
Through the Looking Glass: Status Liability and the Single Member and Series LLC Perspective

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Until the release of Revenue Ruling 88-76, only two states adopted limited liability company legislation, Wyoming in 1977 and Florida in 1982. In 1975, Alaska rejected adoption of the first limited liability company legislation based on concerns regarding the tax classification of a limited liability company. When Revenue Ruling 88-76 resolved those concerns, all fifty states and the District of Columbia adopted legislation by 1996, only eight years later. Revenue Ruling 88-76, however, did not resolve whether a single-member limited liability company should be classified as a sole proprietorship or a corporation. That matter was not resolved until 1997 with the release of the check-the-box regulations. Again, within a few years all states had amended their limited liability company legislation to permit a single-member limited liability company. Further still, while Delaware adopted series limited liability company legislation in 1996, the check-the-box regulations did not address the classification of a series within a limited liability company. Since 1996, only six other states have followed suit. The 2008 release of Private Letter Ruling 200803004 classifying a series in the same manner as any other business entity under the check-the-box regulations signals a potential amendment of those regulations to embrace the series. If so, once again, all remaining states might be expected to provide for a series.

These enormous events raise important transparency questions regarding where disregarded entities exist for state law purposes. Stated another way, what is the state of member status liability in these forms? As this article explores, the tax classification and state statutory amendments have given rise to a proliferation of these forms while failing to address fundamental state law liability concerns that separate owners from the obligations in these forms.

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I. INTRODUCTION

Important historical moments are recorded in different forms. Time and context frame watershed events, even those heuristic in nature. This symposium, “Limited Liability Companies at 20,” is an epistemological exploration and story separating fact from fiction and the lessons to be learned from the meteoric rise of the limited liability company in the past twenty years. Specifically, what learning has developed since the Internal Revenue Service (Service) released the landmark Revenue Ruling 88-76¹ classifying a Wyoming limited liability company² as a partnership for federal income tax purposes?³ All of us who participated in the Symposium are enormously grateful to the talented contributors, many of whom were responsible for the development of the limited liability company in the time frame examined.

To those more interested in the present and less in history, the twenty-year time frame may be less than obvious. The fundamental assumption is that Revenue Ruling 88-76 and the revised approach of the so-called “check-the-box” (CTB) federal tax regulations⁴ released in 1997 had a profound, unprecedented, and perhaps unpredictable impact on the future development of unincorporated business organizations. Until that time, the corporation was unquestionably the dominant entity of choice for an operating business. Limited partnerships were utilized for single purpose investment ventures such as real estate and general partnerships for service firms such as law and accounting. In both cases, all general partners were personally liable for the debts and obligations of the partnership by status alone. While misconduct might also create personal liability, that same liability created status liability for other general partners simply because they were general partners. As a result, the corporation was the primary if not the exclusive choice where all owners, regardless of number, were free from status liability and hence were not personally liable for the debts and obligations of the entity simply because they were owners. In order to mitigate untoward double taxation effects, a corporation could elect to be taxed as a Subchapter S corporation eliminating in most regards the corporate level entity tax and taxing the entity determined income and loss directly to the owners.

All this was about to change in 1978 when Wyoming adopted state legislation enabling the creation of a new business form—the limited liability company. The new form promised corporate limited liability for all owners while eliminating the entity tax even more completely than the corporate Subchapter S election. But this revolutionary idea caught the attention of the Treasury Department that sensed decimation of the corporate tax base. In

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

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

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

4. T.D. 8697, 1997-1 C.B. 215.

response, the Treasury undertook a study to determine whether an unincorporated entity with corporate limited liability could or should be classified other than as a corporation. Tax law had already predetermined that a publicly traded partnership would be taxed as a corporation regardless of its non-corporate form. After an exhaustive ten-year study, the Treasury conceded that indeed corporate styled limited liability was not an inviolate characteristic of the corporate form. The rush of statutory enactments accelerated, and the rush for Treasury rulings confirming non-corporate tax classification grew proportionately. Ultimately, in the 1997 CTB regulations, the Treasury simply threw in the towel and acknowledged that any entity not formed under a corporate statute would not be classified as a corporation.

The deal was sealed. Every state now has first, second, or even third generation limited liability company acts.⁵ The limited liability company has become the entity of choice for non-publicly traded business of every degree. A few odd characteristics and externalities have developed over time, and two in particular are the subject of this article. While single-shareholder corporations were and are quite common, single-member limited liability companies were not common prior to 1997. The CTB regulations classify such entities as a tax nothing. But a federal tax nothing remains a state law something. This dual identity crisis continues to create situational conflict and is contextually explored according to the subject of the confusion. Also, while every state enables a single-member limited liability company, only a few enable a series limited liability company. Like an investment trust with series, a series limited liability company is a single limited liability company with assets and liabilities barricaded in separate internal series, each with a distinct liability shield. If respected, the multiple internal liability shields dispense with forming several limited liability companies for the same purpose. This article is their story.

II. LLC TAX CLASSIFICATION HISTORY

Limited liability company tax classification has long and important roots impacting state legislative adoptions and hence the proliferation of the entity itself. As discussed below, Alaska rejected limited liability company legislation in 1975 largely because of tax concerns. Similar legislation was adopted in 1997 in Wyoming and then in 1982 in Florida. Use of the entity, however, was severely retarded by the uncertainty regarding the tax classification of the entity as a partnership or corporation. Not until the release of Revenue Ruling 88-76⁶ classifying a Wyoming limited liability company

5. See CARTER BISHOP & DANIEL KLEINBERGER, LIMITED LIABILITY COMPANIES: TAX AND BUSINESS LAW ¶ 1.07 (Supp. 2008) (concerning status of every state law on various aspects of limited liability company law).

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

with at least two members as a partnership did states quickly embrace limited liability company legislation.

Even then, state statutes other than Texas required a limited liability company to have two or more members so that it could be classified as a partnership rather than a corporation. The single-member limited liability classification as a sole proprietorship or corporation was not addressed in Revenue Ruling 88-76 because Wyoming legislation did not permit the formation of a limited liability company with only one member. This question was in limbo for nearly another ten years until the release of the CTB regulations, applicable for tax years beginning after January 1, 1997. The CTB regulations resolved the tax classification of a single-member limited liability company by treating it as a sole proprietorship with a liability shield.

Once again, the series limited liability company was not addressed in either Revenue Ruling 88-76 or the CTB regulations. The issue was addressed only recently in a 2008 private letter ruling. Because a private letter ruling is not binding authority, the status of the series limited liability company remains a cloud over state enactments and use. While Delaware enacted the first series legislation in 1996, only six states have followed suit and even then the concept is not heavily utilized because of the tax classification cloud. The discussion below traces the historical significance of these events.

A. Tax Classification of a Multiple Member LLC

A few states and the practicing bar enthusiastically embraced the early development of the limited liability company as a principled alternative to corporation and partnership entity forms⁷ even before the release of the 1988 ruling and the 1997 CTB regulations.⁸ The early roots of limited liability company legislation reach to Alaska. In 1975, the Hamilton Brothers Oil

7. The limited liability company resembles a pre-dated partnership operating form with full corporate-styled limited liability for all members, referred to as limitadas and limited partnership associations. Limitadas are foreign organizations that can be structured to lack the corporate characteristics of continuity of life and free transferability of interests. In Private Letter Ruling 80-03-072 (Oct. 25, 1979), the Internal Revenue Service (Service) classified a Brazilian limitada as a partnership for tax purposes. I.R.S. Priv. Ltr. Rul. 80-03-072 (Oct. 25, 1979); see also I.R.S. Priv. Ltr. Rul. 80-19-112 (Feb. 15, 1980); I.R.S. Priv. Ltr. Rul. 78-41-042 (July 14, 1978). Limitadas were rarely used in the United States because of capital and natural person ownership restrictions as well as concerns regarding whether the liability shield would be fully recognized. See generally Richard Johnson, Comment, *The Limited Liability Company Act*, 11 FLA. ST. U. L. REV. 387 (1983). Limited partnership associations, which exist in a few states, also possess limited liability for all members and can be structured to lack two of the three remaining corporate characteristics. In Private Letter Ruling 75-05-290-310A (May 29, 1975), the Service classified a Michigan limited partnership association as a partnership for tax purposes providing that its creation and conduct were in substantial compliance with all state statutes pertaining to limited partnerships. I.R.S. Priv. Ltr. Rul. 75-05-290-310A (May 29, 1975). Again, this statute is seldom used because of various restrictions. See, e.g., MICH. COMP. LAWS ANN. § 449.301 (West 1977) (granting limited liability for all members).

