THE TAXATION OF DOMESTIC LIMITED LIABILITY COMPANIES AND LIMITED PARTNERSHIPS: A CASE FOR ELIMINATING THE PARTNERSHIP CLASSIFICATION REGULATIONS

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I. INTRODUCTION

Within a relatively short period of time, the availability and use of the domestic limited liability company (LLC)[1], a new form for doing business introduced by the state of Wyoming in 1977[2] and first recognized by the Internal Revenue Service as a partnership for federal income tax purposes in 1988,[3] exploded out of obscurity into the mainstream of American business.[4] The LLC possesses many of the business traits found in close

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1. The articles written on LLCs are too numerous to cite completely. *See generally* Karen C. Burke, *The Uncertain Future of LLCs*, 12 AM. J. TAX POL'Y (forthcoming Spring 1995); Susan Pace Hamill, *The Limited Liability Company: A Midpoint Evaluation*, 52 INST. ON FED. TAX'N 1 (1994); Joseph C. Vitek, *Tax Aspects of Limited Liability Companies*, 27 CREIGHTON L. REV. 191 (1993); Robert R. Keatinge et al., *The Limited Liability Company: A Study of the Emerging Entity*, 47 BUS. LAW. 375 (1992); Thomas Earl Geu, *Understanding the Limited Liability Company: A Basic Comparative Primer* pts. 1 & 2, 37 S.D. L. REV. 44 (1992); Susan Kalinka, *The Limited Liability Company and Subchapter S: Classification Issues Revisited*, 60 U. CIN. L. REV. 1083 (1992); Wayne M. Gazur & Neil M. Goff, *Assessing the Limited Liability Company*, 41 CASE W. RES. L. REV. 387 (1991); Susan Pace Hamill, *The Limited Liability Company: A Possible Choice for Doing Business*, 41 U. FLA. L. REV. 721 (1989).

2. Act of March 4, 1977, ch. 155, 1977 Wyo. Sess. Laws 512; *see infra* note 45 and accompanying text.

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

4. Before the Service issued Revenue Ruling 88-76, only Wyoming and Florida, which passed its LLC statute in 1982, recognized domestic LLCs. WYO. STAT. §§ 17-15-101 to 17-15-136 (1977); FLA. STAT. ANN. §§ 608.401 to 608.471 (West 1982). LLCs experienced a slow growth from the time the Service issued Revenue Ruling 88-76 through the close of 1991. In 1990 both Colorado and Kansas passed LLC statutes. COLO. REV. STAT. ANN. §§ 7-80-101 to 7-80-913 (West 1990); KAN. STAT. ANN. §§ 17-7601 to 17-7651 (1990). In 1991 four more states (Nevada, Texas, Utah, and Virginia) joined them. 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. §§ 48-2b-101 to 48-2b-157 (1991); VA. CODE ANN. §§ 13.1-1000 to 13.1-1123 (Michie 1991). In 1992 and 1993 the growth of LLC statutes exploded. By the close of 1992 ten more states, including Delaware, had passed LLC statutes. ARIZ. REV. STAT. ANN. §§ 29-601 to 29-857 (1992); DEL. CODE ANN. tit. 6, §§ 18-101 to 18-1106 (1992); ILL. ANN. STAT. ch. 805, para. 180/1-1 to 180/60-1 (Smith-Hurd 1992); IOWA CODE §§ 490A.100-490A.1601 (1992); LA. REV. STAT. ANN. §§ 12:1301-12:1369 (West 1992); MD. CODE ANN., CORPS. & ASS'NS §§ 4A-101 to 4A-1103 (1992); MINN. STAT. §§ 322B.01-322B.955 (1992); OKLA. STAT. ANN. tit. 18, §§ 2000-2060 (West 1992); R.I. GEN. LAWS §§ 7-16-1 to 7-16-68 (1992); W. VA. CODE §§ 31-1A-1 to 31-1A-69 (1992). In 1993 eighteen more states passed statutes. ALA. CODE §§ 10-12-1 to 10-12-61 (1993); ARK. CODE ANN. §§ 4-32-10 to 4-32-1316 (Michie 1993); 1993 Conn. Pub. Act 93-267; GA. CODE ANN. §§ 14-11-100 to 14-11-1109 (1993); IDAHO CODE §§ 53-601 to 53-672 (1993); IND. CODE ANN. §§ 23-18-1-1 to 23-18-13-1 (Burns 1993); MICH. COMP. LAWS ANN. §§ 450.4101-.5200 (West 1993); MO. REV. STAT. §§ 347.015-347.187 (1993); MONT. CODE ANN. §§ 35-8-101 to 35-8-1307 (1993); NEB. REV. STAT. §§ 21-2601 to 21-2645 (1993); N.H. REV. STAT. ANN. §§ 304C:1 to 304C:85 (1993); 1993 N.J. Laws 210; N.M. STAT. ANN. §§ 53-19-1 to 53-19-74 (Michie 1993); N.C. GEN. STAT. §§ 57C-1-01 to 57C-10-07 (1993); N.D. CENT. CODE §§ 10-32-01 to 10-32-155 (1993); OR. REV. STAT. §§ 63.001-63.990 (1993); S.D. CODIFIED LAWS ANN. §§ 47-34-1 to 47-34-59 (1993);

corporations, including limited liability protection for all members and the flexibility to adopt individualized agreements addressing the management, dissolution and transferability of the business.[5] Close corporations, however, will always be taxed as corporations,[6] while LLCs offer for the first time a domestic entity combining the tax advantages of a partnership with the limited liability protection for all members commonly associated with corporations.[7] LLCs are often compared to general and limited partnerships because of their common tax advantages and, in the case of limited partnerships, limited liability protection for limited partners. However, unlike partnerships, LLCs never require managers or members to bear personal liability for all obligations of the LLC and do not restrict the ability of members to participate in the business.[8]

In order to secure partnership status for tax purposes, LLCs must lack two of the four corporate characteristics—continuity of life, free transferability of interests, centralized management and limited liability—defined in the Treasury Regulations addressing the federal income tax classification

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WIS STAT. §§ 183.0102-183.1206 (1993). By the close of 1994 almost all the remaining states, including New York and California, had passed LLC statutes. ALASKA STAT. §§ 10.50.10-.995 (Supp. 1994); CAL. CORP. CODE §§ 17000-17705 (West Supp. 1994); 1994 D.C. Act 10-243; 1994 Ky. Acts 275.001-275.455; 1994 Maine Laws 718 (H.B. 1123); MISS. CODE ANN. §§79-29-101 to 79-29-1201 (Supp 1994); N.Y. LTD. LIAB. CO. LAW ch. 34 (1994); OHIO REV. CODE ANN. ch. 1705 (Anderson Supp 1994); 1994 Pa. Laws 106; 1994 S.C. Acts 448; TENN. CODE ANN. §§ 48-201-101 to 48-208-601 (Supp. 1994); WASH. REV. CODE ANN. ch. 25 (West 1994). The few states still without statutes, Hawaii, Massachusetts, and Vermont, all have LLC statutes pending in their legislatures, making it highly likely that all states will recognize LLCs by 1995 or 1996. Furthermore, in August of 1994, the National Conference of Commissioners on Uniform State Laws approved the final reading of the Uniform Limited Liability Company Act.

5. *See infra* text accompanying notes 124-45.

6. *See infra* note 149 and accompanying text; *see also infra* text accompanying notes 170-71 (describing how closely held corporations eliminate the double tax on corporations).

7. The Internal Revenue Code taxes corporations at both the corporate and shareholder levels while only the partners of partnerships are subject to tax. Losses flow through partnerships to the partners but do not flow through corporations. *See* I.R.C. §§ 11, 301, 701, 702 (1988 & Supp. IV 1992); *see infra* note 170 for a discussion of Subchapter S corporations.

Partnerships, but not corporations, are entitled to certain inside basis adjustments. *See* I.R.C. §§ 734, 743(b) (1988). Both the partnership and the partner generally can defer unrealized gain when distributing appreciated property. *See id.* §§ 731-733. Corporations, however, must recognize gain when they distribute appreciated property, and shareholders generally have a taxable dividend equal to the fair market value of the property received. *See id.* §§ 301, 311. For an exhaustive examination and defense of the policy behind the fundamental partnership taxation rules, see Rebecca S. Rudnick, *Enforcing the Fundamental Premises of Partnership Taxation*, 22 HOFSTRA L. REV. 229 (1993).

8. *See* UNIF. PARTNERSHIP ACT § 15 (1914) [hereinafter UPA]; REVISED UNIF. PARTNERSHIP ACT § 306 (1993) [hereinafter RUPA]; REVISED UNIF. LTD. PARTNERSHIP ACT §§ 303, 403 (1985) [hereinafter RULPA].

of all unincorporated organizations.[9] In early 1995 the Service issued Revenue Procedure 95-10 providing guidelines LLCs must follow in order to obtain a partnership classification ruling.[10] Revenue Procedure 95-10 generally creates the same gateway to partnership taxation for LLCs that limited partnerships have long enjoyed. The revenue procedure does this by essentially treating LLC managers as general partners for purposes of applying the standards for lacking continuity of life, free transferability of interests and centralized management, and arguably allows LLCs even more flexibility than limited partnerships if an LLC attempts to lack the corporate characteristic of limited liability.[11] Recently, in response to President Clinton's February 21, 1995 announcement to identify regulations that have become obsolete or unduly burdensome,[12] the Service and the Treasury stated in Notice 95-14 that they are considering allowing certain unincorporated business organizations, which include domestic LLCs and limited partnerships, to elect either partnership or association treatment.[13]

In order to place the tax classification of limited partnerships and LLCs in perspective, Part II of this Article traces the historical evolution of the entity classification area. Over time, the Service made numerous unsuccessful attempts, in response to developments arguably unrelated to entity classification, to make partnership treatment more difficult to obtain. Ultimately, Congress curbed the most important problem, the growth of tax shelters, by enacting the passive loss limitations as part of the Tax Reform Act of 1986.[14] This effectively cleansed partnerships of their abuse potential as the vehicle of choice for tax shelters. Part III then examines how the entity classification regulations have been applied to limited partnerships. This review illustrates that the tougher classification

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

10. Rev. Proc. 95-10, 1995-3 I.R.B. 20. Revenue Procedure 95-10 modifies Revenue Procedure 89-12, which provides the equivalent ruling guidelines for limited partnerships, by making Revenue Procedure 89-12 inapplicable to LLCs.

Revenue Procedure 95-10, like all other revenue procedures, merely represents the Service's ruling policy and does not necessarily reflect the substantive rules of law. *Id.* In the entity classification area, the Service historically has imposed more requirements on taxpayers seeking a ruling than the courts would otherwise require. *See infra* notes 96-100. However, as a practical matter, for most LLCs Revenue Procedure 95-10 represents the substantive rule of law for obtaining partnership treatment. LLCs unexpectedly treated as corporations may face disastrous tax consequences, *see supra* note 7, and most LLCs cannot afford the sophisticated tax advice needed to feel comfortable predicting partnership status without complying with Revenue Procedure 95-10.

11. *See infra* text accompanying notes 111-45.

12. President's Remarks on Regulatory Reform, 31 WEEKLY COMP. PRES. DOC. 278 (Feb. 21, 1995).

13. I.R.S. Notice 95-14, 1995-14 I.R.B. 1.

14. *See infra* text accompanying notes 52, 62.

requirements existing prior to Revenue Procedure 89-12 had no effect on the growth of tax shelters, while the more flexible requirements of Revenue Procedure 89-12 allowed limited partnerships to receive almost automatic partnership tax classification. After briefly reviewing the Service's handling of LLCs from 1990 to early 1995, Part IV then examines how the classification regulations apply to LLCs, focusing on the guidelines set out in Revenue Procedure 95-10. Because Revenue Procedure 95-10 essentially treats LLC managers as general partners, the classification of LLCs will almost certainly evolve in a manner similar to limited partnerships, with the result that LLCs will also receive virtually automatic partnership classification.

Finally, in Part V, the Article proposes that the tax policymakers[15] eliminate the use of the partnership classification regulations when determining the taxation of domestic LLCs and limited partnerships.

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15. By using the term "tax policymakers," this Article deliberately leaves open the pure procedural issue of whether the Internal Revenue Service and the Treasury as an administrative agency can or should eliminate the use of the classification regulations. Although this Article strongly supports, on a substantive level, the proposal in Notice 95-14, an exhaustive analysis and conclusion addressing the Service's authority to make this change by interpretative regulation is beyond the scope of this Article. However, a preliminary examination of the relevant authorities reveals that a serious issue concerning the Service's authority exists. This uncertainty suggests that the elimination of the classification regulations might be more safely accomplished legislatively. Section 7701(a)(3) of the Code defines corporation to include "associations" and the Supreme Court, in Morrissey v. Commissioner, 296 U.S. 344 (1935), interpreted the term association as based on resemblance to, not absolute identity with, a corporation. The Court then set forth the characteristics relevant to the corporate resemblance test, which later appeared in the classification regulations that the Service proposes to eliminate. Arguably, eliminating these regulations by interpretative regulation, whether by creating a taxpayer election system or requiring per se partnership treatment, exceeds the Service's authority under I.R.C. § 7805 for at least two reasons. First, making corporate taxation totally voluntary or partnership taxation automatic is arguably inconsistent with § 7701(a)(3), which by defining "corporation" to include "associations" clearly contemplates that at least some unincorporated organizations will be classified as associations and subject to the corporate tax provisions. Moreover, by eliminating the relevance of the corporate resemblance test, either approach completely overturns the Supreme Court's interpretation of § 7701(a)(3) that has been in force for 60 years.

Regulations in the classification area have been held to be invalid. After the Service promulgated the classification regulations in 1960, effectively denying professional partnerships association status and the accompanying pension benefits, state legislatures recognized the professional corporation. In 1965 the Service amended the classification regulations in order to treat professional corporations with partnership business characteristics as partnerships for tax purposes. *See* T.D. 6797, 1965-1 C.B. 553. Primarily because the statutory definition of partnership in § 7701(a)(2) explicitly excludes corporations, courts held the regulations to be an invalid extension of the definition of partnership. *See* Kurzner v. United States, 413 F.2d 97 (6th Cir. 1969); O'Neill v. United States, 410 F.2d 888 (6th Cir. 1969); United States v. Empey, 406 F.2d 157 (10th Cir. 1969); *see also* WILLIAM S. MCKEE ET AL., TAXATION OF PARTNERSHIPS AND PARTNERS ¶ 3.06[1] (2d ed. 1990).

