, and thereby allows the system to tolerate these investors complete or almost complete tax avoidance on dividends. Dividends paid to taxable investors, however, receive the harshest treatment, a two-tier tax at both the corporate and investor levels. Consequently, the business tax system creates a bias discouraging taxable investors from, and encouraging tax-exempt and foreign investors to, purchase corporate equity.

Moreover, the favored treatment that corporate debt enjoys over corporate equity in the context of tax-exempt foreign and taxable investors further reveals more distortive effects of the two-tier corporate tax. The current business tax system creates a bias for all investors to favor debt over equity because debt investments will generally yield a higher after-tax rate of return. Moreover, because interest received by taxable investors bears one level of tax and escapes tax entirely in the hands of

tax-exempt or foreign investors, debt issued to tax-exempt and foreign investors enjoys the most favored tax treatment and therefore has the potential to yield the greatest after-tax rate of return. Consequently, issuers that are willing and able to pay the regular return, required by most debt as a business matter, will prefer for tax reasons to market debt to tax-exempt and foreign investors instead of taxable investors.

Although the LLC cannot become a serious alternative for larger businesses, as the LLC gains more acceptance and takes its place in the mainstream of smaller businesses, it will become increasingly difficult for lawmakers to pretend that the current corporate tax system, co-existing as it does with complete pass-through taxation for partnerships, contains any rationally based tax policy. The increased use of LLCs exposes the disconcerted tax regimes of the incorporated and unincorporated worlds and implores tax policymakers to take a serious look at business taxation and work toward a careful well considered resolution of the corporate integration issue.

APPENDIX

Between September 2, 1988 — the date of the IRS's ruling classifying the Wyoming LLC as a partnership — and December 31, 1989, approximately thirty-two new LLCs had filed to do business in Wyoming,²¹⁵ an increase of almost seventy-three percent when compared to all previous Wyoming LLC filings.²¹⁶ By 1991 a combined total of approximately 1700 new LLCs filed to do business in the eight states boasting LLC acts, with Colorado emerging as the leader with approximately 350 LLC filings by year's end 1991.²¹⁷ In 1992 the seventeen

215. See Cochran Interview, *supra* note 46.

216. See *supra* note 46. Adding the estimated eight LLC filings that occurred in 1988 after Revenue Ruling 88-76 to the twenty-four new LLC registrations for 1989 yields thirty-two.

Because Florida LLCs could rely on Revenue Ruling 88-76 and receive partnership tax treatment, it is reasonable to assume that the rate of LLC growth in Florida mirrored that of Wyoming. See *supra* note 46.

217. See Letter from the Office of the Colorado Secretary of State (Sept. 5, 1995) [hereinafter Colorado Letter]; Telephone Cushing Interview, *supra* note 46; Telephone Interview with Jackie Barnes, Office of the Kansas Secretary of State (Aug. 29, 1995) [hereinafter Barnes Interview]; Telephone Interview with Mike Lee, Office of the Nevada Secretary of State (Feb. 6, 1996) [hereinafter Lee Interview]; Telephone Interview with Delores Eitt, Office of the Texas Secretary of State (Sept. 7, 1995) [hereinafter Eitt Interview]; Telephone Interview with Cathy Berg, Office of the Utah Secretary of State (Aug. 30, 1995) [hereinafter Berg Interview]; Telephone Interview with Kim Monk, Office of the Virginia Secretary of State (Aug. 30, 1995) [hereinafter Monk Interview]; Cochran Interview, *supra* note 46.

Statistics received from Colorado and Utah were based on a fiscal year ending on June 30. Data obtained from Texas were based on a fiscal year ending August 31. In

states that were then accepting LLC applications established approximately 7000 new LLCs, roughly four times the number of 1991 filings.²¹⁸ The Southwestern and Western states, including Colorado,

each instance, calendar year figures were estimated by dividing each fiscal year total by twelve months and attributing to each portion of the calendar year a number equal to the monthly average multiplied by the number of months in the portion of the calendar year covered by the fiscal year.