8. Susan Pace Hamill, *The Limited Liability Company: A Catalyst Exposing the Corporate Integration Question*, 95 MICH. L. REV. 393, 393-94 (1996).

Company in Denver, Colorado, unsuccessfully sought adoption of limited liability company legislation in Alaska.⁹ The company was familiar with South American limitadas¹⁰ and thought that entity structure would be useful in the United States. The new entity was to provide state revenue from filing fees and annual taxes.¹¹ The early efforts were dashed, however, when the legislation failed to be enacted even after a Service tax classification ruling was sought.¹² Apparently the legislative uncertainty and debate focused on the tax classification issue.¹³ Hamilton Oil refused to give up and shifted its legislative efforts to oil-rich Wyoming where in 1977, notwithstanding the same Alaska tax classification debate, legislation was introduced and enacted.¹⁴

Unlike Alaska, the Wyoming legislature adopted the legislation prior to learning the Service's view on the federal tax classification issue.¹⁵ Soon thereafter, a ruling was requested and released that classified a Wyoming limited liability company as a partnership for federal tax purposes.¹⁶ Unfortunately the ruling did not settle the matter because the prior day the Service had published proposed regulations that were inconsistent with the ruling.¹⁷ The proposed regulations required that an organization with no member personally liable for the debts of the organization under state law be classified and taxed as a corporation.¹⁸ The proposed regulations severely limited acceptance and use of the Wyoming law. Indeed, only thirty limited liability companies were formed in the first eleven years following enactment.¹⁹ Contrary to the first ruling classifying a Wyoming limited liability company as a partnership, a subsequent 1982 ruling, based on the proposed regulations, classified a limited liability company as a corporation.²⁰ The proposed regulations certainly had the effect of chilling further legislative enactments. Only Florida adopted limited liability company legislation by 1982.²¹

The regulatory classification scheme in place during the suspension was familiar. A critical factor to the utility of the limited liability company was that

9. Joseph A. Rodriguez, Comment, *Wyoming Limited Liability Companies: Limited Liability and Taxation Concerns in Other Jurisdictions*, 27 LAND & WATER L. REV. 539, 544 (1992).

10. See *supra* note 7 (discussing limitadas).

11. See Rodriguez, *supra* note 9, at 544.

12. *Id.*

13. *Id.*

14. See Wyoming Limited Liability Company Act, WYO. STAT. ANN. §§ 17-15-101 to -147 (1977).

15. See Rodriguez, *supra* note 9, at 544-45.

16. I.R.S. Priv. Ltr. Rul. 81-06-082 (Nov. 18, 1980) ("Since it will lack continuity of life and free transferability of interests, Z will not have a preponderance of corporate characteristics. Therefore, Z will be treated as a partnership for Federal income tax purposes and not as an association taxable as a corporation.").

17. See Classification of Limited Liability Companies, 45 Fed. Reg. 75, 709 (proposed Nov. 17, 1980) (to be codified at 26 C.F.R. 301); Prop. Treas. Reg. §§ 301.7701-2(a)(2)-(4) (Oct. 18, 2005).

18. See Classification of Limited Liability Companies, 45 Fed. Reg. at 709; Prop. Treas. Reg. § 301.7701-2(a)(2), 70 Fed. Reg. 60475 (Oct. 18, 2005).

19. See Rodriguez, *supra* note 9, at 557.

20. I.R.S. Priv. Ltr. Rul. 83-04-138 (Oct. 29, 1982).

21. FLA. STAT. §§ 608.401-608.514 (2007); see Johnson, *supra* note 7, at 387.

it avoided classification as a corporation and thus became subject to the corporate entity level tax. Under the tax classifications regulations applicable in 1977, an unincorporated entity like a limited liability company could be classified as a corporation, partnership, or trust based on whether the entity possessed “corporate characteristics.”²² While state law determines whether a particular characteristic exists, federal law controls the meaning of that characteristic in the classification scheme.²³ When an unincorporated entity more closely resembled a corporation than a trust or partnership, the regulations regarded the entity as an association and taxed it as if it were a corporation.²⁴ The regulations identified six characteristics indicative of corporate status: associates, an objective to carry on business and divide the gains, continuity of life, centralization of management, limited liability, and free transferability of interests.²⁵

Characteristics common to both compared organizations were ignored.²⁶ To determine corporate versus partnership status, the associates and business objective characteristics were ignored because both are common to both entities.²⁷ Thus, a limited liability company would be classified as a partnership if it possessed no more than two of the remaining four characteristics.²⁸ Obviously, a Wyoming limited liability company possessed the corporate limited liability characteristic because no member was personally liable for the debts or claims against the organization.²⁹ Thus, unless limited liability was a super-controlling factor, the 1977 regulations classified a limited liability company as a corporation only if it possessed two of the three remaining characteristics: continuity of life, centralization of management, or free transferability of interests.

For a limited liability company to possess the corporate characteristic of free transferability of interests, substantially all of the owners must have the power to transfer, without the consent of any other owner, all attributes of ownership in the organization to a person not then a member of the organization.³⁰ An unlimited right to assign only the interest in profits without a right to participate in management and otherwise exercise full rights of ownership did not

22. Treas. Reg. § 301.7701-1(c) (as amended in 2006).

23. *Id.*

24. *Id.* § 301.7701-2(a)(3).

25. *Id.* § 301.7701-2(a)(1).

26. Treas. Reg. § 301.7701-2(a)(3).

27. *Id.*

28. *Id.* (as amended in 2006).

29. *Id.* § 301.7701-2(d)(1); *see* WYO. STAT. ANN. § 17-15-113 (1977) (“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 any other manner, for a debt, obligation or liability of the limited liability company.”).

30. Treas. Reg. § 301.7701-2(e) (as amended in 2006).

constitute free transferability of interests.³¹ Like a general partnership,³² a Wyoming limited liability company lacked free transferability of interests because no person can become a member without the consent of all the remaining members.³³ Accordingly, unless limited liability was accorded weighted significance, a Wyoming limited liability company would be classified as a partnership for federal tax purposes provided it lacked either continuity of life or centralized management.

For a limited liability company to possess the corporate characteristic of continuity of life, it must not cease to exist merely because one or more of its original owners dies, retires, resigns, or suffers insanity, bankruptcy, or expulsion.³⁴ Thus, if an entity dissolves by reason of the occurrence of any of these events, it lacks the corporate characteristic of continuity of life.³⁵ A Wyoming limited liability company dissolves at the earlier of any of the following: the expiration of the period fixed for its duration; the unanimous agreement of the members to terminate; or the death, retirement, resignation, insanity, bankruptcy or expulsion of a member, unless all remaining members consent to continue the business.³⁶ Accordingly, unless limited liability was accorded weighted significance, a Wyoming limited liability company would always lack continuity of life and hence be classified as a partnership regardless of the outcome on the centralized management characteristic. In essence, the Wyoming limited liability company dissolution provisions were nearly identical to those applicable to general partnerships.³⁷

By 1983, public criticism of the proposed regulation finally caused the Service to withdraw the proposed regulations and commit to study the effect of limited liability on entity tax classification.³⁸ At the same time, the Service announced it would not issue further rulings until the study was completed.³⁹

The uncertainty caused by the classification study and the no-ruling policy

31. *Id.*

32. *See* UNIF. P'SHIP ACT § 18(g) (1914).

33. WYO. STAT. ANN. § 17-15-122 ("The interest of all members in a limited liability company constitutes the personal estate of the member, and may be transferred or assigned as provided in the operating agreement. However, 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 and the return of contributions, to which that member would otherwise be entitled.").

34. Treas. Reg. § 301.7701-2(b)(1) (as amended in 2006).

35. *Id.*

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

37. *See* UNIF. P'SHIP ACT § 31 (1914).

38. I.R.S. Announcement 83-4, 1983-2 I.R.B. 31 (Jan. 10, 1983) ("After considering the public comments received after the proposed regulations were published, the Service has decided to withdraw them and undertake a study of the rules for classification of entities for federal tax purposes with special focus on the significance of the characteristic of limited liability.").