Domestic[16] LLCs with at least two members[17] and limited partnerships[18] could either be taxed automatically as partnerships under a per se approach, similar to the classification of domestic corporations, based on the local law filing under the state LLC or limited partnership statute; or be permitted to elect partnership or association taxation as outlined in Notice 95-14. Elimination of the classification regulations with respect to domestic LLCs and limited partnerships will save taxpayers and the Service substantial transaction costs without adversely affecting the revenue base derived from the corporate tax.[19] Moreover, elimination of the classification regulations will not increase the focus on form at the expense of substance, because the determination under the classification regulations as to whether unincorporated businesses fall under the corporate or partnership tax regimes bears no resemblance to the absence or presence of corporate or partnership

16. Foreign entities sometimes face enormous administrative difficulties meeting the technical requirements of the partnership classification regulations, primarily because the drafters of foreign statutes understandably are unfamiliar with U.S. tax law. Whether the classification regulations should be applied to foreign entities is beyond the scope of this Article. Under current law, all foreign entities (except those meeting the definition of publicly traded under I.R.C. § 7704), including those "incorporated" under the foreign law, are classified as either partnerships or associations based on the entity classification regulations. *See* Rev. Rul. 88-8, 1988-1 C.B. 403. Notice 95-14 states that in addition to allowing certain domestic entities to elect partnership or association status, the Service and the Treasury are considering allowing foreign entities to make the same election. I.R.S. Notice 95-14, 1995-14 I.R.B. 1. The Service expressed several special concerns that arise in the foreign area only including the possibility of inconsistent or hybrid entity classification. However, it is not clear whether the classification regulations directly and efficiently address these special concerns, and arguably the new anti-abuse regulation applicable to all entities treated as partnerships could address these concerns in a more cost effective manner. *See* Treas. Reg. § 1.701-2 (1994). For an extensive analysis of how the partnership provisions apply to foreign joint ventures, including the identification of open issues, see Bruce N. Davis & Steven R. Lainoff, *U.S. Taxation of Foreign Joint Ventures*, 46 TAX L. REV. 165 (1991).

17. The tax treatment of one-member LLCs is beyond the scope of this Article. An LLC with only one member cannot be classified as a partnership because partnerships must have at least two partners joining together in a business enterprise as co-proprietors. *See* Treas. Reg. § 1.761-1(a) (as amended in 1972). Currently, no published authorities indicate whether a one-member LLC will receive flow-through tax treatment as a sole proprietorship or be treated as an association. *See generally* Francis J. Wirtz & Kenneth L. Harris, *Tax Classification of a One-Member Limited Liability Company*, 59 TAX NOTES 1829 (1988).

A related issue, how LLCs owned by members who are commonly owned by a single economic interest (e.g., when the members of the LLC are wholly owned subsidiaries of the same common parent corporation) will be treated for tax purposes is similarly beyond the scope of this Article. The Service has addressed the classification of foreign entities owned by a single economic interest and concluded that under some circumstances foreign entities owned ultimately by a single economic interest will be treated as associations even though they technically meet the partnership classification regulations. *See* Rev. Rul. 77-214, 1977-1 C.B. 408, as modified and superseded by Rev. Rul. 93-4, 1993-3 I.R.B. 5. However, no authority addresses how the single interest authorities apply to domestic LLCs. *See generally* Barbara C. Spudis & Michael J. Wilczynski, *Entity Classification Update: Revenue Ruling 93-4*, 71 TAXES 164 (1993).

18. Limited partnerships must always have at least two partners, one being a limited partner and one being a general partner. *See* RULPA § 101(7) (1985).

19. *See infra* text accompanying notes 146-87.

business characteristics.[20]

Although saving substantial transaction costs represents a positive improvement in tax policy, elimination of the classification regulations nevertheless fails to solve the root problem behind both the corporate and partnership tax regimes: with or without the classification regulations, corporations and partnerships receive disparate tax treatment without any reasonable business basis. This crucial problem can only be solved fully if Congress addresses the most important tax policy question affecting business enterprises, the corporate integration issue.[21]

II. HISTORICAL EVOLUTION

A. Developments Before the 1960 Regulations

The difficulties in entity classification that have haunted business taxation over the last six decades are readily apparent in the Internal Revenue Code's statutory definitions of corporation, which includes "associations, joint-stock companies, and insurance companies,"[22] and partnership, which includes "a syndicate, group, pool, joint venture, or other unincorporated organization . . . which is not . . . a corporation . . . ."[23] The tax definitions of corporation and partnership follow similar paths without connecting. A corporation clearly cannot be taxed as a partnership, but a partnership or other unincorporated organization, if deemed an association, can be taxed as a corporation. However, the statute fails to state explicitly what causes an entity to be a corporation or what criteria apply to determine when a partnership or other unincorporated entity crosses the boundary into association status.[24]

In its 1935 decision in *Morrissey v. Commissioner*,[25] the Supreme Court

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20. *Id.*

21. An extensive discussion of why resolving the corporate integration issue is so critical to solving the problems associated with the different tax treatment afforded corporations and partnerships is beyond the scope of this Article. *See infra* notes 53, 64-67, 146, 172, 184.

22. I.R.C. § 7701(a)(3) (1988 & Supp. 1994).

23. *Id.* § 7701(a)(2). For an excellent description of the legislative history behind the definitions of both partnership and corporation, see Stephen B. Scallen, *Federal Income Taxation of Professional Associations and Corporations*, 49 MINN. L. REV. 603, 609-24 (1965).

24. Because the language of these definitions have changed very little from their original forms, first enacted in 1917 and 1932, respectively, at least one commentator concluded that Congress must have thought that local law adequately determined corporate status. *See* Scallen, *supra* note 23, at 622; *see also* John J. Sexton & Donald F. Osteen, *Classification as a Partnership or as an Association Taxable as a Corporation*, 24 TUL. TAX INST. 95 (1975). Sexton and Osteen note that the definition of corporation first appeared in the War Revenue Act of 1917, ch. 63, 40 Stat. 300, 302, and that a slightly modified definition was included in the Revenue Act of 1918, ch. 18, 40 Stat. 1057. Sexton & Osteen, *supra* at 99.

25. 296 U.S. 344 (1935). Although *Morrissey* generally enjoys uniform recognition as the seminal case in the development of the fundamental concepts that distinguish partnerships from associations,

identified and discussed in detail the characteristics that determine whether an association is subject to corporate taxation. The *Morrissey* Court held a state law trust[26] formed to develop a golf course for profit to be an association taxable as a corporation. The Court rejected the plaintiffs' argument that organization under a state corporate statute constituted a prerequisite for taxation under the corporate provisions. Because Congress included associations within the definition of corporation, the Court reasoned that Congress intended corporate taxation status to be based on resemblance to a corporation rather than absolute identity with a corporation.[27] The characteristics the Court deemed indicative of corporate similarity were the ability of the organization to hold title, the continuation of the entity despite the death of an owner, the centralization of management authority, the ability to transfer ownership interests, and the ability to limit liability for debts of the organization.[28] In *Morrissey*, the Court determined that the trustee had broad management powers, the death of a trustee or a beneficiary did not terminate the trust, the beneficial interests were freely transferable, and liability was limited to the trust's assets. The corporate characteristics identified in *Morrissey* later formed the basis for the 1960 partnership classification regulations that determine the taxation of unincorporated business associations today.[29]

The most significant set of entity classification regulations issued by the Service[30] prior to the 1960 regulations were the regulations promulgated in 1953. The 1953 regulations state that any unincorporated organization, including a partnership, can be treated as an association. However, the 1953 regulations failed to address the effect of the presence of limited liability.

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description of the pre-*Morrissey* cases and regulations, see Sexton & Osteen, *supra* note 24, at 99-100.

26. Persons usually create trusts by will or inter vivos declaration in order to have the trustee take title to property and protect and conserve it for the beneficiaries. The regulations treat this arrangement as a trust for tax purposes as long as the beneficiaries are not associates with an objective to carry on business and divide the gains, which would cause the Service to treat the trust as an association or a partnership based on the four-factor test applicable to unincorporated organizations generally. *See* Treas. Reg. § 301.7701-4 (as amended in 1993); *see also* Rev. Rul. 88-79, 1988-2 C.B. 361 (classifying a trust formed under Missouri law for the purpose of buying, holding, and selling oil and gas royalty interests as a partnership because it had associates and a business objective and lacked two of the remaining four corporate characteristics). A detailed discussion of business trust classification is beyond the scope of this Article. The Service and Treasury propose in Notice 95-14 to allow trusts with associates and a business objective to elect partnership or association treatment without affecting the existing rules for classifying and taxing trusts formed to protect and conserve property without associates and a business objective. I.R.S. Notice 95-14, 1995-14 I.R.B. 1.

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

28. *Id.* at 359-60.

29. *See infra* text accompanying notes 34-36.

30. Before the 1953 regulations, earlier regulations dealt with the status of partnerships and limited partnerships. As in the 1953 regulations, the continued existence of the business and centralization of management assumed a more important role than other characteristics. *See* Sexton & Osteen, *supra* note 24, at 117-19.

These regulations simply stated that an organization will be treated as an association if the affairs of the business are conducted by a board or other group in a representative capacity and the organization continues despite a change in its members.[31]

The 1960 Service regulations were a direct response to the famous watershed case in the entity classification area, *United States v. Kintner*.[32] In *Kintner* a group of doctors specifically structured a state law partnership—by providing for executive committee governance and continued existence despite a change in the partners—to meet the definition of association. The doctors sought association status in order to obtain pension benefits then unavailable to state law partnerships. The Ninth Circuit held that the state law partnership qualified as an association under the 1953 regulations.[33] In response to the *Kintner* decision, the Service issued new entity classification regulations, finalized in 1960, that made it considerably more difficult for unincorporated organizations to be treated as associations.[34]

B. Developments After the 1960 Regulations

The 1960 regulations, which survive largely intact today, identify six characteristics of corporate status to apply in the classification of unincorporated organizations: (1) the presence of associates, (2) an objective to carry on business and divide the gains, (3) continuity of life, (4) centralization of management, (5) limited liability, and (6) free transferability of interests.[35] The Service treats an unincorporated organization as an association only if it possesses more corporate than noncorporate characteristics. Because unincorporated organizations seeking partnership classification typically have associates and a business objective, the test between partnership and association status boils down to the last four listed corporate characteristics. Because the regulations require more characteristics for association treatment, unincorporated organizations seeking partnership classification need only lack two of the four corporate characteristics.[36]

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31. Treas. Reg. §§ 39.3797-2, -4 (1953); *see also* MCKEE ET AL., *supra* note 15, ¶ 3.06[1]; Sexton & Osteen, *supra* note 24, at 119-20.

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

33. *Id.* at 428.

34. Prop. Treas. Reg. § 301.7701-2, 24 Fed. Reg. 10451 (1959); *see also* Sexton & Osteen, *supra* note 24, at 120-22; MCKEE ET AL., *supra* note 15, ¶ 3.06[1] (describing the Service's failed attempt to treat state law professional corporations as partnerships after the states passed legislation allowing professionals to incorporate in order to receive pension benefits directly).

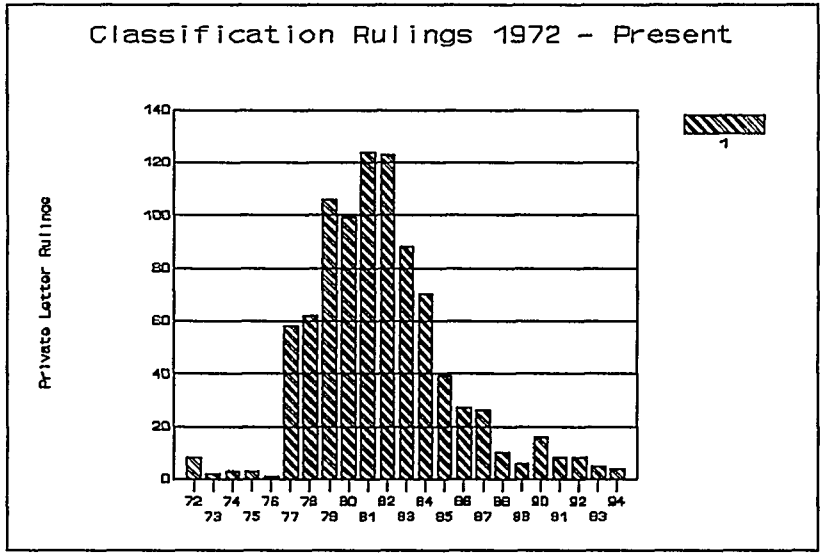
35. Treas. Reg. § 301.7701-2 (as amended in 1993).

36. *Id.*

The 1960 regulations allowed creative tax planners to devise new ways to use the partnership form to achieve tax benefits. In the 1970s tax planners developed large syndicated tax shelters as limited partnerships that easily met the technical requirements for partnership status. Although in the 1970s the Service imposed stringent requirements on limited partnerships seeking a ruling,[37] the use of tax shelters organized as limited partnerships proliferated out of control.[38] Around 1980 large, widely held limited partnerships, known as master limited partnerships, whose interests were

37. See, for example, Rev. Proc. 72-13, 1972-1 C.B. 735 and Rev. Proc. 74-17, 1974-1 C.B. 17, discussed *infra* notes 96-99 and accompanying text.

38. *See Still a Healthy Crop of Tax Shelters*, BUS. WK., Dec. 25, 1978, at 179; *Psst! Wanna Buy a Tax Shelter?*, FORBES, Oct. 29, 1979, at 120. From 1972 through 1976, the period during which the Service released private letter rulings to the public on a discretionary basis, the Service released an average of only four partnership classification private letter rulings per year. In 1977, when the Service released all private letter rulings to the public, the number increased over 1000% to 59, and continued to increase an average of 23% per year until peaking in 1981 at 124. Search of LEXIS, FEDTAX Library, PLR File (Jan. 10, 1995). Although the Service's policy of only releasing selected private letter rulings before 1977 makes the true growth hard to measure, one can reasonably assume that the use of tax shelters increased dramatically by the late 1970s.



