ALASKA LEGISLATURE COMMITTEE FILES 1993-1994 8672
7974 HOUSE LABOR & COMMERCE

239

HB

420

HOUSE COMMITTEE REPORT

(7)

Date Referred: February 24, 1994 FURTHER REFERRALS: Judiciary
State Affairs

Date of Committee Action: 3/08/94

The LABOR AND COMMERCE Committee considered: SSHB 420

SPONSOR SUBSTITUTE FOR HOUSE BILL NO. 420 LIMITED LIABILITY COMPANIES

"An Act relating to limited liability companies; amending Alaska Rules of Civil Procedure 20 and 24; and providing for an effective date."

RECOMMENDATIONS: [ ] the same title
be replaced with _____ [ ] a new title

[ ] have attached amendments(s)
[ ] do pass
[ ] do not pass
[ ] no recommendations
[X] individual recommendations
[ ] additional referral to the _____ Committee

ADOPTS: _____ letter of Intent

ATTACHES NEW FISCAL NOTE(s): (Dept) APPROVES PREVIOUS: (Dept/Date)

[ ] fiscal impact _____ [ ] fiscal note(s) _____

[X] zero fiscal note Commerce [ ] zero fiscal note(s) _____

SIGNING DO PASS	DP	OTHER RECOMMENDATIONS	DNP	NR	AM
Glenn Ludwig	✓	W.K. Williams		✓	
		Joe Sutton		✓	
		Bill Hudson		✓	

Bill Hudson
CHAIRMAN'S SIGNATURE

Alaska State Legislature

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House District 33

While in Juneau
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House Of Representatives

HB 420: "An act relating to limited liability companies; amending Alaska Rules of Civil Procedure 20 and 24; and providing for an effective date."

Sponsor: Representative Gene Therriault

Sponsor Statement:

The limited liability company is a relatively new, hybrid form of business structure that combines the tax advantages of a partnership and the liability safeguards of a corporation. Although a combination of these two business structures is currently allowed in statute through formation of an S corporation, this structure has limitations that are avoided by LLCs. For example, S corporations do not allow ownership by certain types of shareholders.

Under current law, corpoarte earnings are subject to double taxation through the payment of corporate taxes and personal taxes after distribution of dividends. LLCs avoid this double taxation by allowing earnings to flow through to individual owners in the same manner partnership income is handled. Although businesses can be organized through an S corporation to avoid double taxation and encompass some of the advantages of partnerships, they do not enjoy all the advantages of partnerships when it comes to allocating income and deductions.

One of the greatest advantages is, as the name implies, the limited liability offered by the LLC structure. With LLC's, as with regular corporations, only the company's assets, and not the owner's personal assets, are at risk in business-related lawsuits. In partnerships, so-called limited partners enjoy such protection, but general partners don't. And limited partners face restrictions on how active they can be in the business. LLCs are designed to protect all members while imposing no limits on their involvement in operation of the business.

Thirty-four states now permit limited liability companies, and passage in most of the remaining states is expected. Wyoming passed the first LLC act in 1977. Other states slowly followed suit until 1988, when the Internal Revenue Service issued Rev. Rul. 88-76, which classified a Wyoming LLC as a partnership for federal tax purposes, even though none of the members or managers were personally liable for any debts of the company. Following the ruling, formation

of LLCs burgeoned, with two states adopting LLC acts in 1990, four in 1991, 10 in 1992 and more than 20 states introducing measures in 1993.

LLCs have tended to be family businesses, professional service firms, venture capital companies, real estate businesses and startups. I believe the LLC will provide these business owners with an efficient and flexible investment vehicle that allows both limited liability, and federal income tax treatment as a partnership. I introduced the bill, which is based on a prototype American Bar Association draft, with the intention of generating discussion on this topic, and am more than willing to discuss proposed changes.

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February 28, 1994

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Representative Bill Hudson
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Re: Sponsor Substitute for House Bill 420
Limited Liability Companies
Our File No. 2270-45

Dear Representative Hudson:

I am the chairman of a working group on limited liability companies composed of members of the Tax Law and Business Law Sections of the Alaska Bar Association. I am writing to request that you promptly schedule a hearing before your committee regarding the limited liability company bill.

Limited liability companies are a relatively new form of business entity in the United States. More than 30 states have now enacted limited liability company legislation and legislation is pending in a number of other states.

A limited liability company is a business entity which combines the best features of a corporation and a partnership. Like corporate shareholders, limited liability company owners are not responsible company liabilities beyond their investment. Like a partnership, there is no corporate double taxation. Rather owners

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(like partners) incur federal income taxation at the individual level based on the profits and losses allocated to them.

Enclosed for your reference are a May 14, 1991 Wall Street Journal article and a June 19, 1993 New York Times article on limited liability companies. Also enclosed is a brief bibliography on the subject and a February 22, 1994, letter from the Alaska Society of CPA's endorsing Sponsor Substitute for House Bill 420.

The proposed legislation is drawn largely from a prototype act drafted by a working group of the Business Law Section of the American Bar Association. Our Alaska working group has modified various provisions to conform with Alaska procedure and additional developments in the law. At this point the lack of limited liability company legislation puts Alaska at a competitive disadvantage in attracting investment from outside. This is particularly so with foreign investors who are familiar with the limited liability company format because it is in common use in European, Asian and South American countries.

We appreciate your assistance in this matter. If you have any questions, please contact me.

Very truly yours,

HUGHES, THORSNESS, GANTZ,
POWELL & BRUNDIN

By: Robert L. Manley
Robert L. Manley

RLM/kah/3463:XKAH
Enc.

LIMITED LIABILITY COMPANIES BIBLIOGRAPHY

By: Robert L. Manley

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2. R. Keatinge, L. Ribstein, S. Hamill, M. Gravelle, and S. Connaughton, The Limited Liability Company, a Study of the Emerging Entity, 47 Business Lawyer 375 (1992). An 85-page article covering most of the relevant tax and non-tax issues.

3. Special Study, Limited Liability Company (LLC) Can Be Preferred Choice of Entity (RIA/Federal Tax Coordinator, August, 1992). A 10-page article covering basic entity choice issues including a good checklist of federal tax consequences to consider in making a choice of entity.

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5. C. Price, Tax Aspects of Limited Liability Companies, 1992 Journal of Accountancy 48 (1992). A brief summary of limited liability company issues.

6. R. Platner, Limited Liability Companies Are Increasingly Popular, 20 Taxation for Lawyers 225 (1992).

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FEB 28 '94 10:12AM HUGHES THORSNESS

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The Many Advantages Of a Hybrid Company

BYLINE: By Jan M. Rosen

BODY

NEW YORK and New Jersey are expected to enact legislation soon allowing privately owned businesses and partnerships to organize as limited liability companies, which combine the tax advantages of a partnership with the legal protection of incorporation.

California and a dozen other states are considering similar proposals, and 31 states already recognize limited liability companies -- so named because liability for such things as legal judgments against a company or bankruptcy are limited to the entity's assets like a corporation. These businesses do not put their owners' personal assets at risk beyond their original investment.

"It's the wave of the future; it provides more flexibility with protection from liability," said Assemblywoman Harriet Derman, Republican of Metuchen, who is sponsoring the measure in New Jersey and expects passage this month.

Accounting firms, for example, are eager to avoid a repeat of "the fiasco when Laventhol & Horwath went under," and partners were personally liable for millions of dollars owed by the partnership, she said. That bankruptcy, which led to a snarl of litigation, caused some managers of other firms to voice doubts about accepting partnerships, if offered.

Kenneth J. Norcross, a partner in Pitney, Hardin, Kipp & Szuch in Morristown, N.J., said that limited liability companies could be useful for "everything from new ventures at A.T.& T. down to the corner deli."

With partnerships, income and losses flow directly to the partners, avoiding corporate taxation, but partners' personal assets can be at risk for their firm's liabilities.
To protect themselves from liability, business owners can incorporate. But they will face Federal corporate taxation unless the business meets the rigorous requirements for an S corporation: no more than 35 partners, no foreign partners and only one class of stock.

Family businesses often want two classes of stock, voting shares for the family members active in the business and nonvoting for those who are not. Thus, they are precluded from a S corporation, but they could set up a limited liability company.

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Services of Mead Data Central, Inc.
FEB 28 '94 10:14AM HUGHES THORSNESS

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MEMORANDUM March 4, 1994

SUBJECT: Sectional summary SSHB 420

TO: Representative Gene Therriault
Attn: Wilda

FROM: Theresa L. Bannister
Legislative Counsel

You have requested a sectional summary of the above-described bill.

As a preliminary matter, note that a sectional summary of a bill should not be considered an authoritative interpretation of the bill and the bill itself is the best statement of its contents.

Section 1. Contains a new chapter on limited liability companies.

Sec. 10.50.010 states that a limited liability company ("company") may be organized for any lawful purpose.

Sec. 10.50.015 requires a company to comply with other applicable laws.

Sec. 10.50.020 requires a company name to contain certain words or abbreviations. Allows the name to use the name of a city, borough, or village but not to contain certain words or to otherwise imply the company is a municipality. Prohibits a person from adopting a name containing "limited liability company" unless the person is organized under this chapter or is registered as a foreign limited liability company under this chapter.

Sec. 10.50.025 requires a company name to be distinguishable on the records of the Department of Commerce and Economic Development ("department") from certain other names.

Sec. 10.50.030 authorizes certain persons to reserve a company name.

Sec. 10.50.035 establishes the procedure for reserving a company name.

Sec. 10.50.040 authorizes the holder of a reserved name to transfer the name to another person. Establishes how the transfer is accomplished.

Sec. 10.50.045 requires a company to maintain in this state a registered office and a registered agent for the service of process.

Sec. 10.50.050 establishes how a company may change its registered office or agent and how an agent may change the agent's address.

Sec. 10.50.055 establishes when a change of a registered office, a registered agent or the address of a registered agent becomes effective.

Sec. 10.50.060 authorizes a registered agent to resign. Indicates how the agent may resign and when the resignation becomes effective.

Sec. 10.50.065 appoints the commissioner of the department under certain circumstances as the agent of a company for the service of process, notice, or demand. Establishes how a person may serve the commissioner. Directs the commissioner to keep a record of documents served on the commissioner. States that this section does not affect the right to serve process, notice, or demand on a company in another manner permitted by law.

Sec. 10.50.070 authorizes one or more persons to organize a company. Establishes the procedure for organization.

Sec. 10.50.075 identifies what the articles of organization must contain, which includes certain information about any election to continue the company until a certain date or event.

Sec. 10.50.080 determines when a company's organization is effective. Provides that the company's existence terminates if its articles are nonconforming and not cured within the specified time.

Sec. 10.50.085 states that a company's existence continues until specified date or event, except under certain circumstances, if the company has made an election to continue until the certain date or event and the election is stated in the articles of organization. Prohibits revocation of an election unless certain specified persons revoke the election. Allows an election to expressly limit the membership terminations that can cause dissolution.

Sec. 10.50.090 establishes that articles of organization that are file-stamped and marked with the filing date are conclusive evidence that the company is organized.

Sec. 10.50.100 authorizes a company to amend its articles at any time and indicates the procedure for doing so.

Sec. 10.50.105 authorizes a company to restate its articles and establishes the procedure for doing so.

Sec. 10.50.110 declares that the members of a company manage the company, unless an operating agreement names a manager for the company or the chapter provides otherwise. Declares that if an operating agreement authorizes a manager for the company, the manager has the exclusive power to manage the company to the extent of the authorization.

Sec. 10.50.115 requires over one-half of the members to approve before a manager is appointed, removed, or replaced, unless an operating agreement provides otherwise.

Sec. 10.50.120 allows a manager to be other than an individual or a company member, unless a company operating agreement provides otherwise.

Sec. 10.50.125 establishes how long a manager holds office.

Sec. 10.50.130 declares that a member who is not a manager of a company that is managed by a manager does not have a fiduciary duty of a manager to the company or to other members when acting solely as a member, unless an operating agreement provides otherwise.

Sec. 10.50.140 requires the members and the managers to account to the company and hold as trustee for the company certain identified benefits obtained without the described consent, unless an operating agreement provides otherwise.

Sec. 10.50.145 establishes what authorization is required for company affairs, depending on whether the company is managed by its members or by managers.

Sec. 10.50.155 indicates that a person may become a company member if the person acquires a company interest in certain ways.

Sec. 10.50.160 establishes when a person's admission to membership in the company is effective.

Sec. 10.50.165 establishes the conditions for an assignee of a company interest to become a company member.

Sec. 10.50.170 establishes the rights, powers, and liabilities of an assignee who becomes a member.

Sec. 10.50.180 establishes that when an assignee of a member's entire membership interest becomes a member with respect to the assignor's entire interest, the assigning member ceases to be a member, unless otherwise provided in an operating agreement.

Sec. 10.50.185 states that a person's company membership terminates if the person withdraws voluntarily from the company. Authorizes a member to voluntarily terminate a company membership at any time, unless an operating agreement provides otherwise.

Sec. 10.50.190 establishes that, if a company has a definite term or undertaking, the voluntary withdrawal of a member before the end of the term or the accomplishment of the undertaking is a breach of the operating agreement, unless the operating agreement provides otherwise.

Sec. 10.50.195 establishes that a company can recover damages from a member who withdraws wrongfully. Authorizes the company to offset the damages against a distribution owed to the member and to pursue other remedies against the member.

Sec. 10.50.205 states that, except as otherwise provided in an operating agreement for the removal of a member, a person's company membership terminates if the person assigns all of the membership interest and if a majority of the members who have not assigned their interests authorize the removal of the member.

Sec. 10.50.210 states that a person's company membership terminates if the member dies or is declared incompetent by a court, unless otherwise provided in an operating agreement.

Sec. 10.50.215 states that the company membership held by a trust or trustee terminates when the trust terminates and that a company membership held by an estate terminates when the estate's entire company interest is distributed by the estate, unless otherwise provided in writing in an operating agreement or by the written consent of all of the members.

Sec. 10.50.220 states that the company membership of a member that is a separate limited liability company terminates when the member dissolves and begins to wind up, unless otherwise provided in writing in an operating agreement or by the consent of all members. Also states that the membership of a corporate member terminates when the corporation is dissolved and 90 days elapse without reinstatement, unless otherwise provided in writing in an operating agreement or by the consent of all members.

Sec. 10.50.225 identifies other events that terminate a company membership.

Sec. 10.50.240 provides that secs. 10.50.185 - 10.50.225(a)-(b) don't apply to the termination of a membership unless the member is also a company manager, if an election has been made to continue the company until a certain date or event.

Sec. 10.50.250 states that a company member is an agent of the company for the purpose of conducting the company's affairs, except under certain circumstances, including where the articles name a manager for the company. If a manager is named, the manager is an agent of the company for the purpose of conducting its affairs, except in certain circumstances. Establishes when a member's or manager's act binds the company.

Sec. 10.50.255 states that an admission or representation by a company member about the company is evidence against the company, except in certain circumstances, including where the articles name a manager for the company. If a manager is named, an admission or representation by a manager is evidence against the company under certain circumstances, and the admission or representation by a member acting solely as a member is not evidence against the company.

Sec. 10.50.260 indicates when a company is charged with the knowledge of or a notice given to a member or manager.

Sec. 10.50.265 states that a company member is not liable, solely by reason of being a member, for a company liability.

Sec. 10.50.275 authorizes a company to issue company interests for property, services, or a promissory note or other obligation to contribute property or services.

Sec. 10.50.280 states that a member's promise to contribute property or services to the company is enforceable only if the promises is in a writing signed by the member. Makes the promise enforceable even if the member is unable to perform because of death, disability, or other reason, unless otherwise provided by an operating agreement. Requires a company member who has not made the required contribution of property or services to contribute cash equal to the shortfall. States that an assignor of a company interest remains liable for a contribution even if the assignee becomes a member with respect to the assigned interest, unless otherwise provided in an operating agreement.

Sec. 10.50.285 prohibits the compromise of a company member's obligation to make a contribution, unless otherwise provided in an operating agreement.

Sec. 10.50.300 declares that, unless otherwise provided in writing in an operating agreement, members are to be repaid their contributions to capital and share equally in the assets of the company after liabilities are satisfied.

Sec. 10.50.305 requires interim distributions to members to be made according to an operating agreement, if an operating agreement provides for the distributions. The operating agreement may authorize different interim distributions for different classes of members.

Sec. 10.50.310 requires interim distributions to members to be equal, unless an operating agreement provides for the distribution.

Sec. 10.50.315 indicates at what times a company member is entitled to an interim distribution.

Sec. 10.50.320 directs a company to distribute to a terminated member any distribution that the member was entitled to receive before the termination, except where the member is removed or the termination does not cause dissolution. In addition, directs the company to distribute to the terminating member the amount of the member's company interest. Establishes the amount of the interest if a company operating agreement does not establish the amount or how to calculate the amount. If an election has been made to continue the company until a certain date or event, the distribution provisions don't apply unless the member is also a company manager.

Sec. 10.50.325 prohibits a member from demanding and receiving a distribution in other than cash, unless otherwise provided in an operating agreement. Prohibits a company from compelling a company member to accept assets in a form other than cash under certain circumstances.

Sec. 10.50.330 states that a company member entitled to receive a distribution becomes a creditor of the company and is entitled to all available creditor remedies.

Sec. 10.50.350 states that property transferred to or otherwise acquired by a company is the property of the company and not of the members individually. States that a company may acquire, hold, and convey property in the name of the company. States that when the company acquires an interest in real property the company holds the title and not the members individually.

Sec. 10.50.355 indicates how a company's property may be transferred, depending on whose name the property is held in and whether the company has a manager.

Sec. 10.50.360 authorizes a company to recover its transferred property if the company proves certain facts, unless certain circumstances exist.

Sec. 10.50.365 authorizes, under certain circumstances, the transfer, free of company or member claims, of company property held in the name of a person other than the company.

Sec. 10.50.370 states that a company interest is personal property.

Sec. 10.50.375 authorizes the assignment of a company interest. States that an assignment entitles the assignee to receive, to the extent assigned, only the distributions to which the assignor is entitled. States that an assignment does not dissolve the company or entitle the assignee to participate in the management and affairs of the company, to become a member, or to exercise member rights. The assignor continues to be a member unless the assignee becomes a member with respect to the interest. Allows a written operating agreement to vary the terms of the section. States that certain activities of a member do not amount to assignments and do not terminate the membership or the rights and powers of the member, unless otherwise provided in an operating agreement.

Sec. 10.50.380 authorizes a court to charge a member's company interest for payment of a judgment creditor against the member. Indicates the effect of the charge.

Sec. 10.50.385 states that in the case of a member's death or incompetency the member's legal representative has the rights of an assignee of the member's company interest.

Sec. 10.50.390 states that if a member (not an individual) terminates or is dissolved, the member's legal representative or successor has the rights of an assignee of the member's interest.

Sec. 10.50.400 identifies the events that dissolve a company and require winding up of its affairs.

Sec. 10.50.405 authorizes the superior court to order a company's dissolution under certain circumstances.

Sec. 10.50.410 indicates who may wind up a company's affairs, unless otherwise provided in an operating agreement.

Sec. 10.50.415 identifies the acts that a person winding up a company's affairs may perform.

Sec. 10.50.420 establishes when, how, and under what circumstances a member or manager can bind a company that is dissolved and winding up its affairs.

Sec. 10.50.425 establishes the manner and priority for the distribution of a company's assets upon its winding up.

Sec. 10.50.430 allows a company to file articles of dissolution with the department after it dissolves. Describes what the articles must state.

Sec. 10.50.435 establishes how a company after its dissolution may dispose of the known claims against it. Declares under what conditions a known claim against the company is barred.

Sec. 10.50.440 establishes how a company after its dissolution may dispose of unknown claims against it. Declares that unknown claims are barred unless the claimant takes certain action within three years after the later of certain events. Authorizes the claimant to enforce a claim against the company's undistributed assets or against company members under certain circumstances; limits a member's total liability.

Sec. 10.50.500 authorizes a company to merge or consolidate with or into a domestic or foreign limited liability company, subject to the law applicable to the other company and unless otherwise provided in an operating agreement.

Sec. 10.50.505 authorizes the rights of, or interests in, a party to a merger or consolidation to be exchanged for or converted into cash, property, obligations, rights or other interests of, or interests in, the surviving or resulting company.

Sec. 10.50.510 establishes what member or other approval is required before a company may approve a proposed merger or consolidation. Authorizes a party to a merger or consolidation to abandon the merger or consolidation as provided in the merger or consolidation agreement.

Sec. 10.50.515 requires the company surviving or resulting from a merger or consolidation under this chapter to file articles of merger or consolidation with the department. The articles must be signed by each company that is a party to the merger or consolidation.

Sec. 10.50.520 describes what the articles of merger or consolidation must state.

Sec. 10.50.525 requires articles of merger or consolidation to be signed by a company that is a party to the merger or consolidation.

Sec. 10.50.530 states that articles of merger or consolidation constitute articles of dissolution for a company that is not the surviving or resulting company in a merger or consolidation.

Sec. 10.50.535 indicates when a merger or consolidation takes effect.

Sec. 10.50.540 states that a merger or consolidation agreement may amend a company's operating agreement or adopt a new operating agreement for the company, if the company is the surviving or resulting company in a merger or consolidation. Authorizes an approved merger or consolidation agreement to provide

that a company's operating agreement will be the operating agreement of the company that is the surviving or resulting company. States when an amendment to an operating agreement or the adoption of a new operating agreement under this section is effective. States that this section does not limit the accomplishment of a merger or other matter covered by the section by other means allowed under an operating agreement, another agreement, or another law.

Sec. 10.50.545 describes the general effects of merger or consolidation. These include the termination of companies that are not the surviving or resulting companies and the transfer of the applicable rights, privileges, immunities, powers, franchises, restrictions, disabilities, and duties of the participating companies to the surviving or resulting company.

Sec. 10.50.550 describes the effects of merger or consolidation on the property of the participating companies.

Sec. 10.50.555 describes the effect of merger or consolidation on the liabilities of the participating companies.

Sec. 10.50.560 declares that creditor rights and liens on the property of a company that is a party to a merger or consolidation are not impaired by the merger or consolidation.

Sec. 10.50.565 states that upon a merger or consolidation a company's interests that are to be converted or exchanged into other property under the merger or consolidation agreement are converted as provided by the merger or consolidation agreement. States that the former holders of interests so converted have the rights provided in the merger or consolidation agreement or otherwise provided by law.

Sec. 10.50.590 defines "limited liability company" for secs. 10.50.500 - 10.50.590.

Sec. 10.50.600 states that, subject to this state's constitution, a foreign company's organization, internal affairs, and the liability and authority of its managers and members are governed by the law of the jurisdiction where the company is organized. Prohibits the department from denying registration to a foreign company because of differences between the law of this state and the jurisdiction where the foreign company is organized.

Sec. 10.50.605 requires a foreign company to register with the department before conducting affairs in this state. The foreign company is required to deliver an application for registration to the department.

Sec. 10.50.610 requires the registration application to be signed by a person who is authorized to sign by the law of the jurisdiction where the company was organized.

Sec. 10.50.615 describes what the registration application must state.

Sec. 10.50.620 prohibits the department from filing the registration of a foreign company unless the company name satisfies certain requirements.

Sec. 10.50.625 authorizes a foreign company to amend its registration by filing articles of amendment with the department.

Sec. 10.50.630 establishes what the articles of amendment must state. Authorizes the amendment of the application in any way as long as the amended application only contains provisions that are otherwise allowed by this chapter to be contained in an application for registration at the time of the amendment.

Sec. 10.50.635 requires a foreign company to maintain an agent in this state for the service of process. Indicates which persons qualify to be an agent.

Sec. 10.50.640 establishes the procedure for changing a foreign company's registered agent or the agent's address.

Sec. 10.50.645 provides guidelines for when the change of registered agent or agent address for a foreign company becomes effective.

Sec. 10.50.650 describes how a registered agent of a foreign company may resign as the registered agent. Requires the department to mail a copy of the resignation to the company. Indicates when the resignation becomes effective.

Sec. 10.50.655 authorizes a foreign company to cancel its registration by filing an application for cancellation with the department.

Sec. 10.50.660 describes what an application for cancellation must state.

Sec. 10.50.665 describes the form, manner, and execution of an application for cancellation of the registration of a foreign company.

Sec. 10.50.670 states that the cancellation of a registration does not terminate the authority of the department to accept service of process on the foreign company with respect to causes of action arising out of the company's conduct of affairs in this state.

Sec. 10.50.675 prohibits an unregistered foreign company conducting affairs in this state from maintaining a action or other proceeding in a court of this state until it has registered. States that the failure to register does not impair the validity of the company's contracts or acts, affect the rights of another party to a company contract

to maintain an action or other proceeding on the contract, or prevent the company from defending an action or other proceeding in a court of this state.