39. Rev. Proc. 83-15, 1983-11 C.B. 676.

severely limited the use of Wyoming and Florida limited liability companies. The Service completed its classification study in 1988 and declared that limited liability would not receive special treatment in delineating between corporations and partnerships.⁴⁰ On the same day, Revenue Ruling 88-76⁴¹ was released, declaring that a Wyoming limited liability company, none of whose members or designated managers were personally liable for any debts of the entity, would be classified as a partnership for federal income tax purposes. Specifically, Revenue Ruling 88-76 classified an unincorporated organization formed under the Wyoming law as a partnership because the limited liability company lacked the corporate characteristics of continuity of life and free transferability of interests.⁴² Consequently, the limited liability company was classified as a partnership even though it possessed the corporate characteristic of limited liability.⁴³

Revenue Ruling 88-76 was welcome news for the Wyoming limited liability company, but it failed to address the tax classification of entities formed under Florida law. While a Wyoming limited liability company enjoyed “bulletproof” partnership tax classification because of its statutes regarding free transferability of interests and continuity of life,⁴⁴ the 1982 version of the Florida limited liability company dissolution statute was more flexible. Specifically, unlike in Wyoming, a Florida limited liability company could negate dissolution (and hence possess continuity of life) when the articles of organization so specified.⁴⁵ Thus, under Florida law, if the articles of organization provide a right to continue the business, then the limited liability company will not dissolve upon the death, retirement, resignation, insanity, bankruptcy, or expulsion of a member, even if all the remaining members refuse to consent to continue the business. While providing important flexibility, this anomaly meant that every Florida limited liability company must be examined to determine whether the articles negated continuity of life. As a consequence, Revenue Ruling 88-76 only addressed a bulletproof Wyoming limited liability company. Some later private letter rulings determined that a Florida limited liability company formed without the toxic

40. Rev. Proc. 88-44, 1988-2 C.B. 634.

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

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

43. *Id.*

44. A few other states with later bulletproof statutes also received revenue rulings: Rev. Rul. 93-5, 1993-1 C.B. 227 (Virginia); Rev. Rul. 93-6, 1993-1 C.B. 229 (Colorado); Rev. Rul. 93-30, 1993-1 C.B. 231 (Nevada); Rev. Rul. 93-50, 1993-2 C.B. 310 (West Virginia); Rev. Rul. 93-91, 1993-2 C.B. 316 (Utah); Rev. Rul. 94-30, 1994-1 C.B. 316 (Kansas).

45. FLA. STAT. § 608.441(1)(c) (2007) (“Upon the death, bankruptcy, or dissolution of a member or upon the occurrence of any other event which terminates the continued membership of a member in the limited liability company, 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.”).

provision in the articles was classified as a partnership for federal tax purposes.⁴⁶ Still later, that message was formalized in Revenue Ruling 93-53.⁴⁷ The same fate was applied to a limited liability company formed in Delaware⁴⁸ and several other states.⁴⁹

Whether bulletproof or flexible, by 1996 and less than eight years after the release of Revenue Ruling 88-76, all fifty states had adopted specific limited liability company statutes and the Uniform Limited Liability Company Act was released for state adoption.⁵⁰ As more states adopted legislation, limited liability company formations rose exponentially creating a critical mass requiring serious tax regulatory responses.⁵¹ Especially burdensome was the fact that every state was submitting requests for a ruling regarding the tax classification of a limited liability company formed under its state laws. The avalanche of ruling requests, none of which was in serious doubt because every state statute was based either on the Wyoming bulletproof model or the Florida flexible model, added a crushing administrative burden on the Service.⁵² Besides tax classification, tax concerns hovered around whether a limited liability company manager could be treated like a general partner for federal tax purposes and whether the same tax classification rules applied as flexibly as to limited partnerships.⁵³

In early 1995, the Service eliminated most of the remaining tax handicaps by treating limited liability company managers as general partners and otherwise applied the partnership classification regulations in the same flexible manner applied to limited partnerships.⁵⁴ Shortly thereafter,⁵⁵ proposed amendments to

46. See, e.g., I.R.S. Priv. Ltr. Rul. 9443018 (Oct. 28, 1994); I.R.S. Priv. Ltr. Rul. 9030013 (July 27, 1990); I.R.S. Priv. Ltr. Rul. 89-37-010 (Sept. 15, 1989).

47. Rev. Rul. 93-53, 1993-2 C.B. 312.

48. Rev. Rul. 93-38, 1993-1 C.B. 233. Many non-bulletproof states never received a public revenue ruling but only a private letter ruling like the early Florida rulings. See Priv. Ltr. Rul. 96-44-059 (Nov. 1, 1996) (Iowa); I.R.S. Priv. Ltr. Rul. 92-10-019 (Mar. 6, 1992) (Texas).

49. See, e.g., Rev. Rul. 93-93, 1993-2 C.B. 321 (Arizona); Rev. Rul. 93-49, 1993-2 C.B. 308 (Illinois); Rev. Rul. 94-5, 1994-1 C.B. 312 (Louisiana); Rev. Rul. 93-92, 1993-2 C.B. 318 (Oklahoma); Rev. Rul. 93-81, 1993-2 C.B. 314 (Rhode Island); Rev. Rul. 94-6, 1994-1 C.B. 314 (Alabama); Rev. Rul. 94-79, 1994-2 C.B. 409 (Connecticut); Rev. Rul. 94-51, 1994-2 C.B. 407 (New Jersey); Rev. Rul. 95-9, 1995-3 I.R.B. 17 (South Dakota).

50. See Hamill, *supra* note 8, at 403-04. In 1990, two states adopted limited liability statutes, including Kansas and Colorado. *Id.* at 403. In 1991, four more states—Nevada, Texas, Utah and Virginia—adopted these statutes. *Id.* In 1992, ten more states adopted the statutes: Arizona, Delaware, Illinois, Iowa, Louisiana, Maryland, Minnesota, Oklahoma, Rhode Island, and West Virginia. *Id.* at 403. In 1993, eighteen states also adopted similar statutes: Alabama, Arkansas, Connecticut, Georgia, Idaho, Indiana, Michigan, Missouri, Montana, Nebraska, New Hampshire, New Jersey, New Mexico, North Carolina, North Dakota, Oregon, South Dakota, and Wisconsin. *Id.* The remaining states and the District of Columbia all adopted the statutes by 1996. *Id.*

51. See Susan Pace Hamill, *The Taxation of Domestic Limited Liability Companies and Limited Partnerships: A Case for Eliminating the Partnership Classifications*, 73 WASH. U. L.Q. 564, 590 (1995).

52. See *id.* at 589-90.

53. See *id.* at 591.

54. Rev. Proc. 95-10, 1995-1 C.B. 501; see BISHOP & KLEINBERGER, *supra* note 5, ¶ 1.01[3][d].

classification regulations were released permitting unincorporated businesses to choose partnership or corporate taxation regardless of their business characteristics.⁵⁶ These regulations were final on December 18, 1996 and effective for entities formed after January 1, 1997. The regulations became known as the CTB regulations.⁵⁷

B. Single Member and Series Tax Classification

These rules are discussed in Part III below as they apply to the single-member limited liability companies. Neither Revenue Ruling 88-76 nor pre-CTB history fully resolved the tax classification of the single-member limited liability company as a sole proprietorship or a corporation under the corporate characteristics test. Obviously, a single-member liability company could not be classified as a partnership because it lacked associates. Consequently, few state limited liability company laws authorized their formation and use prior to the 1997 CTB regulations.⁵⁸ Once the CTB regulations resolved the tax classification issue, all fifty states amended their state limited liability company laws to permit the formation and operation of a single-member limited liability company.⁵⁹ The uses, problems, and nuances of those entities under the CTB regulations are discussed below.

The experience of the series limited liability company has been the reverse. Early limited liability company statutes did not authorize multiple series within a single limited liability company. Moreover, neither the 1988 ruling nor the 1997 CTB regulations addressed the issue of tax classification. The glass ceiling appears to be showing signs of cracking,⁶⁰ and thus the development of the series limited liability may follow the exponential growth pattern of the single-member limited liability company. That subject is discussed below in Part IV.