Although most of the tax shelters producing the greatest amount of loss write-offs probably relied on tax opinions rather than seeking private letter rulings from the Service, the number of private letter rulings from the late 1970s through the early 1980s serves as a reasonable barometer of the growth of the tax shelters. By the latter half of the 1980s, taxpayers were sufficiently comfortable with the limited partnership's ability to obtain partnership classification that they needed less guidance from the Service. This increased comfort level likely explains the overall decline in private letter ruling requests.

traded on the stock exchange emerged. Successful master limited partnerships produced cash distributions to the limited partners that exceeded taxable income, with the units essentially serving as substitutes for debt instruments paying fixed cash flows. Although not organized as tax shelters, the development of master limited partnerships turned the entity classification area on its head. Because the master limited partnerships met the technical requirements—by lacking continuity of life and limited liability—owners of these limited partnership interests received all the benefits of publicly traded corporate stock combined with flow-through taxation under the partnership provisions.[39]

The Service was unable to control the increased use of limited partnerships as tax shelters by tightening up the classification regulations. In 1977, following two judicial decisions that resulted in limited partnerships organized as tax shelters being classified as partnerships despite their substantive resemblance to corporations,[40] the Service issued new proposed regulations. The Service proposed to replace the technical four-factor test in the 1960 regulations with a facts and circumstances analysis that did not place a premium on formalistic distinctions. The proposed regulations, apparently attempting to curb the revenue loss from tax shelters by changing the entity classification rules, contained guidance on whether the entity resembled a corporation for purposes of each of the four factors. However, they did not guarantee that partnership treatment would result merely because the entity failed to resemble a corporation with respect to two of the four characteristics.[41] Although these proposed regulations did not deem any of the four characteristics a super factor, they generally made it more difficult for all entities to be classified as partnerships and probably

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39. Master limited partnerships were able to lack continuity of life by filing under statutes on the Service's list of state statutes corresponding to the Revised Uniform Limited Partnership Act, *see infra* note 72, and to lack limited liability by funding the corporate general partner with enough capital to meet net worth requirements, *see infra* notes 96-99. For a description of the general mechanics and methods of solving technical problems inevitably arising from applying the partnership provisions to such a large entity, see generally Frank R. Goldstein & Anthony H. Rickert, *Structuring Publicly Traded Partnerships: Depositary Receipts, Assignee Units, or Limited Partnership Interests*, 4 J. PARTNERSHIP TAX'N 204 (1987); Stephen T. Limberg, *Master Limited Partnerships Offer Significant Benefits*, 65 J. TAX'N 84 (1986). For an easy-to-understand discussion outlining the investment benefits of master limited partnerships, see *Congress Created a Way to Avoid Taxes that Companies Just Can't Resist; The Master Limited Loophole*, U.S. NEWS & WORLD REP., Mar. 30, 1987, at 63.

40. *See* Zuckman v. United States, 524 F.2d 729 (Ct. Cl. 1975); Larson v. Comm'r, 66 T.C. 159 (1976), *acq.* 1979-1 C.B. 1.

41. For example, if the percentage of owners in the entity enjoying limited liability protection substantially exceeded the percentage of owners personally liable, the entity resembled a corporation with respect to the characteristic of limited liability. *See* Prop. Treas. Reg. § 301.7701-2, 24 Fed. Reg. 10451 (1959).

would have classified many tax shelters as associations.[42] Following protests by industries using limited partnerships, such as oil and gas, real estate and housing, as well as foreign entities and trusts,[43] the proposed regulations were withdrawn on January 4, 1977, one day prior to their publication.[44]

During this period, the Service further attempted to revise the classification regulations, but these revisions neither controlled the increased use of tax shelters nor addressed the development of master limited partnerships. Apparently in response to Wyoming's creation of the domestic limited liability company in 1977,[45] the Service issued another set of proposed entity classification regulations in 1980. The 1980 proposed regulations automatically denied partnership classification to all limited liability companies, defined as any organization in which all owners enjoyed limited liability protection under local law. The regulations looked solely to limited liability protection granted by local law and ignored other arrangements that substantively provide virtually identical limited liability protection.[46] Consequently, limited partnerships that used corporate general partners to achieve substantive limited liability had no fear of being deemed associations under the 1980 proposed regulations.[47] Unlike the 1977 proposed regulations,[48] the 1980 proposed regulations reflected a policy decision to treat limited liability as the ultimate corporate characteristic, carrying with it the burdens of the corporate tax.[49] Like the 1977 proposed regulations,

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42. *See* 42 Fed. Reg. 1038 (1977).

43. *See* Robert Reinhold, *Tax Shelter Ban Defeated*, N.Y. TIMES, Jan. 6, 1977, at A1; *Simon Vetos Tax Shelter Ban*, FACTS ON FILE WORLD NEWS DIGEST, Jan. 22, 1977, at 36; *see also* Kalinka, *supra* note 1, at 1149 n.357.

44. *See* 42 Fed. Reg. 1489 (1977).

45. In 1977 Wyoming passed legislation creating the first domestic limited liability company. Act of March 4, 1977, ch. 155, 1977 Wyo. Sess. Laws 512. Apparently after experiencing some resistance from the Internal Revenue Service, the Wyoming Secretary of State's Office, on the eve of the 1980 proposed regulations, secured a private letter ruling that the Wyoming LLC would be treated as a partnership for tax purposes. *See* Priv. Ltr. Rul. 81-060-82 (Nov. 18, 1980).

46. *See* 45 Fed. Reg. 75,709 (1980).

47. *See supra* note 38 (illustrating graphically that limited partnerships were as popular as ever in the early 1980s). The preamble to the 1980 regulations explicitly states that limited partnerships corresponding to RULPA and general partnerships corresponding to UPA, by virtue of the liability imposed on general partners by state law, will not be subject to per se association treatment regardless of any substantive arrangements by the partners to limit that liability exposure. *See* 45 Fed. Reg. 75,709 (1980).

48. *See supra* notes 41-44 and accompanying text (explaining that the 1977 proposed regulations were intended as a direct attack on tax shelters).

49. The 1980 regulations appeared at a time when the LLC was so new (only Wyoming had a statute, *see supra* note 4, that virtually no businesses were using it. Because the Service still had to deal with the immediate problem of the tax shelters, it seems odd that resources were devoted to what could

the 1980 proposed regulations received many unfavorable comments. Critics argued that the regulations would interfere with certain domestic commercial arrangements, such as equipment leasing trusts, and limit the participation of U.S. persons in foreign enterprises.[50] The Service later withdrew these regulations and stated it would conduct an extensive study concerning the effect of the limited liability characteristic on entity classification.[51]

While the Service was conducting this study, two legislative developments directly addressed the appeal of limited partnerships organized as tax shelters or master limited partnerships. First, in 1986, Congress enacted the passive activity loss limitations in section 469 of the Code.[52] These limitations prohibited investors from deducting their tax shelter losses against their salaries and other investment portfolio income. Because limited partnerships organized as tax shelters only had economic viability if losses flowed through in deductible form to the limited partners, this legislation effectively shut down the tax shelter industry. Second, in 1987 Congress added section 7704 to the Code, which conclusively treats publicly traded partnerships as corporations for tax purposes.[53] This legislative determination of corporate status was based on the assumption that publicly traded partnerships eroded the corporate tax base.[54] Ultim-

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only have been at that time a theoretical problem if it represented a problem at all.

50. *See, e.g.*, I.R.S. News Release IR-82-145 (Dec. 16, 1982).

51. *Id*; *see* Ann. 83-4, 1983-2 I.R.B. 30.

52. Tax Reform Act of 1986, Pub. L. No. 99-514, § 501(a), 100 Stat. 2085 (1986). For a detailed description of the passive loss limitations and a policy critique, see Robert J. Peroni, *A Policy Critique of the Section 469 Passive Loss Rules*, 62 S. CAL. L. REV. 1 (1988).

53. I.R.C. § 7704 (1988). A complete discussion and analysis of whether § 7704 preserves the double tax on corporations is beyond the scope of this Article. Arguably, § 7704's sole contribution toward improving tax policy is making the system more administrable, because the partnership provisions simply were not designed to cope with publicly traded interests. *See supra* note 39 (articles cited discuss the problems of applying the partnership provisions to publicly traded partnerships). Critics of § 7704 believe, for at least two reasons, that the per se corporate taxation of publicly traded partnerships does nothing to preserve the corporate tax. Publicly traded corporations conducting active businesses (rather than merely serving as investment vehicles) would probably continue to use the corporate form for business reasons even if Congress had not enacted § 7704. Moreover, the availability of master limited partnerships did not undermine the double taxation of corporations and actually improved the economy as a whole. Equity investments in master limited partnerships took the place of investments in corporate debt (which allow the corporation to avoid the double tax indirectly by deducting interest payments), either of which avoid the double taxation on corporations. Master limited partnerships represent a better choice for the economy because missed distributions, unlike missed interest payments, do not trigger defaults and bankruptcies. *See Hearings on Master Limited Partnerships Before the Subcomm. on Select Revenue Measures of the House Comm. on Ways and Means*, 100th Cong., 1st Sess. (1987).

54. *Id*; *see also Treasury Repeats Need for Restricting Master Limited Partnerships, But Notes White House Concerns*, Daily Rep. for Executives (BNA), July 22, 1987, at G-1 (statements of Assistant

ately, amending the classification regulations proved to be ineffective in combating these uses of limited partnerships. The uncontrolled use of tax shelters and the development of master limited partnerships both required legislative action.

In 1988 the Service finished its study and concluded that limited liability represents only one of four corporate characteristics with equal weight. Accordingly, instead of changing the 1960 regulations, the Service issued Revenue Ruling 88-76, classifying a Wyoming LLC as a partnership, and Revenue Procedure 89-12, adding substantial flexibility to the requirements for limited partnerships seeking a partnership classification ruling.[55]

C. *Significance of the Historical Development*

This abbreviated version of the rather tortured and confused history surrounding entity classification offers more than mere interesting trivia for tax and business buffs. The history of entity classification reveals a rather haphazard development starting with unclear statutory definitions of corporation and partnership. By conclusively excluding corporations from the definition of partnership, the statute itself provides the foundation for the per se imposition of the corporate tax on all incorporated entities regardless of their characteristics. Congress must have assumed that incorporating brought with it the traditional corporate characteristics in addition to the corporate form and, in the early part of the twentieth century, this assumption was probably accurate.[56] Congress did not make incorporation a mandatory characteristic for corporate tax status, however. By allowing a partnership or other unincorporated organization to fall under the definition of corporation by meeting the definition of association, Congress clearly intended that partnerships and other unincorporated business associations resembling corporations be taxed as such.[57]

As time passed, local law labels became less reliable indicators of the basic characteristics of a business. Business participants sought to use the classification regulations to achieve tax advantages, first in the form of pension benefits, and then in the use of tax shelters, areas raising policy

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Secretary for Tax Policy, J. Roger Mentz); *Ways-Means Chairman Rostenkowski Says Nature of MLP Deals Will Determine Tax Treatment*, Daily Rep. for Executives (BNA), Sept. 21, 1987, at G-6 ("In other words, if it looks like a duck, walks like a duck, and sounds like a duck, it ought to be taxed as a duck.").

55. *See infra* text accompanying notes 101, 111.

56. *See supra* notes 22-24 and accompanying text. However, in today's business arena, incorporation does not guarantee that a business will have the traditional corporate characteristics. *See generally* Laurence E. Mitchell, *Close Corporations Reconsidered*, 63 TUL. L. REV. 1143 (1989).

57. *See supra* notes 22-24 and accompanying text.

concerns not directly related to entity classification. The Service's attempts to address these problems through the classification regulations proved unsuccessful. Although the 1960 regulations arguably represented a positive tax policy development because they closely reflected the *Morrissey* decision and provided taxpayers with more certainty, they ultimately failed to limit the use of pension benefits.[58] The 1977 proposed regulations, behind which lay a good motive, ultimately represented bad tax policy[59] for entity classification in general, and because they were never finalized, failed to control tax shelters.[60]

Although the 1960 regulations were driven by arguably questionable motives, those regulations proved to be uncommonly resistant to change—probably because they offer more certainty and flexibility than existed before.[61] Strong taxpayer resistance to the Service's attempts in 1977 and 1980 to change the 1960 regulations by making it more difficult to achieve partnership status illustrates how much taxpayers rely on the certainty and flexibility those regulations offered. Ultimately, many of the problems indirectly caused by the 1960 regulations were resolved legislatively. The passive activity loss limitations addressed the major policy concern of the 1970s and 1980s, the uncontrolled growth of tax shelters, which both eroded the tax base and severely undermined the public perception of the tax system.[62] Moreover, the publicly traded partnership provisions prevented limited partnerships from competing with publicly traded corporations without requiring the Service to change the four-factor test for all unincorporated business associations.[63]

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58. *See supra* note 15 (describing the creation of the professional corporation and the Service's failure to deny them pension benefits by using the classification regulations).

59. Although arguably more theoretically pure and less subject to taxpayer manipulation, the facts and circumstances approach of the 1977 regulations introduced substantial uncertainty in the entity classification area. Few actors have as compelling a need for certainty as do business associations trying to figure out whether they should file as taxable corporations or flow-through partnerships.

60. *See supra* notes 7, 10 (describing the Service's power to affect the choice of entity through the classification regulations and their interpretation of them).

61. After reaching a peak of 124 in 1981, the number of partnership classification private letter rulings issued by the Service declined at an average rate of 16.6% per year until 1985 when the rate of decline increased to 44.3%. This pattern probably occurred because taxpayers were comfortable that limited partnerships were easily classified as partnerships. The decline in requests for rulings continued, and by 1988, when the full effects of the Tax Reform Act of 1986 could be felt, the number of private letter rulings dropped to only ten. Search of LEXIS, FEDTAX Library, PLR File (Jan. 10, 1995).

62. *See* STAFF OF THE JOINT COMM. ON TAXATION, 100TH CONG., 1ST SESS., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986 (H.R. 3838, 99TH CONGRESS; PUBLIC LAW 99-55) 209 (Comm. Print 1987).