Florida, Kansas, Nevada, Texas, Utah, Virginia, and Wyoming do not maintain records that separate the total number of LLC filings into domestic LLCs and foreign LLCs. Domestic LLCs are those that have organized under the laws of a particular state, say State X. By contrast, foreign LLCs are LLCs that have formed under the laws of another state and have then qualified to do business in State X. In tabulating the number of LLCs, it is important to exclude foreign LLCs in order to avoid double-counting. So, to approximate the number of foreign LLCs in the above states (and thus exclude them from our LLC count), we calculated the average percentage of new foreign LLCs each year in states that do distinguish between domestic and foreign LLC filings and multiplied each year's average percentage by the total LLC filings each year in the above states that do not record domestic and foreign data separately. We then subtracted the result, which represents an estimate of the number of foreign LLCs, from the number of total LLC filings to achieve an approximation of the number of domestic LLCs registered in these states.

Nevada and Florida were unable to provide yearly statistics on new LLC filings but were able to furnish year-to-date information. To estimate the number of filings per year in Nevada, we multiplied Nevada's total year-to-date filings as of December 31, 1995 by the average percentage of LLC filings per year in states that maintain yearly data and whose LLC statutes were likewise enacted in 1991. We approximated the number of yearly filings in Florida based upon the percentage of new LLC registrations in Wyoming each year.

218. See Telephone Interview with Bill Parkerson, Office of the Arizona Secretary of State (Sept. 5, 1995) [hereinafter Parkerson Interview]; Colorado Letter, *supra* note 217; Telephone Interview with Pauline Fry, Office of the Delaware Department of State (Aug. 30, 1995) [hereinafter Fry Interview]; Cushing Interview, *supra* note 46; Telephone Interview with Tess Cornett, Office of the Georgia Secretary of State (Sept. 7, 1995) [hereinafter Cornett Interview]; Telephone Interview with Karen Ubaldo, Office of the Iowa Secretary of State (Sept. 19, 1995) [hereinafter Ubaldo Interview]; Barnes Interview, *supra* note 217; Telephone Interview with Deborah O'Banion, Office of the Louisiana Secretary of State (Aug. 30, 1995) [hereinafter Barnes Interview]; Letter from Joe Jenkins, SpecPrint, 7R Aylesbury Road, Timonium, Md. 21093 (Oct. 25, 1995) (on file with author) [hereinafter Jenkins Letter]; Lee Interview, *supra* note 217; Letter from Doena Bortvit, Office of the Oklahoma Secretary of State (Sept. 7, 1995) (on file with author) [hereinafter Bortvit Interview]; Telephone Interview with Cathy Albanese, Office of the Rhode Island Secretary of State (Sept. 1, 1995) [hereinafter Albanese Interview]; Eitt Interview, *supra* note 217; Berg Interview, *supra* note 217; Monk Interview, *supra* note 217; Telephone Interview with Darlene Atkinson, Office of the West Virginia Secretary of State (Jan. 19, 1996) [hereinafter Atkinson Interview]; Cochran Interview, *supra* note 217.

Statistics received from Arizona, Colorado, Georgia, and Utah were based upon a fiscal year ending on June 30. Data obtained from Texas were based upon a fiscal year ending August 31. See *supra* note 217, for an explanation of calendar year estimates.

Florida, Kansas, Nevada, Rhode Island, Texas, Utah, Virginia, West Virginia, and Wyoming do not maintain records that separate the total number of LLC filings into domestic LLCs and foreign LLCs. See *supra* note 217, for an explanation of domestic and

Texas, Utah, and Wyoming, were the first to enact LLC statutes and remained the leaders in LLC formation, organizing over 1000 LLCs each between the time they began accepting filings and December 31, 1992.²¹⁹ Thus, in a period of just over four years, over 8500 LLCs were created.²²⁰

The boom of businesses filing as LLCs continued in the years following 1992. By 1994, it was clear that this new business entity was a viable alternative to the partnership and the corporation. In 1993 thirty-two states collectively recognized over 23,000 new LLCs.²²¹ Of the thirty-two states accepting LLC filings in 1993, Texas, Utah, and Colo-

foreign LLCs and the process of approximating the number of domestic and foreign LLCs in states not recording separate statistics.

Florida, Nevada, and West Virginia were unable to provide yearly statistics on new LLC filings but were able to furnish year-to-date information. See *supra* note 217, for explanation of how year-by-year figures were approximated in Florida and Nevada. To estimate yearly filings in West Virginia, we multiplied West Virginia's total year-to-date filings as of December 31, 1995 by the average percentage of LLC filings per year in states that maintain yearly data and whose LLC statutes were likewise enacted in 1992.