Sec. 10.50.680 states that a foreign company that conducts affairs in the state without being registered appoints the department as its agent for service of process with respect to a cause of action arising out of conducting affairs in this state.

Sec. 10.50.685 provides for service on the commissioner in the manner provided under sec. 10.50.065(b) and under certain circumstances. Requires the commissioner to keep a record of the processes, notices, and demands served on the commissioner. States that this section does not affect the right to make service in another manner permitted by law.

Sec. 10.50.690 states that a foreign company conducting affairs in this state without registration is liable to the department for certain fees and penalties.

Sec. 10.50.700 states that a foreign company that conducts affairs in this state without registration is subject to a civil penalty and authorizes the attorney general to recover the penalty.

Sec. 10.50.710 authorizes a court, under certain circumstances, to issue an injunction against a foreign company conducting affairs in the state in violation of this chapter. Indicates how long the injunction may continue.

Sec. 10.50.715 states that a member or manager of a foreign company is not liable for the debts and obligations of the company solely because the company conducts affairs in this state without registration.

Sec. 10.50.720 lists the transactions that do not constitute conducting affairs for a foreign company in this state.

Sec. 10.50.730 authorizes a court action to be brought by or against the company in the name of the company.

Sec. 10.50.735 prohibits a person from bringing a court action on behalf of a company in the name of the company unless the requirements of the section are met. Sets out these requirements.

Sec. 10.50.740 prohibits a company from asserting the lack of authority of a company member or manager to bring court action on behalf of a company as a defense to the action or as a basis for bringing a subsequent action on the same cause of action.

Sec. 10.50.800 declares that, unless an operating agreement provides otherwise, a company member or manager is not liable to the company or the company members

for damages or other relief for an act or a failure to act on behalf of the company unless the act or failure to act amounts to gross negligence or wilful misconduct. Provides that an operating agreement may limit or eliminate the personal liability of a company member or manager for breaches of duty under secs. 10.50.130 - 10.50.140 or subsec. (a).

Sec. 10.50.805 authorizes a company to use an operating agreement to authorize the company to indemnify a company member or manager for judgments, settlements, penalties, fines, or expenses incurred by the person under certain circumstances.

Sec. 10.50.810 states that a company member is not a proper party to a proceeding by or against the company just for being a member, except in certain circumstances.

Sec. 10.50.820 states that a company operating agreement may authorize a company to issue a certificate as evidence of a company interest and to authorize and provide for the assignment or transfer of the interest represented by the certificate.

Sec. 10.50.830 establishes how a document is to be delivered to or filed with the department.

Sec. 10.50.840 establishes the department's procedure and criteria for filing documents. Prohibits the department from filing a document if the section's requirements are not met.

Sec. 10.50.850 establishes who is to sign documents filed with the department and how the documents are to be signed. Authorizes a person to sign as an attorney-in-fact.

Sec. 10.50.855 establishes a procedure for obtaining a court order to direct the department to file certain documents.

Sec. 10.50.860 directs the department to charge fees for filing and other services it provides under the chapter.

Sec. 10.50.870 requires a company, unless otherwise provided in writing in an operating agreement, to maintain certain described records at its principal place of business.

Sec. 10.50.875 authorizes a company member to inspect and copy the company's records under certain conditions.

Sec. 10.50.880 requires certain persons to disclose to a member under certain circumstances true and full information of all matters that affect the members of a company.

Sec. 10.50.890 states that a company's failure to maintain a required record or information does not make a member or manager liable for the company's obligations.

Sec. 10.50.900 authorizes the department to adopt regulations to implement the chapter, in addition to any regulations the department is required to adopt under this chapter.

Sec. 10.50.910 authorizes a company organized and existing under this chapter to conduct its affairs and exercise the powers granted by this chapter in another jurisdiction, subject to the laws of that jurisdiction.

Sec. 10.50.920 declares the chapter's support of the principle of freedom of contract and enforceability of operating agreements. States that the rule that statutes in derogation of the common law are to be strictly construed does not apply to the chapter.

Sec. 10.50.990 defines terms for the new chapter.

Sec. 10.50.995 gives the new chapter a short title.

Section 2. Amends the for-profit corporations code to prevent that code from prohibiting a limited liability company from using "limited" in its name.

Section 3. Describes how a section of the new chapter amends the Alaska Rules of Civil Procedure.

Section 4. Makes the Act effective January 1, 1995.

If I may be of further assistance, please advise.

TLB:gc
94-168.glc

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March 1, 1994

Representative Bill Hudson, Chairman
House Committee on Labor and Commerce
State Capital Rm 108
Juneau, Alaska 99801-1182

VIA FAX
465-6790

Re: Sponsor Substitute for House Bill 420

Dear Representative Hudson:

As an attorney in the State of Alaska, I am very eager to have the state pass legislation authorizing limited liability companies, as has been done in virtually all other states in the country. Accordingly, I urge that your committee promptly schedule a hearing on the sponsor substitute for House Bill 420.

Your assistance in ushering this bill through your committee would be deeply appreciated.

Very truly yours,

FORTIER & MIKKO, P.C.

By: _____
John L. Hoffer, Jr.

JLH:mlv JLH\Hudson.ltr

Department of Commerce & Economic Development / POSITION PAPER

HB 420: "An Act relating to limited liability companies; amending Alaska Rules of Civil Procedure 20 and 24; and providing for an effective date."

The department strongly supports the concept of Limited Liability Company legislation. The primary goal for the state to adopt this legislation is to offer increased business opportunities in the State of Alaska. Limited Liability Companies (LLC) offer individual liability protection to its members and managers while avoiding the restrictions place upon subchapter "S" corporations. LLC also avoid the multi-level taxation of "C" corporations. This type of arrangement is especially attractive to individuals, corporations, and other enterprises interested in establishing joint ventures, both domestically and with foreign countries.

While the provisions of HB 420 provide for the foundation of LLC law, it lacks the department's administrative procedures established for other types of business organizations. These procedures are effective in required filings of limited partnerships, profit and nonprofit corporations, both domestic and foreign, professional corporations, cooperatives, and in the administration of trade names. The department over this past year has been working with the Alaska Bar Association to develop an LLC law that would meld into the existing efficient administrative procedures that are now in place. With the ABA proposal, the new LLC law would not be a "new" program but a new category of existing procedures requiring no additional expense to initiate and administer.

Again, the department endorses the LLC legislation but must encourage consideration for the work that has been done by the Alaska Bar Association and the department to efficiently administer the Act. It is our understanding that the ABA bill will be introduced in the Senate within the next ten days.

for S. E. Reed
Paul Fuhs, Commissioner

2-17-94
Date

PF/WF/294pp.wk
021794a

FISCAL NOTE

STATE OF ALASKA
1994 LEGISLATIVE SESSION

BILL NO. HB 420

Revision Date:
Title: An Act relating to limited liability companies

Sponsor: Representative Therriault
Requestor: House Labor & Commerce

Department Affected: Commerce and Economic Development
BRU: Banking, Securities and Corporations
Component:

COMPONENT SERIAL NO.

Expenditures/Revenues:

OPERATING EXPENDITURES	FY 95	FY 96	FY 97	FY 98	FY 99	FY 00
PERSONAL SERVICES	0	0	0	0	0	0
TRAVEL	0	0	0	0	0	0
CONTRACTUAL	0	0	0	0	0	0
SUPPLIES	0	0	0	0	0	0
EQUIPMENT	0	0	0	0	0	0
LAND & STRUCTURES	0	0	0	0	0	0
GRANTS, CLAIMS	0	0	0	0	0	0
MISCELLANEOUS	0	0	0	0	0	0
TOTAL OPERATING	0	0	0	0	0	0
CAPITAL EXPENDITURES	0	0	0	0	0	0
CHANGE IN REVENUES ( )	0	0	0	0	0	0
FUND SOURCE						
1002 Federal Receipts	0	0	0	0	0	0
1003 GF Match	0	0	0	0	0	0
1004 GF	0	0	0	0	0	0
1005 GF/Program Receipts	0	0	0	0	0	0
1006 GF/MHTIA	0	0	0	0	0	0
Other	0	0	0	0	0	0
TOTAL	0	0	0	0	0	0

Estimate of current year (FY 94) cost: $ 0

POSITIONS						
FULL-TIME	0	0	0	0	0	0
PART-TIME	0	0	0	0	0	0
TEMPORARY	0	0	0	0	0	0

ANALYSIS: (Attach a separate page if necessary.)

Prepared by: Willis F. Kirkpatrick, Director
Division: Banking, Securities and Corporations
Phone: 465-2521
Date: 2/16/94

Approved by Commissioner: Paul Fuhs
Agency: Commerce and Economic Development
Date: 2-17-94

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Partnership, Corporation Aren't Only Ways to Start Out

Forming as a Limited Liability Company Offers Best of Both Worlds

By JEFFREY A. TANNENBAUM
Staff Reporter of THE WALL STREET JOURNAL

Robert H. Kane's start-up enterprise is a mouthful: Octagon Communications Limited Liability Co.

The name doesn't exactly have a ring to it. It's rather awkward on stationery and business cards. It even fails to convey the company's intended business: investments in rural cellular-telephone companies.

But loud and clear, the name conveys something else: a new form of ownership that Mr. Kane and his seven partners expect will serve them well. Their enterprise—to be based in Denver—is neither a traditional partnership nor a traditional corporation. Rather, under Colorado law, it is a "limited liability company," or LLC.

Growing Interest

Mr. Kane and his partners expect to enjoy the best of both worlds: the tax advantages of a partnership and the legal safeguards of a corporation. Yet they face none of the drawbacks associated with forming a so-called subchapter-S corporation, which also is taxed much like a partnership. For example, S corporations can't have corporate shareholders, but LLCs can. "If some corporation ever wants to offer me jillions of dollars for my interest, I'll be able to sell it," Mr. Kane says.

Not yet worth jillions, Octagon doesn't even have an office. But it is in the forefront of a movement toward the LLC as a form of ownership for small U.S. businesses and joint ventures. "Interest in the LLC concept is growing remarkably fast," says John R. Maxfield, a Denver lawyer who helped write the LLC law there.

Fast, anyway, by the slow-paced standards of lawmaking. In 1977, Wyoming became the first state to authorize LLCs, but it took until 1988 for the Internal Revenue Service to confirm that the new Wyoming entities would be treated as partnerships for federal tax purposes.

To date, only five other states—Colorado, Florida, Kansas, Virginia and, most recently, Utah—have followed Wyoming in authorizing their own LLCs, according to an American Bar Association survey. But lawyers in many other states report growing interest because of the IRS ruling. Two ABA panels are studying the topic, as is the National Conference of Commissioners on Uniform State Laws, a group allied with the ABA. Meantime, moves are afoot to introduce LLC statutes in Arizona, Illinois, Maryland, Michigan, Nevada, Ohio, Oklahoma and Texas, the ABA survey found.

"I'm stunned by the amount of excitement generated by these entities," says Barbara C. Spudis, a Chicago attorney and the head of one ABA panel on LLCs.

Flexibility of a Partnership

One appeal of LLCs is that, as with partnerships, any income flows through untaxed to the individual owners. Such owners don't avoid personal taxes, but they do avoid corporate taxes. Regular corporations face higher maximum taxes in the first place. And if the corporations pay dividends, owners are taxed again.

Of course, S corporations avoid double taxation—but they don't enjoy all the advantages of partnerships when it comes to juggling income and deductions. For example, the 20%-owner of an S corporation normally must pay taxes on 20% of any income. By contrast, partnership members are free to divvy up any income and tax liability as they see fit. Thus, equal partners might change the allocations of profit or loss year to year to fit their individual tax needs. LLCs offer the same freedom.

With LLCs, as with regular corporations, only the company's assets, and not the owners' personal assets, are at risk in business-related lawsuits. In partnerships, so-called limited partners enjoy such protection, but general partners don't. And limited partners face restrictions on how active they can be in the business. LLCs are designed to protect all partners while imposing no limits on their activity.

Not surprisingly, lawyers in a few states say LLCs are an easy sell. Since Colorado's LLC statute went into effect in April 1990, 250 LLCs have been organized there, an official says. Forming an LLC usually costs $1,000 to $5,000 in attorney and filing fees, depending on complexity, says Mr. Maxfield, the Denver lawyer.

But some state programs have drawbacks. Florida LLCs are exempt from federal corporate taxes but subject to the state's 5.5% corporate-income tax. Since Florida has no personal income tax affecting partnership income, "that 5.5% is enough to scare people off," says Jose M. Sariego, a Miami lawyer.

Moreover, the IRS has yet to give its imprimatur to any state LLC program except Wyoming's, though a few LLCs elsewhere have gotten favorable private-letter rulings. And lawyers say it's unclear how enterprises treated as LLCs in their home states will be treated in states without LLC laws. Of the states without LLCs, Indiana alone explicitly recognizes LLCs organized elsewhere. "There has been no litigation on LLCs," says Robert R. Keatinge, a Colorado lawyer who heads the other ABA panel on LLCs. "And nobody wants to be the test case."

Benefit for Foreigners

Still, proponents say the LLC raises little risk for enterprises operating only in their home state or outside the U.S. And it's ideal for foreign investors—normally barred from S corporations.

LLCs don't limit the number or type of owners, as S corporations do, except for a two-owner minimum. But because of other restrictions, only closely held enterprises are suited to be LLCs. For example, if any owner leaves, the others must all formally agree to keep the enterprise going. "If you have 200 members, it's hard to get everybody to sign off on anything," Mr. Keatinge says.

But even closely held companies face uncertainties on a number of technical and procedural issues, such as whether the conversion of a partnership into an LLC amounts to a "termination" under tax law, which might increase tax liability. IRS rulings are still awaited. In the meantime, warns Ms. Spudis, the Chicago lawyer, many LLC investors are entering uncharted territory.

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REVIEW

Supreme Court Decisions In *Allied-Signal* And *Kraft* Push States To Consider Combined Reporting

Paull Mines, Counsel
Multistate Tax Commission

The following is an account of why States now employing separate entity accounting principles[1] will inevitably face the adoption of combined reporting following the 1991 term of the U.S. Supreme Court.[2] This view is based on the Court's strong reinforcement of the unitary business principle in *Allied-Signal Inc. v. Director, Div. of Taxation*, 112 S.Ct. 2251 (1992), and *Kraft General Foods, Inc. v. Iowa Dept. of Revenue & Finance*, 112 S.Ct. 2365 (1992).

In *Allied-Signal*, the U.S. Supreme Court embraced the unitary business principle as the governing precept for determining the apportionability of the income of a multistate business enterprise in a particular taxing State.[3] In *Kraft General Foods*, the Court rejected the attempt to justify Iowa's disparate taxation of foreign dividends by reference to how other States were taxing the same unitary business. *Kraft General Foods* is important, because it requires States to stand or fall under the unitary business principle on their own, separate state tax systems. In *Kraft General Foods*, Iowa was required and failed to justify its ostensibly disparate treatment of foreign dividends (which, ar-

See Combined Reporting, Page 3.

In This Issue:

Limited Liability Companies: What Are They, And What Are Their Implications For State Taxation?

(Part I)

Scott D. Smith, Assistant Counsel
Multistate Tax Commission

Many complex and unanticipated state tax issues may be presented by the limited liability company ("LLC"), a new form of business entity being authorized by a rapidly-increasing cohort of states. At present, eighteen States have enacted legislation creating LLCs,[1] and several others are contemplating LLC legislation.[2] Part I of this article describes LLCs and examines issues surrounding their entity classification for federal and state tax purposes. Part II (to be published in the next issue of the *MULTISTATE TAX COMMISSION REVIEW*) will discuss a number of state tax issues presented by LLCs classified as partnerships for state tax purposes.

I.
THE NATURE AND ADVANTAGES OF LLCs.

An LLC is a hybrid, unincorporated business association providing all of its members with limited liability for their equity investments, flexible management alternatives, and liberal member qualification requirements. In many respects, LLCs combine traditional partnership and corporation attributes. LLCs resemble limited liability organizations existing in several European and South American countries and elsewhere.[3] Although relatively few LLCs have yet been organized, as more States enact LLC enabling legislation, they will likely become increasingly important entities for doing business by providing an alternative to the traditional corporation and partnership.[4]

Since LLC interests are generally subject to significant transfer restrictions, LLCs may be of questionable utility for

See Limited Liability Companies, Page 5.

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Volume 1992 Number 1 December 1992

Limited Liability Companies, from Page 1.

ventures traditionally conducted by widely held limited partnerships and C corporations. These transfer restrictions may also limit LLCs in raising capital. Similarly, unless all members desire to manage the entity, a limited partnership can, as a practical matter, obtain pass-through tax advantages yet still provide limited liability to all partners by using a corporate general partner. An S corporation can be utilized to achieve the same results. Likewise, if members do not want pass-through tax treatment, they can form a C corporation to manage themselves while having limited liability. LLCs may, however, represent a sound choice of organizational form for such high-risk operations as highly-leveraged real estate and natural resources ventures, in which ensuring limited liability for all members and providing pass-through tax advantages, without the restrictions of a limited partnership or S corporation, are substantial concerns.

The Internal Revenue Service (the "Service") has classified an LLC formed under Wyoming's LLC Act as a partnership for federal tax purposes.[5] A series of private letter rulings indicate that the Service continues to classify most LLCs as partnerships.[6]

The hybrid character of LLCs (encompassing corporation and partnership attributes) means that they offer certain advantages over other "pass-through" entities. For example, LLC members can retain the principal economic benefit of being a limited partner – limited liability – yet suffer neither of the principal drawbacks: an inability to participate in the management of the business and potentially being subject to "passive activity loss" limitations on utilizing losses to shelter other income.

In addition, the treatment of LLCs as partnerships for federal tax purposes provides them with several advantages over S corporations. LLCs avoid S corporation "qualification" restrictions: the 35 shareholder limit applicable to S corporations does not apply to LLCs; corporations, partnerships, trusts, non-resident aliens, ESOPs, retirement plans, and charitable organizations can be LLC members; and LLCs are not prohibited from having more than one class of interests.[7] LLCs provide greater flexibility than S corporations in other ways as well: LLC members may increase their tax bases to the extent of their share of LLC liabilities; LLCs avoid the built-in gains tax and passive investment income tax imposed on S corporations; and LLC members can utilize Code 754 elections to adjust their inside tax bases to reflect the purchase price of their LLC interests. (This step-up in basis is not permitted to a person who buys or inherits stock in an S corporation). Finally, LLCs are not subject to S corporation inadvertent termination and, unlike S corporations, can utilize subsidiary corporations to operate their business.[8]

II.
LLC FEDERAL TAX CLASSIFICATION ISSUES.

A. Current Federal Tax Classification of LLCs.

It is important to understand federal tax classification of LLCs, because (as will be discussed below) most States are likely to adopt the federal classification for state tax purposes. Whether a business organization is treated as a partnership or a corporation for federal tax purposes does not depend on its characterization under state law.[9] Rather, the federal tax classification regulations classify an organization by applying a mechanical test that looks to see whether the organization possesses at least three of four declared "corporate characteristics."[10] If this test is satisfied, then the organization is classified as an association taxable as a corporation.[11] The four characteristics relevant to the Service's classification of an organization as an "association" taxable as a corporation for federal tax purposes are:

(1) continuity of life;
(2) centralized management;
(3) limited liability; and
(4) free transferability of interests.

These four characteristics are given equal weight.[12]

The Service applied this test to the LLC at issue in *Rev. Rul. 88-76*, which was structured as follows:

(1) Upon the death, bankruptcy, retirement, expulsion, resignation, or dissolution of any member of the LLC, the LLC would dissolve unless all remaining members consented to continuing the LLC. The Service held that the LLC lacked continuity of life. (The lack of continuity of life is a partnership tax characteristic).

(2) The LLC had the discretion under the Wyoming Act to be managed either by a board of designated managers or by all of the members. The members chose to have the LLC managed by a board of designated managers. The Service held that the LLC possessed centralized management (a corporate tax characteristic).

(3) No members were personally liable for the LLC's debts or obligations. The Service held that the LLC possessed limited liability (a corporate tax characteristic).

(4) A member could transfer or assign his interest but the transferee/assignee member did not acquire all the attributes of ownership in the LLC unless all remaining members consented to the transfer. The Service held that the LLC lacked freely transferable interests. (The lack of freely transferable interests is a partnership tax characteristic).

Because the LLC possessed two partnership and two corporate characteristics, the Service classified the Wyoming LLC as a partnership for federal tax purposes.

B. Application of the "Declared Corporate Characteristics" to Specific State LLC Provisions.

The Wyoming LLC statute at issue in *Rev. Rul. 88-76* varies in a number of respects from the statutes in the other LLC States. Moreover, the interaction of the federal classification regulations with a variety of options the States provide with respect to the formation of LLCs makes it likely that the classification of LLCs for federal and state tax purposes will continue to be made on a case-by-case basis. For both of these reasons, it is important to understand thoroughly the federal classification regulations and the manner in which the Service has applied them to LLCs.

1. Centralized Management.

An LLC will possess the corporate characteristic of centralized management under the federal classification regulations when "any person (or any group of persons which does not include all members) has continuing exclusive authority to make the management decisions necessary to the conduct of the business for which the organization was formed."[13]

Compared to corporations and limited partnerships, one feature of LLCs that taxpayers may consider to be a virtue is the relative flexibility LLCs provide for establishing the management

See Limited Liability Companies, Page 6.

Limited Liability Companies, from Page 5.

structure of the entity. Although a limited partnership must be managed by its general partner and a corporation must be managed by its directors and officers, most of the LLC States permit all members to manage the LLC or to elect member or non-member managers.[14] Members can therefore establish an LLC's management structure in accord with their business and tax entity classification considerations. Accordingly, for LLCs organized in most States, the determination of whether the LLC possesses the corporate characteristic of centralized management must be made on a case-by-case basis.

Colorado and Minnesota vary from the other LLC States with respect to the flexibility allowed in the LLC management structure, however. Colorado does not permit all LLC members to manage an LLC; rather, it requires management by a board of designated managers.[15] The mandated management structure of a Minnesota LLC is similar to that of a corporation. A Minnesota LLC must have a "board of governors" who manage the "business affairs" of the LLC,[16] and it must also have a "chief manager" and a "treasurer."[17] Consequently, Colorado and Minnesota LLCs will always possess two federal corporate characteristics: limited liability and centralized management.

2. Free Transferability of Interests.

The federal classification regulations treat an organization as having the corporate characteristic of freely transferable interests if the members owning substantially all of the interests in the organization have the power to transfer all rights and attributes of ownership to a non-member without the consent of the other members.[18] The LLC states fall into three groups with respect to this characteristic.

Colorado, Florida, Kansas, Nevada, Virginia, West Virginia, and Wyoming require unanimous consent of LLC members for an interest to be transferred with all rights and attributes of ownership.[19] Accordingly, all LLCs formed in these seven states will lack "free transferability of interests."[20]

Iowa, Maryland, and Texas comprise the second group. These three states generally require the unanimous consent of LLC members to the transfer of an LLC interest, but permit the LLC's operating agreement to provide otherwise.[21]

Utah, Arizona, and Minnesota comprise the third group, each of them providing their own variations on transfers of interest. Utah requires only that members who will constitute a majority of the profit interests following the transfer of an LLC interest consent to the transferee's receiving all rights and attributes of ownership.[22] Arizona requires unanimous consent as a general rule, but permits an LLC to empower one or more members with the authority to admit additional members without the consent of the other members.[23] Minnesota generally requires unanimous consent to a transfer, but does not require it if the transfer is made to another member.[24]

The federal classification regulations do not indicate whether a transfer-of-interest approval requirement providing for less than unanimous consent will cause a business association to be characterized as possessing freely transferable interests. Arguably, some LLCs in both the second and third group of states could be so-characterized. Nonetheless, the Service appears willing to provide LLCs with substantial flexibility in structuring transfer restriction alternatives in a way that provides members with freedom to transfer their interests with all rights and attributes of ownership without being characterized as possessing freely transferable interests.[25]

3. Continuity of Life.

An organization possesses the corporate characteristic of continuity of life if "the death, insanity, bankruptcy, retirement, resignation, or expulsion of any member will not cause a dissolution of the organization."[26] A "dissolution" means an "alteration of the identity of an organization by reason of a change in the relationship between its members as determined under local law."[27] If a "dissolution event" occurs but the business of the organization is continued with the unanimous consent of the "remaining members," the organization will not be characterized as possessing continuity of life.[28]

The States of Colorado, Iowa, Maryland, Minnesota, Nevada, Virginia, West Virginia, and Wyoming require unanimous consent of the remaining members for an LLC to continue following a dissolution event. Accordingly, all LLCs organized in these states will lack the corporate characteristic of continuity of life.