63. Section 7704 of the Code treats all publicly traded partnerships as corporations notwithstanding their lacking two—continuity of life and free transferability of interests—of the four corporate

However, the 1980 proposed regulations touched upon, indirectly and incompletely,[64] a far more sensitive and important tax policy question. By conclusively treating all limited liability companies[65] as associations, the Service implicated the core issue at the foundation of entity classification: Does the double tax imposed on corporations represent sound tax policy or should this double tax be eliminated or mitigated? The corporate tax integration issue has been debated by tax practitioners and scholars for almost fifty years.[66] The question whether and under what circumstances limited liability protection[67] should carry the price of the corporate tax

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characteristics. Partnerships with interests traded on an established securities market, or readily tradeable on a secondary market (or the substantial equivalent), meet the definition of publicly traded partnerships. *See* I.R.C. § 7704(b) (1988). The Conference Committee Report on the Revenue Act of 1987 provides details on when the free transferability of partnership interests rises to public trading. *See* H.R. CONF. REP. NO. 495, 100th Cong., 1st Sess. 943-53, *reprinted in* 1987 U.S.C.C.A.N. 2313-45, 2313-1689 to 1699. When publicly traded partnerships automatically are treated as corporations, investors desiring the benefits of liquidity in a public market cannot avoid the effects of the corporate tax. However, certain publicly traded partnerships in which 90% or more of the gross income constitutes "qualifying income" can retain their status as partnerships if they otherwise lack continuity of life and limited liability. *See* I.R.C. § 7704(c) (1988). Qualifying income generally consists of interest, dividends, rents on real property, gains from disposing of real property, income from certain natural resource ventures, and gains from dealing in commodities, futures, options, or forward contracts where the partnership's principal activity is buying and selling those items. *See id.* § 7704(d).

64. By only mandating corporate taxation for LLCs providing statutory limited liability protection, the 1980 regulations failed to address completely whether limited liability protection should be the criterion for imposing the corporate tax. Partnerships providing substantive limited liability protection (e.g., a limited partnership with a minimally capitalized corporate general partner) still qualified for partnership classification.

65. The issue of whether the increased use of LLCs indirectly achieves corporate integration is beyond the scope of this Article and will be explored in a subsequent piece. Hypothetically, if LLCs were unavailable, closely held businesses would simply use a partnership that provides limited liability in substance or a corporation that eliminates the corporate tax through self-help techniques. *See infra* notes 161-72 and accompanying text. Similarly, if LLCs were unavailable, widely held investment ventures (that avoid the publicly traded partnership provisions) seeking access in the public capital market would simply use a limited partnership that carries as much corporate resemblance, including substantial limited liability protection, as the LLC. *See infra* notes 173-87 and accompanying text.

66. *See, e.g.*, Joseph S. Platt, *Integration and Correlation—The Treasury Proposal*, 3 TAX L. REV. 59 (1947); Alvin C. Warren, Jr., *The Relation and Integration of Individual and Corporate Income Taxes*, 94 HARV. L. REV. 717 (1981); Charles E. McLure, Jr., *Integration of the Personal and Corporate Income Taxes: The Missing Element in Recent Tax Reform Proposals*, 88 HARV. L. REV. 532 (1975); Fred W. Peel, *A Proposal For Eliminating Double Taxation of Corporate Dividends*, 39 TAX LAW. 1 (1985); Eric M. Zolt, *Corporate Integration After the Tax Reform Act of 1986: A State of Disequilibrium*, 66 N.C. L. REV. 839 (1988); Rebecca S. Rudnick, *Who Should Pay the Corporate Tax in a Flat Tax World?*, 39 CASE W. RES. L. REV. 965 (1988-89).

67. If the presence of limited liability serves as the test for the imposition of the corporate tax, all entities providing statutory or substantive limited liability should be subject to the corporate tax. Obviously LLCs, because they provide statutory limited liability, would face the corporate tax. However, partnerships in which the partners have created substantive limited liability must also face the corporate tax or taxpayers who can incur the transaction costs of using a partnership with

burden lies at the heart of the corporate tax integration question and remains unanswered.

III. PARTNERSHIP CLASSIFICATION RULES APPLIED TO LIMITED PARTNERSHIPS

A. Continuity of Life

Under the partnership classification regulations, an unincorporated organization lacks continuity of life if it dissolves due to the death, retirement, resignation, insanity, bankruptcy, or expulsion of one of the original owners.[68] Corporations traditionally possess continuity of life because they continue to exist until formal liquidation even if one of these events occur.[69] As a business matter, owners of many unincorporated organizations, including limited partnerships, seek to guard against dissolution and to maximize the stability of the business without causing the organization to possess continuity of life. A limited partnership lacks continuity of life if the relevant documents or state law provide that the death, insanity, bankruptcy, retirement, resignation, or expulsion of any general partner causes a dissolution unless the remaining general partners, or at least a majority in interest of all the partners, agree to continue the partnership.[70] Since the promulgation of the 1960 regulations, limited partnerships have always found it easy to lack continuity of life for classification purposes, yet still enjoy on a substantive level almost all the benefits of a continued business existence.

The 1960 regulations unequivocally state that a limited partnership formed pursuant to a state statute corresponding to the Revised Uniform Limited Partnership Act automatically lacks continuity of life.[71] The

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substantive limited liability protection will be treated more favorably than those who cannot. Also, greater efforts must be made to prevent corporations from avoiding the double tax by making deductible payments to shareholders. A full examination of what standard should determine which, if any, entities pay the corporate double tax is beyond the scope of this Article.

68. Treas. Reg. § 301.7701-2(b)(1) (as amended in 1993).

69. *See* REVISED MODEL BUSINESS CORP. ACT §§ 2.03(a), 14.02, 14.20, 14.30 (1984) [hereinafter RMBCA].

70. Treas. Reg. § 301.7701-2(b)(1) (as amended in 1993); *see also* Rev. Proc. 89-12, 1989-1 C.B. 319. Under Revenue Procedure 89-12, if the last general partner is removed (involuntarily ousted from the partnership for some sort of wrongdoing), at least a majority in interest of the limited partners must agree to continue the partnership. *Id.*

71. *See* Treas. Reg. § 301.7701-2(b)(3) (as amended in 1993). Under the regulations, general partnerships subject to a statute corresponding to the Uniform Partnership Act automatically lack continuity of life. *Id.* General partnerships formed under state statutes that have adopted the dissolution provisions of the Revised Uniform Partnership Act lack continuity of life, because a partner's express

Service compiles a list of these corresponding state limited partnership statutes for determining lack of continuity.[72] Despite the existence of the list, the Service received many partnership classification ruling requests regarding limited partnerships organized under listed state statutes that had relied on lacking continuity of life.[73] Apparently to avoid wasting resources, in 1992 the Service issued Revenue Procedure 92-88 stating that it will not issue a ruling that a limited partnership lacks continuity of life if the partnership is organized pursuant to a state statute on this list.[74]

Since 1993, the Service has provided more guidance and given all unincorporated organizations, especially limited partnerships, more opportunity to guard against dissolution and to increase business stability while still lacking continuity of life. Before 1993, all remaining limited partners, rather than simply a majority in interest, had to agree to continue the business if a dissolution event occurred with respect to the sole or last general partner.[75] The requirement of unanimous agreement was problematic in cases where dissatisfied limited partners refused to agree or other limited partners could not be located. To avoid the harshness of the unanimity requirement, the Service amended the continuity of life portion of the classification regulations by adding a majority-in-interest threshold for agreeing to continue the business.[76]

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will to withdraw from the partnership dissolves the original partnership without a term regardless of whether the others agree to continue. If the partnership has a specified term, the death, bankruptcy or express will to withdraw dissolves the original partnership unless a majority in interest of the remaining partners agree to continue the original partnership. *See* RUPA § 801 (1993). Although a partner's withdrawal before the completion of a term partnership will be treated as wrongful and may expose the withdrawing partner to damage claims, the damages should not substantively undermine the basic power to withdraw, because RUPA focuses on calculating actual damages and rejects automatically denying the wrongfully withdrawing partner its share of the value of the partnership's goodwill. *See id.* §§ 602, 701 and accompanying comments.

72. See Rev. Rul. 95-2, 1995-1 I.R.B. 7, for the most recent list of states whose limited partnership statutes correspond to the Revised Uniform Limited Partnership Act for purposes of Treas. Reg. § 301.7701-2.

73. Of the 890 partnership classification private letter rulings issued by the Service after 1972 but prior to Revenue Procedure 92-88, over 95% relied on lacking continuity of life and limited liability. After Revenue Procedure 92-88, there have been only 11 private letter rulings regarding partnership classification, and in all of these the limited partnerships requested rulings only on free transferability of interests because the partnerships were formed in states on the RULPA list and therefore automatically lacked continuity of life. Search of LEXIS, FEDTAX Library, PLR File (Jan. 10, 1995).

74. Rev. Proc. 92-88, 1992-2 C.B. 496.

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

76. *See id.* Although the term "majority in interest" remains undefined in the regulations, the Service recently created a safe harbor providing that the limited partners owning a majority of the interests in the partnership's capital and profits will constitute a majority in interest. The majority-in-interest safe harbor measures the partners' economic interest in the limited partnership rather than simply "counting heads." *See* Rev. Proc. 94-46, 1994-28 I.R.B. 129.

The continuity of life regulations, written in the disjunctive (*or*, not *and*), have always allowed partnerships to provide that only one rather than all of the dissolution events will trigger an agreement-to-continue requirement to avoid a real dissolution.[77] The Service recently confirmed in Revenue Procedure 95-10 that as few as one of the enumerated dissolution events can be selected without causing continuity of life to be present, as long as the event selected provides a meaningful possibility of dissolution.[78] Consequently, a limited partnership lacks continuity of life if only one meaningful event with respect to any of the general partners, bankruptcy for example, triggers a requirement that the remaining general partners or a majority in interest of all the partners must agree to continue in order to avoid a real dissolution.[79]

B. Centralized Management

By its nature, a corporation possesses centralized management because, under the state statutory default provisions,[80] a board of directors manages the corporation's business in a representative capacity for the true owners—the shareholders. The 1960 regulations treat unincorporated organizations as possessing centralized management if any person or group that does not include all the owners of the organization has the exclusive authority to make business and management decisions.[81] Although general partners of limited partnerships exclusively manage the partnership,[82] the

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

78. Rev. Proc. 95-10, 1995-3 I.R.B. 20. There seems to be little doubt that the portion of Revenue Procedure 95-10 clarifying the number of dissolution events the LLC can choose would be equally applicable to limited partnerships, because there exists no valid distinction between limited partnerships and LLCs for this purpose. *See infra* text accompanying notes 124-29.

79. Treas. Reg. § 301.7701-2(b)(1) (as amended in 1993).

80. *See* RMBCA § 801 (1984).

81. Treas. Reg. § 301.7701-2(c)(4) (as amended in 1993). General partnerships organized under a state statute that corresponds with the Uniform Partnership Act automatically lack centralized management, because all partners are agents of and have the power to bind the partnership. Moreover, if partners in general partnerships agree to vest management in an executive committee, partners not on the committee can still bind the partnership because these agreements are ineffective against outsiders who have no notice of the agreement. *Id.* General partnerships organized under state statutes corresponding to the Revised Uniform Partnership Act normally lack centralized management because each partner has the agency power to bind the partnership. *See* RUPA § 301 (1993). However, unlike the UPA, the RUPA allows the partners to destroy that agency power by filing a statement of authority, which also, depending on the individual facts, may cause the partnership to possess centralized management. *See id.* § 303.

82. *See* RULPA § 303 (1985). Although the numerous exceptions in § 303 to the general rule forbidding limited partners from participating in the partnership's business indicate that the distinction between general and limited partners is disappearing, limited partners still cannot control the ordinary business operations of the partnership and maintain limited partner status. *Id.* At least one state, Georgia,

regulations state that limited partnerships organized under state statutes that correspond with the Revised Uniform Limited Partnership Act lack centralized management unless the limited partners own substantially all the interests in the partnership.[83] The Service apparently focuses on the percentage of the partnership owned by the limited partners because state law grants management authority to the general partner and exposes the limited partners to personal liability for the debts of the partnership only when they participate in the management of the partnership's business.[84] Consequently, the regulations presume that a general partner who owns a small interest in a limited partnership must be managing the partnership on behalf of the limited partners, which leads to the conclusion that the partnership possesses centralized management. Conversely, a general partner owning a meaningful interest must be managing primarily for itself as a true owner, which allows the limited partnership to lack centralized management.

The regulations gave taxpayers little guidance concerning what percentage the general partner needed to own for the partnership to lack centralized management.[85] Moreover, the regulations contain language indicating that a substantial unrestricted right to remove the general partner for reasons other than gross negligence or self-dealing may cause the partnership to possess centralized management even if the general partner owns a meaningful interest.[86]

Although many limited partnerships sought partnership classification rulings during the 1970s and 1980s, very few relied on lacking centralized management.[87] This result could have been partly due to the absence of

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has eliminated this distinction, and allows limited partners the right to participate freely in and control the partnership's business without affecting their limited liability protection. *See* GA. CODE ANN. §§ 14-9-100 to 14-9-1204 (1994). Nevertheless, Georgia limited partnerships are on the Service's approved list for continuity of life purposes. Rev. Rul. 95-2, 1995-1 I.R.B. 7.

83. The examples in the regulations illustrate limited partnerships possessing centralized management when the general partners owned only 5.7% and 2.9% of the partnership interests. *See* Treas. Reg. § 301.7701-3(b)(2) exs. 1 & 2 (as amended in 1967). The Tax Court stated that a limited partnership lacked centralized management if the general partner owned a "meaningful proprietary interest" in the partnership. *See* Larson v. Comm'r, 66 T.C. 159, 177 (1976), *acq.* 1979-1 C.B. 1.

84. Treas. Reg. § 301.7701-2(c)(4) (as amended in 1993).

85. As a likely consequence of this uncertainty, of the 854 private letter rulings issued by the Service in response to request for partnership classification guidance, only four relied on lacking centralized management. Search of LEXIS, FEDTAX Library, PLR File (Jan. 10, 1995).