219. See *supra* note 218 and accompanying text.

220. See *supra* notes 215-19 and accompanying text.

221. See Telephone Interview with Joanne Ninesling, Office of the Alabama Secretary of State (Jan. 16, 1996) [hereinafter Ninesling Interview]; Parkerson Interview, *supra* note 218; Telephone Interview with Charlotte Henderson, Office of the Arkansas Secretary of State (Sept. 25, 1995) [hereinafter Henderson Interview]; Colorado Letter *supra* note 217; Telephone Interview with Diane Stier, Office of the Connecticut Secretary of State (Sept. 8, 1995) [hereinafter Stier]; Fry Interview, *supra* note 218; Cushing Interview, *supra* note 46; Cornett Interview, *supra* note 218; Telephone Interview with Tonya (could not release last name), Office of the Idaho Secretary of State (Sept. 1, 1995) [hereinafter Tonya Interview]; Telephone Interview with Bob Gardner, Office of the Indiana Secretary of State (Sept. 1, 1995) [hereinafter Gardner Interview]; Ubaldo Interview, *supra* note 218; Barnes Interview, *supra* note 64; O'Banion Interview, *supra* note 218; Jenkins Letter, *supra* note 218; Telephone Interview with Kit Murphy, Office of the Michigan Secretary of State (Sept. 1, 1995) [hereinafter Murphy Interview]; Telephone Interview with Nancy Kurtz, Office of the Minnesota Secretary of State (Aug. 30, 1995) [hereinafter Kurtz Interview]; Telephone Interview with Patty Hartman, Office of the Missouri Secretary of State (Jan. 18, 1996) [hereinafter Hartman Interview]; Telephone Interview with Garth Jacobson, Office of the Montana Secretary of State (Jan. 25, 1996) [hereinafter Jacobson Interview]; Telephone Interview with Julie Von Busch, Office of the Nebraska Secretary of State (Sept. 1, 1995) [hereinafter Von Busch Interview]; Lee Interview, *supra* note 217; Telephone Interview with Diana Northcott, Office of the New Hampshire Secretary of State (Sept. 12, 1995) [hereinafter Northcott Interview]; Telephone Interview with Manuel Salinas, Office of the New Mexico Secretary of State (Sept. 21, 1995) [hereinafter Salinas Interview]; Telephone Interview with Bonnie Elek, Office of the North Carolina Secretary of State (Jan. 31, 1996) [hereinafter Elek Interview]; Telephone Interview with Clara Jenkins, Office of the North Dakota Secretary of State (Sept. 13, 1995) [hereinafter Jenkins Interview]; Bortvit Letter, *supra* note 218; Albanese Interview, *supra* note 218; Telephone Interview with Penny Nelson, Office of the South Dakota Secretary of State (Sept. 5, 1995) [hereinafter Nelson Interview]; Eitt Interview, *supra* note 217; Berg Interview, *supra* note 217; Monk Interview, *supra* note 217; Atkinson Interview, *supra* note 218; Cochran Interview, *supra* note 46.

rado continued to lead the pack. Utah and Colorado each created over 2000 new LLCs, while Texas organized more LLCs than any other state, roughly 3000 in 1993 alone. Other states that quickly embraced the new business entity included Arizona, Maryland, and Virginia, each registering over 1000 new LLCs in 1993. And not far behind these frontrunners were Louisiana, Michigan, and Oklahoma, each of which exceeded 900 new LLC filings in 1993.

In 1994 forty-four states and the District of Columbia received approximately 64,000 new LLC registrations.²²² That same year, sixteen

Statistics received from Arizona, Colorado, Georgia, and Utah were based upon a fiscal year ending on June 30. Data obtained from Texas were based upon a fiscal year ending August 31. See *supra* note 217, for explanation of calendar year estimates.

Florida, Idaho, Kansas, Missouri, Nevada, Rhode Island, South Dakota, Texas, Utah, Virginia, West Virginia, and Wyoming do not maintain records that separate the total number of LLC filings into domestic LLCs and foreign LLCs. See *supra* note 217, for an explanation of domestic and foreign LLCs and the process of approximating the number of domestic and foreign LLCs in states not recording separate statistics.