The Arizona, Florida, Kansas, Texas, and Utah provisions may permit the LLC to continue after a dissolution event with less than unanimous consent of the remaining members. Arizona generally requires unanimous member consent to continue an LLC following a dissolution event. However, an Arizona LLC can, alternatively, empower one or more managers or members to decide whether to continue the LLC after a dissolution event without the consent of all remaining members.[29] A Florida LLC will dissolve if any dissolution event occurs, "unless the business of the limited liability company is continued by the consent of all the remaining members *or under a right to continue stated in the articles of organization* of the limited liability company."[30] Kansas provides a similar rule.[31] Utah requires only the "consent of the remaining members *entitled to receive a majority of the capital* of the limited liability company" in order to continue an LLC following a dissolution event.[32] Texas requires unanimous consent to continue or, alternatively, consent by a stated number of members or of a particular class as provided in the LLC's articles of organization or regulations.[33]

The Service has required unanimous consent to continuation of an LLC following a dissolution event in order for the LLC to avoid being characterized as possessing continuity of life. In *Ltr. Rul. 9010027*, the Service ruled that a Florida LLC had continuity of life because its articles of organization required only a majority of members to consent to continuation of the LLC following a dissolution event. Consequently, Utah LLCs and LLCs organized in Arizona, Florida, and Kansas and using their entity continuation alternatives will possess the corporate characteristic of continuity of life.[34]

Moreover, a Texas LLC whose articles of organization or regulations require less than unanimous consent by remaining *members* to continuation following a dissolution event should also run afoul of the Service's position as expressed in *Ltr. Rul. 9010027*. It is unclear, at this point, whether a Texas LLC requiring unanimous consent only from a particular *class* of members under the alternative provision of Texas' LLC statute will be characterized as possessing continuity of life.[35]

Although private letter rulings do not constitute authority,[36] *Ltr. Rul. 9010027* is an expression of the Service's position on the application of the continuity of life principle.[37] In short, although provisions allowing less than unanimous consent to the transfer of an LLC interest will apparently not cause an LLC to possess free transferability of interests, provisions allowing less than unanimous consent of members to the continuation of an LLC following a dissolution event appear likely to result in a characterization of the LLC as possessing the corporate characteristic of continuity of life.[38]

4. Limited Liability.

The federal classification regulations define "limited liability" as follows: "[a]n organization has the corporate characteristic of limited liability if under local law there is no member who is personally liable for the debts of or claims against the organization. Personal liability means that a creditor of an organization may seek personal satisfaction from a member of the organization to the extent that the assets of such organization are insufficient to satisfy the creditor's claim."[39]

The LLC states provide *all* LLC members with limited liability from the debts, obligations, or liabilities of an LLC.[40] The limited liability of *all* members of an unincorporated association is an issue that is not addressed by the federal classification regulations, by *Rev. Rul. 88-76*, or by Service private letter rulings. When all members of an entity are cloaked with limited liability, however, the entity closely resembles a corporation rather than a partnership. As a result, LLCs obviate the need for any "limited liability" analysis under the federal classification regulations.

The arbitrariness of the equal weighing of the four "corporate characteristics" contained in the federal classification regulations becomes readily apparent when every member of an entity has limited liability. It makes sense to weigh limited liability equally with the other declared corporate characteristics when a true state law partnership is being classified since the extent of limited liability requires a factual inquiry (*i.e.*, does the general partner have "substantial assets – other than his interest in the partnership – which could be reached by a creditor of the organization, or is the general partner "merely a 'dummy' acting as the agent of the limited partners"?).[41] On the other hand, limited liability vested in every member is such a strong corporate characteristic that it appears to deserve greater emphasis.[42]

5. Summary Analysis of Declared Corporate Characteristics.

From the foregoing discussion, it is apparent that the entity classification for federal tax purposes of LLCs will have to be done on a case-by-case basis and may effectively be elective in a number of LLC States. In other words, where state laws provide for a number of organizational options, the form of the organizational documents, and not the provisions of the State laws themselves, will determine whether the corporate characteristics of centralized management, free transferability of interests, and continuity of life are avoided or satisfied for a specific LLC. States permitting election of one or more of the declared corporate characteristics other than limited liability (which will always be present, at least in the LLC States[43]) are summarized in the following table.

Centralized Management: States permitting election to be managed by designated managers or all LLC members.	Free Transferability of Interests: States permitting election to require unanimous consent or less than unanimous consent to transfer of an LLC interest.	Continuity of Life: States permitting election to require unanimous consent or less than unanimous consent to continue the LLC following a dissolution event.
Arizona	Arizona	Arizona
Florida		Florida
Iowa	Iowa	
Kansas		Kansas
Maryland	Maryland	
	Minnesota	
Nevada		
Texas	Texas	Texas
Utah	Utah	Utah
Virginia		
West Virginia		
Wyoming		

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The table indicates that LLCs organized in Colorado (by its absence from the table), Minnesota, Nevada, Virginia, West Virginia, and Wyoming will always be classified as partnerships since they can have, at most, two corporate characteristics (including limited liability). LLCs organized in the other seven States would have the option to organize themselves in such a way that they would be characterized as corporations for federal tax purposes.

The ability to be classified as a partnership for tax purposes and yet provide all members with limited liability and management options is, arguably, the greatest attraction of LLCs. Nonetheless, LLCs organized in those States in which it is effectively possible to elect federal corporate tax treatment provide additional flexibility in meeting members' tax objectives. For example, the members may desire corporate tax classification in order to be able to utilize net operating loss and capital loss carryforwards and carrybacks. (A partner may only deduct losses from a partnership to the extent of the partner's basis.)[44] A corporation may select a fiscal year for its tax accounting period,[45] whereas a partnership's tax accounting period is generally restricted to the calendar year.[46] The shareholders of a corporation, unlike the partners of a partnership, can also be employees and thereby eligible for tax favored employee fring benefits. If the LLC anticipates holding inventory that will substantially appreciate or will have unrealized receivables, then the members may realize tax benefits if they elect corporate tax lassification. Although a partner generally realizes a capital gain o. the sale of its partnership interest, the sale will generate ordinary income to the extent of the partnership's unrealized receivables and substantially appreciated inventory.[47] Lastly, the member may simply want to operate as a corporation without being subject to S corporation restrictions[48] and without the necessity of adhering to corporate formalities.[49]

C. Other Classification Issues.

As suggested, the entity classification of LLCs for federal tax purposes is largely elective in the LLC States that provide organizational options affecting two or more of the declared corporate characteristics. There are tw ons, however, which may dictate how LLCs are deral tax purposes.

1. Impact of Related Members.

Under the Service's "no separate interests theory," a limited liability organization whose members are related (under common control) is deemed to have freely transferable interests. The Service will so rule even if state law (or foreign law, in the case of a foreign entity) and/or the organization's operating instrument requires unanimous consent of the members to transfer an interest.[50]

In *Rev. Rul. 76-435*[51] the Service classified a domestic limited partnership as an association taxable as a corporation since its corporate general partner was owned equally by the two limited partners.[52] Likewise, *Rev. Rul. 93-4*[53] concerned a German GmbH, an unincorporated business organization, formed by two U.S. subsidiaries of the same U.S. parent. The GmbH had limited liability and centralized management under German law. The Service held that the GmbH possessed freely transferable interests, even though unanimous consent to transfer was required under the GmbH's "memorandum of association." Because the members of the GmbH were under common control, consent to transfer was deemed not meaningful. In short, the Service's "no separate interests" theory may effectively eliminate the ability of some LLCs, consisting of commonly controlled members, to be treated as partnerships for federal tax purposes, unless an LLC's operating agreement either prohibits the transfer of interests or provides that a transfer of interests causes a dissolution of the LLC. *Rev. Rul. 93-4.*

2. A "Substantial Interests" Requirement for LLC Managing Members?

In *Ltr. Rul. 9029019* (April 19, 1990), the Service imposed what appears to be a "substantial interests" requirement in order for an LLC to avoid having its favorable (partnership tax classification) private letter ruling retroactively revoked. The Service required that the LLC continuously satisfy *Rev. Proc. 89-12*[54] and in particular 4.01 and 4.03 therein. These provisions of *Rev. Proc. 89-12* apply to the circumstances under which the Service will consider a private letter ruling request from a limited partnership (or LLC) with regard to its classification for federal tax purposes. (The ruling requirements of *Rev. Proc. 89-12* are procedural only and do not constitute substantive law).

Section 4.01 conditions the Service's consideration of a ruling request for partnership classification purposes on all general partners (or LLC managing members)[55], "taken together," having interests in each "material item of partnership income, gain, loss, deduction, or credit" at least equal to 1 percent of each item at all times during the existence of the partnership (or LLC). Section 4.03 requires general partners (or LLC managing members), "taken together," to maintain minimum capital account balances equal to 1 percent of total capital account balances or $500,000, whichever is less.

Consequently, even though they are not part of the federal classification regulations, a managing LLC member may have to satisfy the Service's minimal interest and capital account requirements in order for the LLC to be recognized as partnership by the Service.[56] At this time, the only apparent exception to the "substantial interests requirement" is if the LLC is managed by all members[57] or, if the LLC is managed by designated managers, if the managers are not members.[58] For LLCs organized under the Arizona, Maryland, and Minnesota LLC statutes, the Service's revocation of an LLC's partnership classification letter ruling may cause the LLC to be classified for state tax purposes as other than a partnership.[59]

III.
LLC RECOGNITION AND CLASSIFICATION AT THE STATE LEVEL

The LLC States themselves are not uniform in their classification of LLCs for tax purposes, with some classifying them as corporations and others conforming to the federal classification (which, as discussed above, will usually be as a partnership). In addition, some ambiguity exists concerning the tax classification of foreign LLCs, particularly in non-LLC States.

A. Current State Tax Classification of LLCs in LLC States.[60]

1. Corporate Classification.

Florida and Texas have classified LLCs as corporations for tax purposes. Florida treats LLCs as "artificial entities", imposes its corporate income tax on LLCs, and treats LLC distributions

as dividends.[61] Texas defines "corporations" to include LLCs and imposes its corporate franchise tax on LLCs.[62] Neither Florida nor Texas has a personal income tax.

2. Partnership Classification.

The only LLC State that unequivocally classifies an LLC as a partnership for tax purposes is Colorado.[63] Arizona, Maryland, and Minnesota classify LLCs as partnerships for state tax purposes if they are so classified for federal tax purposes.[64]

Although Kansas, Iowa, Utah, Virginia, and West Virginia have not specifically classified LLCs for state tax purposes, it appears these States will conform with the federal classification. Virginia should treat LLCs as partnerships given its general conformity statute and its conformity to federal tax definitions.[65] Utah will probably conform to the federal classification because it conforms to Code 761.[66] Iowa does not provide any specific definition of a partnership for tax purposes, but Iowa's tax regulations require an organization to file an Iowa partnership information return if it must file a federal partnership information return Form 1065.[67]

Similarly, although Kansas has not definitively classified LLCs for tax purposes, it conforms to the Internal Revenue Code under a general conformity provision. This provides, in pertinent part, that: "[a]ny term used in this act shall have the same meaning as when used in a comparable context in the federal internal revenue code."[68] West Virginia characterizes an LLC as an "unincorporated association"[69] and may, therefore, treat an LLC as a partnership for tax purposes because it defines a "partnership" for its business franchise tax in conformity with Code 761.[70]

B. Tax Classification of Foreign LLCs by LLC and Non-LLC States.

Twelve of the LLC States explicitly provide for registration of foreign LLCs.[71] Most of these twelve States will, presumably, conform to the federal tax classification of foreign LLCs for State tax purposes.[72] It should be noted, however, that complete interstate uniformity will not necessarily follow. For example, an LLC formed in Florida or Texas will always be taxed as a corporation in its domiciliary state[73] but will be treated as a partnership if it registers to do business in Colorado.[74] LLCs organized in Minnesota, Virginia, and West Virginia will always be classified as partnerships, but some foreign LLCs doing business in those states could be taxed as corporations if they were organized in states that effectively permitted them to elect to be so-classified for federal tax purposes.[75]

Among the non-LLC states, California[76], Indiana[77], and North Carolina[78] have already indicated that they will treat foreign LLCs as partnerships for tax purposes.

How the LLC states that do not recognize foreign LLCs and the non-LLC states (other than California, Indiana, and North Carolina) will treat foreign LLCs for tax purposes is ambiguous at this time. As a general rule, state tax classification of organizations is not well developed; most states simply conform to the federal classification. Thus, it seems likely that these states will do the same.[79]

Even assuming that non-LLC states will conform to the federal tax classification, an additional ambiguity remains: whether LLCs classified as partnerships will be treated for state tax purposes as general or limited partnerships. A general partnership is a creature of the common law, is formed voluntarily without the need for statutory authorization, and is founded upon contract, not statute.[80] A limited partnership, on the other hand, is a creature of statute and cannot exist unless the partnership satisfies state limited partnership law.[81] Although an LLC is also a creature of statute, it is not a limited partnership. Consequently, in the absence of specific legislation, an LLC may well be treated as a general partnership for state tax purposes.[82] This has obvious state tax consequences in those States in which limited partnerships are taxed at the entity level or are subject to minimum taxes.[83]

IV.
CONCLUSION

Until the ambiguities surrounding the tax treatment of foreign LLCs in many LLC and non-LLC States are resolved, it seems unlikely that these relatively new entities will be widely used to conduct a general multistate business.[84] This is perhaps fortunate, because it may give the States some time in which to resolve some thorny issues involving the taxation of individual and corporate members of LLCs, particularly non-resident and non-domiciliary corporate members.[85] States will also have to confront tax issues arising from transactions involving LLCs and their members such as mergers/conversions involving corporations/partnerships into LLCs and the income and sales tax ramifications thereof, unitary combination issues relating to LLCs and their corporate members, LLC cash and property distributions, and sales of LLC member interests. These issues are the subject of Part II of this article.

FOOTNOTES

1. *See, e.g.*, Arizona Limited Liability Company Act, Title 29, Chap. 4, 39-601, *et seq.* (S.B. 1084, June 2, 1992) (hereinafter, the "Arizona Act"); COLO. REV. STAT. 7-80-101, *et seq.*; FLA. STAT. ANN. 608.401, *et seq.*; Iowa Limited Liability Company Act, 490A.100 *et seq.* (H.F. 2369, 1992) (hereinafter, the "Iowa Act"); KAN. STAT. ANN. 17-7601, *et seq.*; Maryland Limited Liability Company Act, Title 4A, 4A-101, *et seq.* (H.B. 373, May 26, 1992) (hereinafter, the "Maryland Act"); Minnesota Limited Liability Company Act, 211B.15, Subd. 1, *et seq.* (H.F. 1910, April 29, 1992) (hereinafter, the "Minnesota Act"); NEV. REV. STAT. 86.011, *et seq.*; TEX. CORPS. & ASS'NS. CODE ANN. Title 32, Art. 1528n, art. 1.01 *et seq.*; UTAH CODE ANN. 48-2b-101, *et seq.*; VA. CODE 13.1-1000, *et seq.*; W. VA. CODE 31-1A-1, *et seq.*; and WYO. STAT. 17-15-101, *et seq.* In this article, these thirteen States shall be collectively referred to as the "LLC States." Delaware, Illinois, Louisiana, Oklahoma, and Rhode Island enacted LLC legislation after the author completed his comparison of LLC provisions in the various States. Accordingly, provisions of the LLC laws in these five States are not cited in the remainder of the article. *See* Delaware Limited Liability Company Act, DEL. CODE ANN. tit. 6, 18-101, *et seq.* (H.B. 608, Ch. 434, Del. Laws 1992, July 22, 1992) (eff. Oct. 1, 1992); Illinois Limited Liability Company Act, S.B. 2163 (September 11, 1992) (eff. Jan. 1, 1994); Louisiana Limited Liability Company Law, 1992 La. Laws Act 780 (H.B. 1262) (eff. July 7, 1992); Oklahoma Limited Liability Company Act, 1992 Okla. Sess. Laws Ch. 148 (S.B. No. 456) (May 1, 1992); and Rhode Island Limited Liability Company Act, 1992 R.I. Pub. Laws Ch. 92-380 (Sept. 19, 1992).

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2. It has been reported that at least 17 other States are considering or have considered legislation creating LLCs. These States are: California, Georgia, Hawaii, Indiana, Michigan, Mississippi, Missouri, Montana, Nebraska, New Hampshire, New Jersey, New York, Ohio, Oregon, Pennsylvania, South Dakota, and Washington.
3. *See, e.g., Ltr. Rul. 7817129* (Jan. 30, 1978) and *Ltr. Rul. 8003072* (Oct. 25, 1979) (both considering *limitadas* formed under the limited liability company laws of Brazil); *Ltr. Rul. 8221136* (Feb. 26, 1982) (considering *Gesellschaft mit beschraenkter Haftung (GmbH)* formed under the laws of the Federal Republic of Germany); *Ltr. Rul. 7826023* (March 28, 1978) (considering *sociedade por quotas de responsibilidade limitada* formed under the laws of Portugal); and *Ltr. Rul. 8006086* (Nov. 19, 1979) (considering limited liability partnerships formed under the laws of the Kingdom of Saudi Arabia).
4. It has been reported that Florida enacted its LLC statute in the hope of attracting foreign business and capital to the State from South and Central American executives familiar with the *limitada* form of business entity. *See* Comment, *The Limited Liability Company Act*, 11 FLA. ST. U. L. REV. 387, 387-388 (1983). Wyoming enacted its LLC statute as special interest legislation for an oil company. *See* Keatinge, Ribstein, Hamill, Gravelle and Connaughton, *The Limited Liability Company: A Study of the Emerging Entity*, 47 BUS. LAW. 375, 383, n. 36 (February 1992) (hereinafter, "*Keatinge*"). For an examination of the history of LLCs and their earliest American and foreign precursors see *Keatinge* at 381-384.
5. *Rev. Rul. 88-76*, 1988-2 C.B. 360. Effective September 19, 1988, the Service began providing advance rulings and determination letters on the classification of LLCs. *See, Rev. Proc. 88-44*, 1988-2 C.B. 634.
6. As this article was going to press, the Service has issued private letter rulings and revenue rulings classifying LLCs as partnerships for LLCs formed under the statutes of only 6 States (excluding Wyoming). In addition to *Rev. Rul. 88-76* (with respect to Wyoming's LLC statute), LLCs formed in Colorado, Florida, Nevada, Texas, Utah, and Virginia have received partnership classification rulings. *See Rev. Rul. 93-6*, 1993-3 I.R.B. ___ (Jan. 19, 1993) (Colorado); *Ltr. Rul. 8937i010* (September 16, 1989), *Ltr. Rul. 9030013* (April 25, 1990) (Florida); *Ltr. Rul. 9227033* (April 8, 1992) (Nevada); *Ltr. Rul. 9210019* (December 6, 1991); *Ltr. Rul. 9218078* (January 31, 1992); and *Ltr. Rul. 9242025* (July 22, 1992) (Texas); *Ltr. Rul. 9219022* (February 6, 1992) (Utah); and *Rev. Rul. 93-5*, 1993-3 I.R.B. ___ (Jan. 19, 1993) (Virginia). There are several other private letter rulings involving LLCs formed in the aforementioned States as well as for LLCs formed in States not disclosed in the letter ruling. These rulings are on file with the author.
7. *See, e.g.*, 1361(b), Internal Revenue Code of 1986, as amended (hereinafter "the Code"). Texas LLCs are specifically permitted to have different classes of members (TEX. CORPS. & ASS'NS. CODE ANN. art. 4.02) and LLCs in the other States are not expressly prohibited from having more than one class of interests. This provides LLCs with greater financial flexibility than an S corporation in determining allocation of losses and income since S corporations cannot specially allocate items of income and losses without violating the one class of stock restriction.
8. *See, e.g.*, 1362(d), (c), and (f) of the Code. S corporations cannot be members of an affiliated group of corporations (1361(b)(2)(A) of the Code). *See also* Keatinge, *supra*, note 4; Jordan and Kloepfer, *The Limited Liability Company: Beyond Classification*, 69 TAXES 203 (April 1991) (hereinafter, "*Jordan and Kloepfer*"); Hamill, *The Limited Liability Company: A Possible Choice for Doing Business*, 41 FLA. L. REV. 721, 748-757 (1989); Comment, *The Wyoming Limited Liability Company: A Viable Alternative to the S Corporation and the Limited Partnership?*, 23 LAND & WATER L. REV. 523 (1988); Comment, The Limited Liability Company: An Organizational Alternative for Small Businesses, 70 NEB. L. REV. 150 (Winter 1991).
9. Treas. Reg. 301.7701-1(c).
10. There are actually six relevant characteristics, but LLCs, like corporations and partnerships, will undoubtedly satisfy the two characteristics common to most business organizations: "associates," and "an objective to carry on business and divide the gains therefrom." Treas. Reg. 301.7701-2(a)(2). Generally, if an organization lacks associates and a joint profit motive, the organization will be classified as a trust. Treas. Reg. 301.7701-2(a)(2).
11. Treas. Reg. 301.7701-2(a)(3). The U.S. Tax Court in *Phillip G. Larson*, 66 T.C. 159 (1976), recognized the bias in the federal classification regulations toward a partnership classification. It noted that at the time the regulations were originally promulgated, the Service was concerned with attempts by non-corporate entities, such as professional partnerships, to qualify as corporations in order to deduct costs of medical insurance and retirement plans. 66 T.C. at 186-187. Virtually all of these advantages of corporate classification were eliminated by the Tax Equity and Fiscal Responsibility Act of 1982 and subsequent legislation.
12. *See, e.g., Phillip G. Larson, supra*, note 11. The *Larson* court majority explained the equal-weighing "as an attempt [by the Service] to impart a degree of certainty to a subject otherwise fraught with imponderables." 66 T.C. at 172. The court further stated: "we can find no warrant for such refined balancing in the regulations or in cases which have considered them. . . Our task herein is to apply the provisions of the respondent's regulations as we find them and not as we think they might of ought to have been written." 66 T.C. at 172.
13. Treas. Reg. 301.7701-2(c)(1). The managers need not be members of the LLC. Treas. Reg. 301.7701-2(c)(2). No centralized management exists if the purported manager(s) has/have authority "merely to perform ministerial acts" and does/do not have "continuing exclusive authority to make independent business decisions on behalf of the organization which do not require ratification by members of such organization." Treas. Reg. 301.7701-2(c)(3).
14. Texas provides a "default" election with respect to centralized management. A Texas LLC must be managed by designated managers in the absence of an agreement of the members to reserve management to themselves. TEX. CORPS. & ASS'NS. CODE ANN. art. 2.12.
15. COLO. REV. STAT. 7-80-401.
16. Minnesota Act 322B.606, Subd. 1. The members can, however, supersede any action taken by the board of governors by unanimous vote. Minnesota Act 322B.606, Subd. 2.
17. Minnesota Act 322B.67. The "chief manager" partakes in the "general active management of the business of the limited liability company." Minnesota Act 322B.673, Subd. 2. The "treasurer" is the LLC's financial officer. Minnesota Act 322B.673, Subd. 3.
18. Treas. Reg. 301.7701-2(e). The term "freely transferable interests" is, in reality, a misnomer. The federal classification regulations are really referring, as a practical matter, to the transferability of the rights

of ownership *other than* the rights to share in profits/losses and assets upon dissolution, e.g., the right to manage the business and the right to vote. Consequently, even if ownership interests in an entity can be transferred freely, the entity will not be characterized as having the corporate characteristic of freely transferable interests if there are certain limitations on the transfer of these *other* rights and attributes of ownership.