86. Treas. Reg. § 301.7701-2(c)(4) (as amended in 1993).

87. *See supra* note 85. The four private letter rulings in which the Service found that a limited partnership lacked centralized management were all unusual cases in which the general partner owned a large part (31% or more) of the limited partnership. Search of LEXIS, FEDTAX Library, PLR File (Jan. 10, 1995).

certainty in the centralized management area. More likely, however, limited partnerships found it unnecessary to defeat centralized management because they automatically lacked continuity of life[88] and were required to lack limited liability due to the absolute requirement for ruling purposes that corporate general partners satisfy net worth tests.[89]

The Service responded in Revenue Procedure 89-12 to the confusion in the centralized management area. Under Revenue Procedure 89-12, the Service will generally rule that a limited partnership lacks centralized management if the general partners own at least twenty percent of the partnership interests. However, Revenue Procedure 89-12 also contains facts and circumstances language that may cause a limited partnership with a twenty percent or greater general partner to possess centralized management if the limited partners directly or indirectly control the general partner.[90] After the Service issued Revenue Procedure 89-12, taxpayers presumably were not comfortable relying on the centralized management factor because of this uncertain facts and circumstances language, and the few post-Revenue Procedure 89-12 ruling requests seeking partnership classification did not rely on a lack of centralized management.[91]

C. Limited Liability

Traditionally, the major advantage of doing business in the corporate form was the ability of shareholders to limit their personal liability for debts and obligations of the business to their actual and promised contributions. Creditors cannot proceed against the shareholders' personal assets.[92] Under the 1960 regulations, an unincorporated organization possesses the corporate characteristic of limited liability if no member is personally liable for claims against the organization. In order for the unincorporated organization to lack limited liability, at least one member must bear personal liability for all the organization's debts.[93] General partners of a limited partnership organized under a state statute that corresponds to the Revised Uniform Limited Partnership Act are, by statute, jointly and severally liable for all claims against the partnership, and the

88. *See supra* note 71 and accompanying text.

89. *See infra* notes 96-97 and accompanying text (discussing the requirements that corporate general partners must satisfy to ensure a lack of limited liability).

90. Rev. Proc. 89-12, 1989-1 C.B. 319.

91. Of the 47 private letter rulings regarding partnership classification issued since the release of Revenue Procedure 89-12, none relied on lacking centralized management. Search of LEXIS, FEDTAX Library, PLR File (Jan. 10, 1995).

92. RMBCA § 6.22 (1984); *cf.* RULPA § 403 (1985).

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

regulations generally treat these partnerships as lacking limited liability.[94] However, apparently in response to the concern that the presence of corporate general partners would render the statutory liability exposure substantively meaningless, the regulations require the general partner to either have substantial assets or not be a dummy agent of the limited partners in order for the limited partnership to lack limited liability.[95]

Before the Service issued Revenue Procedure 89-12, Revenue Procedure 72-13 required all limited partnerships with corporate general partners seeking a partnership classification ruling to meet a substantial net worth threshold as an absolute requirement to receiving the ruling.[96] The absolute net worth requirement, which when satisfied caused the limited partnership to lack limited liability, implicitly made limited liability, at least for ruling purposes, a super factor and arguably imparted some substance to this criterion.[97] However, the net worth and other requirements of Revenue Procedure 72-13 failed to impose any serious checks on tax shelters,[98] possibly because the Tax Court refused to recognize that corporate general partners were required to meet a substantive net worth standard.[99] Furthermore, the Service never finalized the proposed 1977 regulations, which tightened up the criteria for lacking limited liability.[100]

Revenue Procedure 89-12 eliminated the absolute requirement that a corporate general partner meet net worth thresholds as a condition to the limited partnership receiving a partnership classification ruling. Under Revenue Procedure 89-12, for a limited partnership to lack limited liability, the corporate general partner must either have a net worth equal to ten percent of the total contributions to the limited partnership or demonstrate,

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94. Treas. Reg. § 301.7701-2(d)(1) (as amended in 1993); *see also* Rev. Rul. 95-2, 1995-1 I.R.B. 7. All partners of a general partnerships are personally liable for the obligations of the partnership and therefore will always lack limited liability. *See* UPA § 15 (1914); RUPA § 306 (1993).

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

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

97. If the contributions to the limited partnership were less than $2.5 million, the corporate general partners's net worth had to equal the lesser of 15% of the contributions or $250,000. If total contributions equaled $2.5 million or more, the corporate general partner's net worth had to equal 10% of the contributions. *Id.* Furthermore, limited partners could not own more than 20% of the corporate general partner's stock. *See id.* In addition to these requirements, the Service announced two years later that it would not issue classification rulings if factual questions concerning the organization suggested the principal purpose for the organization was to reduce federal income taxes. The facts suggesting tax avoidance included the general partner owning less than 1% of the partnership and the partners claiming aggregate losses in the first two years exceeding their equity invested in the partnership. *See* Rev. Proc. 74-17, 1974-1 C.B. 438.

98. *See supra* note 38 and accompanying text.

99. Larson v. Comm'r, 66 T.C. 159 (1976), *acq.* 1979-1 C.B. 1 (discussed *supra* notes 40, 83).

100. *See supra* notes 41-44 and accompanying text.

based on all the facts and circumstances, that it has substantial assets or will act independently of the limited partners. Revenue Procedure 89-12 granted much more flexibility to limited partnerships for ruling purposes by giving all four factors equal weight and recognizing that net worth was neither required nor restricted to an absolute dollar figure.[101] By the time the Service issued Revenue Procedure 89-12 in 1989, the number of limited partnerships seeking partnership classification had already dropped substantially, presumably because the passive loss limitations reduced the appeal of investing in tax shelters. The numbers of limited partnerships seeking rulings continued to drop after 1989.[102]

D. Free Transferability of Interests

Because shares of stock are considered personal property freely alienable by the owner unless the shareholders have affirmatively entered into a stock transfer restriction agreement, corporations possess free transferability of interests.[103] Stock transfer restrictions generally must be conspicuously noted on the stock certificate and meet judicial standards of reasonableness.[104] For an unincorporated organization to possess the corporate characteristic of free transferability of interests, substantially all of the owners must have the power to transfer, without consent of other owners, all attributes of ownership to a person not currently a member of the organization. An unlimited right of owners to transfer only the economic interests, rather than full rights to participate in management and control, does not cause the organization to possess free transferability of interests.[105]

Under the 1960 regulations, limited partnerships can easily lack free transferability of interests. Consent for a complete transfer can be obtained from the general partner (rather than the limited partners), and the limited partnership can still lack free transferability of interests.[106] Although the

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101. Rev. Proc. 89-12, 1989-1 C.B. 319.

102. After Revenue Procedure 89-12 was issued in January 1989, the number of private letter rulings issued in response to limited partnership classification requests that were found to lack limited liability declined steadily until January 1991, and since then no private letter rulings have been issued that find a limited partnership lacks limited liability. Search of LEXIS, FEDTAX Library, PLR File (Jan. 10, 1995).

103. RMBCA § 6.27 & cmts. (1984).

104. *Id.*

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

106. Treas. Reg. § 301.7701-3(b)(2), ex. 1 (as amended in 1967). General partnerships operating under statutes corresponding to the Uniform Partnership Act or the Revised Uniform Partnership Act lack free transferability of interests because all partners must consent to a transfer of the economic and governance rights to a person not already a member of the partnership. *See* UPA § 18(g) (1914); RUPA

general partner must have the authority to withhold consent for any reason, in many business situations, especially as the number of limited partners grows, the general partner will never exercise this authority. Moreover, the ability of the limited partnership to automatically lack continuity of life and the necessity of lacking limited liability resulted in very few limited partnerships seeking free transferability rulings before the Service issued Revenue Procedure 89-12.[107] The regulations have never required all of the owners transferring interests to obtain consent as a condition to the organization lacking free transferability of interests. Revenue Procedure 92-33 clarified the regulations by providing that a partnership will generally lack free transferability of interests if more than twenty percent of the interests must obtain the required consent for a complete transfer.[108]

By allowing the general partner to grant the consent for the complete transfer and, at the same time, allowing almost eighty percent of the interests to avoid obtaining consent at all, the regulations create a great deal of flexibility for investors to structure a limited partnership that technically lacks free transferability while retaining the business advantages of minimal transferability restrictions. However, there remain some limits on the ability of limited partnerships to have freely traded interests as a business matter while still securing partnership status by relying on lacking free transferability of interests. Limited partnerships that are widely held but technically avoid the definition of public trading must still be mindful of the famous pig theory if they plan on defeating free transferability when securing partnership status.[109] Especially in the past few years, the Service has valued substance over form when testing for free transferability and may deem limited partnerships technically meeting the requirements for lacking free transferability to possess free transferability on the grounds that the

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§ 520 (1993).

107. From 1972 until the Service released Revenue Procedure 89-12, there were 854 partnership classification private letter rulings available on Lexis. Only nine (all released in the 1970s) of the 854, or 1%, lacked free transferability of interests. However, after the Service released Revenue Procedure 89-12 (but before 1992), 43% (13 out of 30 private letter rulings) lacked free transferability of interests; after 1992, 100% (17 total) lacked free transferability of interests. Search of LEXIS, FEDTAX library, PLR File (Jan. 10, 1995). Presumably, Revenue Procedure 89-12's elimination of the absolute net worth requirement made lacking free transferability a more attractive characteristic to rely upon.

108. Rev. Proc. 92-33, 1992-1 C.B. 782.

109. The pig theory is an informal metaphor used by tax pundits to identify any situation where the taxpayer, by taking too much, risks being reined in by the Internal Revenue Service even when the taxpayer, by focusing purely on the technical rules, has a reasonable argument. The author credits Professor Robert J. Peroni (now at George Washington) for providing a first introduction to the pig theory in his teaching of *Crane v. Commissioner* in Basic Income Tax in the Fall of 1983.

restrictions on transfers are not meaningful.[110]

IV. PARTNERSHIP CLASSIFICATION RULES APPLIED TO LIMITED LIABILITY COMPANIES

After deciding that LLCs could be classified as partnerships, the Service's interpretation of how the partnership classification rules apply to LLCs followed a gradual evolution. The process began with Revenue Ruling 88-76, which by necessity took a conservative approach,[111] and concluded with the release of Revenue Procedure 95-10, which grants LLCs almost as much flexibility as is accorded to limited partnerships by essentially treating LLC managers as general partners for purposes of applying the classification regulations. During this period, the Service expended a tremendous amount of resources providing guidance in the LLC classification area and generally enjoyed a positive relationship with the bar and taxpayers interested in LLC issues.[112] Although most of the unanswered questions in the LLC classification area revolved around the issue of whether an LLC manager could be treated as a general partner for classification purposes, many of the requests for guidance concerned questions with readily ascertainable answers.[113]

Practitioners from the American Bar Association conducted several meetings with representatives of the Internal Revenue Service, formally asked for more guidance concerning the classification of LLCs, and suggested answers to the many open issues, including the critical question of whether an LLC manager can be treated as a general partner for classification purposes.[114] In addition to answering informally by tele-

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110. Rev. Proc. 95-10, 1995-3 I.R.B. 20 (requiring, as a condition to receiving a ruling that an LLC lacks free transferability, that the restrictions on transfer be meaningful); *see also infra* notes 120, 177, 180

111. Rev. Rul. 88-76, 1988-2 C.B. 360 (holding that LLCs formed under the Wyoming statute are classified as partnerships). Under the Wyoming statute, the death, retirement, resignation, insanity, bankruptcy, or expulsion of any of the members triggered a dissolution unless all remaining members agreed to continue the business, and no member could transfer a complete interest without the consent of all remaining members. *Id.* Because the statute did not allow the members to change these rules by agreement, the ruling could not vary the facts and make the dissolution or transferability provisions less conservative.

112. *See infra* notes 114-19.

113. *See supra* notes 7, 10 (explaining why taxpayers will seek Service advice on classification questions with clear answers); *see also infra* note 117 (many telephone callers asked questions with clear answers) and 118 (many of the LLC private letter rulings involved routine application of the partnership classification regulations).

114. *See* Letter from Barbara C. Spudis, Chair of the Limited Liability Company Task Force, Section of Taxation, American Bar Association, to all members of the Subcommittee on Limited Liability Companies of the American Bar Association's Committee on Partnership Taxation (Dec. 7,

phone the questions of state drafting committees preparing LLC legislation,[115] the Service decided to issue partnership classification revenue rulings, similar in format to Revenue Ruling 88-76, for each state LLC statute. By early 1993, the Service was issuing and continues to issue these revenue rulings with consistent regularity.[116] In addition to the copious and largely undocumentable informal telephone assistance provided to taxpayers in general,[117] the Service issued many private letter rulings to taxpayers seeking guidance in the LLC classification area.[118] Finally, the Service sent representatives to the Uniform Limited Liability Company Act drafting meetings of the National Conference of Commissioners on Uniform State Laws and issued an informal letter to the drafting committee

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1990) (describing meeting with Service personnel concerning LLC issues) (on file with author); Memorandum from Barbara C. Spudis to officers of the American Bar Association's Partnership Taxation Committee (June 30, 1992) (describing informal meeting held with Service representatives on May 14, 1992) (on file with author); Comments on LLCs submitted by the American Bar Association Section of Taxation, Committee on Partnerships (Feb. 27, 1992) (on file with author); Draft Revenue Procedure, dated September 14, 1993, prepared by the Limited Liability Company Task Force of the Section of Taxation of the American Bar Association, principal responsibility exercised by Barbara C. Spudis, Chair of the Task Force (suggesting ruling guidelines for determining whether an LLC is a partnership or an association).

115. *See infra* note 117.

116. Rev. Rul. 93-5, 1993-3 I.R.B. 6 (Virginia); Rev. Rul. 93-6, 1993-3 I.R.B. 8 (Colorado); Rev. Rul. 93-30, 1993-16 I.R.B. 4 (Nevada); Rev. Rul. 93-38, 1993-21 I.R.B. 4 (Delaware); Rev. Rul. 93-49, 1993-25 I.R.B. 11 (Illinois); Rev. Rul. 93-50, 1993-25 I.R.B. 13 (West Virginia); Rev. Rul. 93-53, 1993-26 I.R.B. 7 (Florida); Rev. Rul. 93-91, 1993-41 I.R.B. 22 (Utah); Rev. Rul. 93-92, 1993-42 I.R.B. 11 (Oklahoma); Rev. Rul. 93-93, 1993-14 I.R.B. 13 (Arizona); Rev. Rul. 94-5, 1994-2 I.R.B. 21 (Louisiana); Rev. Rul. 94-6, 1994-3 I.R.B. 11 (Alabama); Rev. Rul. 94-51, 1994-32 I.R.B. 11 (New Jersey); Rev. Rul. 95-9, 1995-3 I.R.B. 17 (South Dakota).