III. TAX CLASSIFICATION AND RELATED SMLLC ISSUES

Tax classification of the single-member limited liability company is the first of the most significant issues affecting this entity. Once the CTB regulation resolved the classification issue, utilization flourished. But as the contexts

55. See I.R.S. Notice 95-14, 1995-1 C.B. 297.

56. Prop. Treas. Reg. §§ 301.7701-1 to -3, 1996-1 C.B. 865, 61 Fed. Reg. 21989 (1996).

57. Treas. Reg. §§ 301.7701-1 to -3, 1997-1 C.B. 215, 61 Fed. Reg. 66584-01 (1996).

58. Texas was the first state to authorize the formation of a limited liability company with one member. See TEX. BUS. ORGS. CODE ANN. § 101.101 (Vernon 2006) ("A limited liability company may have one or more members."). Prior to the release of the CTB regulations, the Service did not release a ruling regarding a Texas limited liability company with one member. A pre-CTB ruling was released regarding a Texas limited liability company, but the entity had three members and associates and therefore could be classified as a partnership. See I.R.S. Priv. Ltr. Rul. 92-18-078 (May 1, 1992).

59. See BISHOP & KLEINBERGER, *supra* note 5, ¶ 1.07[7].

60. I.R.S. Priv. Ltr. Rul. 20-080-3004 (Jan. 18, 2008).

proliferated so did the unresolved issues, particularly those relating the status liability of the single member for entity obligations and the reverse. The classification and variable resulting use issues are discussed below.

A. Tax Classification of the SMLLC

Prior to the release of the CTB regulations, the tax classification of a single-member limited liability company was uncertain. While the absence of two members precludes partnership status, it does not preclude corporate status.⁶¹ Thus, a single-member limited liability company conducting a business for profit could be classified either as a corporation or as a sole proprietorship conducting its business through its agents, including the only member. Indeed, an early ruling determined a single-member trust was not a partnership because it lacked associates and not a corporation because it lacked continuity of life and limited liability.⁶²

With the addition of limited liability, it was uncertain whether the single-member limited liability company would turn toward sole proprietorship or corporation status. As late as 1995, the Service was uncertain regarding the tax classification of a single-member limited liability company.⁶³ As a result, early limited liability statutes required the presence of two or more members because partnership status was the target.⁶⁴ Because a limited liability company clearly has limited liability, pre-CTB classification depended on the entity lacking two of the three remaining characteristics—normally, continuity of life and free transferability of interests.⁶⁵ As discussed below, the CTB regulations affirmatively resolve the treatment of a single-member limited liability company as a sole proprietorship.⁶⁶

While the CTB regulations clearly solve the classification and tax status of a single-member limited liability company, the regulations do not address the tax classification of a separate series within a limited company.⁶⁷ Nontax bankruptcy concerns as well as whether the liabilities of a separate series can effectively be isolated from the assets of another internal series dominate

61. See I.R.S. Gen. Couns. Mem. 38,707 (May 1, 1981); I.R.S. Gen. Counsel Mem. 39,395 (Aug. 5, 1985).

62. See I.R.S. Gen. Counsel Mem. 39,395 (Aug. 5, 1985).

63. See Rev. Proc. 95-10, 1995-1 C.B. 501 (“The Service will consider a ruling request that relates to classification of an LLC as a partnership for federal tax purposes only if the LLC has at least two members and, to the extent applicable, the conditions in sections 4 and 5 of this revenue procedure are satisfied.”).

64. WYO. STAT. ANN. § 17-15-106 (1977) (“Any person may form a limited liability company which shall have two (2) or more members by signing and delivering one (1) original and one (1) exact or conformed copy of the articles of organization to the secretary of state for filing. The person forming the company need not be a member of the limited liability company.”).

65. See *supra* notes 30-37 and accompanying text.

66. See Treas. Reg. § 301.7701-3(b)(1)(ii) (2006).

67. See DEL. CODE ANN. tit. 6, § 18-215 (2006).

concern,⁶⁸ but tax classification concerns are important as well.⁶⁹ Unfortunately, unlike the single-member limited liability company, the CTB regulations are silent regarding the tax classification of a series limited liability company.

The 1997 check-the-box regulations provide that a domestic eligible entity⁷⁰ with a single owner is disregarded for all federal tax purposes,⁷¹ unless the entity elects to be classified as an association taxable as a corporation.⁷² This approach represents an important clarification of prior law. Prior to the release of the check-the-box regulations, the Service failed to issue any formal guidance on wholly owned unincorporated business entities and refused to rule that single-member limited liability companies could be taxed as partnerships.⁷³

Prior to “check the box,” analysis of the single-member issue concerned a general counsel memorandum (GCM) that considered the classification of a wholly owned New York business trust.⁷⁴ The GCM concluded that such a business entity was not a corporation because it lacked continuity of life and limited liability, two of the four then essential corporate characteristics. The GCM also noted that while a single-member organization could be treated as having associates for purposes of determining if it is an association, associates did not exist in the partnership sense and therefore such an organization cannot be a partnership. Thus, such an organization was neither an association nor a partnership and occupied the land of uncertainty. The GCM concluded that the entity should be regarded as “an arrangement along the lines of a sole proprietorship that conducts business through an agent.”

The check-the-box regulations formalized the GCM’s position making single-member eligible entities more useful, in some respects, than eligible entities taxed as partnerships. Although partnership income and losses pass through to an entity’s owners, a partnership is nevertheless recognized as a separate entity for purposes of determining its taxable income and making tax elections.⁷⁵ A disregarded entity, in contrast, is completely “transparent.”

68. See BISHOP & KLEINBERGER, *supra* note 5, ¶ 2.11.

69. *See id.*

70. A foreign eligible entity is classified under a dual default test: (1) always a corporation unless at least one member of the entity has personal liability for entity assets under local law, and (2) if so, the number of members. Thus, a foreign eligible entity with at least one member with personal liability is classified as either a partnership or disregarded entity depending on whether it has more than one member. *See* Treas. Reg. § 301-7701-3(b)(2)(i)(A) (2006). A foreign eligible entity may elect to change its default classification from either a corporation or a partnership or disregarded entity. *See id.* § 301-7701-3(c)(1)(i). Per se corporate status cannot be altered by election in either the domestic or foreign context.

71. Treas. Reg. § 301.7701-3(a) (2006).

72. *Id.*

73. *See* Rev. Proc. 95-10, 1995-1 CB 501.

74. I.R.S. Gen. Couns. Mem. 39,395 (June 24, 1983).

75. *See* I.R.C. § 701 (1954).

B. Shelf LLC

Virginia⁷⁶ and North Carolina⁷⁷ permit an LLC to be formed without a member identified at the time of formation. This so-called “shelf LLC” attracted considerable debate in the drafting of the Revised Uniform Limited Liability Company Act (RULLCA).⁷⁸ As a result, RULLCA included its own version of the “shelf LLC.”⁷⁹ The approaches vary with regard to how and when a member can be added, how long the memberless LLC survives without a member, and whether the memberless LLC can conduct any business until it has a member.

The fundamental issue remains the same with regard to the appropriateness of a shelf LLC. Flexibility favors the shelf LLC in states where it requires too much time to form an LLC because of delays in secretary of state filings. In these states, the memberless LLC can be pulled from the lawyer’s “shelf” to simply add members and an operating agreement to fit a currently negotiated deal. This shelf perspective follows the corporate approach that the legal entity can and does exist independent of its shareholder owners.

On the other hand, unlike a corporation, an LLC is considerably more agreement-based and indeed the entity itself arises from the agreement of the owners. Both general and limited partnerships require the existence of a partnership and partners to be formed. Either can simultaneously or thereafter construct a liability shield through a public filing of an LLP or LP certificate. Likewise, an LLC arguably requires the existence of a partnership-styled agreement among members to be formed.

The debate shifted somewhat when most states approved the concept of a single-member LLC (SMLLC). After all, how does a solitary member have an agreement with that solitary member. Is an operating agreement not a contract, and does not a contract require the existence of at least two parties? Assuming that every LLC has an operating agreement that includes the statutory default terms plus other elected terms,⁸⁰ how does such an agreement satisfy the definitional requirements where only one member exists.⁸¹

Whether the flexibility and practical “shelf” controls the theoretical “no

76. VA. CODE ANN. § 13.1-1038.1.A.3 (2006).

77. N.C. GEN. STAT. ANN. § 57C-2-20(c) (West 2002).

78. See Carter G. Bishop and Daniel S. Kleinberger, *The Next Generation: The Revised Uniform Limited Liability Company Act*, 62 BUS. LAW. 515, 529 n.84 (2007); Larry E. Ribstein, *An Analysis of the Revised Uniform Limited Liability Company Act* (U. Ill. Law & Econ., Research Paper No. LE07-027, 2007), available at <http://ssrn.com/abstract=1003805>; Robert R. Keatinge, *Shelf LLCs and Opinion Letter Issues: Exegesis and Eisegesis of LLC Statutes*, PUBOGRAM (Am. Bar Ass’n Comm. on P’Ships and Unincorporated Bus. Orgs., Chicago, Ill.), Mar. 2006, at 15.