19. COLO. REV. STAT. 7-80-702; FLA. STAT. ANN. 608.432; KAN. STAT. ANN. 17-7617; NEV. REV. STAT. 86.351; VA. CODE 13.1-1039; W. VA. CODE 31-1A-34(c)(1); and WYO. STAT. 17-15-122.
20. *Rev. Rul. 88-76.*
21. Iowa Act 490A.903.1; Maryland Act 4A-601(B)(1); TEX. CORPS. & ASS'NS. CODE ANN. art. 4.07.
22. UTAH CODE ANN. 48-2b-131.
23. Arizona Act 29-731.B.2.
24. Minnesota Act 322B.313, Subd. 2.
25. *See, e.g., Ltr. Rul. 9219022*, holding that Utah's majority consent requirement was sufficient to avoid a free transferability of interests characterization. Two Service private letter rulings involving Texas LLCs have reached the same conclusion. In *Ltr. Rul. 9210019*, a Texas LLC's regulations provided as follows: interests could be transferred subject only to the consent of the LLC manager unless the manager was the transferor or was not a member of the LLC (in which case majority consent was required). In addition, no consent to a transfer of interests was required if the transfer was incident to the death, dissolution, divorce, liquidation, merger, or termination of the transferor and the transferee member constituted a "permitted transferee" under the LLC's regulations. The Service held that the LLC lacked freely transferable interests. In *Ltr. Rul. 9218078*, a Texas LLC's regulations conditioned the transfer of an interest on two-third's (2/3rds) consent of the "outstanding units." The Service held that the LLC lacked freely transferable interests. The Service's interpretation of the freely transferable interests characteristic in *Ltr. Rul. 9210019* also appears to permit Arizona and Minnesota LLCs to use their respective election provisions without being characterized as possessing freely transferable interests.
26. Treas. Reg. 301.7701-2(b)(1). These occurrences are hereinafter collectively referred to as "dissolution events."
27. Treas. Reg. 301.7701-2(b)(2). A partnership or LLC dissolution is not the same as a "termination." A termination has independent tax significance under Code 708. A partnership terminates for federal tax purposes (and State tax purposes if a State conforms to Code 708) if the partnership business, financial operation, or venture fails to be carried on by the partnership or its partners or if, in any twelve month period, there is a sale or exchange of 50 percent or more of the total interest in partnership capital and profits. Code 708(b)(1)(A) and (B).
28. Treas. Reg. 301.7701-2(b)(2).
29. Arizona Act 29-781.A.3.
30. FLA. STAT. ANN. 608.441(c) (Emphasis added).
31. KAN. STAT. ANN. 17-7622(a)(3).
32. UTAH CODE ANN. 48-2b-137(3) (Emphasis added).
33. TEX. CORPS. & ASS'NS. CODE ANN. art. 6.01(4). This article provides, in pertinent part: ". . . and the business of the limited liability company is continued by the consent *of the number of members or class thereof stated in the articles of organization or regulations* of the limited liability company or if not so stated, by all remaining members." (Emphasis added).
34. *See also Ltr. Rul. 9030013*, wherein the Service ruled that a Florida LLC lacked continuity of life because the LLC did not elect to use the Florida alternative, but, rather, required unanimous consent to continuation of the LLC following a dissolution event.
35. There is some authority in the federal classification regulations for the position that requiring unanimous consent from one particular class of interest is sufficient to avoid continuity of life. Treas. Reg. 301.7701-2(b)(1) provides, in pertinent part: "If the retirement, death, or insanity of a *general partner* of a *limited partnership* causes a dissolution of the partnership, unless the remaining *general partners* agree to continue the partnership or unless all remaining members agree to continue the partnership, continuity of life does not exist." (Emphasis added). A general partner interest is a different class of partnership interest from a limited partner interest. Consequently, use of the Texas alternative may not result in continuity of life if (1) the class that must consent to continuation is the class whose member has been affected by the dissolution event and (2) the Texas LLC is treated as a limited partnership for federal tax purposes. An LLC likely will be treated as a "limited partnership" by the Service, at least for letter ruling purposes. *Rev. Proc. 89-12*, 1.02, 1989-1 C.B. 798 (1.02 provides that "a 'limited partnership' includes an organization formed under a law that limits the liability of any member for the organization's debts and other obligations to a determinable fixed amount.")
36. *See, e.g.*, 6110(j)(3) of the Code and *Rev. Proc. 92-1*, 11.02, 1992 I.R.B. 9.
37. *See also Ltr. Rul. 9210019* and *Ltr. Rul. 9218078*, *supra* note 25. In both of these private letter rulings there was no continuity of life issue because the LLCs' operating agreements required unanimous consent of members to continuation of the LLC following a dissolution event.
38. Proposed regulations applicable to limited partnerships that the Service has recently issued may render these issues moot. These proposed regulations permit a "majority in interest of the remaining partners" to agree to continue a limited partnership upon the occurrence of any event causing the withdrawal of a general partner and still avoid being characterized as possessing continuity of life (Prop. Treas. Reg. 301.7701-2(b)(1), 57 Fed. Reg. 32473 (July 22, 1992) (PS-7-92)). Rev. Proc. 92-35, 1992-18 I.R.B. 21, also permits majority consent to continuation of a limited partnership but only if the dissolution event is the general partner's bankruptcy or removal. Consequently, for LLCs treated for federal purposes as limited partnerships, the questions surrounding continuity of life and majority consent to continuation after a dissolution event may be resolved in favor of partnership tax classification. In accordance with Rev. Proc. 89-12, *supra* note 35, an LLC should be treated as a limited partnership for federal tax purposes.
39. Treas. Reg. 301.7701-2(d)(1).
40. Arizona Act 29-651 (Arizona extends limited liability to employees, agents, officers, and non-member managers); Colo. Rev. Stat. 7-80-705; Fla. Stat. Ann. 608.436; Iowa Act 490A.601; Kan. Stat. Ann. 17-7620; Maryland Act 4A-301; Minnesota Act 322B.303., Subd. 1 (includes agents); Nev. Rev. Stat. 86.371; Tex. Corps. & Ass'ns. Code Ann. art. 4.03; Utah Code Ann. 48-2b-109 (Utah extends limited liability to employees); Va. Code 13.1-1019; W. Va. Code 31-1A-33; and Wyo. Stat. 17-15-113.
41. Treas. Reg. 301.7701-2(d)(2). LLCs eliminate any partnership-existence controversy with respect to the "limited liability" factor of the

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federal classification regulations. Arguably, this treatment is different from what putative state law limited partnerships receive. At least one federal circuit court of appeals has suggested that the characteristic of limited liability is the most substantive factor that distinguishes corporations from partnerships. *Kurzner v. United States*, 413 F. 2d 97 (5th Cir. 1969).

42. Indeed, the Service issued proposed regulations in 1980 treating any entity vesting limited liability in all members as an association taxable as a corporation. Prop. Reg. 301.7701-2(a)(2), (g) Example (1). 45 Fed Reg. 75,709 (1980). This can be taken as a previous Service position that overall limited liability is so indicative of the corporate form that this single factor required federal tax classification as a corporation. These proposed regulations were later withdrawn. *I.R.S. Announcement 83-4*, 1983-2 C.B. 31. Moreover, the U.S. Treasury Department has in the past proposed treating limited partnerships as corporations if they had more than 35 limited partners. *See, e.g.*, U.S. Department of the Treasury, 2 *Tax Reform for Fairness, Simplification and Economic Growth–General Explanation of the Treasury Department's Proposals*, 146-150 (1984). Because of strong criticism, this proposal was never included in any tax reform package.
43. The issue of whether non-LLC states will recognize the limited liability of LLC members is also an issue which may present itself if LLCs begin operating to a substantial degree in interstate commerce. *See Keatinge, supra*, note 4 at 442-456.
44. Code 704(d). A net operating loss of a corporation can be carried forward 15 years or carried back 3 years. Code 172(b)(1)(A) and (B). A capital loss of a corporation can be carried forward 5 years and carried back 3 years. Code 1212(a)(1)(A) and (B). Taxpayers, other than corporations, may carry capital losses forward only to the next succeeding taxable year. Code 1212(b).
45. Code 441. A personal service corporation generally must select a calendar year tax accounting period. Code 441(i).
46. Under Code 706(b)(1)(B), a partnership's tax accounting period is, in order of priority: (1) the "majority interest taxable year" (*i.e.*, the taxable year of one or more partners having an aggregate interest in partnership profits and capital of more than 50 percent. Code 706(b)(4)(A)(i)); (2) the taxable year of the partnership's "principal partners" (*i.e.*, a partner having an interest in partnership profits or capital of 5 percent or more. Code 706(b)(3)); or (3) the calendar year. Partnerships may also be capable of using a "business purpose" tax accounting period under Code 706(b)(1)(C) (*i.e.*, when the partnership is engaged in a business having a "natural business year." Treas. Reg. 1.706-1(b)(4)(iii)). If the partnership cannot use the "majority interest taxable year" or the "principal partners" taxable year, the tax accounting period selected must provide for the "least aggregate deferral of income for the partners." Treas. Reg. 1.706-1T(a)(1).
47. Code 741 and 751(a).
48. *Supra*, p. 5.
49. For example, the REV. MODEL BUSINESS CORPORATION ACT requires a corporation to file articles of incorporation (2.01), hold an organizational meeting (2.05), adopt bylaws (2.06), issue shares (6.21), hold shareholder meetings (7.01), maintain a registered office and agent (5.01), appoint officers (8.40), hold board of directors meetings (8.20), and file annual reports (16.22). On the other hand, most of the LLC States require LLCs to file articles of organization, maintain a registered office and agent, file annual reports, and, if the LLC is to be managed by managers, appoint managers.
50. *See* Lederman, *Miami Device: The Florida Limited Liability Company*, 67 TAXES 339, 345 (1989). It should be noted, however, that the validity of the Service's "no separate interests" theory has not been tested by the courts. The only time a court was presented with this theory (in a case involving an unincorporated foreign business organization), it sidestepped the issue. *See MCA, Inc. v. United States*, 685 F. 2d 1099 (9th Cir. 1982).
51. 1976-2 C.B. 490.
52. *See also Rev. Proc. 89-6*, 1989-1 C.B. 776, 3.014 (Service will not rule on whether a non-U.S. LLC is a partnership if (1) the taxpayer seeking the ruling is a corporation and less than 20% of the LLC's interests are held by unrelated parties; or (2) unrelated parties hold only a nominal interest in the LLC regardless of whether the taxpayer is a corporation).
53. 1993-3 I.R.B. ___ (Jan. 19, 1993). "GmbH" is the abbreviation for *Gesellschaft mit beschrankter Haftung*. *Rev. Rul. 93-4* modifies and supercedes *Rev. Rul. 77-214*, 1977-1 C.B. 408, which held that a GmbH consisting of two wholly-owned U.S. subsidiaries of the same U.S. parent possessed freely transferrable interest *and* continuity of life. *Rev. Rul. 93-4* held that the GmbH *lacked* continuity of life and provided that the presence or absence of separate interests is irrelevant to the determination of whether an entity possesses continuity of life.
54. *Supra*, note 35. The same requirement was also set forth in *Ltr. Rul. 9218078*, *supra* note 25, and *Ltr. Rul. 9147017* (August 21, 1991) This requirement has not been explicitly imposed in all private letter rulings concerning LLCs.
55. The Service should treat LLC managing members as general partners for letter ruling purposes. According to *Rev. Proc. 89-12*, 1.02, "[r]eferences to 'general partners' and 'limited partners' apply also to comparable members of an organization not designated as a partnership under controlling law and documents; the 'general partners' of such an organization will ordinarily be those with significant management authority relative to the other members."
56. The substantial interest requirement is not necessary for establishing a tax return position nor can it be applied on audit. *See Rev. Proc. 89-12*, 1.03.
57. *Ltr. Rul. 9030013.*
58. *Ltr. Rul. 9227033.*
59. *See* note 64, *infra*.
60. Wyoming and Nevada have not found it necessary to classify LLCs for tax purposes because neither state imposes a corporate or personal income tax. Wyoming does, however, impose a graduated annual fee on LLCs based on the amount of LLC capital. WYO. STAT. 17-15-132.
61. FLA. STAT. ANN. 608.471(2) and 608.426. House Bill 633, considered in the Florida legislature in 1989, would have exempted a Florida LLC from Florida's corporate income tax if it was classified as a partnership for federal tax purposes. The bill did not pass. *See* also FLA. STAT. ANN. 220.13(j) defining LLC "taxable income."
62. TEX. TAX CODE ANN. 171.001(a)(2) and (b)(1).
63. COLO. REV. STAT. 39-22-205(1) and 39-22-201.5. Recall from the previous analysis that the provisions of Colorado's statute prevent a Colorado LLC from ever possessing continuity of life or free transferability of interests.
64. Arizona Act, 29-857; Maryland Act, Title 10, 10-104(9) and 10-819(B); Minnesota Act 211B.15, Subd. 3b. Maryland characterizes

an LLC as an "unincorporated business organization." Maryland Act 4A-101(L). Maryland requires an LLC to pay a personal income tax on behalf of its non-resident members. Maryland Act 10-102.1(b).

65. *See, e.g.*, VA. CODE 58.1-301.A.; VA. INC. TAX REG. 630-3-302.15. Virginia characterizes an LLC as an "unincorporated association" for non-tax purposes. VA. CODE 13.1-1002.
66. *See, e.g.*, UTAH CODE ANN. 59-10-103(i). Code 761 defines a "partnership" for federal tax purposes in accordance with the federal classification regulations. Treas. Reg. 1.761-1(a). It also defines other terms such as "partner," "partnership agreement," and "liquidation of partnership interest." Code 761 also provides an election for certain partnerships to be excluded from partnership tax treatment under Subchapter K (*i.e.*, investment partnerships not engaged in an active trade or business, organizations availed of for the joint production, extraction, or use of property, but not availed of to sell services or property produced or extracted, and organizations engaged in the short-term selling of securities for the purpose of underwriting, selling, or distributing a particular issue of securities). *See, e.g.*, Treas. Reg. 1.761-1(a).
67. IOWA ADMIN. CODE 45.1(422).
68. KAN. STAT. ANN. 79-32,109(a). In addition, KAN. ADMIN. REGS. 92-12-8 conforms to the federal definition of "corporation." Moreover, KAN. STAT. ANN. 17-7603(b) characterizes an LLC for non-tax purposes and provides that "a limited liability company formed under this act shall be a separate legal entity and shall not be construed as a corporation." Kansas imposes an annual entity level franchise tax payable when the LLC files its Kansas report. KAN. STAT. ANN. 17-7647(c). Kansas also imposes an annual entity level franchise tax on limited partnerships. KAN. STAT. ANN. 56-1a606(d) and 56-1a607(d). The Kansas franchise tax is paid to the secretary of state and is based on an amount equal to $1.00 for each $1,000.00 of the "net capital accounts located in or used in this state at the end of the preceding taxable year as required to be reported on the federal partnership return of income." KAN. STAT. ANN. 17-7647(c). *See also* KAN. STAT. ANN. 17-7647(b)(2) which requires a Kansas LLC to provide a reconciliation of the capital accounts in the same manner that is required on the federal partnership return of income. This is further evidence that Kansas will treat LLCs the same as limited partnerships for tax purposes.
69. W. VA. CODE 31-1A-2(8).
70. W. VA. CODE 11-23-3(b)(17). West Virginia generally conforms with the Internal Revenue Code's definitions. W. VA. CODE 11-23-3a.
71. Arizona Act 29-801; COLO. REV. STAT. 7-80-901 to 7-80-913; Iowa Act 490A.1402; KAN. STAT. ANN. 17-7636 to 17-7645, and 17-7648; Maryland Act 4A-1001 to 4A-1011; Minnesota Act 322B.905; NEV. REV. STAT. 86.551; TEX. CORPS. & ASS'NS. CODE ANN. arts. 7.01 to 7.13; UTAH CODE ANN. 48-2b-143 to 48-2b-148; VA. CODE 13.1-1051 to 13.1-1060; and W. VA. CODE 31-1A-49. The twelfth state is Florida, which recognizes foreign LLCs for tax purposes. FLA. STAT. ANN. 220.13(j).
72. It should be noted that a State is not obligated to conform to the federal tax classification of an organization. *See, e.g., Commonwealth v. N.I., Inc.*, 31 Pa. Commw. 235, 375 A. 2d 898 (1977), *aff'd.*, 482 Pa. 261, 393 A. 2d 653 (1978) (Pennsylvania's non-recognition of federal S corporation status was held not to constitute a violation of the Supremacy Clause). *See also Garlin v. Murphy*, 42 A.D. 2d 30, 344 N.Y.S. 2d 402 (1973), *aff'd.*, 34 N.Y. 2d 921, 359 N.Y.S. 2d 552 (1974) (New York's non-recognition of federal S corporation status held not to constitute a violation of the Fourteenth Amendment).
73. *Supra*, notes 61 and 62.
74. *Supra*, note 63.
75. Table, *supra*, p. 7.
76. *See FTB Notice 92-5* (August 21, 1992). California's entity tax classification regulations substantially conform to the federal classification regulations. *See* CAL. ADMIN. CODE 23038(b).
77. Indiana has announced that it will classify LLCs for Indiana tax purposes in the same manner as an LLC is classified for federal tax purposes. *See Indiana Tax Policy Directive #2*, Limited Liability Companies (Ind. Dept. of Revenue, May 1992), 1992 Ind. St. Tax Rep. (CCH), 89-952. Earlier, Indiana had recognized foreign LLCs as limited partnerships for non-tax purposes. IND. CODE ANN. 23-16-10.1-1 through -4.
78. Letter dated September 20, 1991, from Myron C. Banks, Deputy Secretary, North Carolina Department of Revenue, to Dorothy Cramer (on file with the Deputy Secretary). The North Carolina Attorney General has also indicated that foreign LLCs can register to do business in the state as a limited partnership. *See*, Letter dated October 16, 1991, from Richard H. Carlton, Chief Deputy Secretary of State of North Carolina to Mr. Frank R. Liggett III, Esq., LeBoeuf, Lamb, Leiby & MacRae, Raleigh, NC (on file with the Chief Deputy Secretary).
79. *See, e.g.*, DEL. CODE ANN. tit. 30, 1901; N.J. ADMIN. CODE tit. 18, 7-1.4; N.Y. PERS. INC. TAX REG. 100.15(c).
80. *See* 1 CAVITCH, BUSINESS ORGANIZATIONS 12.01 (Matthew Bender & Co., Inc. 1988); *Klein v. Weiss*, 284 Md. 36, 395 A. 2d 126 (1978).
81. *See* 2 CAVITCH, BUSINESS ORGANIZATIONS 39.05[1] (Matthew Bender & Co., Inc. 1988); *Dwinell's Central Neon v. Cosmopolitan Chinook Hotel*, 21 Wash. App. 929, 587 P. 2d 191 (Wash. Ct. App. 1978); *Klein v. Weiss*, *supra*, note 80.
82. The Indiana and North Carolina attorneys general have ruled that an LLC will be treated as a limited partnership in those States. *Supra*, notes 77 and 78.
83. California *FTB Notice 92-5*, *supra*, note 76, does not indicate whether LLCs will be treated as limited or general partnerships. Characterization as a limited or general partnership has tax consequences in California because a limited partnership doing business in California is required to file a partnership information return under CAL. REV. & TAX CODE 17932 and pays a minimum tax of $800. CAL. REV. & TAX CODE 23081.

Other States may treat limited partnerships (or limited partnerships not electing particular tax treatment) as corporations for tax purposes. *See, e.g.*, ARK. ADMIN. REG. Art. 4.84-2002(7); N.J. DEPT. OF TREAS.–TAXATION REG. 18:7-1.5; and PENN. DEPT. OF REV. REGS. 153.1(a)(3), (9), and (b)(3). A number of states impose entity level income or franchise taxes generally on unincorporated business associations. *See, e.g.*, D.C. CODE ANN. 47-1808.3 (unincorporated business franchise tax); HAWAII REV. STAT. 237-1 (gross income tax on partnerships doing business in Hawaii); ILL. REV. STAT. ch. 120, 2-205(b) (personal property replacement tax on the net income of all business organizations with activities in Illinois); MICH. COMP. LAWS 208.6(1) ("single business tax" on all business organizations with Michigan business activities); N.H. REV. STAT. ANN. 77:14 (business profits tax

See Limited Liability Companies, Page 14.

ALASKA CORPORATION NET INCOME TAX

– WHO MUST FILE–

--CORPORATIONS. A corporation or a partnership with a corporate partner must file an Alaska income tax return if it has a business activity or a taxable nexus with the State that is not protected under Public Law 86-272. Taxable nexus may include:

a. Owning or using property in the State including leased or mobile property;
b. Presence of employees in the State for business purposes;
c. Making sales into the State, or making sales from the State where the seller is not taxable at the destination of the buyer; or,
d. Generation of income from sources within the State without regard to whether there is a physical presence in the State.

--ELECTING SMALL BUSINESS CORPORATION (S CORPORATION). Alaska adopts Subchapter S (IRC Sec. 1361 - 1379) under AS 43.20.021(a), including the pass-through nature of an S Corporation. While an S Corporation may have no Alaska tax liability for the tax year, it is still required by AS 43.20.030(a)-(d) to file an Alaska Corporation Net Income Tax return and a complete copy of its federal form 1120S.

--LIMITED LIABILITY COMPANIES (LLC'S). Alaska does not recognize limited liability corporations organized in other states. An LLC engaged in business in Alaska, regardless of characterization as a partnership for federal and other state tax purposes, is treated as a corporation and must file a corporation net income tax return reporting the income of the corporation under the federal corporation income tax provisions as incorporated into Alaska law.

--INACTIVE CORPORATIONS. If a corporation had no business activities in Alaska and no income from Alaska sources during the tax year, only Page 1 of form 04-611 should be filed with the "INACTIVE" block checked. No other attachments are required.

--EXEMPT ORGANIZATION. An exempt organization includes those entities that are required to file a federal form 990 or 990-PF. An exempt organization is subject to the Alaska tax to the same extent as the organization is subject to federal tax. These organizations must file with the Alaska return a copy of the federal form 990 or 900-PF, as well as a copy of other federal forms that were filed such as 990-T and 1120-POL.

Please detach this portion and return to the Alaska Department of Revenue; P.O. Box 110420; Juneau, AK 99811-0420

Please answer the following questions to register with Revenue-Income & Excise Audit:

1. Name of corporation: _____
   Mailing address: _____
   City, State, ZIP: _____
2. Provide your federal Employer Identification Number (EIN/FIN): _____
3. What year did you begin doing business in Alaska? _____
4. Do you operate on a fiscal or calendar year end? Fiscal ☐ Calendar ☐
   Provide your tax year ending date: _____
5. Did you file your federal return on a consolidated basis? Yes ☐ No ☐
   If yes, provide the name of the parent corporation: _____
   Parent's EIN/FIN: _____
6. Do you have a valid Alaska Business License? Yes ☐ No ☐
   If yes, provide the Alaska Business License number: _____

If you need Alaska Corporation Net Income Tax Booklet forms, please call the following numbers:

Juli at (907)465-4988 or Rita at (907)465-3774 (Please note: these numbers are for FORMS ONLY)

Our fax number is: (907)465-2375

Limited Liability Companies, from Page 13.

imposed on partnerships equal to the aggregate percentage interests of the resident partners); and TENN. CODE ANN. 67-2-102 (bond interest and stock dividends received by partnerships taxed at partnership level).

The possible liability of LLCs for entity-level taxes raises the interesting issue of whether the limited liability of the members extends to State tax claims in the event that the LLC fails to remit tax and its assets are insufficient to pay a tax judgment. Although limited liability from an LLC's business debts or claims should probably not extend to unsatisfied state tax obligations of the LLC, States may have to enact specific "responsible party" legislation requiring LLC members to pay unsatisfied entity level state tax obligations of the LLC.

84. Precisely for this reason, tax practitioners are beginning to develop and to call for the enactment of uniform state LLC legislation that includes an explicit statement of partnership tax treatment. *See*, Hubbard, *Practitioner Calls for Uniform State Legislation on Limited Liability Companies*, 57 TAX NOTES 1629 (December 21, 1992).
84. Slow penetration of the LLC form into the business world may also give States time in which to consider the revenue implications of authorizing LLCs, about which there is growing concern. *See*, Carson, *Tax Revenues Will Suffer, But LLCs May Be Here to Stay*, 3 STATE TAX NOTES 802 (November 30, 1992); Sheppard, *New York Contemplates Cost of Partnership Treatment for LLCs*, 3 STATE TAX NOTES 887 (December 14, 1992).

Summary Of Multistate Tax Commission Actions On Policy Issues 1991 And 1992 Annual Meetings

At its August 2, 1991 Annual Meeting in Vail, Colorado, the Multistate Tax Commission:

- Adopted as a uniformity recommendation to the States the American Bar Association's Model S Corporation Income Tax Act ("MoSCITA") together with Six Proposed Modifications. The Proposed Modifications were not recommended by the Commission, but rather intended only as proposed language that will modify MoSCITA to conform it to an adopting State's existing state tax policy. (The Six Proposed Modifications, as adopted, were published and discussed in the March 1991 issue of the *REVIEW*.)
- Adopted a policy resolution endorsing S. 1564, "The Property Tax Fairness and Community and School Fiscal Stability Act of 1991" sponsored by Senator Kent Conrad of North Dakota. The bill would amend the 4-R Act to limit the railroads' privileged access to the federal courts by requiring them to exhaust all available state or local judicial and administrative remedies prior to review by the federal courts; repeal the "any other tax" provision; and clarify that federal courts do not have the authority to review railroad valuations determined by state and local assessors. (The history of 4-R Act related litigation is discussed in a cover story of the March 1991 issue of the *REVIEW*). It is anticipated that Senator Conrad will re-introduce this bill in the upcoming session of Congress.