117. The author served as an attorney advisor from May 1990 to May 1994 in one of the three branches with subject matter jurisdiction over partnerships (which includes LLCs) in the Division of Passthroughs & Special Industries of the Chief Counsel's Office of the Internal Revenue Service, Washington, D.C. Although it is impossible to calculate the exact amount of time expended on informal telephone assistance, the author estimates receiving during these four years of government service an average of approximately 10 to 15 telephone calls per week seeking assistance on LLC issues, many of which were classification questions. Because the three branches with subject matter jurisdiction over LLCs employ at any given time approximately 30 to 35 attorneys, many of whom spend a significant amount of time on LLC matters, one can only imagine the amount of the Service's resources that have been spent and continue to be expended informally answering LLC classification questions.

118. Between the issuance of Revenue Ruling 88-76 and January 20, 1995, the Service issued 52 private letter rulings classifying LLCs. The number of taxpayers seeking LLC rulings increased as the number of states with LLC statutes grew; the Service issued 24 of the 52 rulings in 1994 alone. Like limited partnerships, LLCs do not tend to rely on lacking centralized management; 43 of the 52 rulings involved the LLCs lacking continuity of life and free transferability of interests, while only eight rulings involved the LLC lacking centralized management (all of which were issued in 1993 or before). Search of LEXIS, FEDTAX Library, PLR File (Jan. 20, 1995).

providing guidance on the statutory default provisions relevant to classification.[119]

By essentially treating LLC managers that are also members of the LLC as general partners for purposes of applying the entity classification regulations, Revenue Procedure 95-10 answered the most important policy question in the LLC classification area. By allowing LLC managers almost exact equivalence to general partners, Revenue Procedure 95-10 grants LLCs considerable business flexibility, to an extent previously only enjoyed by limited partnerships. This flexibility protects LLCs against unplanned and unwanted dissolutions and allows transfers to proceed in an orderly fashion. The ability of LLCs to lack limited liability by having a member become personally liable for all obligations of the LLC and to lack continuity of life while only tying the dissolution events to the managers allows business participants structuring larger investment vehicles to choose between the LLC and limited partnership purely on the basis of business considerations.[120]

The Service's decision to treat LLC managers as general partners for purposes of applying the entity classification regulations represents a

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119. *See* Letter from Edith O. Davies, Executive Secretary, NCCUSL, to Susan Pace Hamill, Chief Counsel's Office, Internal Revenue Service (Sept. 4, 1992) (on file with author); Letter from Edward I. Cutler, Chair, Drafting Committee for the Uniform LLC Act, to Susan Pace Hamill (Aug. 19, 1992) (on file with author); Letter from Edward I. Cutler to Dianna Miosi (Aug. 31, 1993) (on file with author); Letter from Dwight A. Hamilton, President, NCCUSL, to Stuart L. Brown (Apr. 9, 1993) (on file with author); Letter from Paul F. Kugler to Edward I. Cutler (July 26, 1993) (on file with author). *See generally* Catherine Hubbard & Lee A. Sheppard, *Guidance Forthcoming on LLC Classification, Practitioners Told*, 58 TAX NOTES 824 (1993).

120. Before the Service issued Revenue Procedure 95-10, no authority indicated whether LLCs could lack continuity of life if the dissolution events only applied to the managers or whether they could lack limited liability under any circumstances. Because a widely held LLC with many passive investors definitely possessed centralized management and free transferability of interests, *see supra* note 110 and *infra* notes 177, 180, and could not safely rely on lacking continuity of life and limited liability, *see infra* note 180, persons structuring large widely held entities not within the publicly traded partnership provisions would not select LLCs. The participants were forced to use limited partnerships because limited partnerships lack continuity of life even though the dissolution events only apply to the general partner and lack limited liability if the general partner is sufficiently capitalized or otherwise independent. *See supra* notes 68-110; *see also* Hamill, *supra* note 1, at 747-48 nn.168-69 (predicting, in 1989, a time when only Wyoming and Florida had LLC statutes and virtually no businesses were using LLCs, that under Revenue Ruling 88-76, LLCs used for widely held businesses could not safely secure partnership status). Because Revenue Procedure 95-10 essentially allows LLCs to lack continuity of life and limited liability under almost the same standards as limited partnerships, business participants can now choose which of the two offers the best form for business purposes.

A complete analysis of the business differences between LLCs and limited partnerships is beyond the scope of this Article. Because the first business issues facing LLCs are just now starting to be identified and discussed, the more important aspect of LLCs, their business virtues and limitations, will have to be covered in a follow-up article.

positive development in tax policy. Despite the obvious observation that general partners bear personal liability exposure under local law and LLC managers do not, on a substantive level, no valid distinction between the two exists. General partners have always been able to, on a substantive level, avoid personal liability exposure.[121] Moreover, the distinctions between limited partners and LLC members not designated as managers are gradually being eliminated.[122] Most importantly, denying LLC managers the same opportunities enjoyed by general partners to mitigate the effect of the classification regulations would be inconsistent with the Service's determination that the presence of limited liability protection under local law does not alone dictate the result under the classification regulations.[123]

A. Continuity of Life

Most LLC statutes contain default provisions related to dissolution that produce an LLC which automatically lacks continuity of life. Typically, with minor and unimportant variations, the statutes require an LLC to dissolve upon the death, insanity, bankruptcy, retirement, resignation, or expulsion of any member unless all or a majority[124] of the remaining members agree to continue the business. Under Revenue Procedure 95-10, LLCs subject to this kind of dissolution provision lack continuity of life if at least a majority in interest of the remaining members must agree to continue.[125]

Most LLC statutes allow the members to agree to change the default dissolution provisions. As a business matter, the necessity of obtaining consent in order to avoid an unplanned dissolution from all or even a majority in interest of the members upon the death, insanity, bankruptcy,

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121. *See supra* notes 96-99 and accompanying text (describing the Service's attempt and the Tax Court's refusal to uphold net worth requirements for corporate general partners).

122. Although LLC members clearly can participate in and control the LLC's business without affecting their limited liability protection, and most limited partners technically cannot, limited partners gradually have been receiving more participation rights and eventually should be able to participate in and control the business without being exposed to personal liability. *See supra* note 82 (discussing recent statutory developments supporting this observation).

123. *See supra* text accompanying note 55.

124. Members of LLCs governed by statutes with default provisions requiring a majority in number (as distinguished from a majority in interest) to agree to continue must ensure that this majority in number also constitutes a majority in interest in order to ensure that the LLC lacks continuity of life. *See supra* note 76.

125. Rev. Proc. 95-10, 1995-3 I.R.B. 20. The Service states clearly that the phrase "any member" means that all of the members must be subject to the above dissolution events. *Id*; *see also supra* note 76 (discussing how to calculate majority in interest).

retirement, resignation, or expulsion of any of the members can be very problematic. Members of LLCs with flexible dissolution provisions may want to increase business stability by having less than all of the above enumerated dissolution events trigger an agreement-to-continue requirement. Under Revenue Procedure 95-10, the Service will still rule that the LLC lacks continuity of life if the members select less than all, or even just one, of these events, as long as the members clearly establish in the ruling request that the event or events chosen provide a meaningful possibility of dissolution.[126]

Members of LLCs may want to increase business stability further by only having the dissolution events apply to the managers, thus preventing triggering of the agreement-to-continue requirement every time the dissolution event occurs with respect to the nonmanager members. Under Revenue Procedure 95-10, the Service will rule that an LLC lacks continuity of life even if the dissolution event or events relate solely to the member-managers, as long as all of the member-managers are subject to the specified dissolution events. The revenue procedure, however, does not treat LLC managers identically to general partners for continuity of life purposes. If the LLC has more than one manager and a dissolution event occurs with respect to one of them, a majority in interest of all the members still must agree to continue the LLC.[127] In contrast, limited partnerships corresponding to the Revised Uniform Limited Partnership Act can lack continuity of life even though the remaining general partners, rather than a majority in interest of all partners, agree to continue if a dissolution event occurs with respect to one of the general partners.[128]

Before the Service issued Revenue Procedure 95-10, LLC members could only be assured that their LLC lacked continuity of life if the dissolution events applied to all the members with a majority in interest of the remaining members agreeing to continue the business.[129] The minor

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126. Rev. Proc. 95-10, 1995-3 I.R.B. 20. Revenue Procedure 95-10 does state how to determine whether a meaningful possibility of dissolution exists. The Service has indicated informally that a meaningful possibility of dissolution requires that a legal possibility, but not necessarily a factual possibility, must exist. Death of a corporate member, a legal impossibility, will not constitute a meaningful possibility of dissolution, but bankruptcy of a corporate member is sufficient even if the chance of the member suffering bankruptcy is remote. *See Officials Explain LLC Revenue Procedure*, 66 TAX NOTES 932 (1995) (remarks of Montel Jackel, IRS Deputy Associate Chief Counsel (Domestic-Technical)).

127. Rev. Proc. 95-10, 1995-3 I.R.B. 20. Generally, the member-managers must in the aggregate own one percent of the LLC and meet certain capital account requirements. *Id.*

128. RULPA § 801 (1985).

129. *See supra* notes 111, 116 (listing state-by-state revenue rulings issued before Revenue Procedure 95-10). Early in the development of the LLC classification area, the Service informally

difference in the treatment afforded limited partnerships and LLCs under Revenue Procedure 95-10—limited partnerships are allowed slightly more business stability—will not likely discourage business participants from choosing the LLC. By allowing LLC managers to be treated essentially as general partners for continuity of life purposes, Revenue Procedure 95-10 provides LLCs a high degree of business stability without threatening their ability to lack continuity of life. Equating managers with general partners and allowing the LLC to select only one meaningful dissolution event to apply to the managers ensures that, like limited partnerships, LLCs will develop to a point where they will automatically, on a substantive level, lack continuity of life, while still enjoying almost all of the business benefits of continued business existence.

B. Centralized Management

LLC statutes almost uniformly[130] offer flexible alternatives for managing the LLC. Generally, the power to manage an LLC vests in all members.[131] However, LLC members may designate managers to run the business affairs of the LLC. The managers often are members, but can be outsiders holding no interest in the LLC. Revenue Procedure 95-10 provides that the Service generally will rule that an LLC lacks centralized management if the members are managing the LLC exclusively in their membership capacity.[132]

Under Revenue Procedure 95-10, if the members designate managers the LLC can still obtain, under limited circumstances, a ruling that it lacks centralized management. Initially, the members that have been designated managers must own at least twenty percent of the total interests in the LLC.[133] However, even if the LLC managers meet the aggregate ownership threshold, the Service will still scrutinize the facts and circumstances

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indicated that the majority-in-interest threshold of consent applicable to limited partnerships also applied to LLCs because no valid distinction between the two existed for that purpose. *See* Charles Davenport et al., *LLC Boosters Blitz Passthrough Sessions*, 55 TAX NOTES 1019 (1992); Hubbard & Sheppard, *supra* note 119; *Use of Limited Liability Companies Seen Not Jeopardizing Corporate Tax Base*, Daily Rep. for Exec. (BNA), at J-1 (Mar. 30, 1993).

130. *But see* Rev. Rul. 93-6, 1993-3 I.R.B. 8 (holding that Colorado LLCs always possess centralized management). Because at the time the Service issued the Colorado revenue ruling the Colorado statute required managers, members will always be managing in a manager rather than a member capacity, even if all the members are designated managers.

131. Management power can vest in the members equally, or based on how the members own the LLC's capital or how they own the LLC's profits.

132. Rev. Proc. 95-10, 1995-3 I.R.B. 20.

133. Obviously, an LLC in which none of the managers own any interest will possess centralized management.

to ensure that nonmanaging members do not control the managers. Moreover, if the managers are subject to periodic elections by the members or if the members have a substantially unrestricted power to remove the managers, the Service will not rule that the LLC lacks centralized management even if the managers have met the ownership threshold in the LLC.[134]

Although the Service added the periodic election and broad removal power caveats to the centralized management requirements for LLCs to ensure that LLC managers in fact resemble general partners more than corporate board members,[135] Revenue Procedure 95-10 still essentially treats managers as general partners for centralized management purposes. Before the Service issued Revenue Procedure 95-10, members of LLCs could only comfortably assume that the LLC lacked centralized management if no managers were designated.[136] Although LLCs now enjoy almost the same flexibility enjoyed by limited partnerships, members of LLCs seeking to lack centralized management will often need guidance because of the cautionary language that qualifies the comfort associated with meeting the ownership requirement.[137]

C. Limited Liability

LLC statutes uniformly provide that no member or manager of an LLC bears personal liability for the debts and obligations of the LLC. Although as a business matter creditors may be able to successfully demand that certain members bear personal liability for certain debts, most LLCs will possess the corporate characteristic of limited liability because no member

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134. Rev. Proc. 95-10, 1995-3 I.R.B. 20.

135. Periodic elections and broad removal powers are more characteristic of corporate management. *See* RMBCA §§ 8.01-8.08 (1984). Although Revenue Procedure 89-12 contains the general facts and circumstances language found in Revenue Procedure 95-10, Revenue Procedure 89-12 does not contain Revenue Procedure 95-10's language denying a centralized management ruling if the manager is subject to periodic elections or removal. Apparently because the default provisions addressing management in the LLC statutes vary enormously and do not always contemplate a permanent manager in the same manner as general partners of limited partnerships formed under the Revised Uniform Limited Partnership Act, the Service believed that an LLC with managers should be scrutinized more closely before receiving a ruling that it lacks centralized management. *See* RULPA §§ 401-403 (1985).

136. *See supra* notes 111, 115, 116, 118.

137. *See supra* note 135. LLCs, like limited partnerships, have rarely relied on, and in the future will not likely increase their reliance on, lacking centralized management to obtain partnership classification. *See supra* note 91. LLCs formed under statutes with default provisions allowing unrestricted removal or periodic elections of the managers must eliminate those provisions by agreement if the LLC needs to lack centralized management.

will be personally liable for all obligations against the LLC.[138] Before the Service issued Revenue Procedure 95-10, no authority existed that addressed the question of whether an LLC could ever lack limited liability, even if one of its members validly agreed to assume personal liability for all obligations of the LLC.