79. REV. UNIF. LTD. LIAB. CO. ACT § 201(b)(3) (2006).

80. *Id.* § 110(b).

81. Because many LLC statutes provide that certain operating agreement default rule provisions can only be modified through the operating agreement, many states affirmatively state that the term “operating agreement” specifically includes an agreement of a SMLLC. See *id.* § 102(13).

shelf” has a few important consequences that help distinguish an LLC from a corporation. In those cases where a shelf LLC exists, the law attempts to adopt the flexibility without negating the distinct contractual nature of an LLC. For example, a corporation generally may not modify the duty of loyalty,⁸² nor may the corporation indemnify liability for conduct violating the duty of loyalty.⁸³ It may, however, purchase insurance for liability that cannot be modified or indemnified, provided such insurance is available.⁸⁴

By way of contrast, an LLC is considerably more contractual in nature. Although operating agreements sanctioning gross negligence or violations of the duty of loyalty might otherwise violate public policy and thus be unenforceable, state statutes often bless such provisions. For example, RULLCA permits various aspects of the duty of loyalty⁸⁵ to be restricted or eliminated⁸⁶ provided the agreement is not manifestly unreasonable.⁸⁷ The term “manifestly unreasonable” is a statutorily defined term.⁸⁸ All members may generally approve or ratify a duty of loyalty violation following disclosure of all material facts.⁸⁹ Some states go even further, declaring the maximum freedom of contract⁹⁰ and that a member or manager’s duties in law and equity may be eliminated by the LLC agreement provided the implied contractual covenant of good faith and fair dealing may not be eliminated.⁹¹

Beyond contractual flexibility, other issues face shelf LLCs, especially in those states that require that a member exist at formation.⁹² Beyond the mundane, and as a matter of reverse analysis, shelf LLCs are often favored by those who want the entity on the shelf for the current deal but also want to be able to issue a firm legal opinion regarding the proper formation of the LLC. This of course is problematic when state law requires a member to exist at formation. One way to “solve” the problem is to consider the LLC “formed” by filing the required forms but not to regard it as a legal entity until it has members with an operating agreement that may relate back to the date of

82. See Model Business Corporation Act § 2.02(b)(4) (2000).

83. See *id.* § 2.02(b)(5) (articles restriction); *id.* § 8.51 (2000) (permissible indemnification); *id.* § 8.52 (mandatory indemnification).

84. See *id.* § 8.57.

85. REV. UNIF. LTD. LIAB. CO. ACT § 409(b) (2006).

86. *Id.* § 110(d)(1)-(3) (governing duty to account, conflict of interest transactions, and competition provisions).

87. *Id.* § 110(d).

88. *Id.* § 110(h).

89. REV. UNIF. LTD. LIAB. CO. ACT § 409(b). Because all the members are required, the interested member may participate and vote but must also achieve unanimous approval of all the remaining members.

90. DEL. CODE ANN. tit. 6, § 18-1101(b) (2006).

91. *Id.* § 18-1101(c).

92. The federal taxation of shelf LLCs is not covered by the current tax classification check-the-box regulations because it has no members. Accordingly, at best, a shelf LLC is probably taxed at the entity level as a corporation if it conducts business and generates income and expense without members. Later, when members are added, it presumably constitutes the liquidation of a corporation and formation of a partnership with significant attendant problems associated with an entity tax on unbooked goodwill.

filing.⁹³

Notwithstanding the arcane statutory language, lenders and third parties may require as a condition of a particular transaction opinion letters that the LLC was “duly formed,” “duly organized,” or in “good standing.”⁹⁴ The “duly formed” opinion is circular in that it generally requires the formation document (articles or certificate of formation) to be filed. The filing of that very document by the filer, however, also generally certifies that all the organizational requirements have been met. If the statute requires a member to form the LLC, then the “duly formed” opinion is immediately deficient and is not cured by the later admission of a member. While most statutes ignore this gap, RULLCA specifically addresses the matter.⁹⁵ Consistent with other statutes, RULLCA requires a member in order for a duly formed opinion.⁹⁶

C. Member and Status Context Categories

The “transparency” of the SMLLC presents several unique tax utilizations and issues. For example, this unique “entity transparency” has prompted consideration of the disregarded entity as a replacement for wholly owned subsidiaries in a consolidated group,⁹⁷ as an alternative to subchapter S corporations,⁹⁸ in foreign tax planning strategies involving hybrid and reverse-hybrid entities,⁹⁹ as a way to simplify structures that include multimember flow-through subsidiaries, and for a variety of other uses.¹⁰⁰ The planning

93. Compare DEL. CODE ANN. tit. 6, § 18-201(b) (date of formation), with DEL. CODE ANN. tit. 6, § 18-201(d) (relation back of operating agreement to date of formation). Nonetheless, Delaware law requires by definition that an LLC is formed under Delaware law with one or more members. *Id.* § 18-101(6).

94. See Keatinge, *supra* note 78, at 20-24 (discussing these terms in the context of an unincorporated entity).

95. This problem is resolved by RULLCA by allowing an LLC to be formed without a member by filing a certificate of organization specifically stating there are no members at that time. REV. UNIF. LTD. LIAB. CORP. ACT § 201(b)(3) (2006). In such a case, the certificate lapses and is void unless the organizer files with the secretary of state a second notice within ninety days stating a member now exists and the date of that membership. *Id.* § 201(e)(1). If so, the date of formation “relates back” to the date of the stated membership, not the date the original certificate was filed. *Id.* § 201(e)(2).

96. See Keatinge, *supra* note 78, at 15 (discussing opinion requirements articulated by the Partnerships and Limited Liability Companies Committee of the Business Law Section of the State of California).

97. See Lawrence M. Axelrod, *Are Consolidated Returns Obsolete*, 97 TAX NOTES TODAY 3-78 (Jan. 6, 1997); Roger F. Pillow et al., *Simplified Entity Classification Under the Final Check-The-Box Regulations*, 86 J. TAX’N 197, 207 (1997). The disregarded entity status may avoid several problems associated with a consolidated return including the following: avoiding the prohibition on deducting losses from the disposition of member stock, the irrevocability of a consolidated return election, avoiding deferral of inter-company losses, and avoiding the inclusion of excess losses in a parent’s basis upon its disposition of the subsidiary’s stock. See Treas. Reg. §§ 1.1502-13, 1.1502-19, 1.1502-20 (2006).

98. See David S. Miller, *The Tax Nothing*, 97 TAX NOTES TODAY 22-69 (Feb. 3, 1997).

99. See John B. Magee et al., *Reexamining Branch Rules in the Context of Check-The-Box*, 77 TAX NOTES 1511 (Dec. 29, 1997); Joni L. Walser and Robert E. Culbertson, *Encore Une Fois: Check-The-Box on the International Stage*, 97 TAX NOTES TODAY 139-71 (July 21, 1997).

100. See Christopher Barton, *Much Ado About a Nothing: The Taxation of Disregarded Entities*, 97 TAX NOTES TODAY 125-98 (June 30, 1997) (recommending use of such entities to avoid uncertainty about the

possibilities for the use of disregarded entities emanate from several general categories of SMLLC effects.

1. Intra-Group Transactions

Transactions between the single member-owner and the disregarded entity are deemed not to have occurred for federal income tax purposes and therefore have no federal tax effect. These same transactions, however, are often recognized and have legally significant consequences under nontax state and federal laws. For example, a lease of property from the single member-owner to the disregarded entity is ignored for federal tax purposes but is generally respected as a legal lease transaction between the parties.

2. Third-Party Transactions

While transactions between the disregarded entity and a third party are recognized for federal tax purposes, they are treated as having occurred directly between the single member-owner and the third party. These same transactions, however, are often recognized, according to their form (between the entity and the third party), under state and federal law for nontax purposes. For example, a lease from a third party to the disregarded entity is treated as a lease directly to the single member-owner for federal tax purposes but is generally treated as a legal lease between the third party and the disregarded entity, not the single member-owner.