At its July 24, 1992 Annual Meeting in Kansas City, Missouri, the Multistate Tax Commission:

- Adopted a policy resolution "urg[ing] the federal government to study and to consider seriously adopting formula apportionment-based methods for determining U.S. source income of multinational enterprises as a substitute for the theoretically-flawed and unadministrable system of attempting to determine 'arms-length' transfer prices under Section 482 of the Internal Revenue Code."
- Adopted a policy resolution that while acknowledging that "there is disagreement among Multistate Tax Commission States as to whether the state of residency or source of pension income should be able to tax pension income", urges that "Congress refrain from any legislation preempting States' rights to apply the source principal of taxation." The resolution notes that MTC States "agree that conflicts between States should be resolved by States, not Congress, and that "States have legitimate concerns that Federal preemption of a narrow issue of taxing pension income of non-residents may burgeon into broad restrictions on state tax practices."
- Adopted a policy resolution endorsing congressional enactment of S.2080/H.R. 4613, the "Preemption Clarification and Information Act of 1991." Introduced by Senators Carl Levin and David Durenberger, and Representative Craig Thomas, the bills would establish a rule of federal statutory construction that "No statute, or rule promulgated under such statute, shall preempt, in whole or in part, any State or local government law, ordinance, or regulation, unless the statute explicitly states that such preemption is intended or unless there is a direct conflict between such statute and a State or local law, ordinance, or regulation so that the two cannot be reconciled or consistently stand together." The bills would also require the Congressional Research Service to prepare an annual report to the President and the Congress spelling out all preemptive federal legislation and recent court cases with preemptive results. Because much of the States' problems with federal legislation preempting their taxing powers arises from legislation that was clearly intended to be preemptive (and thus not covered by the bills' rule of construction), the Commission also recommended that Congress take additional steps to address these problems, e.g., inclusion of a five-year "sunset" in all federal legislation preempting state taxing authority.

Copies of all the policy resolutions summarized are available by writing to the Commission at the address listed on the front cover of the *REVIEW*.

COMPLIMENTARY COPY

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Property ownership: Key considerations in choice of entity

Choosing the most efficient form of ownership of real property can be complicated by various tax and nontax factors. Determining what form is most efficient — partnership, REIT, S corporation, C corporation, or another form — requires careful planning.

by Arthur Gould, Esq., and Alan Van Dyke, Esq.

In most cases, a complex set of tax and nontax factors must be weighed in choosing the form of ownership of real property. Important nontax goals include the limitation of personal liability that could arise as a result of owning the real property and the acquisition or maintenance of control over the management of the property. Important tax concerns include whether tax benefits, such as net losses and credits, can be realized directly by the owners, whether the income and gain generated by the property will be subject to multiple levels of taxation, and whether ownership of the real property will have an impact on the tax status or character of the owner of the property (e.g., whether ownership would affect the status of the owner as a tax-exempt entity).

The most tax-efficient form of ownership depends on such factors as the number of owners, the types of owners (e.g., individuals, taxable entities, tax-exempt entities, or foreign owners), the nature of the property, the expected economic performance of the property, and other goals of the parties. This article reviews the various tax and nontax factors that need to be considered before choosing a form of ownership for real estate. The types of entities discussed include partnerships, real estate investment trusts, S corporations, C corporations, and Wyoming limited liability corporations. Special considerations for tax-exempt entities are also examined.

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Partnerships

A partnership offers great flexibility as a form of ownership of real property. It also provides the ability to limit exposure to liabilities if it constitutes a limited partnership and no entity-level tax is imposed.

General nontax considerations. Unlike S corporations, real estate investment trusts (REITs), and the various vehicles available only to certain types of tax-exempt organizations, partnerships have no limitation on the number or type of investors, and multiple classes of interests can be used. A partnership can be structured so that the sharing ratios for cash distributions and the ratios for allocating taxable income or loss can shift over time or upon the occurrence of specified events. However, the pass-through character of partnerships can be a disadvantage for tax-exempt partners if the partnership generates unrelated

business taxable income. Foreign investors may also be disadvantaged if the tax rates in their country of residence are substantially higher than U.S. tax rates and partnerships are treated as pass-through entities for purposes of their local taxing jurisdiction.

A general partnership offers its partners no protection from partnership liabilities. Limited partners in a limited partnership are protected from partnership liabilities except to the extent that they are obligated to make additional capital contributions to the partnership. However, protection from partnership liabilities is lost if they become actively involved in the partnership's day-to-day management. A general partner of a limited partnership has unlimited exposure to the liabilities of the partnership.

Partnership classification for federal income tax purposes. An unincorporated organization, such as a partnership, will be treated as an association that is taxable as a corporation for federal income tax purposes if it has more than two of four corporate characteristics:

- Continuity of life;
- Centralization of management;
- Limited liability (liability for debts limited to the assets of the organization); and
- Free transferability of interests.[1]

Continuity of life. An organization has continuity of life "if the death, insanity, bankruptcy, retirement, resignation, or expulsion of any member will not cause a dissolution of the organization."[2] Continuity of life does not exist if the occurrence of any of these events with respect to any member will cause a dissolution of the organization. A limited partnership organized under a statute corresponding to the Uniform Limited Partnership Act (ULPA) will not possess continuity of life because the bankruptcy of the general partner will result in technical dissolution under local law.[3]

Centralized management. An organization has centralized management if a person or group of persons that does not include all members and is not acting solely at the direction of the members has exclusive authority to make management decisions for the organization. Generally, a limited partnership formed under a statute corresponding to the ULPA does not have centralized management unless substantially all the interests are owned by the limited partners.[4]

Limited liability. The classification regulations provide that an organization possesses the corporate characteristic of limited liability "if under local law there is no member who is personally liable for the debts of or claims against the organization."[5] In the case of a general partnership subject to a statute corresponding to the UPA, personal liability exists with respect to each general partner.

A partnership provides great flexibility as a form of ownership of real property. It also provides the ability to limit exposure to liabilities if it constitutes a limited partnership and no entity-level tax is imposed.

Because general partners in a limited partnership are subject to personal liability under the ULPA, the regulations provide that "in the case of a limited partnership subject to a statute corresponding to the [ULPA], personal liability exists with respect to each general partner" unless the general partner "has no substantial assets (other than his interest in the partnership) which could be reached by a creditor of the organization and when he is merely a 'dummy' acting as the agent of the

[1] Reg. § 301.7701-2(a).
[2] Reg. § 301.7701-2(b)(1).
[3] Reg. § 301.7701-2(b)(3); see also Larson v. Comm'r, 66 T.C. 159 (1976), *acq.*, 1979-1 C.B. 1.
[4] Reg. § 301.7701-2(c)(4).
[5] Reg. § 301.7701-2(d)(1).

limited partners."[6] The Internal Revenue Service ruled that a Wyoming limited liability company that lacked continuity of life and free transferability of interests was classified as a partnership for federal income tax purposes even though it had limited liability.[7]

Free transferability of interests. An organization has free transferability of interests if each member can, without the consent of other members, confer on another person who is not a member of the organization all the attributes of his interest in the organization.[8] If a partner cannot substitute his assignee for himself in the organization without the consent of a general partner or the consent of all the partners, free transferability does not exist even if he may assign his income and distribution rights.

Publicly traded partnerships. Section 7704[9] provides that a "publicly traded partnership" shall be treated as a corporation for federal income tax purposes and defines "publicly traded partnership" as any partnership in which interests are traded on an established securities market or are readily tradable on a secondary market or the substantial equivalent thereof. However, a publicly traded partnership will not be treated as a corporation for a taxable year if the partnership met certain gross income requirements for the taxable year and each preceding taxable year beginning after December 31, 1987, during which the partnership (or any predecessor) was in existence.

Those gross income requirements are generally satisfied if 90 percent or more of the gross income of the partnership consists of the following:

- Interest not dependent on income or profits;
- Dividends;
- Real property rents not dependent on income or profits and not received from affiliates;
- Gain from the sale or other disposition of real property;
- Certain oil- or mineral-related income and gain; and
- Gain from the sale or other disposition of a capital asset or property described in Section 1231(b) (i.e., real property and depreciable assets used in a trade or business and held more than one year) that were held for the production of the types of income previously described.

Certain safe harbors are provided for that, if met, would ensure that interests in a partnership would not be considered to be "readily tradable on a secondary market or the substantial equivalent thereof."[10]

Taxation of profits and losses. Section 701 provides that no federal income tax is paid by a partnership as an entity. In determining his income tax, each partner takes into account separately his allocable share of the partnership's income, gains, losses, deductions, and credits, whether or not any actual cash distribution is made to the partner during his taxable year.

Subject to the at-risk limitations,[11] the passive activity loss limitations,[12] and certain other limitations, a partner in a partnership is generally entitled to deduct on his income tax return his allocable share of the partnership's losses, if any, to the extent of the tax basis of his partnership interest at the end of the partnership year in which the losses occur. To the extent that a partner's share of partnership losses exceeds the basis of his partnership interest at the end of the taxable year in which the losses occur, those excess losses cannot be utilized in that year by the partner for any purpose. However, the losses may be utilized as a deduction (subject to the limitations referred to previously) in the first succeeding year in which and to the extent that there is an increase in the basis of the partner's partnership interest.

[6] Reg. § 301.7701-2(d)(2).
[7] Rev. Rul. 88-76, 1988-2 C.B. 360.
[8] Reg. § 301.7701-2(e)(1).
[9] All section references are to the Internal Revenue Code of 1986, *as amended* (the Code) unless otherwise noted.
[10] Notice 88-75, 1988-2 C.B. 386
[11] I.R.C. § 465.
[12] I.R.C. § 469.

Basis rules and treatment of cash distributions. A partner's basis in his partnership interest is relevant, among other things, for determining his ability to deduct losses from the partnership (subject to other applicable limitations) and for determining gain or loss on a sale or other disposition of his interest in the partnership and on receipt of certain partnership distributions. Generally, the tax basis of any partner's interest in a partnership is equal to its cost[13] reduced (but not below zero) by the partner's share of partnership distributions and losses and increased by the partner's share of partnership income.[14] A partner's basis in his partnership interest also includes his proportionate share of partnership liabilities as determined under the regulations promulgated under Section 752.

Cash distributions from a partnership do not generally constitute taxable income for federal income tax purposes.[15] If the cash distributions in any year (including a reduction in the partner's share of the partnership's liabilities) exceed the partner's share of the partnership's taxable income for that year, the excess will constitute a return of capital to the partner to the extent of the partner's basis in his interest. A return of capital will not be reportable as taxable income by a recipient for federal income tax purposes but will reduce the tax basis of the recipient's partnership interest (but not below zero). If a partner's tax basis should be reduced to zero, his share of any subsequent cash distributions for any year[16] in excess of his share of taxable income will be taxable to the partner as though the excess were a gain on the sale or exchange of his interest.

REITs

REITs are another form of real estate ownership to consider.

General tax characteristics. Like partnerships and S corporations, REITs and their owners generally are subject to only a single level of tax on the earnings of the REIT. However, unlike partnerships and S corporations, a REIT is not a "pass through" entity whose owners are treated for tax purposes as directly receiving the taxable income or loss of the entity. Rather, distributions from REITs are taxed as ordinary dividend income to their shareholders (except in the case of capital gain dividends), and the REIT-level tax is avoided by means of a dividends-paid deduction. Therefore, REITs cannot "pass through" losses or credits to their shareholders. REITs have less flexibility than partnerships because a REIT must have at least a certain number of shareholders and must also meet certain asset and income tests. However, all REIT shareholders have protection from the liabilities of the REIT. In addition, a REIT is the most practical vehicle if an entity with publicly traded interests is desired.

REIT organizational requirements. A REIT must meet certain organizational requirements, among which are the following:

- The REIT must be managed by one or more "trustees or directors"[17];
- Beneficial ownership must be evidenced by transferable shares or transferable certificates of beneficial interest[18];
- The REIT must be taxable as a domestic corporation but for the REIT provisions[19];
- The REIT may not be either a financial institution referred to in Section 582(c)(5) or an insurance company taxed under subchapter L of the Code[20];
- During at least 335 days of a 12-month taxable year or a proportionate part of a short taxable year (other than during the first taxable year of a REIT's existence), the benefi-

[13] The tax basis of an interest received in exchange for property is equal to the basis of the property. I.R.C. § 722.

[14] I.R.C. § 705. The basis in the interest is reduced by losses whether or not these losses can be utilized on account of passive loss or other limitations.

[15] I.R.C. § 731.

[16] For this purpose, cash distributions include the partner's share of any reduction in the partnership's liabilities. I.R.C. § 752(b).

[17] I.R.C. § 856(a)(1).

[18] I.R.C. § 856(a)(2).

[19] I.R.C. § 856(a)(3).

[20] I.R.C. § 856(a)(4).

cial ownership of the REIT must be held by 100 or more persons[21];

- After application of the attribution rules of Section 544 (as modified by Section 856(h)(1)), five or fewer persons cannot own more than 50 percent of the stock of a REIT during the last half of a taxable year[22];
- A REIT must file an election to be taxed as a REIT[23]; and
- A REIT electing REIT status after 1976 must be a calendar-year taxpayer.[24]

Income and asset limitations. The income and asset limitations imposed on a REIT by Section 856(c) define the scope and character of permissible REIT activities as passive real estate investment. The five major limitations are as follows:

- Of the REIT's gross income, 75 percent must derive from rents from real property, gain from the sale of real property, interest from mortgages on real property, dividends from other REITs or gain from the sale of REIT stock, and other real estate activity;
- Of the REIT's gross income, 95 percent must derive the same sources as under the 75 percent test, with the addition of other (non-real estate) interest, dividends and gain from the sale of stock or securities;
- Less than 30 percent of the REIT's gross income must be derived from sales of stock held less than six months, sales of real property held as a dealer, or sales of real property held less than four years;
- Of the value of the REIT's assets, 75 percent must be represented by real estate assets, cash, and government securities; and
- Not more than 25 percent of the REIT's assets may be represented by nongovernment securities.

For purposes of these tests, the term "real estate assets" includes real property, interests in real property, interests in mortgages on real property, shares in qualified REITs, and stock or debt instruments representing the temporary investment of newly raised capital. Interests in foreign real estate also qualify.[25]

Dividends-paid deduction and distribution requirement. REITs are allowed the dividends paid deduction as defined in Section 561 for distributions made out of the REIT's current or accumulated earnings and profits.[26] A "preferential" dividend will not qualify for the dividends-paid deduction. A dividend is "preferential" under Section 562(c) if it is not pro rata to all shares of the same class or if a class of stock receives a preference over another class that is not provided for in its governing instruments.

In order to claim the benefit of the dividends-paid deduction and be taxed under the REIT rules, a REIT must distribute an amount equal to (with certain adjustments) 95 percent of its REIT taxable income before taking into account the dividends-paid deduction and excluding capital gains.[27] If certain conditions are met, a REIT can count distributions made after the close of a taxable year toward the 95 percent distribution requirement for that taxable year. Section 860 also provides a procedure for making deficiency distributions for taxable years for which the REIT's taxable income was adjusted as a result of an audit.

Taxation of REITs. A REIT computes its tax liability differently with respect to different categories of income. A REIT's taxable income is its regular corporate taxable income, computed and taxed in the same manner as a C corporation, with certain specified adjustments, the most important of which is the deduction for dividends paid. A REIT may designate all or a portion of its dividend distribution for a taxable year as a capital gain dividend up to the amount of the REIT's net capital gain for the taxable year.[28]

If a portion of REIT's net capital gain is retained (i.e., not distributed and designated as a capital gains dividend), it is subject to an alternative tax similar to that imposed by Sec-

[21] I.R.C. § 856(a)(5).
[22] I.R.C. § 856(a)(6).
[23] I.R.C. § 856(c)(1).
[24] I.R.C. § 859.
[25] Rev. Rul. 74-191, 1974-1 C.B. 170.
[26] I.R.C. § 857(b)(2)(B).
[27] I.R.C. § 857(a)(1).
[28] I.R.C. § 857(b)(3)(C).

tion 1201 on regulator corporations with net capital gains.[29] A REIT is also subject to a tax on certain prohibited transactions and on income from foreclosure property and is also subject to penalty taxes under certain circumstances.

Taxation of REIT shareholders. Distributions by a REIT not designated as a capital gain dividend in general are taxed under the same rules as distributions by ordinary C corporations. The distributions are treated as dividends to the extent of the current or accumulated earnings and profits of the REIT. Distributions in excess of earnings and profits are treated as a return of capital that reduces the adjusted basis of the shareholder's stock, and distributions in excess of basis are treated as gain from the sale or exchange of the stock. REIT dividends received by a corporate shareholder are not eligible for the 80 percent or 70 percent dividends-received deduction.[30] A capital gain dividend is reported as a long-term capital gain by the REIT shareholders, regardless of the shareholder's holding period for the stock.[31] However, if a REIT shareholder sells or exchanges shares with a holding period of less than six months after receipt of a capital gain dividend, then any loss on the sale of the shares is treated as a long-term capital loss up to the amount of the long-term capital gain recognized on receipt of the capital gain dividends.[32]

All REIT dividends are treated as portfolio income for purposes of the rules limiting the deductibility of losses from passive activities.

S corporations

Because S corporations are treated as pass-through entities for federal income tax purposes, their income and gain is generally subject only to tax at the shareholder level, and there is some ability to pass losses through to their shareholders. However, because of restrictions on the number and identity of shareholders and on the capital structure of the corporations, S corporations offer far less flexibility than partnerships. In addition, although a partner in a partnership includes in the basis of its partnership interest its share of partnership liabilities, a shareholder in an S corporation cannot include in the basis of his stock any amount of the S corporation's debt.[33] However, unlike REITs, S corporations are not subject to limitations on the type of assets that they may hold or the type of income that they may receive.[34]

Qualifications. To be eligible to make an election to be taxed as an S corporation, a corporation may have no more than thirty-five shareholders (all of whom are individuals — other than nonresident aliens), estates, or certain types of trusts), and it may have no more than one class of stock.[35] A member of an affiliated group of corporations (i.e., the owner of more than 80 percent of the stock of another corporation) is not eligible to elect S corporation status, and certain other types of corporations are also ineligible.[36] An election to be taxed as an S corporation may be made as follows:

- On or before the fifteenth day of the third month of the taxable year for either the current year or the next taxable year; or
- At any other time, for the next taxable year.[37]

Taxation of the S corporation. Although an S corporation is not subject to the corporate income tax, an S corporation that was formerly a C corporation is subject to tax on capital gain realized during a ten-year period beginning with the first day of the first taxable year for which the corporation was an S corporation. The tax is applied to the amount of

[29] I.R.C. § 857(b)(3)(A).
[30] I.R.C. §§ 243(d)(3), 857(c).
[31] I.R.C. § 857(b)(3)(B).
[32] I.R.C. § 857(b)(7).
[33] A shareholder can take into account the basis of debt of the S corporation owed to the shareholder in determining the limitation on the deduction of losses from the S corporation.
[34] The rules governing S corporations are found in I.R.C. §§ 1361–1379.
[35] However, there may be differences in voting rights among the shares.
[36] Section 1361(b).
[37] I.R.C. § 1362(b).

gain that is due to appreciation during years in which the corporation was a C corporation. An S corporation that has earnings and profits that were derived in years when it (or a corporation of which it is a successor) was a C corporation is taxed on passive investment income and on certain other items. An S corporation can also incur a corporate-level tax with respect to property acquired from a C corporation in a tax-free transaction. In addition, recent legislation added a provision requiring LIFO recapture by a C corporation in the last taxable year prior to its conversion to an S corporation. The tax imposed on the LIFO recapture is payable in four equal annual installments.

Taxation of S corporation shareholders. A shareholder includes his portion of an S corporation's income and loss on his return for the year in which the S corporation's taxable year ends.[38] The shareholder's portion of any item is computed on a daily basis in proportion to the number of shares of stock held by the shareholder on each day.

A shareholder cannot deduct losses from an S corporation in an amount exceeding the sum of the shareholder's basis in his stock and his basis in the corporation's indebtedness to him; however, disallowed losses can be carried over indefinitely for the life of the S corporation.[39] A shareholder is also subject to the at-risk limitation and the limitation on deductibility of losses from passive activities with respect to his share of losses from the S corporation.

Distributions. In the case of an S corporation that has no earnings and profits, the distribution will be tax free to the extent of the shareholder's basis in his stock. To the extent the amount of the distribution exceeds stock basis, the excess will be treated as gain from the sale or exchange of his stock.[40] If an S corporation has earnings and profits (carried over, for example, from a year in which it was a C corporation), more complicated rules apply, and a portion of a distribution may constitute a dividend.[41]

Other Forms of Ownership

C corporations. C corporations are generally not regarded as a tax-efficient form of ownership of investment real property. They are subject to an entity-level tax at a 34 percent rate on all income and gain, including gain realized upon the distribution of appreciated property. Also, all distributions from the corporation and gain from the sale of stock of the corporation are subject to an additional tax at the shareholder level. Furthermore, a C corporation is subject to the adjusted current earnings (ACE) adjustment[42] under the corporate alternative minimum tax and is also subject to other provisions, such as the personal holding company tax, collapsible corporation treatment, and the prohibition on paying unreasonable compensation. Such treatment does not present serious problems now but may become a disadvantage again if a lower capital gains tax rate is enacted.

Despite these disadvantages, foreign investors may find it desirable to invest in real property through a domestic C corporation in certain circumstances. Although the corporation would be subject to full U.S. corporate-level taxation, the foreign investors may pay little or no shareholder-level tax on the investment as a result of the following:

- The effect of tax treaties;
- Creditability of U.S. taxes against the foreign country taxes;
- The consequences of the relationship between U.S. corporate tax rates and tax rates in the investor's country; and
- Possible favorable treatment of dividends under the foreign tax laws in question.

Wyoming limited liability companies. A Wyoming limited liability company provides a vehicle that is taxed as a pass-through entity, insulates its owners from personal liability, and is not subject to the restrictions imposed

[38] I.R.C. § 1366.
[39] I.R.C. § 1366(d).
[40] I.R.C. § 1368(b).
[41] I.R.C. § 1368(c).
[42] I.R.C. § 56(g).

on S corporations. The pass-through nature of the entity is based on a ruling[43] that held that a Wyoming limited liability company that did not have the corporate characteristics of continuity of life or free transferability of interests was classified as a partnership, rather than an association taxable as a corporation, even though none of the members or designated managers had unlimited liability for the liabilities of the company.

However, because of the need for the entity to lack either centralized management or free transferability of interests, this vehicle may not be practical for real property investments with a large number of investors. Florida recently enacted a similar statute for limited liability companies. One issue confronting limited liability companies is their acceptance in states other than Florida and Wyoming, particularly as to the personal liability of its members.

Tax-exempt entities: Special considerations

There are some special issues to which tax-exempt entities should pay close attention. Tax-exempt entities, including group trusts, need to consider the potential for unrelated business taxable income. In addition, the key characteristics of qualifying as a Section 501(c)(25) tax-exempt organization is a special issue that corporations and trusts should not overlook. These topics are discussed next.

UBTI. Tax-exempt entities are generally subject to tax on their unrelated business taxable income (UBTI), which generally includes the following:

- Income derived from certain exempt organizations from a trade or business, except for certain permissible forms of passive income[44];
- Income derived by other exempt organizations from a trade or business when the conduct of such entities is not substantially related to the organization's exempt purpose;
- Income derived from "debt-financed property"; and
- Income from a publicly traded partnership.[45]

Subject to certain exceptions, "debt-financed property" is generally any property that is held to produce income and with respect to which there is "acquisition indebtedness" at any time during the taxable year, or, if the property was disposed of during the taxable year, at any time during the twelve months preceding the date of disposition.[46] Acquisition indebtedness is generally indebtedness incurred by a tax-exempt entity directly or through a partnership as follows:

- In acquiring or improving a property;
- Before acquiring or improving a property if the indebtedness would not have been incurred but for such acquisition or improvement; or
- After acquiring or improving a property if the indebtedness would not have been incurred but for such acquisition or improvement and the incurrence of such indebtedness was reasonably foreseeable at the time of the acquisition or improvement.[47]

Under Section 514(c)(9), in the case of plans qualified under Section 401(a) and certain other tax-exempt organizations ("qualified organizations"), under certain circumstances,

Consider the particular circumstances of each potential purchaser or developer of real property to choose the form of ownership most suitable in that situation.

[43] Rev. Rul. 88-76, 188-2 C.B. 360.

[44] Permissible forms of passive income include (in the case of property that is not "debt-financed property") interest, dividends, royalties, real property rents, not dependent on income or profits, and gains from disposition of noninventory property.

[45] I.R.C. § 512.

[46] I.R.C. § 514(b).

[47] I.R.C. § 514(c)(1).

indebtedness incurred in acquiring or improving real property will not be treated as acquisition indebtedness.

Investment through a group trust. A group trust is an entity that is itself tax-exempt and is subject to tax on its UBTI. Distributions from the group trust to its owners do not constitute UBTI unless the participant borrows to acquire its interest. Ownership of interests in group trusts is limited to qualified pension plans, and its operation is subject to the Employee Retirement Income Security Act of 1974 and other rules relating to pension plans as well as special rules for group trusts.