Revenue Procedure 95-10 answered the question by finding that an LLC lacks limited liability if it meets certain requirements. Most important, at least one member[139] must validly assume personal liability for all obligations of the LLC pursuant to express authority granted in the controlling LLC statute. Like general partners of limited partnerships, the liability-assuming member of the LLC must meet certain net worth requirements.[140] However, Revenue Procedure 95-10 does not require that the assuming member also be a manager, thus allowing an LLC more flexibility than a limited partnership when seeking a ruling that it lacks limited liability.[141]

The requirement that the LLC statute contain express authority allowing a member to validly assume all the LLC's obligations may bar many LLCs from attempting to lack limited liability. Although some LLC statutes contain general language allowing the members to vary most default provisions by agreement, very few LLC statutes expressly state within the section granting limited liability protection that the members can assume personal liability and spell out whether or not this assumption of liability must be written into the articles. However, any problems caused by the express authority requirement will probably only be temporary. State legislatures that deem important the ability of members to satisfy the express authority requirement for purposes of lacking limited liability under Revenue Procedure 95-10 can amend their statutes.[142]

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138. To lack limited liability, one member of the LLC must be personally liable for all the debts of the LLC. Consequently, LLCs in which members bear personal liability for some debts but not others—e.g., a professional LLC in which the members bear personal liability for their own negligence but not the negligence of their fellow members—still possess limited liability. *See* Rev. Rul. 94-6, 1994-1 C.B. 314.

139. The assuming member must own at least one percent of the LLC and meet certain capital account requirements. *See* Rev. Proc. 95-10, 1995-3 I.R.B. 20.

140. *Id*; *see* Rev. Proc. 89-12, 1989-1 C.B. 798; Rev. Proc. 92-88, 1992-2 C.B. 496.

141. In a limited partnership, only the general partner can provide the necessary liability exposure that causes the limited partnership to lack limited liability. In contrast, any member of an LLC, even a member without management authority in an LLC with designated managers, can provide the necessary liability exposure that causes the LLC to lack limited liability. *See* Rev. Proc. 95-10, 1995-3 I.R.B. 20.

142. The requirement that the liability exposure be pursuant to express authority in the controlling statute will be far more problematic for foreign LLCs seeking to lack limited liability. Foreign statutes

D. Free Transferability of Interests

The LLC statutory default provisions governing restrictions on transfers of LLC interests produce an LLC that automatically lacks free transferability of interests. Typically, with minor and unimportant variations, the statutes forbid the LLC members from transferring an interest in both the economic and the governance rights to a nonmember unless either all or a majority of the nontransferring members consent to the transfer. Even before the Service issued Revenue Procedure 95-10, LLC members enjoyed a high degree of comfort that LLCs with these transferability restrictions lacked free transferability. LLC members also received informal assurances from representatives of the Internal Revenue Service that as long as more than twenty percent of all the interests in the LLC had to obtain consent for a complete transfer, the LLC still lacked free transferability of interests.[143] However, LLC members had no authority stating that the LLC manager could provide the required consent without jeopardizing the LLC's ability to lack free transferability of interests.

Revenue Procedure 95-10 confirmed that LLCs lack free transferability of interests if more than twenty percent of the interests must obtain consent to transfer a complete interest in the LLC to a nonmember. When determining whether the majority consent threshold for the transfer is met, the revenue procedure defines majority flexibly to include either a majority in interest, a majority based on the capital or profit interests of the LLC, or a majority determined on a per capita basis. Most important, the revenue procedure essentially treats LLC managers as general partners for free transferability purposes by allowing the LLC to lack free transferability of interests when a majority of the member-managers not transferring interests provide the consent for the transfer.[144]

The combination of allowing the LLC manager to grant the consent for a complete transfer, and allowing almost eighty percent of the interests to avoid obtaining consent at all, allows LLCs the same flexibility enjoyed by limited partnerships. LLCs can lack free transferability on a technical basis, yet retain the business advantages of minimal transferability restrictions. However, the requirement in Revenue Procedure 95-10 that the power to withhold consent to the transfer constitute a meaningful restriction should serve as warning to all LLCs seeking to possess free transferability of

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are simply not drafted or amended to suit the nuances of U.S. tax law.

143. *See supra* notes 114-19 and accompanying text.

144. Rev. Proc. 95-10, 1995-3 I.R.B. 20. The manager-managers providing the consent must meet the one percent ownership and certain capital account requirements.

interests substantively while technically complying with the rules. Widely held LLCs, like widely held limited partnerships, should not rely on lacking free transferability to secure partnership status.[145] Moreover, because the parameters of this language are not defined, some LLCs that fall between being closely and widely held may find it necessary to seek guidance in the free transferability area.

V. ELIMINATION OF THE PARTNERSHIP CLASSIFICATION REGULATIONS

A. The General Framework

Under the current corporate and partnership tax regimes, which have not resolved nor even significantly addressed the corporate integration issue,[146] applying the classification regulations to domestic LLCs and limited partnerships serves no legitimate tax policy purpose. The tax policymakers[147] should eliminate the classification regulations by either adopting a new approach that taxes LLCs and limited partnerships as partnerships solely because the participants selected that form for doing business under the applicable state statute or allowing members of LLCs and limited partnerships to elect partnership or association treatment consistent with the Service's proposal under Notice 95-14.[148] Taxing domestic LLCs and limited partnerships per se as partnerships based on their choice under local law rather than allowing the members or the partners to elect partnership or corporate tax treatment presents a system for LLCs and limited partnerships that parallels the current per se corporate taxation of statutory domestic corporations. All businesses that incorporate under a state's corporation statute are taxed per se as corporations

145. *See supra* notes 110, 120; *infra* notes 177, 180.

146. By taking the position that the classification regulations should be eliminated for domestic LLCs and limited partnerships, this Article in no way supports the current system for taxing businesses. By providing two completely different tax regimes, partnership and corporate, and artificially requiring all incorporated entities to follow the corporate rules while allowing other entities that avoid the publicly traded partnership rules access to the partnership rules, the current system fosters disparate tax treatment for entities with similar business characteristics. The issue whether LLCs or other partnerships that substantively provide limited liability protection should bear the burden of the corporate tax represents an important part of the global corporate integration issue. A general discussion of what circumstances, if any, justify imposing the corporate tax, the corporate integration issue, and how the increased use of LLCs affects the resolution of that issue is beyond the scope of this Article and will be explored in a follow-up article. *See generally* Burke, *supra* note 1.

147. This Article takes no position on whether the Service has the power to accomplish this or whether it must be done legislatively. *See supra* note 15.

148. I.R.S. Notice 95-14, 1995-14 I.R.B. 1.

regardless of the corporation's individual business characteristics.[149] By choosing an LLC or limited partnership, the members or partners would automatically invoke the partnership tax provisions regardless of the organization's individual business characteristics. The members or partners would therefore have no opportunity to directly elect association status as they would under the proposal set out in Notice 95-14.

Taxing domestic LLCs and limited partnerships automatically as partnerships under a per se approach offers the advantages of a more simple system free from the complexities which always come, at least to some degree, with elections. Moreover, at least on the domestic side, the per se approach arguably promotes consistency by providing a mirror image to the per se taxation of statutory corporations. Neither the corporate nor unincorporated forms for doing business would enjoy the right to elect whether they want to be taxed under the corporate or partnership provisions; both would be governed by the state law form chosen by the participants.

However, allowing the taxpayers to elect corporate or partnership treatment under the Service's proposal in Notice 95-14, sometimes referred to informally as "check-the-box," offers some material advantages and points out at least two problems with the per se aproach.[150] Allowing domestic LLCs and limited partnerships to elect partnership or association status represents a less drastic change from existing law, because under the classification regulations LLCs and limited partnerships can effectively elect their tax treatment by failing to comply with the formalistic partnership requirements.[151] Moreover, the proposal under Notice 95-14 contemplates covering foreign entities as well.[152] Because foreign entities could not easily fit into a per se taxation approach based on United States business organizations, allowing the taxpayer to elect partnership or association treatment would be the only viable method to eliminate the classification regulations with respect to these entities. Eliminating the classification

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149. *See supra* notes 22-24 and accompanying text (explaining that the statutory definitions of corporation and partnership literally do not allow corporations to be taxed as partnerships); *see also* Gen. Couns. Mem. 37,127 (May 18, 1977); Gen. Couns. Mem. 37,953 (May 14, 1979) (citing Dartmouth College v. Woodward, 17 U.S. 518 (1819); Priv. Ltr. Rul. 79-21-084 (Feb. 27, 1979).

150. I.R.S. Notice 95-14, 1995-14 I.R.B. 1; *see supra* note 15 (discussing the serious issue of whether the Service has the power to eliminate the classification regulations under either the per se or check-the-box approach).

151. *See supra* notes 68-145 and accompanying text. Under the current system, because these requirements have little or no effect on the substantive business characteristics of the entity, well-advised LLCs and limited partnerships can effectively elect partnership or association status by manipulating the regulations.

152. I.R.S. Notice 95-14, 1995-14 I.R.B. 1.

regulations by taxing domestic LLCs and limited partnerships per se as partnerships while allowing foreign entities to elect their treatment introduces inconsistent treatment between foreign and U.S. business organizations and arguably treats the U.S. entities less favorably.[153]

Regardless whether the tax policymakers choose the per se or check-the-box approach, eliminating the classification regulations with respect to domestic LLCs and limited partnerships will save both taxpayers and the Service an enormous, if largely unmeasurable, amount of transaction costs. Without having to seek expensive advice or use the Service's resources,[154] persons deciding among the major domestic entities—the corporation, the partnership, and the LLC—can be absolutely certain of the tax treatment of their entity. Moreover, because the current system does not materially increase the number of businesses subjected to the corporate tax, elimination of the classification regulations will not harm the revenue base. If the classification regulations were eliminated, the publicly traded partnership provisions still prevent LLCs and limited partnerships from displacing the domain of the C corporation.[155] Furthermore, elimination of the classification regulations will not decrease federal tax revenue from closely held businesses, because the well advised have always been able to avoid the corporate tax by forming as a partnership or LLC that complies with the classification regulations or a corporation that pays out its earnings in deductible items or elects Subchapter S.[156]

Although elimination of the classification regulations undoubtedly will allow some limited partnerships and LLCs with a preponderance of corporate characteristics to enjoy the many benefits offered by the partnership tax provisions, this adds no new legal inconsistencies or formalistic distinctions to those that already exist under the current classification regulations. The choice of entities in the business world has evolved to a point where the traditional business characteristics once attributable only to corporations can be found in limited partnerships, while the traditional partnership characteristics can be found in many statutory corporations.[157] The LLC, the newest development in this continuing evolution of business forms, can be structured to resemble a traditional

153. Whether or not the classification regulations should apply to foreign entities is beyond the scope of this Article. *See supra* note 16.

154. *See supra* notes 115-19 and accompanying text.

155. *See supra* notes 53, 54, 63; *infra* note 184.

156. *See infra* text accompanying notes 161-72.

157. *See id.*

partnership, a statutory corporation or any variation in between.[158] The classification regulations currently allow limited partnerships and LLCs to secure partnership tax status even though they substantively resemble corporations.[159] Moreover, for quite some time, close corporations have been able to adopt business characteristics of traditional partnerships, yet the tax system still automatically taxes them under the corporate provisions.[160]

B. The Closely Held Business Perspective

The classic general partnership, which always receives partnership tax treatment,[161] contemplates a small group of business owners that all participate in the business and regard each other as equals.[162] Over time, these closely held businesses began to incorporate,[163] often in order to obtain limited liability protection.[164] Many of these closely held businesses currently choose the LLC form to combine limited liability protection and the traditional partnership business characteristics with the ability to secure partnership tax classification.[165] As a business matter, owners of

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158. *See supra* text accompanying notes 111-45.

159. *See supra* text accompanying notes 68-145. The rare LLC or limited partnership that wishes to be taxed as an association can effectively so elect by deliberately possessing three of the four corporate characteristics. This manipulation of the regulations need not have any material affect on the business characteristics of the LLC or limited partnership.

160. *See infra* text accompanying notes 161-72.

161. *See supra* notes 71, 81, 94, 106.

162. *See* UPA §§ 9, 15, 18(a), 18(e), 22 (1914); RUPA §§ 301, 401, 404 (1993) (providing that all partners are agents of the partnership, bear joint and several liability for partnership obligations, share profits and losses equally, have equal rights to manage the partnership, and owe each other general fiduciary duties of loyalty).

163. These general partnerships chose corporations rather than limited partnerships probably because the limited partnership statutes restrict the ability of limited partners to participate in ordinary day-to-day business operations. *See* RULPA § 303 (1985). The original Uniform Limited Partnership Act allowed limited partners very little leeway to participate in the limited partnership's business and still enjoy limited liability protection. *See* UPA § 7 (1916). The 1976 revision of the Uniform Limited Partnership Act added § 303, which defined activities that would not cause the limited partners to lose limited liability protection, and that safe harbor list continued to grow with the 1985 revision.

164. *See generally* Mitchell, *supra* note 56, at 1147 n.10.

165. The classification regulations also cause closely held investment ventures conducted in limited partnerships or LLCs to incur unnecessary transaction costs. An investment LLC or limited partnership not widely held will incur transaction costs both to ensure it defeats continuity of life and to plan which of the other three corporate characteristics to defeat. Depending on the business circumstances (whether it can afford to have the manager or general partner own a substantial interest and whether the ability to transfer can be sufficiently restricted), the closely held investment LLC or limited partnership will probably lack either centralized management or free transferability of interests. In any event, the LLC or limited partnership always has the option of sufficiently capitalizing the member or general partner to lack limited liability. Smaller investment LLCs or limited partnerships have the same ability enjoyed

closely held LLCs in which all members are active in the business will want restrictions limiting the ability of new members to own an interest in the firm as well as some ability to dissolve the firm and withdraw the capital invested. The default provisions of state LLC statutes provide for restrictions on transfers, dissolution at will and direct member management and control that both satisfy the business needs of many closely held firms and cause the LLC to be classified as a partnership.[166] Forcing these LLCs to comply with the classification regulations unnecessarily increases transaction costs. Some members will feel compelled to consult with attorneys, accountants or the Service regardless of whether the advice is necessary. Members wishing to change the default business provisions governing transferability, dissolution or management must obtain expensive advice to avoid inadvertently causing the LLC to be classified as an association.