Alabama, Connecticut, Florida, Missouri, Montana, Nevada, North Carolina, and West Virginia were unable to provide yearly statistics on new LLC filings but were able to furnish year-to-date information. See *supra* note 217, for an explanation of how year-by-year figures were approximated in Florida and Nevada. See *supra* note 218, for an explanation of how year-by-year figures were approximated in West Virginia. To estimate yearly filings in Alabama, Connecticut, Missouri, Montana, and North Carolina, we multiplied the total year-to-date filings in each state as of December 31, 1995 by the average percentage of LLC filings per year in states that maintain yearly data and whose LLC statutes were likewise enacted in 1993.

222. See Ninesling Interview, *supra* note 221; Parkerson Interview, *supra* note 221; Henderson Interview, *supra* note 221; Telephone Interview with Cynthia Willis, Office of the California Secretary of State (Sept. 13, 1995) [hereinafter Willis Interview]; Colorado Letter, *supra* note 217; Stier Interview, *supra* note 221; Fry Interview, *supra* note 218; Telephone Interview with Marchelle Harris, D.C. Dept. of Consumer and Regulatory Affairs, Office of Information Services (Mar. 6, 1996) [hereinafter Harris Interview]; Cushing Interview, *supra* note 46; Cornett Interview, *supra* note 218; Tonya Interview, *supra* note 221; Telephone Interview with Jennifer Borders, Office of the Illinois Secretary of State (Aug. 29, 1995) [hereinafter Borders Interview]; Gardner Interview, *supra* note 221; Ubaldo Interview, *supra* note 218; Barnes Interview, *supra* note 217; Telephone Interview with Ann Hanly, Office of the Kentucky Secretary of State (Sept. 7, 1995) [hereinafter Hanly Interview]; O'Banion Interview, *supra* note 218; Jenkins Letter, *supra* note 218; Murphy Interview, *supra* note 221; Kurtz Interview, *supra* note 221; Telephone Interview with Cathy French, Office of the Mississippi Secretary of State (Sept. 15, 1995) [hereinafter French Interview]; Hartman Interview, *supra* note 221; Jacobson Interview, *supra* note 221; Von Busch Interview, *supra* note 221; Lee Interview, *supra* note 217; Northcott Interview, *supra* note 221; Telephone Interview with Greg Harkham, Office of the New Jersey Secretary of State (Sept. 12, 1995) [hereinafter Harkham Interview]; Salinas Interview, *supra* note 221; Telephone Interview with Alan Adami, Office of the New York Secretary of State (Sept. 7, 1995) [hereinafter Adami Interview]; Elek Interview, *supra* note 221; Jenkins Interview, *supra* note 221; Telephone Interview with Judy Geers, Office of the Ohio Secretary of State (Sept. 12, 1995) [hereinafter Geers Interview]; Bortvit Letter, *supra* note 218; Telephone Interview with Dorothy Peterson, Office of the Oregon Secretary of State (Sept.

states, including Alabama, Georgia, Illinois, Indiana, Kansas, Louisiana, Maryland, Missouri, Nevada, New York, North Carolina, Ohio, Oklahoma, Oregon, Tennessee, and Wyoming, each established over 1000 new LLCs. It is notable that New York did not begin accepting LLC applications until October 24, 1994, and yet by December 31, 1994 (a period of just under ten weeks) it registered over 1000 LLCs. States exceeding the 2000 mark for 1994 included Connecticut, Delaware, New Jersey, Virginia, and Wisconsin. These data clearly indicate that even though the LLC boom commenced primarily in the South and Midwest, the East coast states have enthusiastically embraced this new business form. While the LLC trend had caught on in every region of the United States by the end of 1994, the Southwestern and Midwestern states who were among the earliest to enact LLC statutes continued to file the most new LLCs annually. Arizona and Utah each organized over 3000 new LLCs in 1994, and Texas and Colorado each created over 4000 new LLCs that year. In addition, Michigan, a relative newcomer that enacted its LLC statute in 1993, filed approximately 3800 new LLCs in 1994.²²³

5, 1995) [hereinafter Peterson Interview]; Albanese Interview, *supra* note 218; Telephone Interview with Jody Steigerwalt, Office of the South Carolina Secretary of State (Feb. 29, 1996) [hereinafter Steigerwalt Interview]; Nelson Interview, *supra* note 221; Telephone Interview with Vickie Bailiff, Office of the Tennessee Secretary of State (Sept. 12, 1995) [hereinafter Bailiff Interview]; Eitt Interview, *supra* note 217; Berg Interview, *supra* note 217; Monk Interview, *supra* note 217; Telephone Interview with Ellen Meyers, Office of the Washington Secretary of State (Oct. 14, 1995) [hereinafter Meyers Interview]; Atkinson Interview, *supra* note 218; Telephone Interview with Bernice Smith, Office of the Wisconsin Secretary of State (Sept. 13, 1995); Cochran Interview, *supra* note 46.