Section 501(c)(25) companies. A corporation or trust qualifies as an exempt organization if it has the following characteristics[48]:

- Has no more than thirty-five shareholders or beneficiaries;
- Includes only one class of stock or beneficial interest; and
- Is organized for the exclusive purpose of acquiring real property,[49] holding title to and collecting income from the property, and remitting all income, less expense, to its shareholders or beneficiaries.

All of an exempt organization's shareholders or beneficiaries must be the following:

- Qualified plans that meet the requirements of Section 401(a);
- Government plans as defined in Section 414(d);
- Plans of the United States or any political subdivision, agency, or instrumentality; or
- Any organization described in Section 501(c)(3).

The shareholders or beneficiaries must have the right to dismiss the investment advisor by majority vote and must have the right to have their interests redeemed or transferred to another permitted owner (so long as the transfer does not violate the thirty-five-owner limitation). The organization may not hold an "indirect interest" in real property, nor may it hold an interest as a tenant in common, but it may use a wholly owned subsidiary to hold real property.

Conclusion

A partnership is often the most efficient type of entity for the ownership of real property because of its flexibility, its ability to limit exposure to liabilities if organized and operated as a limited partnership, and the avoidance of an entity-level tax. However, in many cases, another form of ownership may be more desirable. Therefore, consider the particular circumstances of each potential purchaser or developer of real property to choose the form of ownership most suitable in that situation. ■

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[48] I.R.C. § 501(c)(25).

[49] For this purpose, real property may include incidental personal property as long as rent attributable thereto does not constitute more than 15 percent of total rent from the property in any taxable year.

From Desk Manual
"The Limited Liability Company
The Better Alternative"

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FORWARD

In 1977, during my third term as a member of the Wyoming House of Representatives, a request was made for me to assist as a House floor manager for the enactment of Senate File 218--the Wyoming Limited Liability Company authorization statute. The Senate sponsor of SF 218 was State Senator Neil Stafford who had strong business connections in the oil and gas industry.

The source of the bill was not then clear to me and what was known has since been forgotten along with loss of notes and references. The proposal was well supported by efficient lobbyists and passed without particular objection. It was assumed that a major Wyoming business was directly interested in the alternative business entity opportunity for the transaction of oil and gas development activities.

Immediately following the 1977 enactment, as a lawyer active in participation and organization of small business development and in predating IRS formal approval decision by about a decade, I organized the first and several of the early Wyoming limited liability companies. The very first, Cheyenne Downtown Limited Liability Co. was established to promote a core city redevelopment-regional shopping center in the center of the downtown area of the city. Governing body shortsightedness and their economic stupidity denied required support for the redevelopment directed downtown business district maintenance challenge and the first Wyoming limited liability company faded into history from the results of city government frustration of its intended purpose. My interest in these succeeding years in the validity of the limited liability company has not diminished, although the first effort had come to no avail.

Other limited liability company filings by many attorneys did follow with more success and today the Wyoming state government and practicing bar is at the forefront in recognition of the advantages to be obtained through the limited liability business entity structure.

The enthusiasm and scholarship of William D. Bagley and Philip P. Whynott, authors of this first treatise on the limited liability company subject is truly to be commended. This publication should support understanding and utilization of this business entity not only in Wyoming, but the other seven states that have followed with comparable legislation. The universe that awaits with this new concept is competently and comprehensively recognized by this Wyoming publication endeavor. The favorable business oriented climate provided for Wyoming and other progressive jurisdictions is clearly authenticated in the text of this book.

January 13, 1992.

Walter Urbigkit

WALTER URBIGKIT
CHIEF JUSTICE,
WYOMING SUPREME COURT

INTRODUCTION

The "Wyoming Limited Liability Company Act" was adopted in 1977. In 1988 a company formed under the Wyoming Act was finally approved by the Internal Revenue Service for partnership tax treatment. **The result is a flexible new business entity combining the advantage of corporate limited liability with IRS approved pass-through tax treatment of a partnership. This new entity should surpass corporations and partnerships in use and popularity.** By November 1991, eight states adopted limited liability company acts. Other states have legislation in process and there is now a move to draft a model or uniform act.

Because of the advantages of (1) flow-through tax treatment, (2) the operational flexibility of a partnership and (3) limited liability, the Limited Liability Company ("LLC") should replace the general partnership, the limited partnership, the joint venture, the S corporation, and closely held corporations as **the better alternative.**

This book titled ***The Limited Liability Company: The Better Alternative- Forms and Materials*** contains the historical background relating to this law; the relevant Internal Revenue Service rulings; a comparison of the limited liability company with other business entities; a discussion of ethics in the commercial law practice; the state by state analysis of limited liability company statutes and practices, including attorney general or advisory opinions that have been issued on this topic; and forms, including state mandatory and example forms to help the attorney in formation and post-formation matters.

This book covers the following topics:

I Introduction. A discussion of historical background of the limited liability company origins in the German company entity known as the Gesellschaft mit beschrankter Haftung [GmbH].

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JUN 1992
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June 5, 1992

Mr. Walter Urbigkit
Chief Justice
Wyoming Supreme Court
P.O. Box 388
Cheyenne, Wyoming 82003

Dear Justice Urbigkit:

I recently had an opportunity to read your forward to "The Better Alternative: The Limited Liability Company" by William D. Bagley and Philip D. Whynott I thought you might appreciate my recollections of the background behind the Wyoming Limited Liability Company statute.

Our company was involved in international oil and gas exploration through Panamanian limited liability companies in the early 1970's. We had reviewed the available alternatives to provide limited liability to individual partners and retain flow-through of U.S. tax benefits for all partners, and decided that the Panamanian entities were the most practical. We received rulings from the IRS that these entities would be treated as partnerships for federal income tax purposes, and we conducted oil and gas exploration through these entities in the United Kingdom Sector of the North Sea and other parts of the world.

In the mid 1970's, we decided to try to get a similar entity created in the United States that would provide more flexibility from a business standpoint and would retain the favorable characteristics of limited liability and flow-through of tax benefits. My recollection is that we originally considered Colorado and Wyoming as states in which such organizations might be formed, but decided that Wyoming would be more conducive to business interests.

Frank Burke, a tax partner with Peat, Marwick, Mitchell & Co. in Dallas, Texas, drafted the terms of the original proposal. He and Richard W. Coates, our chief counsel, then worked with Hugh Duncan of Casper, Wyoming to have the proposed legislation considered by the Wyoming legislature.

We formed our first Wyoming limited liability company on May 16, 1977, following the enactment of the legislation on March 4, 1977, and immediately filed a ruling request with the Internal Revenue Service requesting that this entity be treated as a partnership for federal income tax purposes. Three and one-half years later, on November 18, 1980, the IRS issued a favorable ruling on this entity. However, the IRS had proposed regulations the previous day that treated all entities with limited liability as associations taxable as corporations, irrespective of their other characteristics. Existing limited liability companies that had begun business before November 17, 1980 were given a grace period until December 31, 1982 before the proposed regulations would be effective.

INTRODUCTION

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Because of the advantages of (1) flow-through tax treatment, (2) the operational flexibility of a partnership and (3) limited liability, the Limited Liability Company ("LLC") should replace the general partnership, the limited partnership, the joint venture, the S corporation, and closely held corporations as the better alternative.

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Because of the proposed regulations, we never used our original Wyoming limited liability company, as the flow-through of tax benefits was critical to its operation. However, we did use another Wyoming limited liability company formed in 1977 for oil and gas operations in the United Kingdom Sector of the North Sea. By the time the IRS regulations were proposed in 1980, this entity had become a wholly-owned subsidiary of a U.S. corporation, so that the flow-through of tax benefits was of less importance, and we continued its operations until a few years ago.

Otherwise, limited liability companies were not considered a practical alternative for our purposes until the IRS issued Revenue Ruling 88-76 on September 2, 1988, agreeing that a Wyoming liability company would be treated as a partnership for federal income tax purposes. This was more than eleven years after enactment of the Wyoming legislation and almost eight years after having proposed regulations to the contrary!

Its good to see limited liability company statutes being enacted in other states and these entities being accepted as a practical way of doing business throughout the United States. I have always felt that the limited liability company entity should be helpful in capital formation endeavors in the United States. As stated by Messrs. Bagley and Whynott, these are certainly a better alternative than S corporations, general partnerships and limited partnerships for many types of businesses.

Sincerely,

A. J. Miller
Executive Vice President
and Chief Financial Officer

cc: Frank M. Burke, Jr.
Richard W. Coates

V A state-by-state analysis of the limited liability acts adopted and proposed, setting out the statutes and the attorney general, advisory and court opinions that have been issued on this topic in each of the states.

VI A limited liability checklist designed to assist the attorney in identifying his client's desires, and to make a record to protect the drafter from future malpractice claims, along with "Preformation Agreements".

VII "Articles of Organization" forms which include provisions for control by strong management, or by strong equity holders, and variations in between. Additionally, we propose numerous clauses to implement the type of organization desired.

VIII "Operating Agreement" forms which contain clauses, provisions, and completed agreements relating to the daily management of the limited liability company.

IX A discussion of the operating and acceptance of limited liability companies in jurisdictions not having limited liability acts.

X A discussion of post formation considerations, powers and duties. Included here are matters relating to (a) meetings of members, (b) elections, (c) amendments of Articles of Organization and Operating Agreements, (d) considerations concerning merger, exchanges and consolidation; records and reports, and (f) dissolution of sale of assets.

Besides the advantages of flexibility, the limited liability companies have significant benefits over limited partnerships by allowing limited liability to all owners. Also, they do not contain the restrictions and limitations of an S corporation.

By June of 1992, Colorado, Kansas, Utah, Texas, Nevada, Virginia, West Virginia, Maryland, Iowa, Oklahoma, Illinois and Minnesota had joined Wyoming and Florida in enacting statutes recognizing this new entity. However, only the Wyoming Act has been blessed by an Internal Revenue Service ruling. (14.100).

HISTORICAL BACKGROUND

The limited liability firm is a triumph of comparative law in action. The origin of this relatively new institution is generally attributed to the German law of 1892, authorizing the Gesellschaft mit beschränkter Haftung.... While drawing some inspiration from the English practice of the private limited company, it was nevertheless an original creation. However, the claim that it was without precedent is negatived by the fact that the State of Pennsylvania had enacted a law in 1874 authorizing the limited partnership association, which was extensively used. This

form of business organization, as we shall note later, bears a striking resemblance to the limited liability firm current today in Europe and Latin America. Eder, "Limited Liability Firms Abroad", 13 Univ. of Pitt L. Rev 193 (1952).

Limited liability companies are neither new nor strange to businessmen in the civil law countries of Europe and Latin America. These business forms have their origin in the 1892 German company law known as Gesellschaft mit beschränkter Haftung (GmbH).[1] Germany not only was the first civil code country to enact this legislation but Germany's enactment became the discussional focal point for the countries which subsequently adopted this commercial enterprise.[2]

Once established in Germany the concept of the limited liability company had a very active and fast growth.[3] Success in Germany soon caused the German model act to become the focal point of extensive debate. Within a short period of time after enactment in Germany the following countries joined the limited liability bandwagon: Portugal(1901) known as the "sociedade por quotas de responsabilidade limitada", Panama (1917), Brazil (1919), Chile (1923), France (1925), Turkey (1926), Cuba (1929), Argentina (1932), Uruguay (1933), Mexico (1934), Belgium (1935), Switzerland (1936), Italy (1936), Peru (1936), Columbia (1937), Costa Rica (1942), Guatemala (1942), and Honduras (1950).[4] In France by the late 1940's the limited liability entity known as "societes de responsabilite limitee" was more popular than the more traditional stock corporation[5] and comprised approximately one-third of all French societes.

The limited liability company laws of each of the above countries all have in addition to limited liability **four basic characteristics which distinguish this entity from other** business forms. (1) All require some use of the word "limited" in the entity's name; (2) the entity is given full juristic personality; (3) the partnership concept of "delectus personae" which permits a member to control admission of new members to the entity; and (4) the codes provide that limited liability firms are dissolved by death of a

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[1] For additional information on foreign limited liability companies see: DeVries & Juenger, "Limited Liability Contract: The GmbH", 64 Colum L. Rev. 866 (1964); Eder, "Limited Liability Firms Abroad", 13 U. Pitt L. Rev. 193 (1952); and Vagts, "Reforming the 'Modern' Corporation: Perspectives from the German", 80 Harv. L. Rev. 23 (1980).

[2] Molitor, Die Auslandische Regelung der G.m.b.H. und die deutsch Reform (1927) and Hallstein, "Die Gessellschaft mit berschrankter Haftung in den Auslandsrechten", 12 Zeitscrift fur auslandisches und internationales Privatrecht 341 (1938).

[3] Ibid.

[4] Ibid. pp 197-202.

[5] Ibid. p 197.

member, unless expressly stated in the articles of association and some provide for probate or sale of a deceased's share.[6]

In the United States several states passed legislation creating entities similar to the limited liability company entity. Pennsylvania, Virginia, New Jersey, Michigan and Ohio in the last quarter of the Nineteenth Century enacted legislation permitting "limited partnership associations" or "partnership associations". These associations were created to provide a form of limited liability coupled with some the beneficial characteristics of the partnership association. The IRS has granted these partnership associations pass-through partnership tax status.[7] The enabling legislation for these associations requires either the principal office or place of business be located in the enacting state. As a consequence of this enabling legislation these associations were not attractive to many entities active outside of these localities. Accordingly, they have not been extensively used.

Wyoming in 1977 became the first American state to enact a true limited liability company act modeled after the 1892 German GmbH Code. (17.6000) and the Panamanian limited liability companies. (1.451). The Wyoming Limited Liability Act permits the formation of limited liability companies organized for any lawful purpose except the business of banking and insurance. W.S. § 17-15-103. Essentially, a Wyoming limited liability company is a conventional non-corporate business entity that has filed Articles of Organization with the Secretary of State. Once filed it secures a notice to third parties that the individual members of the company are not personally liable for debt, obligations, acts, or liability of the company. While the legislative history for the Wyoming legislation is essentially non-existent the statute parallels the four characteristics of the European and Latin American Acts. The Wyoming Act has, besides limited liability, the **same four basic characteristics** of the European and Latin American Codes which distinguish this entity. **First,** Wyoming requires some use of the word "limited" in the entity's name. **Second,** the entity is given full juristic personality. **Third,** the partnership concept of "delectus or intuitus personae" is present that permits a partner to control admission of new partners to the partnership. **Fourth,** Wyoming's act provides that limited liability firms have to be dissolved by death of a member and provides for probate or sale of a deceased's share.

Florida, in 1982, adopted the act in an attempt to stimulate economic development and compete with the flow of investment money to the Central and South American countries:

> The purpose behind the legislation's enactment [limited liability company act] was to lure capital to the state in order to add to the economic base of Florida. In committee hearings it was disclosed that a motivating factor was to provide a

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[6] Ibid. pp 202-203.

[7] Burke and Sessions, "The Wyoming limited liability company: An alternative to Sub S and limited partnerships", 54 J. Tax 232, 233 (1981).

business vehicle to accommodate international investments from Central and South America.... It was thought that having a familiar business organization would attract foreign investment. Besides attracting international investment, it was also thought that the combination of limited liability and federal taxation as a partnership would encourage businesses to move to Florida. The committee reports were very optimistic as to the impact which the new entity would have on the business community.[8]

Private Letter Ruling 81-06082 (November 18, 1980) recognized a Wyoming limited liability company as a partnership for federal income tax purposes. Yet, it was not until 1988 that this entity came to adult life in the American states. Effective September 19, 1988, the United States Internal Revenue Service, after extensive study, issued a formal opinion on Wyoming's Limited Liability Company Act (Rev.Rul. 88-76, 1988 2 C.B. 360). This ruling dealt with classification of organizations for tax treatment. The IRS concluded that this limited liability company formed under the Wyoming act would be classified for federal tax purposes as a partnership. Partnership classification was given even though none of the members or managers were personally liable for any debts of the company.

Though the LLC may be in good standing under the state act, this IRS ruling sets forth the test with which it must comply to obtain the non-corporate tax treatment.

To retain the federal tax advantages of being classified or recognized for partnership tax treatment, rather than as a corporation, the IRS ruled that a limited liability company must avoid at least two of the four corporate characteristics identified in Treasury Regulation §301.7701-2. (See detailed discussion at 14.100.) **If more than two of these four characteristics are present in the entity, it will not receive partnership pass-through benefits.** The four IRS entity characteristics mandated by the IRS are:

1. **Continuity of Life.** A typical corporate characteristic is that the entity is perpetual or has continuity of life. Under most limited liability company acts, the limited liability company has a life of no more than thirty (30) years. Under all limited liability company acts, the company dissolves upon the death, retirement, resignation,expulsion, or other event that cancels the continued membership of a member. Revenue Ruling 88-76 (14.300) found the latter restriction sufficient, though the remaining members may agree to continue the business. It appears that the arbitrary 30 year limit is an unnecessary state restriction. The Virginia and the West Virginia Acts do not include this limitation. (17.5600).

2. **Centralization of Management.** A characteristic of a corporation is that the owners (shareholders) usually do not manage the corporation. Management vests in the Board of Directors and professional management hired by the Board of Directors. Absent other provisions in the statute or articles of a limited liability company, management shall be reserved to the members in proportion to their ownership interests. If all members retain management, the corporate characteristic

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[8] Johnson, "The Limited Liability Company Act", 11 Fla. S.L. Rev. 387 (1983-1984).

of centralization of management is avoided. If members manage the company, individual members (with or without actually authority) may contract debts and incur liabilities for the limited liability company without being personally liable, except, possibly to the LLC or the other members if that member acts in excess of actual authority. However, under the statutes, other management may be established in the Articles, but if management consists of less than all members, the corporate characteristics of centralization of management will be found by the IRS. (14.102).

3. **Limited Liability.** This characteristic is to be found in all limited liability companies.

4. **Free Transferability of Ownership Interest.** The corporate characteristic of free transferability of ownership interest is not present under Wyoming's or most states' Acts, where a member can assign only the right to share in the profits of the limited liability company:

> . . . if all of the other members of the limited liability company other than the member proposing to dispose of his or its interest do not approve of the proposed transfer or assignment by unanimous written consent, the transferee of the member's interest shall have no right to participate in the management of the business and affairs of the limited liability company or to become a member. The transferee shall only be entitled to receive the share of profits or other compensation by way of income. . . . W.S. § 17-15-122.

The Internal Revenue Service found this language sufficient to avoid the corporate characteristic of free transferability of ownership interest and all other state acts have similar language.

Issuance of the 1988 IRS ruling blessing Wyoming's Limited Liability Act caused many states to become actively interested in this commercial form. Florida (1982), Colorado (April, 1990),[9] Kansas (July, 1990),[10] Nevada (October, 1991),[11] Texas (1991),[12] Utah (July, 1991)[13] Virginia (1991)[14], West Virginia (1992)[15], Maryland

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[9] Colo. Rev. Stat. §§ 7-80-101 et seq.

[10] K.S.A. §§ 17-7601 et seq.

[11] 1991 Nev. Stat. 442.

[12] 1991 Tex. Gen Laws 901.

[13] Utah Code Ass. §§ 48-2b-101 et seq.

[14] Va. Code Ann. §§ 13.1-1000 et seq.

[15] W.Va. Code Ann. §§ 31-1A-1 et seq.

(1992)[16], Iowa (1992)[17], Oklahoma (1992)[18], Minnesota (1992)[19] and Illinois[20] have enacted limited liability acts. Indiana in 1990 and Georgia in 1992 have enacted legislation permitting the regis n of foreign limited liability companies.[21]

The Wyoming Act and its Revenue Ruling have become the focal point from which all states have premised their legislation. Section 7701 of the IRS Code and its accompanying regulations not only light the p h for legislation in this area but warn legislators that to vary significantly may result in lost federal tax benefits. **Compliance with the state act does not assure the desired tax treatment.**

Unfortunately, the Wyoming Act still uses the old corporate act language. This has caused most other states to venture into drafting exercises of their own, sometimes onto thin ice. Care must be taken to comply with the IRS guidelines (14.100) even though state statutes may offer greater latitude. Wyoming limited liability companies are created when two or more persons file duplicate original verified Articles of Organization with the Secretary of State. W.S. § 17-15-106. A "person" is defined as

> . . . individuals, general partnerships, limited partnerships, limited liability companies, corporations, trusts, business trusts, real estate investment trusts, estates and other associations. W.S. § 17-15-102 (a)(iv).

In some states the statutory definition of "person" encompasses more. (4.600).

Limited liability companies have several useful advantages over their nearest relative, the **S corporation.** (2.153.) Limited liability companies have (1) no citizenship requirements, (2) no limitation on the size or number of members, (3) no limitation of one class of shares, (4) no limitation on ownership of other corporations, and, (5) usually, no tax penalties on liquidation, and (6) it can avail itself of § 754 code elections.

Limited liability companies have significant benefits over **limited partnerships (2.151) by allowing** limited liability to all members, including those who participate in management. Wyoming Statute § 17-15-113 provides that: Neither the members of a limited liability company nor the managers of a limited liability company managed by a manager or managers are liable under a judgment, decree or order of a court, or in

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[16] MD Code Ann. §§ 4A-101 et seq.

[17] 1992 Iowa Stat. § 490A.125.

[18] Oklahoma Title 18-2000.

[19] Minnestota Limited Liability Company Act, Chapter 322B.

[20] Illinois Limited Liability Company Act, § 5-45.

[21] Ind. Code §§ 23-16-10.1-1 et seq.

any other manner, for a debt, obligation or liability of the limited liability company. All states have similar provisions.

The main disadvantage is the restriction on transferability of the full rights of membership. Yet, a minority shareholder in a corporation is also without a meaningful right to participate in the management of that entity. Unlike the S corporation, the LLC can have broad based ownership, including corporations and trusts.

The limited liability company is a new statutory entity in its own right, separate from the corporation or the partnership. Yet, some states have restricted its potential by grafting unnecessary corporate or partnership language into their limited liability statute. Perhaps the promised model act will not restrict the LLC potential. (16.100).

CAVEAT

WARNING! Blind use of these forms can be dangerous to your legal health. Prior to drafting Articles of Organization for the client, careful attention must be given to the entity being created, as it affects the desires and needs of the participants. Information along the lines of the "Client Questionnaire" and "Formation Checklist" found at page 2.300 of this book should be obtained. Once obtained, this material needs to be analyzed and discussed with the representatives of the proposed entity. A perfect world probably would contain a detailed Pre-formation Agreement which participants would sign acknowledging full disclosure by the attorney of all "opt in" features and default rules contained in the Limited Liability Company Act, and affirming that the Articles of Organization and Operating Agreement or other internal regulations contain those, and only those, features desired. The adopted Articles and Operating Agreement or other regulation amount to a contract of parties, whose interests, in certain details, may well differ.

Commodity Year Book. Commodity Research Bureau, Inc. Annual.
Daily Market Record. Daily.
Statistical Annual: Grains, Options on Agricultural Futures. Chicago Board of Trade. Annual.
United States Census of Agriculture. *Bureau of the Census*. Quinquennial. Most recent: 1982.

CORNER "Control or monopoly over a commodity or security to get control of or to dictate prices" (S. S. Pratt, "Work of Wall Street"). Technically, a corner occurs on a stock exchange when shorts cannot borrow stock, i.e., have sold more stock than the floating supply makes available for purchase. Those who have a corner can dominate the situation and dictate price terms to their unfortunate victims—the shorts who are forced to settle at artificially dictated prices, thereby incurring heavy losses. The two important corners in stocks were the Northern Pacific corner (1901) and the Stutz corner (1920).

Corners have been more frequent in grain than in stock speculation and in most cases have proved disastrous for their promoters. The three great corners on the Chicago Board of Trade are known as the Hutchinson corner (1888), the Leiter corner (1898), and the Patten corner (1909). An attempt to corner silver occurred in the 1980s.

A corner has been declared to be illegal by the courts for two reasons: it is a gambling transaction and contracts thereunder are therefore unenforceable, it is in restraint of trade.

Under the COMMODITY EXCHANGE ACT and its successor the Commodity Futures Trading Commission Act of 1974, the Commodity Futures Trading Commission can set limitations both upon the amount of speculative trading done daily by any one individual and upon the speculative net position, long or short, of any speculative account at any one time, and requires the reporting to it of any holdings in excess of certain amounts. Under the Securities Exchange Act of 1934, operations of the stock exchanges and their members, and of security brokers and dealers generally, are subjected to regulation of the Securities and Exchange Commission.

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CORN-HOG RATIO The number of bushels of corn equal in value to 100 pounds of hog, liveweight, which indicates at market prices the relative attractiveness to farmers of selling their corn or feeding it to their hogs for hog marketing.

In addition to the corn-hog ratio, the Department of Agriculture also regularly compiles other local market commodity-feed price ratios, such as the egg-feed ratio (pounds of laying feed equal in value to one dozen eggs), broiler-feed ratio (pounds of broiler grower equal in value to one pound of broiler, liveweight), turkey-feed ratio (pounds of turkey grower equal in value to one pound of turkey, liveweight), and milk-feed ratio (pounds of concentrate ration equal in value to one pound of whole milk).