Allowing closely held LLCs the freedom to adopt corporate characteristics without suffering the burdens of complying with the classification regulations introduces no new legal inconsistencies or formalistic distinctions in the closely held business context, because current business law already blurs the traditional distinctions between the corporate and partnership forms. Courts have afforded shareholders of close corporations fiduciary duty protection similar to the protection granted to partners in partnerships.[167] Also, many corporate statutes contain close corporation supplements allowing shareholders to dispense with the board of directors and run the business like a partnership, dissolve at will or provide for transfer restrictions more characteristic of partnerships.[168] Even if a close corporation contains all these partnership characteristics, the tax law still taxes the corporation under the corporate provisions solely because the shareholders incorporated the business under state law.[169]

Elimination of the classification regulations will not create new opportunities for closely held business to avoid paying the corporate tax.

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by larger, widely held investment ventures to adopt substantively corporate business characteristics while meeting the classification regulations. *See infra* notes 173-87 and accompanying text.

166. *See supra* text accompanying notes 124-45.

167. *See, e.g.*, Wilkes v. Springside Nursing Home, Inc., 353 N.E.2d 657 (Mass. 1976) (holding that majority shareholders who removed minority shareholders from the corporation's payroll and refused to pay a dividend owed the minority shareholder a duty of utmost good faith and loyalty); Donahue v. Rodd Electrotype Co., 328 N.E.2d 505 (Mass. 1975) (holding that majority shareholders of close corporation owed minority shareholders the same fiduciary duty as partner owes to another partner); *see also* Mitchell, *supra* note 56.

168. *See* MODEL STATUTORY CLOSE CORP. SUPP. §§ 1-55 (1984); DEL. CODE ANN. tit. 8, § 341 (1991); CAL. CORP. CODE § 158 (West Supp. 1994).

169. *See supra* note 149 and accompanying text.

Closely held LLCs will enjoy partnership treatment while incurring minimal or no transactional costs even if they possess corporate characteristics. However, because closely held corporations, which clearly can possess corporate characteristics, currently enjoy opportunities to avoid the double corporate tax, the ability to use an LLC, regardless whether the classification regulations apply, should have no material effect on the bottom line amount of revenue collected from closely held businesses. Close corporations can either make a Subchapter S election, which provides the corporation with a flow-through tax regime at the shareholder level but lacks many of the benefits and flexibility of the partnership provisions,[170] or pay out a significant portion of their earnings in rent, interest, salaries and other deductible items.[171] These methods for avoiding the corporate tax obviously create transaction costs for close corporations that will not be affected by eliminating the application of the classification regulations to LLCs. Although elimination of the classification regulations may cause even more business participants to choose LLCs instead of close corporations, because the choice between the LLC and the close corporation essentially produces neutral revenue results, this development should not concern tax policymakers.

Arguably, the existence of two extremely different tax regimes—the

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170. For example, eligibility restrictions that burden S corporations do not apply to partnerships. An S corporation can have no more than 35 shareholders and only U.S. citizens, resident aliens and certain trusts can be shareholders. Because S corporations can only have one class of stock, shareholders of S corporations are effectively prohibited from making special allocations of the corporation's income and losses. Moreover, no mechanism exists in subchapter S that allows shareholders to increase stock basis for a share of the corporation's third party liabilities. Thus, shareholders are prevented from currently deducting losses attributable to borrowed funds. *See* I.R.C. §§ 1361, 1367 (1988). *See generally* James S. Eustice, *Subchapter S Corporations and Partnerships: A Search for the Passthrough Paradigm (Some Preliminary Proposals)*, 39 TAX L. REV. 345 (1984).

A complete examination of the differences between Subchapter S and the partnership provisions is beyond the scope of this Article. For an examination of the tax and business considerations relevant to whether an existing S corporation should convert to an LLC, see Jill E. Darrow, *Limited Liability Companies and S Corporations: Deciding Which Is Optimal and Whether to Convert to LLC Status*, 48 TAX LAW. 1 (1994).

171. A Lexis search conducted on March 1, 1995 in the TAXRIA library produced 260 annotated cases in which the Service attempted to recharacterize deductible payments made by closely held corporations into dividends. Of the total, the taxpayer prevailed completely in 138 of those cases, meaning that no amount of the taxpayer's deductible payments were recharacterized as dividends. Of the remainder, only 72 of the cases recharacterized the entire amount challenged by the Service as a dividend, and in 50 cases, the judge recharacterized part of the challenged amount as a dividend and left part of the payment as a deductible item. Given that the Service normally only takes cases to court where it perceives a reasonable chance of winning, these numbers illustrate that the Service cannot effectively prevent closely held corporations from avoiding the double tax by paying out corporate earnings in deductible items. Closely held corporations that seek out and can afford competent tax advice can always minimize or avoid the double tax.

corporate double tax applying to corporations, with the opportunity to elect Subchapter S or engage in self-help techniques of paying out corporate earnings as deductible items, and the flexible flow-through rules applying to partnerships and LLCs—produces intolerable inequities. Many closely held businesses have very similar business characteristics regardless of the form the participants choose under local law. However, under current law, closely held LLCs and limited partnerships receive the benefits of partnership taxation by complying with the classification regulations, while closely held corporations must either elect Subchapter S or engage in self-help techniques: the type of entity chosen under local law currently determines the tax consequences. Eliminating the classification regulations by either dictating per se partnership taxation or allowing LLCs and limited partnerships to elect either partnership or association status will only eliminate the transaction costs associated with applying the classification regulations; it will have no effect on the root problem of disparate treatment between closely held corporations, partnerships and LLCs.[172]

C. *The Widely Held Business Perspective*

Limited partnerships[173] and LLCs can be used to sell investment units to passive investors on a wide basis. LLCs and limited partnerships with a large number of passive owners easily can meet the partnership classification requirements, as long as the interests are not publicly traded,[174] by lacking continuity of life and limited liability. LLCs and limited partnerships have the ability to automatically lack continuity of life simply by enumerating one meaningful dissolution event with respect to the managers or general partners that will trigger an agreement-to-continue requirement to avoid a real dissolution.[175] LLCs, as well as limited partnerships, can lack limited liability by sufficiently capitalizing a member or general

172. This basic inconsistent treatment between corporations, partnerships and LLCs has nothing to do with the classification regulations, but rather lies at the heart of the corporate integration issue. *See supra* notes 65, 67, 146.

173. The inability of limited partners in most states to participate in the day-to-day affairs of the business makes limited partnerships unsuitable for most businesses except investment ventures with the general partner managing the assets and the limited partners serving as passive investors. *See supra* note 82.

174. *See supra* note 53 and accompanying text.

175. Well-advised taxpayers seeking to create even more stability for the business can attempt, either contractually or through the use of proxies, to gain assurances before a dissolution event occurs that the relevant persons will agree to continue. Although the Service has informally expressed hostility toward these techniques, taxpayers have a strong argument that the LLC or limited partnership lacks continuity of life as long as local law still allows the relevant persons to refuse to continue the LLC or limited partnership at the time of the dissolution event.

partner.[176]

The requirement that restrictions on transfers be meaningful will discourage widely held LLCs and limited partnerships from relying on defeating free transferability of interests, even though the transferability restrictions only must apply to slightly more than twenty percent of the interests and the manager or general partner can provide the consent.[177] Moreover, for business and economic reasons, widely held LLCs and limited partnerships cannot concentrate any significant percentage of the ownership interests in the manager or the general partner and therefore will not be able to defeat centralized management.[178]

Eliminating the classification regulations with respect to domestic LLCs and limited partnerships will wipe out the transaction costs incurred by both the taxpayers and the Service to ensure that widely held LLCs and limited partnerships comply with the largely meaningless formalities of lacking continuity of life and limited liability. On a substantive level, the one dissolution event tied to the manager or general partner produces an LLC or limited partnership that for all practical purposes enjoys a continued business existence. The ability to lack limited liability by adequately capitalizing the corporate manager or general partner[179] merely adds another cost to the general cost of conducting the transaction with the rest of the owners enjoying limited liability protection. The current classification regulations provide no meaningful check on the ability of widely held LLCs and limited partnerships to secure partnership tax treatment while enjoying corporate business characteristics.[180]

The publicly traded partnership rules will still draw the line that separates C corporations from limited partnerships and LLCs. Eliminating the partnership classification regulations and the transaction costs that go

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176. *See supra* text accompanying notes 101, 139-41.

177. Investors in these types of LLCs and limited partnerships will demand the ability to at least freely transfer the economic interests. Larger LLCs and limited partnerships that technically comply with the free transferability regulations by imposing the bare minimum requirements on transfers of complete ownership interests while the passive investors can freely transfer the economic rights run a high risk of substantively possessing free transferability of interests. *See supra* note 120.

178. *See supra* notes 73, 85, 87, 91 (illustrating that very few limited partnerships have relied on lacking centralized management).

179. *See supra* text accompanying notes 101, 139-41.

180. Before the Service issued Revenue Procedure 95-10, widely held investment ventures could only safely use limited partnerships. LLCs had no authority allowing them to lack limited liability, and without the clear ability to tie the dissolution events to the manager, a widely held LLC could not safely lack continuity life and obtain the necessary level of business stability. *See supra* notes 111, 116 (listing LLC state-by-state revenue rulings issued before Revenue Procedure 95-10 that require the dissolution events to apply to all members).

along with them will not allow widely held LLCs and limited partnerships to cause a revenue drain,[181] because the publicly traded partnership rules serve as a backstop to protect any revenue base provided by the corporate tax.[182] Larger LLCs and limited partnerships that fall into the definition of a publicly traded partnership will be taxed under the corporate provisions. Larger LLCs and limited partnerships that fall outside the definition of publicly traded[183] currently receive partnership treatment by the classification regulations and will continue to receive such treatment if the regulations are eliminated, minus the transaction costs necessary to comply with the regulations.

Arguably, the disparate treatment given to LLCs and limited partnerships not subject to the publicly traded partnership rules and similarly situated widely held corporations produces inequities similar to the inequities found when comparing closely held corporations to LLCs. Widely held corporations that are not publicly traded under the publicly traded partnership definition are even worse off than closely held corporations. Unlike closely held corporations, widely held corporations will not be able to mitigate the corporate tax by electing Subchapter S or paying out most or all of their earnings in deductible items.[184] For these reasons, widely held businesses that are not publicly traded will likely select LLCs or limited partnerships in greater numbers if the needs of the business do not depend on the structures set up in the corporate statutes. However, continuing to apply the classification regulations will do nothing to stop this shift.[185]

If too many potential widely held corporations choose to operate as widely held LLCs or limited partnerships, the tax policymakers will still

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181. *See supra* notes 173-180 and accompanying text; *infra* notes 182-87 and accompanying text.

182. *But see supra* note 53; *infra* note 184. Many commentators believed the rise of master limited partnership did not threaten the corporate tax base. An extensive analysis and conclusion of that issue is beyond the scope of this Article.

183. *See supra* note 63.

184. Before Congress enacted the publicly traded partnership provisions, many argued that master limited partnerships provided a back door to corporate integration. *See supra* note 54 and accompanying text. Although the publicly traded partnership provisions seem to ensure that many widely held and publicly traded entities bear the corporate tax, publicly traded and widely held corporations routinely issue corporate debt instead of equity in order to generate deductible interest rather than paying nondeductible dividends. To the extent corporations choose debt instead of equity solely to generate deductible interest, the corporate tax is undermined and the economy is adversely affected. A comprehensive discussion of the disparate treatment of corporate interest and dividend payments and how that complicates the corporate integration issue is beyond the scope of this Article. *See generally* Alvin C. Warren, Jr., *The Corporate Interest Deduction: A Policy Evaluation*, 83 YALE L.J. 1585 (1974).

185. *See supra* notes 68-110, 173-184 and accompanying text; *infra* notes 186-87 and accompanying text.

have options to control or reverse this shift even if the classification regulations no longer apply. In other words, eliminating the classification regulations with respect to LLCs and limited partnerships will not destroy the ability to control the use of these larger LLCs and limited partnerships. The historical evolution of partnership classification illustrates that abuses perpetrated through limited partnerships were best controlled by direct legislative action rather than tinkering with the classification regulations.[186] Assuming the corporate double tax continues to be imposed on at least some corporations, tax policymakers may decide that larger LLCs and limited partnerships are competing too much with C corporations. If that point ever comes, it would be far more effective and efficient to tighten up the publicly traded partnership rules than to tinker with the classification regulations.[187]

VI. CONCLUSION

The history surrounding the partnership classification regulations illustrates a migration toward standards based on completely formalistic distinctions that carry no substantive force. Even before the LLC emerged, limited partnerships on a substantive level received automatic partnership classification. The Service's release of Revenue Procedure 95-10, essentially equating LLCs and limited partnerships for classification purposes, allows LLCs to receive essentially automatic partnership classification and frees owners to choose their statutory form based on business considerations alone. Revenue Procedure 95-10 represents a positive tax policy development because no valid reason exists to treat LLCs and limited partnerships differently for classification purposes.

Eliminating the classification regulations with respect to domestic LLCs and limited partnerships would be an even greater tax policy development. Liberating LLCs and limited partnerships from the burdensome classification regulations would save enormous transaction costs without affecting the number and kinds of businesses that can use these forms. Because the classification regulations fail to send unincorporated business organizations to the partnership or corporate tax rules based on the meaningful business distinctions between corporations and partnerships, elimination of these regulations will not aggravate the problem at the center of business taxation: two extremely different tax regimes, the corporate and partnership

186. *See supra* note 52 and accompanying text.

187. This might entail eliminating some or all of the exceptions to the publicly traded partnership rules.

provisions, arbitrarily apply to entities that often have almost identical business characteristics. Elimination of the classification regulations presents no threat to the revenue base, because both closely held and widely held businesses have the same opportunities to avoid or mitigate the corporate tax regardless of whether or not the classification regulations apply. Elimination of the classification regulations with respect to LLCs and limited partnerships does not offer a magic cure to the problems associated with fundamentally different tax regimes applying to entities with similar or identical business characteristics. Although elimination of the classification regulations would go a long way toward improving efficiency in the taxation of business organizations, only a careful and complete resolution of the corporate integration question can promote total symmetry between the tax regimes applied to domestic entities and the business characteristics of those entities.