Statistics received from Arizona, Colorado, Georgia, and Utah were based upon a fiscal year ending on June 30. Data obtained from Texas was based upon a fiscal year ending August 31. See *supra* note 217, for an explanation of calendar year estimates.

California, Florida, Idaho, Kansas, Missouri, Nevada, New Jersey, Oregon, Rhode Island, South Dakota, Texas, Utah, Virginia, Washington, West Virginia, and Wyoming do not maintain records that separate the total number of LLC filings into domestic LLCs and foreign LLCs. See *supra* note 217, for an explanation of domestic and foreign LLCs and the process of approximating the number of domestic and foreign LLCs in states not recording separate statistics.

Alabama, Connecticut, Florida, Kentucky, Missouri, Montana, Nevada, North Carolina, and West Virginia were unable to provide yearly statistics on new LLC filings but were able to furnish year-to-date information. See *supra* note 217, for an explanation of how year-by-year figures were approximated in Florida and Nevada. See *supra* note 218, for an explanation of how year-by-year figures were approximated in West Virginia. See *supra* note 221, for an explanation of how year-by-year figures were approximated in Alabama, Connecticut, Missouri, Montana, and North Carolina. To estimate yearly filings in Kentucky, we multiplied its total year-to-date filings as of December 31, 1995 by the average percentage of LLC filings per year in states that maintain yearly data and that likewise began registering LLCs in 1994.

223. See *supra* note 222 and accompanying text.

In 1995 forty-seven states and the District of Columbia experienced explosive growth in the number of new LLC formations, accepting roughly 115,000 new LLC filings.²²⁴ For example, New York

224. See Ninesling Interview, *supra* note 221; Telephone Interview with Kris Kramer, Office of the Alaska Secretary of State (Jan. 16, 1996); Parkerson Interview, *supra* note 221; Henderson Interview, *supra* note 221; Willis Interview, *supra* note 222; Colorado Letter, *supra* note 217; Stier Interview, *supra* note 221, Fry Interview, *supra* note 218; Harris Interview, *supra* note 222; Cushing Interview, *supra* note 46; Cornett Interview, *supra* note 218; Tonya Interview, *supra* note 221; Borders Interview, *supra* note 222; Telephone Interview with John Ernst, Office of the Indiana Secretary of State (Jan. 26, 1996); Ubaldo Interview, *supra* note 218; Barnes Interview, *supra* note 217; Hanly Interview, *supra* note 223; O'Banion Interview, *supra* note 218; Telephone Interview with Tracy Willett, Office of the Maine Secretary of State (Jan. 25, 1996); Jenkins Letter, *supra* note 218; Telephone Interview with Susie Smith, Office of the Michigan Secretary of State (Jan. 22, 1996); Telephone Interview with Nancy Kurtz, Office of the Minnesota Secretary of State (Jan. 24, 1996); Telephone Interview with Sylvia Jacobs, Office of the Mississippi Secretary of State (Jan. 19, 1996); Hartman Interview, *supra* note 221; Jacobson Interview, *supra* note 221; Von Busch Interview, *supra* note 221; Lee Interview, *supra* note 217; Northcott Interview, *supra* note 68; Harkham Interview, *supra* note 222; Salinas Interview, *supra* note 221; Adami Interview, *supra* note 222; Elek Interview, *supra* note 221; Telephone Interview with Clara Jenkins, Office of the North Dakota Secretary of State (Jan. 19, 1996); Telephone Interview with Chris [last name not available], Office of the Ohio Secretary of State (Jan. 22, 1996); Bortvit Interview, *supra* note 222; Peter son Interview, *supra* note 222; Letter from Dawn Brown, Office of the Pennsylvania Department of State (Sept. 15, 1995); Albanese Interview, *supra* note 218; Steigerwalt Interview, *supra* note 69; Nelson Interview, *supra* note 221; Bailiff Interview, *supra* note 222; Eitt Interview, *supra* note 217; Berg Interview, *supra* note 217; Monk Interview, *supra* note 217; Meyers, *supra* note 222; Atkinson, *supra* note 218; Telephone Interview with Bernice Smith, Office of the Wisconsin Secretary of State (Feb. 13, 1996); Cochran Interview, *supra* note 46.