CORN PIT *See* PIT.

CORPORATE AGENT A person or firm empowered to act for another. Banks serve as corporate agents for a fee in various capacities for corporations, state and local governments, municipalities, and persons, including the following:

1. **Stock transfer agent.** Banks maintain stock transfer books and shareholders' ledger when retained by a corporate client.
2. **Stock registrar.** Banks serve as stock registrars who countersign stock certificates and ensure that each certificate is properly issued.
3. **Coupon and bond paying agent.** Banks and trust companies occasionally pay maturing coupons and principal of corporate clients. Paid coupons and bonds are cremated and either a cremation certificate or the paid coupons and bonds are returned to the principal.
4. **Dividends disbursing agent.** Banks pay dividends to stockholders of record and provide a report to the corporation of such disbursements when retained to do so.
5. **Fiscal agent.** Banks serve as fiscal agent for a government, especially for taxes withheld that are deposited with it for the account of the government.

CORPORATE RECORDS Those records of a CORPORATION required by incorporation laws and pertaining to its corporate character. Among these are the certificate of incorporation, bylaws, book of minutes of the board of directors, stock book, stock transfer book, etc. Section 10 of the New York Stock Corporation Law requires that every stock corporation keep at its office correct books of account of all its business and transactions and a stock book showing the names of all persons, alphabetically arranged, who are stockholders of the corporation, their addresses, number of shares of stock held, the time when they became stockholders, and the amount paid thereon.

CORPORATE STOCK In municipal financing, sometimes used as the title for bonds of long-term maturity, with sinking fund retirement and other characteristics of bonds.

See MUNICIPAL BONDS.

CORPORATE TRUSTS *See* TRUST.

CORPORATION **The corporate form of business organization is dominant in the U.S. in manufacturing and wholesale trade both in number of firms and in operating terms (sales, employees). In retail trade and the service industries, corporations are in the minority numerically but account for more sales and employment than unincorporated firms (U.S. Bureau of the Census, U.S. Census of Business). This dominant position of the corporation as to size of operations underscores the major financial and managerial advantages of the corporate form. Financially, the corporate form structurally facilitates more extensive financing for a firm for the following reasons.**

1. **Limited liability.** When stockholders become investors in a corporation they can foretell the limits of maximum loss (the extent of the investment), without personal liability for debts of the firm, unlike the case for the proprietorship and the general partnership.
2. **Separability of investor and managerial motivations.** The investor who is not interested in active participation in management may invest in nonvoting stock or, where he invests in voting stock, may by proxy designate persons to vote for him in his name, place, and stead, in elections of directors and on other corporate matters. In either case, management may be delegated to others (the directors, who in turn appoint the officers). If the stockholder is so motivated, he may participate actively in election of directors or become a member of the board of directors and/or member of the officers to the extent that his voting power and qualifications justify. The corporation's capitalization may be appropriately proportioned as to debt, nonvoting stocks, and voting stocks.
3. **Divisibility and transferability of ownership.** The corporation's total ownership is divisible into an appropriate number of units (shares of stock) by the device of par value (or if no par value stock is issued, by number of shares with suitable stated value per share). Such conveniently sized units of ownership may be sold to a larger number of investors, as contrasted to total lump sum proprietorship interest or proportionate interests of partners. Further, a fundamental right of stockholders is to receive certificates of ownership, which may be readily assigned to new owners and/or transferred, heightening marketability.
4. **The absence of "delectus personae" among stockholders** (the personal right of general partners to choose their associates as partners). Each and every stockholder of a particular class of stock is entitled to all the rights and privileges applicable to all other holders of that class of stock. Existing stockholders cannot refuse to admit new stockholders to full status as such.
5. **Separate legal existence of the corporation as an entity, apart from its owners, creditors, and agents** (directors, officers, employees, etc.). Because the corporation may own, buy, and sell property in its own name; make contracts; sue and be sued in its own name; exercise all its express, implied, and incidental authorized powers, it may continue its separate existence, with its own financial integrity, apart from turnover of such individuals, pursuant to its charter. Such durability of existence facilitates long-term financing.

A *de jure* corporation is one formed in compliance with the pro-

visions of an incorporation statute. A *de facto* corporation is one formed without full compliance with all material, mandatory provisions of an incorporation statute.

Corporations are also classified as public or private. Private corporations may be stock or nonstock corporations. Stock companies normally operate for profit, while nonstock corporations such as certain hospitals and churches usually are not-for-profit organizations. Corporations also can be classified as follows:

1. Public corporations are government-owned entities such as the Federal Deposit Insurance Corporation.
2. Open corporations are private stock corporations whose stock is available to the public and is usually traded on a stock exchange (a listed corporation) or in the over-the-counter market (unlisted).
3. Closed corporations are private corporations whose stock is not offered for sale to the general public but is usually held by a few individuals.
4. Domestic corporations are incorporated in a particular state. Foreign corporations operate in a state other than the one in which they are incorporated.

Managerially, the corporate form, aside from its general advantage of assembling skills, money, and property, especially facilitates use of the line and line and staff types of internal organization for large-scale operations, making possible functionalization and decentralization of operations with centralization of responsibility and accountability maintained.

The rise of the corporation as the most important form of business organization was especially facilitated in the latter part of the last century by enactment of general incorporation statutes among the states, making it possible for any group of incorporators complying with the objective statute's requirements to form corporations freely. By contrast, the previous system of special acts of the legislatures for chartering corporations inhibited new incorporations by making it possible for existing corporate interests to block the new charters by political pressure.

The corporation is a creature of statute, both as to procedure for formation and subsequent exercise of permissible powers, but the corporation is legally protected against arbitrary impairment of charter powers by the sovereign, the state, because the corporate charter is a contract that the state of incorporation may not impair (*Dartmouth College* v. *Woodward*, 4 Wheat. 518 [1819]). The corporation, although a legal entity, has no freedom of movement, as natural persons have, to do business in any state; as a foreign corporation seeking to do business in other states, it may validly be required to be licensed and designate agent therein for service of process in case of litigation. As a creature of statute, the corporation may be subjected to nonarbitrary or discriminatory regulation, especially in such fields as banking, insurance, and other regulated lines of activity.

Since the corporation is a separate legal entity, it is itself the legitimate object of taxation, both federal and state, both organizational taxes (incorporation fees, annual franchise taxes) and operational taxes (income, property, and excise taxes). This leads to the disadvantage for stockholders of double taxation (the corporation pays taxes and stockholders pay income taxes on dividends declared and distributed). To the extent of properly retained earnings, the corporation may legitimately avoid such double taxation. Intercorporate dividends are taxed only at their tax rate on only 15% of the dollar amount, so that, for example, at a 46% tax bracket for the corporation, the net tax is 6.9%, which constitutes welcome relief from the double taxation. The giant corporation of modern times is likely to be either purely or partly a HOLDING COMPANY, owning interests in other corporations.

The growth of giant corporations led some early observers (e.g., A. A. Berle, Jr., and G. C. Means, *The Modern Corporation and Private Property*, 1933) to view with alarm the concentration of industry in relatively few corporations and, projecting such growth, to conclude that the giant corporation was a threat to government itself. Other observers viewed with misgivings the impersonal nature of the corporation, hiding its principals behind its corporate veil and giving rise to a new professional class—the managers—normally insulated against effective accountability to independent stockholders because of massive proxy voting. The dire projections of concentration, however, have been modified by growth of the economy as a whole. Proxy battles for control indicate the vulnerability of arbitrary managements; the emphasis by giant corporations upon stockholder relations and public relations indicates responsibility as compared with the predatory irresponsibility of the latter part of the nineteenth century. And government, with its proliferations of laws and administrative agencies in regulation of business, has not been taken over by the corporation.

See PARENT COMPANY.

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CORPORATION BONDS Obligations of a business corporation as distinguished from civil bonds, obligations of a governmentality (federal, state, or municipal government).

The soundness of corporation bonds depends upon many factors including the character of collateral offered, the character of the issuer, the nature of the industry, and the stability of its earnings. The market value of corporation bonds is primarily influenced by money rates in the case of highest grade obligations, and business activity and conditions in the case of lower grade issues, while civil bonds of fiscally sound public bodies are primarily influenced by the level of money rates.

See BOND, INDUSTRIAL BONDS, INVESTMENT, PUBLIC UTILITY BONDS, RAILROAD BONDS.

CORPORATION FINANCE The division of finance that deals with the promotion, organization, capitalization, financing, reorganization, and financial conduct of business corporations. "Corporation finance aims to explain and illustrate the methods employed in the promotion, capitalization, financial management, consolidation, and reorganization of business corporations" (S. E. Mead, *Corporation Finance*, 1910). The descriptive approach of pioneer texts, emphasizing legal and accounting aspects of the subject, continues to be fundamental in modern works, but added thereto has been more emphasis on theory and decision-making, particularly from case materials, accentuating the managerial approach.

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CORPORATION PAPER Notes, acceptances, and bills of exchange issued by corporations, as distinguished from paper issued by individuals and copartnerships.

CORPORATION: TAX FORMULA The computation of the federal income tax liability for a corporation is presented here:

Sample Certificate of Participation

No. _____

$ _____

CERTIFICATE OF PARTICIPATION
issued by
Blank National Bank of New York

has allotted to _____ Bank
in participation of _____
in a note for $ _____
made by _____
dated _____
with interest at _____ % per annum.

PARTICULAR AVERAGE In marine insurance, insurance with particular AVERAGE, without limitation of percentage, covers any partial loss resulting from marine perils.

PARTIES The parties to a check are the drawer, payee, drawee, and endorsers; to a draft or bill of exchange, the DRAWER, DRAWEE (called acceptor after he accepts it), payee (often the same party as the drawer), and endorsers; to a note, the MAKER, PAYEE, and endorsers.

PARTNER'S CAPITAL The amount of money contributed by the partners of a firm for investment in the partnership business. This term is also sometimes applied to the capital contributed by the stockholders of a corporation, presumably represented by the aggregate amount of preferred and common stock outstanding, as distinguished from the amount of capital represented by bonds and other forms of fixed indebtedness. Stocks are sometimes referred to as share capital, while bonds, notes, mortgages, debentures, equipment trust certificates, etc., are called loan capital.

PARTNERSHIP A general partnership is a form of business organization in which two or more persons (no limit as to the number) are associated as coowners for the purposes of business or professional activities for private pecuniary gain. Each general partner is a general agent for the others and may bind the partnership for acts within the scope of the partnership's business. It is a contractual relationship needing no written partnership agreement to arise. It is preferable, however, to prepare written articles of copartnership, especially in order to define the duties of each partner and respective authorities which will be binding as among the partners and to specify the agreed sharing of profits and losses which otherwise in the absence of specification will be implied to be equal.

As distinguished from the corporation, the general partnership requires no formal legal proceedings in the form of charter or franchise from the state, although legal incidents of the general partnership have been enacted by all states except Georgia and Louisiana by their versions of the Uniform Partnership Law, declaratory of common law principles which will otherwise prevail in other jurisdictions which have not enacted statutes. Moreover, the general partnership has no separate legal existence apart from the partners, and so is not taxed as a firm for income tax purposes as is the corporation. Because of such lack of legal entity, however, the general partnership is subject to unlimited personal liability by the general partners for any of the partnership debts, each general partner being jointly and severally liable for the firm debts. In recovering from personal assets of the partners, however, firm creditors are subject to the rule of marshaling of assets, pursuant to which personal creditors have first claim upon personal assets in the event of conflict as to priorities. In turn, personal creditors are subject to the firm creditors' first claim upon firm assets. In addition, because of the lack of legal entity for the general partnership as a firm, the firm's existence is very fragile, being subject to *dissolution* (not necessarily *liquidation* in each case) by reason of the death, withdrawal, bankruptcy, or legal disability of any of the general partners. Usually such lack of permanence of duration of the firm is a disadvantage insofar as long-term firm financing is concerned. This factor, as well as the divisibility of ownership into conveniently sized units (shares) enjoying limited liability and transferring readily without legal difficulty, makes the corporation the feasible form of business organization where substantial external financing is required for a firm.

Unlike the general partnership, the limited partnership is purely statutory and will arise by implication and without written articles of copartnership. A limited partnership is formed by express written agreement, pursuant to statute of the home state, between one or more general partners and one or more limited partners. The limited liability feature applies only to the limited partners, provided they are merely investors in the firm and actually do not have a voice in the management. The general partners in the limited partnership are subject to all the legal incidents of general partnership law. Most states have enacted their versions of the Uniform Limited Partnership Act. A limited partnership, like the corporation and unlike the general partnership, has no freedom of movement and will be simply a general partnership in any jurisdiction other than the home state of creation. State procedural requirements for the creation of the limited partnership, including the filing of a certificate or articles of partnership and publication thereof, are not onerous. Specific compliance, however, is necessary in order to achieve limited liability for the limited partners. Moreover, the limited partners' claims as to withdrawal of capital investment, sharing in profits, or withdrawal of loans to the firm must not impair the ability of the firm to provide for firm creditors. As investor-partners, however, limited partners enhance the financial resources of a partnership, the usual motivation for such form of organization. The disadvantage of impermanence of the firm because of the dissolution incidents of the general partnership will also apply to the limited partnership insofar as the general partners are concerned. As far as the limited partners are concerned, their withdrawal pursuant to agreement or transfer of their interest will not work a dissolution of the firm. A limited partner may legally demand a dissolution, however, if after notice and without injury to the claims of creditors, the return of his investment is not forthcoming.

Other forms of partnership are the following:

1. The joint venture modified as to (a) limitation of existence for a single undertaking or specified period, and (b) centralized authority in the manager.
2. The mining partnership modified as to (a) coownership only as to profits, tenancy in common of the individuals as to the mine; (b) possibility of issuance of stock for transferable ownership interests in the mine; (c) no general agency authority in each of the partners to bind the partnership within the scope of the business, a manager usually having limited authority for necessary labor, supplies, etc.; and (d) personal liability of partners for firm debts incurred while they were owners or until notice of retirement is given to creditors.
3. The limited partnership association modified as to (a) formal organizational procedure, akin to that of the corporation, including organization tax; (b) legal entity for the firm so that limited liability applies; (c) division of the capital into shares of stock; (d) election by the shareholders of a board of managers or directors akin to that of the corporation; (e) transferability of stock subject to the requirement that new shareholders must be accepted by a majority of the existing stockholders in order to vote. Should the new shareholder be denied election, he may, pursuant to law, demand the purchase of his shares by the association, either by negotiations or pursuant to appraisal by court-appointed appraiser. This requirement for cash might prove embarrassing to the liquidity of the firm. Like the limited partnership and corporation, the limited partnership association is a creature of statute of the home state and will not have freedom of movement as such into other states. Only four states provide for this variation of the partnership, with their own variations of the form in each case.

Partnerships are treated as separate accounting entities from the partners. A partner's capital interest in a partnership is a claim against the net assets of the partnership as reflected in the partner's capital account. A partner's interest in profit and loss determines how the partner's capital interest changes as a result of subsequent operations.

Advantages associated with the partnership form of business organization include the ease of formation and dissolution, its ability to pool capital and personal talents and skills, its nontaxable status for income tax purposes, and the relative freedom and flexibility partners enjoy in business matters. Disadvantages of

partnerships include their limited life, the ability of a partner to commit the partnership in contractual matters, the unlimited personal liability of partners, and the difficulties of raising large sums of capital and of transferring ownership interests as contrasted with the corporate form of business organization.

A person may become a partner in an existing partnership by purchasing an interest from one or more of the existing partners by investing cash or noncash assets in the partnership. A person can be admitted to a partnership only with the consent of all continuing partners in the new partnership enterprise.

The tax bases for assets contributed by the partners to the partnership are the same tax bases that applied to the individual partner making the contribution. The tax basis of a partner's interest in capital of a partnership is the sum of the tax bases of the assets contributed by the partner, increased by the personal liabilities of other partners which the partner assumes, and decreased by the partner's personal liabilities assumed by other partners. The sum of the tax bases of the partnership assets equals the sum of the tax bases of the partners' separate interests in capital.

Summary. Numerically, business firm population in the United States is about 80% simple proprietorships, with 10% partnerships and 10% corporations. Corporations account for the bulk of business assets, sales, and employment in the aggregate. This reflects their advantages for assembling large aggregations of capital. The partnership form is required in some states for firms involved with professional responsibility of a personal nature to clients. Law and accounting firms are often formed as partnerships.

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PAR VALUE Face value or nominal value.

Bonds. The par or face value of a bond is the principal amount (denomination) at which the obligor (issuing corporation) contracts to redeem the bond at maturity. It is also the basis upon which the cash interest rate on the bond is computed. Although bonds are usually originally issued at an interest rate sufficiently attractive to assure their sale approximately at par or at slight discount, they will subsequently fluctuate in accordance with the trend of money rates and yields (if high-grade) and general business conditions (if second-grade or speculative) and earnings available for charges of the issuer. Whether a bond commands an open market premium or discount, the closer it approaches maturity, the closer the market value should approximate the par value, unless there is serious question about the ability to repay or refund by the issuer. At the date of maturity, it should be worth precisely par, since that is its redemption value. In the United States, business corporation bonds are usually issued in denominations of $1,000, although $500 and $100 denominations are not infrequent. Higher denominations such as $5,000 and $10,000 occur in relatively fewer instances, designed for institutional investors.

Stocks. The par or face value of shares of stock is not uniform, although $100 was formerly the most common par value. Shares may be given any specified par value, e.g., $50, $25, $10, and even smaller or odder denominations especially as the result of split-ups. In speculative enterprises, such as in the oil and mining industries, the par value of shares is usually small, and in turn the number of shares on a given dollar amount of capital is large. This is done in order to attract a wider market than would be possible if shares were of higher par value and hence there were fewer shares on a given dollar amount of capital, resulting in higher per-share figures for earnings, asset value, dividend (if any), and market price. In many states, shares may be issued without par value, in which cases the shares are assigned a stated or declared value for purposes of the capital stock account. In relatively rarer cases, par value of business corporations may be a multiple of $100, e.g., $500, $1,000, etc.; this may be done by privately owned or closely held corporations to restrict the number of holders. The significance of par value is that it must be fully paid (in the case of business corporations, issuable for cash, property, or services) in order that the stock may attain nonassessable status (limited liability). In the case of no par value shares, the subscription price must similarly be fully paid, even though the stated or declared value may be a fraction of the subscription price. But the subscription price on subsequent issues may be varied flexibly in line with market conditions as compared with the rigid par value requirement in the case of par value shares.

The treasury stock device in connection with the promotion of new speculative enterprises has been rendered obsolete by no par value shares and by fractional par values (something less than $100). That device would call for issuance of stock to the promoter for his services (subject to a test of reasonableness of the value thereof) at full par value. Next, the promoter would then donate back to the corporation a portion of his holdings, allowing the corporation thereafter to sell the treasury stock thus donated at any price to investors in the speculative venture, such resold treasury stock being entitled to fully paid and nonassessable status (having been originally issued at full par value). Thus the new corporation would be able to raise cash needed for the venture.

See without par value stock.

PASS A DIVIDEND When a board of directors omits to declare a regular or expected dividend, it is said to pass a dividend.

PASSBOOK A bank book; a book in which deposits, or deposits and withdrawals, are recorded. Passbooks are provided for both commercial and savings accounts. In commercial checking accounts the passbook is merely a memorandum of deposits. It is neither a book of original entry nor a statement of account. The deposit slip is the original entry and the important record from a legal point of view. Unlike the savings bank passbook, the nonsavings account passbook is not a contract. Entries should not be considered as absolute receipts admissible as court records, but rather as acknowledgments of receipts of deposits corresponding in amount to the footing of the accompanying deposit slips. It is not necessary to present a passbook when making deposits in a commercial checking account. It is only necessary to fill out a deposit slip, a duplicate being rendered if desired. The acceptance of a deposit for absolute receipt and credit, except for cash, is usually conditional upon the collection and payment of such deposit. Deposits of checks, in other words, are subject to final payment and therefore to cancellation of credit for such portions as may be returned unpaid.

In order that commercial depositors may understand the purpose of a passbook and the conditions under which deposits are accepted, a notation such as the following should be imprinted on the flyleaf.

> This passbook is issued for the convenience of customers and is intended for a record of deposits only. It is not a book of original entry, nor a statement of account. Statements of account will be rendered monthly.
>
> All items, other than money, are subject to cancellation of credit if not paid on presentation. It must be understood that the liability of the bank is limited to the observance of due diligence in selecting its immediate correspondents for the presentation and collection of items in this city and elsewhere and that the endorsement "Pay to any bank or banker," or its equivalent, shall not exceed such liability, and this bank will not be responsible for loss of any kind due to the acts of negligence of such correspondents in the selection of subagents for presentation and collection, etc., or for loss in or through the mails, or for any failure to present, demand, or collect on any Saturday or holiday.

The status of a savings account passbook is legally very different from that issued for a checking account. In savings bank practice, it is used as a voucher or receipt, both for money deposited and for money withdrawn. It must be presented whenever a deposit or withdrawal is made, and periodically for the credit of interest

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Table 1 / Life Insurance—Insurance in Force and Benefit Payments by State: 1986
(Policies to policyholders and payments in the U.S.)

Division, State	Insurance in Force			Benefit payments [1]
	Policies (1,000)	Value (bil. dol.)	Average per household (dol.)	(mil. dol.)
	394,883	7,452	82,800	71,432
	83,229	1,686	89,800	19,665
Southeast	97,407	1,854	83,700	18,907
Southwest	154,709	2,496	80,800	20,562
South	59,538	1,416	77,800	12,298
West	20,893	443	92,500	4,567
New England	1,935	31	68,800	291
Maine	1,667	30	85,000	305
New Hampshire	852	15	73,600	169
Vermont	8,755	200	91,300	2,108
Massachusetts	1,823	31	85,300	304
Rhode Island	5,861	123	111,700	1,390
Connecticut	62,336	1,247	88,900	15,098
Middle Atlantic	27,958	590	87,800	7,498
New York	12,042	286	102,000	3,365
New Jersey	22,336	367	82,500	4,235
Pennsylvania	69,832	1,304	84,200	13,690
East North Central	18,451	334	82,900	3,483
Ohio	9,099	161	78,500	1,641
Indiana	19,907	388	90,800	4,160
Illinois	14,510	283	84,400	2,981
Michigan	7,865	138	77,100	1,425
Wisconsin	27,575	550	82,500	5,217
West North Central	6,221	119	87,500	1,252
Minnesota	4,578	86	80,200	998
Iowa	8,324	153	88,100	1,402
Missouri	991	21	87,000	154
North Dakota	905	19	73,000	178
South Dakota	2,427	52	84,600	525
Nebraska	4,129	80	84,700	708
Kansas	79,754	1,281	81,800	10,898
South Atlantic	1,313	26	109,000	238
Delaware	8,192	154	92,700	1,534
Maryland	2,053	46	185,600	337
District of Columbia	13,284	203	93,500	1,471
Virginia	3,090	40	56,900	435
West Virginia	13,498	186	77,900	1,517
North Carolina	7,757	96	79,800	664
South Carolina	12,646	208	92,200	1,427
Georgia	17,921	322	67,300	3,275
Florida	32,949	412	73,800	3,325
East South Central	6,069	86	62,800	710
Kentucky	9,988	143	78,600	1,348
Tennessee	12,704	123	83,200	849
Alabama	4,188	60	70,000	418
Mississippi	42,006	803	79,000	6,339
West South Central	2,766	47	67,000	401
Arkansas	9,065	129	82,600	1,031
Louisiana	4,445	87	96,700	916
Oklahoma	25,730	540	90,500	3,991
Texas	19,007	370	77,500	3,214
Mountain	1,109	21	67,800	197
Montana	1,308	23	65,000	215
Idaho	630	13	74,900	125
Wyoming	5,303	113	90,000	942
Colorado	1,858	36	68,400	308
New Mexico	5,057	94	75,400	865
Arizona	2,437	45	87,600	364
Utah	1,305	25	62,800	198
Nevada	40,531	1,046	77,900	9,084
Pacific	5,025	125	71,100	1,135
Washington	3,310	68	63,300	674
Oregon	29,674	800	79,400	6,832
California	656	15	84,800	123
Alaska	1,866	38	112,000	320

[1] Includes death payments, matured endowments, disability and annuity payments, surrender values, and policy dividends.

Source: American Council of Life Insurance, Washington, DC, *Life Insurance Fact Book*, annual.

LIMIT The definite price fixed by a customer in an order placed with a broker to buy or sell securities or commodities. A limit order is to be executed at the limit or better; e.g., a buy order for a round lot of X(U.S. Steel) at 70 shall be executed at a price of $70 per share or less; or a sell order of a round lot of J (Standard Oil of New Jersey) at 42 shall be executed at price of $42 per share or higher.