3. Transfer of Ownership Interest

The transfer of the interest in a disregarded entity is not treated as a transfer of the interest for federal tax purposes, but rather as a transfer of the assets of the disregarded entity. The same transfer, however, is generally recognized under state and federal law for nontax purposes.

4. Entity Conversion

The conversion of an entity into or out of disregarded entity status is treated as a transfer to or by the owner, and at least with respect to the conversion out of disregarded entity status, such a conversion should qualify for non-recognition treatment under federal income tax law. However, the conversion and the new entity arising therefrom generally are matters having legal significance and consequences under nontax provisions of state and federal law.

qualification of buyer's note for installment sale treatment in a Section 338(h)(10) transaction); Miller, *supra* note 98, at 22-69 (suggesting that such entities are a better alternative to a grantor trust, title-holding company, or a qualified subchapter S subsidiary); *see also* Jasper L. Cummings, Jr. & Samuel P. Starr, *The Impact of the New S Corporation Revisions*, 85 J. TAX'N 197, 203-05 (1996) (discussing qualified subchapter S trust).

A disregarded entity can also help with some of the remaining strictures on S corporations. As to who may be an S corporation shareholder, the Service has ruled that a disregarded single-member LLC may own S corporation stock because the stock will be deemed owned directly by the sole owner of the disregarded LLC.¹⁰¹ As to permitted subsidiaries, a disregarded entity can in effect expand the scope of a “qualified subchapter S subsidiary” under Section 1361(b)(3)(B). An S corporation may own 100 percent of a qualified subchapter S subsidiary and may generally treat such a subsidiary as a disregarded entity. The disregarded entity status of a check-the-box entity can extend this treatment to other contexts. For example, only a domestic entity may be a qualified subchapter S subsidiary, but the check-the-box regulations will permit an S corporation to own 100 percent of a foreign entity, permit the S corporation parent to be treated as if it incurred the disregarded entity’s foreign taxes directly, and therefore entitle the shareholders of the parent to report foreign tax credit.¹⁰²

The uses discussed below are by no means exclusive, although they do highlight some important characteristics.

D. Owner and Liability for SMLLC Employment Taxes

Unless an unincorporated¹⁰³ business entity¹⁰⁴ with a single owner¹⁰⁵ elects to be classified as a corporation,¹⁰⁶ it is disregarded as an entity separate from its owner and its activities are treated in the same manner as a sole proprietorship, branch, or division of the owner.¹⁰⁷ The Service has generally rationalized the existence of this type of unincorporated disregarded entity with other special corporate forms already recognized under other special tax sections as disregarded entities.¹⁰⁸ Generally, when an entity is disregarded, its entity status under state law is ignored for federal tax purposes, and all of its assets, liabilities, and items of income, deduction, and credit are treated as the assets, liabilities, and tax items of the single owner of the disregarded entity.¹⁰⁹

This analysis may lead to the conclusion that the tax liability of the disregarded LLC is directly the tax liability of the owner. This characterization is particularly important in the context of employment taxes and raises the issue

101. See I.R.S. Priv. Ltr. Rul. 97-39-014 (Sept. 26, 1997).

102. See generally Pillow et al., *supra* note 97.

103. See Treas. Reg. §§ 301.7701-2(b), 301.7701-2(c)(2)(i) (2008).

104. *Id.* § 301.7701-2(a).

105. *Id.* §§ 301.7701-1(a)(4), 301.7701-2(c)(2)(i).

106. Treas. Reg. §§ 301.7701-3(b)(1)(ii), 301.7701-3(c) (2006).

107. Treas. Reg. § 301.7701-2(a) (2008).

108. See *infra* Part III.H (discussing mergers and disregarded entities); see also Treas. Reg. § 1.368-2(b)(1)(ii) (2008). The term “disregarded entity” includes an unincorporated LLC with a single owner as well as two special corporate forms—a Section 1361(b)(3)(B) qualified Subchapter S subsidiary and a Section 856(i)(2) qualified REIT subsidiary.

109. See, e.g., I.R.C. §§ 1361(b)(3)(B)(i), 1361(b)(3)(B)(ii).

of whether the disregarded entity or its owner is responsible for employment taxes related to the employees of the disregarded entity—particularly where they are not properly paid.¹¹⁰ The Service’s official view evolved earlier in a 1999 notice, progressed through proposed regulations, and was finally solidified in 2007 in final regulations.

The first formal position of the Service appeared in Notice 99-6¹¹¹ that specifically addressed employment tax issues involving disregarded entities. This notice provided guidance regarding calculating, reporting, and paying employment tax obligations with respect to “employees of disregarded entities.” Because the federal tax classification regulations ignore the separate existence of a disregarded entity, the owner of the disregarded entity, and not the entity itself, is treated as the employer and therefore employment tax responsibilities traditionally rest with the owner. The owner is generally required to withhold and pay over applicable taxes from employees’ wages, pay employer taxes, make timely tax deposits, file employment tax returns, and issue wage statements to employees. Because the employees are actually “employed” by the disregarded entity under state law, however, this interpretation created considerable confusion.

After requesting comments and suggestions, Notice 99-6 established two taxpayer options to clarify reporting until further rules were released. These are discussed below.

1. *Owner Employer and EIN*

Calculation, reporting, and payment of all employment tax obligations with respect to employees of a disregarded entity by its owner (as though the employees of the disregarded entity are employed directly by the owner) and under the owner’s name and employer identification number (EIN).

2. *Disregarded Entity Employer and EIN*

Separate calculation, reporting, and payment of all employment tax obligations by each state law entity with respect to its employees under its own name and taxpayer identification number. (But see discussion immediately below making the owner personally liable for nonpayment.)

Finally, the notice states that even assuming the LLC is considered the

110. See *Littriello v. United States*, 2005 WL 1173277, at *4 (W.D. Ky. May 18, 2005), *aff’d*, 484 F.3d 372 (6th Cir. 2007), *cert. denied*, 128 S. Ct. 1290 (2008) (holding that the individual owner of a SMLLC was personally liable for the federal withholding and FICA taxes incurred by the entity for its employees). The court upheld the validity of the classification regulations under the standard established in *Chevron, U.S.A., Inc. v. Nat’l Resources Defense Council, Inc.*, 467 U.S. 837 (1984), and further refused to resort to the Section 6672 “responsible person” paradigm to make the owner personally liable. Rather, the court stated that the owner was personally liable for all federal taxes simply because he was the owner of an entity disregarded for federal tax purposes.

111. I.R.S. Notice 99-6, 1999-1 CB 321.

employer and fails to pay required employment taxes, the entity alone will not be solely liable. Therefore, the owner will be personally liable by status for all entity employment taxes simply because the legal entity is an SMLLC.¹¹²

The treatment of LLC employment taxes as the direct and personal liability of the single owner in an SMLLC is a counter-intuitive notion. While the entity is disregarded for federal tax purposes, it is common to consider the employment taxes as the sole responsibility of the employing entity. Perhaps because of this confusion, proposed regulations released on October 18, 2005, completely reversed the rule that the single owner is directly liable for SMLLC employment taxes.¹¹³ As a result, provided the SMLLC is the actual employer, it alone is directly liable for its own employment tax liabilities.

Indeed, the Service released final regulations on August 16, 2007, essentially adopting the position of the proposed regulations.¹¹⁴ The final regulations clarify that single-owner disregarded entities will be regarded as separate entities for employment tax purposes.¹¹⁵ Specifically, a disregarded entity such as an SMLLC is treated as a corporation with respect to the entity's employment taxes.¹¹⁶ This rule applies for purposes of calculating, reporting, and paying employment taxes.¹¹⁷ The entity must use its own separate employer identification number to file and pay employment taxes.¹¹⁸

The final regulations apply to wages paid after December 31, 2008.¹¹⁹ The final regulations further clarify that the individual owner of a disregarded entity will continue to be treated as self-employed and not as an employee of a disregarded entity for employment tax purposes.¹²⁰ Until December 31, 2008, disregarded entities and their owners continued to use the procedures set forth in Notice 99-6.¹²¹

While conceptually important, the taxpayer victory will only be significant where the owner is not also a "responsible person" and thus indirectly liable

112. *Id.*

113. Disregarded Entities; Employment and Excise Taxes, 70 Fed. Reg. 60,475-01 (Oct. 18, 2005) (to be codified at 26 C.F.R. pt. 301.7701-2).