Statistics received from Arizona, Colorado, Georgia, and Utah were based upon a fiscal year ending on June 30. Data obtained from Texas was based upon a fiscal year ending August 31. See *supra* note 217, for an explanation of calendar year estimates. Arizona, Georgia, and Utah were able to provide statistics on the number of filings from July 1, 1995 through December 31, 1995, which were added to the estimated figures (derived from the fiscal year data) for January 1, 1995 through June 30, 1995.

California, Florida, Idaho, Kansas, Missouri, Nevada, New Jersey, Oregon, Pennsylvania, Rhode Island, South Dakota, Texas, Utah, Virginia, Washington, West Virginia, and Wyoming do not maintain records that separate the total number of LLC filings into domestic LLCs and foreign LLCs. See *supra* note 217, for an explanation of domestic and foreign LLCs and the process of approximating the number of domestic and foreign LLCs in states not recording separate statistics.

Alabama, Connecticut, Florida, Kentucky, Missouri, Montana, Nevada, North Carolina, and West Virginia were unable to provide yearly statistics on new LLC filings but were able to furnish year-to-date information. See *supra* note 217, for an explanation of how year-by-year figures were approximated in Florida and Nevada. See *supra* note 218, for an explanation of how year-by-year figures were approximated in West Virginia. See *supra* note 221, for an explanation of how year-by-year figures were approximated in Alabama, Connecticut, Missouri, Montana, and North Carolina. See *supra* note 222, for an explanation of how year-by-year figures were approximated in Kentucky.

In Colorado, Connecticut, Kentucky, Maryland, New Mexico, Pennsylvania, Washington, and Wisconsin, actual figures were only obtained for several months into 1995.

organized over 7000 new LLCs in 1995 alone. Not far behind were California and Delaware, which received over 6000 new LLC filings each in 1995. Other states with a significant showing in LLC formation for 1995 include Arizona, Colorado, Michigan, and Texas, each of which created over 5000 LLCs in 1995; Connecticut and Ohio, each of which recognized more than 4000 new LLCs; Missouri, New Jersey, North Carolina, Tennessee, Utah, Virginia, Washington, and Wisconsin each of which welcomed over 3000 LLCs; Georgia, Illinois, Indiana, Louisiana, Maryland, and Oklahoma, which organized in excess of 2000 LLCs each; and Alabama, Florida, Idaho, Iowa, Kansas, Kentucky, Minnesota, Nevada, New Mexico, Oregon, and Wyoming, each of which acknowledged over 900 new LLCs.²²⁵ In sum, as of December 31, 1995, over 210,000 business ventures across the United States²²⁶ had chosen the LLC form since the IRS recognized the LLC's ability to be classified as a partnership in 1988.²²⁷

To estimate the total 1995 filings in these states, the average number of filings per month (based on the 1995 monthly statistics received) was multiplied by the number of missing months, and added to the actual 1995 data obtained.

225. See *supra* note 224 and accompanying text.

226. Regionally speaking, it is interesting to note that the bulk of LLCs are currently located in the Midwestern and Southwestern states, the majority of whom enacted LLC statutes prior to 1993. Together, these states boast an estimated 66,000 LLCs. In the Midwest, since the inception of their respective statutes, Colorado, Kansas, Oklahoma, and Utah, and Wyoming together have recognized almost 36,000 LLCs. In the Southwest, Arizona, Nevada, New Mexico, and Texas together have organized approximately 30,000 LLCs. It is not clear, however, that these regions will continue to lead the rest of the country in LLC filings. The Northeastern states of Delaware, Connecticut, Maryland, New Jersey, and New York have already surpassed both the Midwest and the Southwest, organizing over 37,000 LLCs through December 31, 1995. Furthermore, on the West Coast, California, Oregon, and Washington, who have only been registering LLCs since 1994 (California and Washington just since October of 1994), have already topped 14,000 in total filings. The South, not traditionally known for its prominence in the business arena (save perhaps Atlanta), also appears to have embraced LLCs. Alabama, Arkansas, Florida, Georgia, Kentucky, Mississippi, North Carolina, South Carolina, Tennessee, and Virginia have recognized an estimated 35,000 LLCs. See *supra* notes 215-24 and accompanying text.

227. See *supra* notes 215-24 and accompanying text.