See ORDERS.

LIMITATIONS *See* ACCEPTANCE CREDIT, NATIONAL BANKING SYSTEM, STATUTE OF LIMITATIONS.

LIMITED COMPANY The term "Company," "Co.," "& Co.," or "& Company" in a firm title, without further wording indicating that the firm is corporate in nature, may indicate either a general or a limited partnership. In the latter form of business organization, which shall consist of one of more limited partners and one or more general partners, the limited partner(s) is not liable personally for firm debts, being limited in his liability to his investment in the firm.

The term "limited" in English terminology refers to the corporation whose stockholders, provided they hold fully paid and nonassessable shares, are not liable personally for firm debts. In American practice, the corporate form of organization is indicated by reference to "Corporation," "Corp.," "Incorporated," or "Inc." in the firm title.

Limited partnership associations are provided for statutorily in four states in the U.S. This type of organization is corporate in nature, with limited liability, division of ownership into shares of stock, and voting for a board of directors or managers. The shares may be transferred, but the transferee must be elected to membership by majority of the members and of the total shares of stock in order to be entitled to the voting privilege. A quirk of this form is that such transferee not elected to membership is entitled to the firm's purchase of his shares at fair value.

The business trust, also called the Massachusetts trust, may also enjoy limited liability for its beneficiaries (holders of transferable certificates of beneficial interest in the trust), but if such beneficiaries have the power of voting for the trustees, limited liability fails because of violation of the basic principle of the trust (power of beneficiaries to vote for or fail to reelect trustees implies control over legal title to the corpus [assets] and hence a merger of the legal and equitable interest), and so a mere partnership may be deemed to result, with personal liability for firm debts.

See CORPORATION, LIMITED LIABILITY.

LIMITED LEGAL TENDER *See* LEGAL TENDER, TOKEN MONEY, UNITED STATES MONEY.

LIMITED LIABILITY The liability of stockholders of the ordinary business corporation extends no further than to payment of the full par value of the issued and outstanding capital stock, such limited liability being one of the principal advantages of the corporate form of business organization. However, even for limited liability corporations, state statutes provide that every holder of shares of stock not fully paid shall be personally liable to the creditors of the corporation to an amount equal to the amount unpaid on the shares held by him for debts of the corporation contracted while such shares were held by the stockholder. Also, state statutes, e.g., New York's, provide that the stockholders of every stock corporation shall jointly and severally be liable personally for all debts due and owing to any of the corporation's laborers, servants, or employees other than contractors for services performed by them for such corporation under specified conditions.

National banks and state banks and trust companies once carried DOUBLE LIABILITY on their stock, stockholders being subject to assessment up to the par value of their shares in addition to losing their original investment. In accordance with the Banking Acts of 1933 and 1935, double liability for national bank stock has been ended, and most states have provided similar legislation for state banks and trust companies.

See LIMITED COMPANY.

LIMITED ORDER Limit order; a buy or sell order placed with a broker for execution at a specified price. Execution is to be effected at the limit or better.

See ORDER.

LIMIT OF TOLERANCE *See* LIGHT GOLD, TOLERANCE.

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FEB 25 1994

February 22, 1994

House Judiciary Committee
Alaska State Legislature
State Capitol
Juneau, AK 99801-1182

Re: Limited Liability Company Bill

Dear Sirs:

On February 17, 1994 the Board of Directors of the Alaska Society of Certified Public Accountants unanimously voted to endorse the Sponsor Substitute for House Bill 420, the introduction of legislation allowing businesses to form and operate as a Limited Liability Company in the State of Alaska.

The membership of the Alaska Society of Certified Public Accountants is State wide. The Board is representative of the membership.

In order for the State to continue to grow through new commerce, it is important that there is flexibility in the type of entity a business can form. The State should be able to offer the same type of entities as any other state offers (right now there over 30 States that allow Limited Liability Companies).

We look forward to the passage of this law in a swift and expedient manner. Businesses that want to operate as a Limited Liability Company may not wait for the legislature, and will seek an operating "home" in some other state.

Very truly yours,

William D. Arnold
President

cc: Wilda Whitaker

PEGGY MENTELE
324 E. Cook
Archorage, AK 99501

March 2, 1994

FAX: 465-6790

Representative Bill Hudson
Chairman, House Committee On Labor and Commerce
State Capitol, Room 108
Juneau, AK 99801-1182

Dear Representative Hudson:

Sponsor Substitute for House Bill 420 deals with a new form of business entity, limited liability companies. I would like to express my support for this bill and hope it will be scheduled for a hearing as soon as possible. This form of business entity would provide Alaskan business investors with partnership tax treatment along with corporate-type limited liability.

Very truly yours,

Peggy Mentele

kah/3472:XKAH
cc: Brian Porter
Joe Green
Eldon Mulder

JAMES M. GORSKI
10243 Stewart Drive
Eagle River, AK 99577

March 2, 1994

FAX: 465-6790

Representative Bill Hudson
Chairman, House Committee On Labor and Commerce
State Capitol, Room 108
Juneau, AK 99801-1182

Dear Representative Hudson:

I would like to express my support for Sponsor Substitute for House Bill 420 on limited liability companies currently before your committee. It is my hope that this legislation can be passed this session.

Limited liability companies are a relatively new business form in many of the Lower 48 states. This entity gives business investors partnership tax treatment while at the sametime providing corporate-type limited liability. I believe this would further business development and investment in Alaska.

Very truly yours,

James M. Gorski

kah/3472:XKAH
cc: Brian Porter
Joe Green
Eldon Mulder

HB
439

HOUSE COMMITTEE REPORT

(7)

Date Referred: February 4, 1994 FURTHER REFERRALS: Judiciary

Date of Committee Action: 3/01/94

The LABOR AND COMMERCE Committee considered: HB 439

HOUSE BILL NO. 439 UNIFORM FRAUDULENT TRANSFER ACT

"An Act enacting the Uniform Fraudulent Transfer Act."

RECOMMENDATIONS: [ ] the same title
be replaced with _____ [ ] a new title

[ ] have attached amendments(s)
[✓] do pass
[ ] do not pass
[ ] no recommendations
[ ] individual recommendations
[ ] additional referral to the _____ Committee

ADOPTS: _____ letter of Intent

ATTACHES NEW FISCAL NOTE(s): (Dept) APPROVES PREVIOUS: (Dept/Date)

[ ] fiscal impact _____ [ ] fiscal note(s) _____

[X] zero fiscal note LAW [ ] zero fiscal note(s) _____

SIGNING DO PASS	DP	OTHER RECOMMENDATIONS	DNP	NR	AM
Brian D. Porter	✓				
Joan Hap	✓				
Ted S. Williams	✓				
Tom Keed	✓				
Bill Hudson	✓				

Bill Hudson
CHAIRMAN'S SIGNATURE

Alaska State Legislature

House of Representatives
House Judiciary Committee

P. O. Box V
State Capitol
Juneau, Alaska 99811
(907) 465-4990
(907) 465-4712

SPONSOR STATEMENT

HB 439 UNIFORM FAUDULENT TRANSFER ACT

Obligation to a financial debt is reinforced by law. Or is it? If a person acquired debt should (s)he be able to manipulate the assets so that creditors will be deprived of their value when (s)he defaults on the debt? The Uniform Fraudulent Transfer Act (UFTA) works as a *deterrent*, preventing such transgressions against obligations incurred. This Act provides creditors with a *remedy* when debtors transfer or hide assets that would otherwise be available to satisfy legitimate debts.

Current Alaska law in this area was adopted in 1949 from the state of Oregon and has received little legislative attention. Nevertheless, many changes in both state and federal law, particularly in the area of bankruptcy, and relationships between creditors and debtors have become more complex. In fact, Alaska law provides that a conveyance of real or personal property will be void if it was made "with the *intent* to hinder, delay or defraud creditors." AS 34.40.010. The existence of this fraudulent intent is a question of fact and the burden of proof is upon the plaintiff (Summers v. Hagen __ P.2d __, No. 3961, May 28, 1993). This burden of proof can be extremely hard to prove.

UFTA would eliminate the present Alaskan necessity of finding actual intent by a property transferor to hinder, delay or defraud a creditor in many situtations where the transferor is obviously transferring assets solely to keep them out of the reach of the transferor's creditors. This Act renders a transfer made or obligation incurred without *adequate consideration* to be constructively fraudulent. UFTA sets out numerous non-exclusive factors to be considered by the court when determining if the debtor had "actual intent." The transferee's "good faith" defense is irrelevant. Consequently, UFTA defines insolvency and establishes a new category of fraudulent transfers, namely, a preferential transfer by an insolvent "insider" (i.e., relative or a person in control of the debtor) to a creditor who had reasonable cause to believe the debtor to be insolvent.

Thirty-two (32) states have adopted UFTA into their laws. Uniformity has become not only a question of law between states, but also between state and federal law. Without *uniformity*, credit becomes less available, and the credit mechanism is less reliable. The Uniform Fraudulent Transfer Act takes into account the considerable development in both law and practice in creditor-debtor relationships.

A Few Facts About

THE UNIFORM FRAUDULENT TRANSFER ACT

PURPOSE: Providing a creditor with the capacity to procure assets a debtor has transferred to another person to keep them from being used to satisfy the debt.

ORIGIN: The Uniform Fraudulent Transfer Act, completed by the Uniform Law Commissioners in 1984, revises the Uniform Fraudulent Conveyance Act of 1918.

ENDORSED BY: American Bar Association

STATE ADOPTIONS:

30

Alabama	Maine	Ohio
Arizona	Minnesota	Oklahoma
Arkansas	Missouri	Oregon
California	Montana	Rhode Island
Colorado	Nebraska	South Dakota
Connecticut	Nevada	Texas
Florida	New Hampshire	Utah
Hawaii	New Jersey	Washington
Idaho	New Mexico	West Virginia
Illinois	North Dakota	Wisconsin

1993 INTRODUCTIONS: Virginia

For any further information regarding the Uniform Fraudulent Transfer Act, please contact John McCabe or Katie Robinson at 312-915-0195.

(4/15/93)

THE UNIFORM FRAUDULENT TRANSFER ACT

by

FRED H. MILLER
Professor of Law at the University of Oklahoma

Section by Section Analysis of the Act

Section 1 contains definitions. Section 2 also contains the definition of "insolvent," and Section 3 the definition of "value." The definition of "asset" in Section 2(2), together with the latter definitions of "insolvent" and "value," in a general sense formulate the core concept of the act: the transfer of an asset (or incurring an obligation) for inadequate value by an insolvent debtor or one rendered insolvent by the transaction is a fraudulent transfer. Subsection 3(B) is worth particular note in this respect because it overrules for state law the controversial holding in Durrett v. Washington Nat. Ins. Co., 621 F.2d 201 (5th Cir. 1980), that a regularly conducted mortgage foreclosure that produces a price "too low" may be avoided as a fraudulent conveyance. By clouding property titles the Durrett rule virtually is a self-fulfilling prophecy.

Section 4 Subsection a(1) states the basic rule of the act: a transfer made or an obligation incurred with actual intent to hinder, delay or defraud creditors is actionable by creditors. How does a creditor prove the debtor's actual intent? Subsection b sets out "badges of fraud" if several of these appear it is strong evidence. Subsection a(2), on the other hand, sets out two cases where the law decrees the intent exists if the facts are as stated.

Section 5 states two further cases where the law decrees the transaction is fraudulent, but only as to present creditors and not also as to creditors arising later as is the case for transfers covered by Section 5.

Section 6 defines when a transaction occurs. It occurs when it can prejudice the rights of third parties, and not when it actually occurs between the parties to it. For example, a creditor does not need this act to set aside a fraudulent security interest that is never filed; the creditor can defeat that interest under the Uniform Commercial Code. Subsection 5 of this Section also states the time when an obligation is incurred.

Section 7 describes the remedies a creditor has to attack and avoid a fraudulent transfer or obligation.

Section 8, however, protects a good faith purchaser for reasonably equivalent value who did not share in the debtor's fraudulent purpose and subsequent good faith transferees for value who are sufficiently remote. Subsection (d) also gives a good faith transferee or obligee against whom the transaction can be avoided protection for any value given.

Subsection (e) is important as protecting lease terminations and security interest enforcement against "Durrett type" attacks, and Subsection (f) allows "workouts" and the like to occur.

Section 9 prescribes statutes of limitation specifically for the act.

Section 10 states the act is supplemented by other law and Section 11 specifies that in interpreting the act, precedent from other states that have enacted it should be used to maintain uniformity.

Section 12 provides the title.

Section 13 repeals the current statutes on the subject, including any old predecessor versions of this act.

WHY STATES SHOULD ADOPT
THE UNIFORM FRAUDULENT TRANSFER ACT

Are we only as good as the extent to which we honor our obligations? Many would argue for this proposition. And when our obligations are financial, the argument is reinforced by law. It is to this proposition that the Uniform Fraudulent Transfer Act is addressed. If we have acquired debt we should not be able to manipulate our assets so that creditors will be deprived of their value when we default on our debt. We should not be able to plan an artificial insolvency by transferring assets to others against the interests of our creditors.

The Uniform Fraudulent Transfer Act works as a deterrent, preventing such transgressions against obligations incurred, and provides creditors with a remedy when debtors transfer or hide assets that would otherwise be available to satisfy legitimate debts.

While the issue of obligation is preeminent, the economic issue is no less important. Credit is essential to the economic life of this country. Consumer credit, commercial credit, secured and unsecured credit enter into our lives, everyday. Credit remains available so long as those who extend it are given certain assurances about their rights at default. The Uniform Fraudulent Transfer Act provides assurances to creditors that help make credit available to all of us.

This economic issue leads directly to the issue of uniformity. The availability and the health of the credit mechanism require national standards. The principles of the old Uniform Fraudulent Conveyance Act became applicable to every person in every state because it was incorporated into the Federal Bankruptcy Act. Much of what is in the newer Fraudulent Transfer Act duplicates the Bankruptcy Reform Act of 1978. Uniformity has become not only a question of law between states, but also between state and federal law. Without uniformity, credit becomes less available, and the credit mechanism is less reliable. To avoid confusion and expense, the same rules must apply throughout the country. Public expectations are the same in every state and jurisdiction.

Associated with the issue of uniformity is the issue of modernity. The original Fraudulent Conveyance Act, which the Fraudulent Transfer Act replaces, was promulgated in 1918. Changes in federal bankruptcy law, in creditor-debtor relations in general, even in the rules governing the conduct of lawyers, make it clear that a modernization is overdue. The Uniform Fraudulent Transfers Act answers that immediate need.

UNIFORM FRAUDULENT TRANSFER ACT

When we say a person "owns" something, we tend to think in all or nothing terms. Whatever a person owns is at that person's disposal - to sell, to give, to abandon, or to pledge as security for a debt. But relationships between people over property are never so simple or so unqualified. A creditor-debtor relationship, for example, may materially change an owner's power over the property owned. A mortgage, clearly, restricts what an owner may do with mortgaged real estate. The creditor has legally protected rights in the real estate securing the debt. Under Article 9 of the Uniform Commercial Code, secured creditors, also, obtain rights in collateral that are protected.

A less clear category, but important to the maintenance of credit, is that of the unsecured creditor-debtor relationship in which the debtor manipulates property to defeat the creditor's interest solely for that purpose and for no other. Perhaps the debtor foresees insolvency and tries to conceal property that a creditor might use to satisfy the debt. Perhaps the debtor never intends to satisfy the debt and manipulates property to make himself judgment-proof. Should the creditor be without recourse, and should the debtor's rights to deal with property be unrestricted in these kinds of cases?

The National Conference of Commissioners on Uniform State Laws (ULC) proposed the Uniform Fraudulent Conveyance Act (UFCA) in 1918 as an answer to that question. It was created to supersede the Statute of 13 Elizabeth which was enacted in some form by many states, and which introduced the concept of the fraudulent conveyance into the law of every American jurisdiction, with or without enactment. The UFCA was adopted in twenty-six states, and its provisions were incorporated into the Federal Bankruptcy Act.

In 1984, this 1918 Act was revised and renamed the Uniform Fraudulent Transfer Act (UFTA). The intent of the UFTA is the same as the UFCA - it classifies a category of transfers as fraudulent to creditors and provides creditors with a remedy for such transfers. The fundamental remedy is the recovery of the property for the creditor. Why a new Act at this time? The terminology of the UFCA had become considerably archaic, and needed to be modernized. The Bankruptcy Reform Act of 1978 changed the federal law on fraudulent transfers in significant ways, and made it imperative to reconsider state law. And creditor-debtor relationships have changed and become more complicated, so that the whole issue of fraudulent transfers needed rethinking. In 1984, the UFTA is ready to promote the modernization of this subject area of law.

UFTA creates a right of action for any creditor against any debtor and any other person who has received property from the debtor in a fraudulent transfer. A fraudulent transfer occurs when a debtor intends to hinder, delay, or defraud a creditor, or transfers property under certain conditions to another person without receiving reasonably equivalent value in return. But not all such transfers are fraudulent to every creditor.

UFTA distinguishes between present and future creditors, and specifies the kinds of transfers that are fraudulent to each of the two categories of creditors. Both present and future creditors may recover property when there is a transfer with intent to defraud. Both may recover when a transfer is made without receiving reasonably equivalent value when the result is to make the debtor's assets unreasonably small in relation to the business or transaction in which the debtor is engaged or about to be engaged. Also, present and future creditors can both recover when a debtor transfers property without receiving reasonably equivalent value when intending to incur debts beyond the ability to pay.

Present creditors, however, can recover property when it is transferred by a debtor to another person without receiving reasonably equivalent value if the debtor is insolvent or becomes insolvent as a result of the transfer. A transfer to an "insider" without receiving reasonably equivalent value when the debtor is insolvent, is also fraudulent to present creditors. The term "insider" is defined, and is someone with a special relationship to the debtor. Examples are relatives or business partners (when the debtor is a partner). To be liable, an "insider" must have reasonable cause to believe that the debtor is insolvent.

The fundamental relief for a creditor when there is a fraudulent transfer is recovery of the property from the person to whom it has been transferred. UFTA allows "avoidance of the transfer or obligation to the extent necessary to satisfy the creditor's claim...." Whatever is necessary to obtain the property is provided for, including attachment, injunctive relief, appointment of a receiver, or "any other relief the circumstances may require." If the creditor has reduced the claim to a judgment, the court may levy execution against the recovered assets. This means that the property can be sold to satisfy the amount of the judgment.

Much of the UFTA resembles the UFCA, its predecessor. What, then, are some of the differences? (A more detailed comparison is available from the ULC.) To begin with, the term "transfer" taken from the Federal Bankruptcy Act replaces the term "conveyance." UFCA uses the term "fair consideration" instead of "reasonably equivalent value." "Reasonably equivalent value" does not include the element of good faith as "fair consideration" does, and is more sharply defined than "fair consideration" is in the UFCA. UFTA overcomes the problem raised in the case of

Durrett v. Washington National Insurance Co., 621 F.2d 201 (5th Cir. 1980), a case that jeopardized mortgage foreclosure sales. Under UFTA, a properly conducted foreclosure sale is not a fraudulent transfer, notwithstanding the fact that it does not recover an amount somewhat near the actual market value of the property. The concept of the "insider" is new in the UFTA. UFTA provides for defenses of transferees and for a statute of limitations. Both issues are not addressed in the UFCA.

The Uniform Fraudulent Transfer Act continues the concept of a civil action for transfers fraudulent to creditors first created in the Statute of 13 Elizabeth, and comprehensively continued in the Uniform Fraudulent Conveyance Act. The new Act takes into account the considerable development in both law and practice in creditor-debtor relationships since 1918. The ULC hopes that it will be adopted uniformly in all states.

WALTER J. HICKEL, GOVERNOR

REPLY TO:

☐ 1031 W 4th AVENUE SUITE 200
ANCHORAGE, ALASKA 99501-1994
PHONE: (907) 276-3550
FAX: (907) 276-3697

☐ KEY BANK BUILDING
100 CUSHMAN ST. SUITE 400
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☒ P.O. BOX 110300 — STATE CAPITOL
JUNEAU, ALASKA 99811-0300
PHONE: (907) 465-3600
FAX: (907) ~~463-5295~~ 465-6735

DEPARTMENT OF LAW

OFFICE OF THE ATTORNEY GENERAL

February 22, 1994

Hon. Bill Hudson
Chair, House Labor and Commerce Committee
Alaska House of Representatives
Room 108, State Capitol
Juneau, Alaska 99811

Dear Representative Hudson:

I am an assistant attorney general and a uniform law commissioner for Alaska representing the Department of Law.

I wanted to bring to your attention (HB 439), an Act concerning fraudulent transfers. This bill would bring Alaska's law into conformity with the other states that have adopted the uniform Act. Also, since Alaska law has not been updated for many years, this bill would update our state law to handle significant problems with our existing statutes concerning the sale or exchange of personal property done fraudulently to avoid creditors.

On behalf of the Alaska Uniform Law Commissioners, I would request a hearing on this important legislation.

Sincerely,

BRUCE M. BOTELHO
ATTORNEY GENERAL

By: Deborah E Behr
Deborah E. Behr
Assistant Attorney General

DEB:cl

cc: Hon. Brian Porter
Alaska House of Representatives

All Alaska Uniform Law Commissioners

03-C5LH

WALTER J. HICKEL, GOVERNOR

DEPARTMENT OF LAW

OFFICE OF THE ATTORNEY GENERAL

P.O. BOX 110300 - STATE CAPITOL
JUNEAU, ALASKA 99811-0300
PHONE: (907) 465-3600
FAX: (907) 463-5295

February 26, 1994

Honorable Bill Hudson, Chair
House Labor & Commerce Committee
State Capitol, Room 108
Juneau, AK 99811

Re: Hearing on Uniform Fraudulent Transfers Bill (HB 439)

Dear Representative Hudson:

Per your staff's request, enclosed are informational materials on HB 439 concerning uniform fraudulent transfers. The bill is modeled after the uniform law adopted by the Uniform Law Commissioners.

Persons planning to appear to testify are Mary Ellen Beardsley, Assistant Attorney General, and Gerald Kurtz, Uniform Law Commissioner for Alaska. We appreciate your scheduling them for testimony at the Anchorage Legislative Information Office.

If you need more information, please let me know.

Sincerely,

BRUCE M. BOTELHO
ATTORNEY GENERAL

By: Deborah E. Behr
Deborah E. Behr
Assistant Attorney General

DEB/bap

Enclosures

03-C32LH

FISCAL NOTE

STATE OF ALASKA
1994 LEGISLATIVE SESSION

BILL NO. HB 439

Revision Date: February 1, 1994
Title: "An Act enacting the Uniform Fraudulent Transfer Act."
Sponsor: Representative Porter
Requestor: Representative Porter

Department Affected: Department of Law
BRU: Legal Services
Component: Operations

COMPONENT SERIAL NO. 0093

EXPENDITURES/REVENUES:

OPERATING	FY 95	FY 96	FY 97	FY 98	FY 99	FY 00
PERSONAL						
TRAVEL						
CONTRACTUAL						
SUPPLIES						
EQUIPMENT						
LAND &						
GRANTS, CLAIMS						
MISCELLANEOUS						
TOTAL OPERATING	-0-	-0-	-0-	-0-	-0-	-0-
CAPITAL						
REVENUE						
FUNDING:						
1002 Federal						
1003 GF Match						
1004 GF						
1005 GF/Program						
1006 GF/MHTIA						
OTHER						
TOTAL	-0-	-0-	-0-	-0-	-0-	-0-
POSITIONS:						
FULL-TIME	-0-	-0-	-0-	-0-	-0-	-0-
PART-TIME						
TEMPORARY						

Estimate of current year (FY94) impact: -0-

ANALYSIS: (Attach a separate page if necessary.)
Please see the attached analysis.

Prepared by: Richard I. Pegues, Director
Phone: 465-3672
Division: Administrative Services Division
Date: February 1, 1994

Approved by Commissioner: Bruce M. Botelho, Attorney General
Richard L. Pegues /FOR/
Agency: Department of Law
Date: February 1, 1994

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FISCAL NOTE

STATE OF ALASKA
1994 LEGISLATIVE SESSION

BILL NO. _____

ANALYSIS CONTINUATION:

This bill amends AS 34 to adopt the Uniform Fraudulent Transfer Act for Alaska. The uniform act is recommended by the National Conference of Commissioners on Uniform State Laws (NCCUSL). Its purpose is to protect creditors against the fraudulent transfer of assets and fraudulent obligations that would otherwise work to defeat a creditor's interests. The proposed act includes personal as well as real property. Current law, which was adopted in the 1940's and is based on even older law, only addresses real property. Because the bill is a Uniform Act based on the NCCUSL model, it will conform to the requirements of most of the other state's thus making its provisions (and protections) available for many interstate transactions. The bill deals primarily with private transactions. It will not have a fiscal impact for the Department of Law.