114. Disregarded Entities; Employment and Excise Taxes, 72 Fed. Reg. 45891-01 (Aug. 16, 2007) added Treasury Regulation § 301.7701-2 in separate parts: (i) added a new last sentence to Treasury Regulation § 301.7701-2(a) ("But see paragraphs (c)(2)(iv) and (v) of this section for special employment and excise tax rules that apply to an eligible entity that is otherwise disregarded as an entity separate from its owner."); (ii) revised Treasury Regulation § 301.7701-2(c)(2)(i) ("Except as otherwise provided in this paragraph (c), a business entity that has a single owner and is not a corporation under paragraph (b) of this section is disregarded as an entity separate from its owner."); (iii) added Treasury Regulation § 301.7701-2(c)(2)(iv) and Treasury Regulation § 301.7701-2(e)(5); and (iv) added Treasury Regulation § 301.7701-2(e)(6).

115. See generally *Current Developments: Regulations Treat Disregarded Entities as Corporations for Purposes of Calculating Employment Taxes and Certain Excise Taxes*, 6 BUS. ENTITIES 55 (2007).

116. See Treas. Reg. § 301.7701-2(c)(2)(iv)(B).

117. See *id.* § 301.7701-2(c)(2)(iv)(B).

118. See *id.* § 301.7701-2(c)(2)(iv)(C).

119. See *id.* § 301.7701-2(e)(5).

120. Treas. Reg. § 301.7701-2(c)(2)(iv)(A).

121. See I.R.S. Notice 99-6, 1999-1 CB 321. The notice is discussed at ¶ 2.07[1][a][i].

under a constructive theory. Thus, the true effect is to shift owner liability from status based liability to conduct and responsibility based liability under Section 6672. Under that section, any responsible person is personally liable for an entity's unpaid employment taxes even if not an owner and regardless of the form of the entity (provided the entity has a liability shield). While the responsible-person liability provides several unique protections not afforded by the current direct-liability rule, those protections are significantly weakened where an informal LLC is used. Also, as with any other creditor, the Service might proceed on a theory of piercing the corporate veil where the LLC's activities are undercapitalized and its operations exceedingly informal.

As noted, the proposed and final regulations made an SMLLC's employment taxes the exclusive liability and responsibility of the SMLLC employer. While the SMLLC would be liable for those taxes, any person¹²² who is required to "collect, truthfully account for, and pay over" such taxes is personally liable for a 100 percent trust fund penalty tax equal to the amount owed by the employing SMLLC provided that person willfully fails to pay the tax.¹²³ The penalty is separate and distinct from the SMLLC's liability, but of course will only be imposed where the LLC fails to make payment.¹²⁴ A person becomes a "responsible person" with respect to an employing SMLLC where the person has a duty under state law to perform the act of collecting and paying the tax, and thus the term includes appropriate officers, employees, and even owners of the entity.¹²⁵

Many factors are relevant to this determination, including ownership status conferring a financial stake in the business as well as control over financial affairs. The owner of an SMLLC is likely to satisfy all these criteria. Liability for the penalty is predicated on a showing that the person "willfully" failed to collect or pay over the tax. This, however, generally requires no more than a voluntary or conscious refusal to pay the tax. Willfulness is generally established by evidence that the person was aware of the tax liability but nonetheless consciously paid the amount to others, including other creditors. Once the Service proves "responsible person" status, the burden of proving the lack of payment was not willful shifts to the alleged "responsible person."¹²⁶ Thus, in most cases, although the "responsible person" liability route theoretically provides the SMLLC owner more protection from personal liability for the SMLLC's employment taxes, that protection may be more illusory than real given the practical realities of the operations of most SMLLCs. In most cases, one would expect the owner of an SMLLC to be

122. Under Section 6672(e), an exception exists for voluntary board members of a tax-exempt organization. I.R.C. § 6672(e).

123. *Id.* § 6672(a).

124. *See* *Farrington v. United States*, 920 F. Supp. 12, 14 (D.N.H. 1996).

125. I.R.C. § 6671(b).

126. *See* *Hutchinson v. United States*, 962 F. Supp. 965, 969 (N.D. Tex. 1997).

heavily engaged in operations.

3. Levy on LLC Assets for Member Tax Liability

Unfortunately, the employment tax controversy and the issuance of regulations did not fully resolve the transparency issue. In two recent releases, the Service has determined that it is permissible to levy upon SMLLC assets to satisfy the non-employment tax obligations of the single owner. In Chief Counsel Advisory 200836002,¹²⁷ the Service considered a SMLLC owned by a lawyer. The lawyer had unpaid tax liabilities not arising from employment taxes. The lawyer practices law through the SMLLC, which receives legal fees from contingent fee agreements between clients and the SMLLC. The lawyer's only significant source of income came from sporadic accounts receivable arising from personal injury contingent fee agreements with the SMLLC. The ruling acknowledges that absent an alter-ego relationship, the Service may not levy on the SMLLC's assets to satisfy the single owner's tax liabilities. Also, the Service argues seizing and selling the lawyer's interest in the SMLLC is not viable because of the lack of purchasers. Accordingly, the ruling focuses on determining whether the SMLLC holds property or rights to property of the lawyer subject to levy.

Generally, the Service may enforce a tax lien¹²⁸ against a taxpayer's property¹²⁹ under two methods. First, the Service can initiate a judicial foreclosure action against the taxpayer's property.¹³⁰ Alternatively, the Service can execute an ex parte administrative levy on the taxpayer's property.¹³¹ Unlike a judicial foreclosure action, a levy is a provisional and administrative procedure¹³² and attaches only to the taxpayer's "property possessed and obligations existing at the time of the levy."¹³³ The "present obligation" requirement is interpreted to refer only to those obligations existing when the liability of the obligor is "fixed and determinable although the right to receive payment thereof may be deferred until a later date."¹³⁴ Payments for services are fixed and determinable when the services are performed.¹³⁵

The state of formation for the SMLLC is not identified but customarily provides that a member has the right to be repaid his capital contribution on liquidation and his right of profits prior thereto. From this member-liquidation right, the ruling segues into the theory that the lawyer has a property right

127. I.R.S. Chief Couns. Advisory 200836002 (Apr. 23, 2008).

128. A collectible tax obligation creates a statutory lien on all the taxpayer's property. I.R.C. § 6321.

129. See *Drye v. United States*, 528 U.S. 49, 56-59 (1999) (defining a taxpayer's property).

130. I.R.C. § 7403.

131. *Id.* § 6331.

132. See *United States v. Nat'l Bank of Commerce*, 472 U.S. 713, 722 (1985).

133. *United States v. Hemmen*, 51 F.3d 883, 887 (9th Cir. 1995).

134. Treas. Reg. § 301.6331-1(a)(1) (1992).

135. *CPS Elec., Ltd. v. United States*, 200 F. Supp. 2d 120, 125 (N.D.N.Y. 2002).

under state limited liability company law. Next, the ruling determines that because the member has such a right, the limited liability has an equivalent obligation to pay. That obligation to pay the lawyer upon the SMLLC liquidation thus became the lawyer's property subject to levy. Therefore, the Service can serve a notice of levy on the SMLLC to require it to turn over income in the SMLLC's possession to which the lawyer is "entitled" as a result of legal services rendered prior to the service of the notice of levy. The SMLLC's obligation to the lawyer is "fixed and determinable" when the SMLLC receives a contingent-fee sum following successful litigation and after setting aside a reserve for overhead expenses.

The problem with this ruling is its failure to consider the differing nature of an employee's "contractual right" to payment for services rendered from a third party and a member of an LLC "statutory interest" in LLC property by virtue of being a member. For example, in Delaware a member of a limited liability company is only entitled to an interim distribution before liquidation as provided in the operating agreement.¹³⁶ Once the member becomes so entitled to receive a distribution, only then does the member obtain creditor status and the LLC the reciprocating obligation to pay.¹³⁷ If the operating agreement is silent, the member does not become entitled to receive any LLC funds, regardless of how the LLC acquired the funds, until a distribution is declared. Until that time, the member clearly has "no interest in specific limited liability company property."¹³⁸ Further stated, no creditor of a member has any right "to obtain possession of, or otherwise exercise legal or equitable remedies with respect to, the property of the limited liability company."¹³⁹

As a result, a creditor of a member may only receive distributions when the LLC becomes obligated to pay a distribution. This would be a formal or informal declaration or vote of the single member of the SMLLC. Should the Service then wish to levy on the property subject to the distribution obligation, it may of course do so. Because most creditors, including the Service, do not want to wait until that magic moment of declaration and obligation for the amount to become fixed and determinable, the customary procedure is to apply to a court for a charging order.¹⁴⁰ In such cases, any future distributions are paid directly to the creditor and not to the member by court order. This assumes that a tax lien qualifies the Service as a judgment creditor simply by virtue of the existence of the lien. If not, the Service must first reduce its lien to judgment and then apply for a charging order.

Unlike some other states, in 1995 Delaware specifically eliminated the right of a judgment creditor to foreclose on a limited liability company interest

136. DEL. CODE ANN. tit. 6, § 18-601 (2006).

137. *Id.* § 18-606.

138. *Id.* § 18-701.

139. *Id.* § 18-703(e).

140. DEL. CODE ANN. tit. 6, § 18-703.

subject to a charging order. This placed a judgment creditor at a disadvantage compared to a UCC Article 9 creditor who may foreclose under the Code. Presumably, the Service would enjoy similar foreclosure rights as a UCC Article 9 creditor under its own statute permitting foreclosure.¹⁴¹ However, the ruling had already concluded that foreclosure was a useless remedy as no purchasers existed for the interest. For a similar analysis in a slightly different context, see Chief Counsel Advisory 200835030.¹⁴²

E. SMLLC Liability for Owner Taxes

In contrast to the discussion in Section A regarding the owner's liability for a SMLLC employment taxes, this section discusses the liability of the SMLLC for tax liabilities of its owner. The discussion again raises the significance of federal tax transparency to state and federal liability for debts and obligations of a SMLLC and its owner.

It is now clear that, while the federal disregarded entity tax rules make the Service a creditor of the entity's owner, those same rules do not make the Service a creditor of the entity itself. As a result, if an SMLLC owner fails to pay an assessed tax liability (regardless of whether it arose from the SMLLC's operations or a separate source), the Service remains merely a creditor of the owner and not the SMLLC.

This has two consequences. First, like any other LLC member's creditor, the Service may attach its lien to the owner's membership interest in the LLC, pursue a charging order (as well as a foreclosure and sale of that interest in some states), and then use the proceeds of the sale to offset the tax liability commensurate with its priority against the member's other personal creditors. With respect to the separate assets of the SMLLC, however, absent fraud or some other overreaching theory, the Service has no legal right to reach the SMLLC's assets. Indeed, to do so would violate the owner's liability shield in a form of "reverse piercing" and thereby fundamentally disrespect the independent status of the entity's other creditors.

The Service has now recognized and accepted this analysis.¹⁴³ In Chief Counsel Advisory 199930013, the Service attempted to levy on the taxpayer's employer. The employer informed the Service that the taxpayer was employed through a contract with the taxpayer's SMLLC. The Service then attempted to levy on the assets of the SMLLC on the theory that the SMLLC was "disregarded for federal tax purposes." The advisory rejected this approach, and indicated that the "disregard" was limited solely to imposing on the owner the liability for taxes applicable to the entity's operations. Because the entity is

141. I.R.C. § 7403.

142. See I.R.S. Chief Couns. Advisory 200835030 (July 18, 2008).

143. See I.R.S. Chief Couns. Advisory 200235023 (June 28, 2002); I.R.S. Chief Couns. Advisory 199930013 (Apr. 18, 1999).

a distinct and separate entity under state law, the advisory properly recognized that the SMLLC's assets did not "belong" to its owner. In this sense, the Service is like any other LLC member's creditor and must therefore approach claim enforcement in the same way. Absent fraud, the Service must attach the owner's interest, obtain a charging order, or conduct a foreclosure sale of the interest (when permitted).

F. Section 1031 Like-Kind Exchanges

Section 1031 generally provides that no gain or loss will be recognized when property held for investment or productive use in a trade or business is exchanged for other property of a like kind that is held for similar purposes.¹⁴⁴ Also, while interests in partnerships¹⁴⁵ and certificates of beneficial interest in trusts¹⁴⁶ are generally not eligible for Section 1031 exchange treatment, this rule does not apply to the ownership interests in a disregarded entity,¹⁴⁷ joint property ownership arrangements that do not constitute a partnership,¹⁴⁸ investing partnerships that properly elect to be excluded from partnership tax treatment, and ordinary trusts where the beneficiaries are regarded as grantors and thus similar to disregarded entities.¹⁴⁹ While this venerable law generally contemplated direct exchanges between two single fee owners of qualifying real or personal property, the evolution of disregarded entity treatment now provides important opportunities to interpose a disregarded entity into the existing like-kind exchange process.

Although the details are beyond the scope of these materials, the general import is that the owner of an SMLLC that owns real estate may treat the interest in the SMLLC as a direct interest in real estate. Therefore, two separate SMLLC owners whose SMLLCs both own real estate may exchange the SMLLC interests rather than the real estate itself.¹⁵⁰

G. Adding and Subtracting Members

Because the default classification of domestic-eligible entities depends on the number of owners, a change in the number of owners after a default classification will have tax consequences. When an LLC with two members

144. I.R.C. § 1031(a)(1).

145. *Id.* § 1031(a)(2)(D).

146. *Id.* § 1031(a)(2)(E).

147. *See generally id.* § 1361(b)(3)(A); Treas. Reg. § 1.1361-4 (2006) (stating that such entities are disregarded as separate from the owner, and thus the owner of the interest in the disregarded entity is treated as holding and owning directly all the assets, liabilities, and items of income, deduction, and credit of the disregarded entity).

148. Rev. Proc. 2002-22, 2002-1 C.B. 733.

149. Rev. Rul. 2004-86, 2004-2 C.B. 191.

150. *See generally* BISHOP & KLEINBERGER, *supra* note 5, ¶ 2.07[1][d]; Michael G. Schinner, *IRS Rulings Expand Opportunities for Using Single-Member LLCs in 1031 Exchanges*, 88 J. TAX'N 286 (1998).

loses one member, its default classification changes from partnership to disregarded entity status.¹⁵¹ Conversely, when an SMLLC adds at least one more member, its default classification changes from disregarded entity to partnership status.¹⁵²

Although these transformations in tax status necessarily have tax consequences for the members involved, the “check-the-box” regulations do not consider those consequences. On January 14, 1999, the Service issued Revenue Rulings 99-5¹⁵³ and 99-6¹⁵⁴ partially to fill that gap. Revenue Ruling 99-5 considers the tax consequences of adding a member to a single-member entity, while Revenue Ruling 99-6 considers the converse situation, namely, the contraction of a two-member LLC into an SMLLC.

Both rulings follow the same overall approach. They (1) address the two most likely business arrangements through which an eligible entity might move from one member to two, or vice versa; (2) deem certain transactions to have occurred as part of those business arrangements; and (3) determine the tax consequences of those deemed transactions.

Both rulings also share four limitations. First, each concerns an LLC rather than any other type of eligible entity taxed as partnership. This limitation makes sense because, as a matter of nontax state law, LLCs are the only widely used non-corporate entities able to operate with a single member.¹⁵⁵ Second, the LLCs involved are “domestic” U.S. entities. Neither ruling considers the ramifications of that characteristic nor suggests whether or how the tax consequences might differ for a foreign eligible entity. Third, both rulings assume that the LLC is debt-free. This limitation restricts the usefulness of the rulings and requires extrapolation in order to apply the rulings to many typical situations. Fourth, the rulings assume that the number of members changes only by one, i.e., from one to two or from two to one, but not, for instance, from four to one or from one to three.

1. SMLLC Becoming a Partnership

Revenue Ruling 99-5 considers the tax consequences of adding a new member to an SMLLC and issues arising on moving from disregarded entity status to partnership tax status. The ruling considers two situations each involving different entry methods for the new member. In Situation 1, the sole member sells part of her SMLLC interest to another who thereafter becomes a member. In Situation 2, the SMLLC admits another person as a new additional member in exchange for a contribution to capital to the SMLLC.

151. Treas. Reg. § 301.7701-3(b)(1)(ii) (2006).

152. *Id.*

153. Rev. Rul. 99-5, 1999-1 C.B. 434.

154. Rev. Rul. 99-6, 1999-1 C.B. 432.

155. For example, both general and limited partnerships must have at least two partners. REVISED UNIF. LTD. P'SHIP ACT § 101(7) (1985); REVISED UNIF. P'SHIP ACT § 202(a) (1997).

In Situation 1, because the SMLLC is disregarded, the owner is treated as owning the assets directly. Accordingly, notwithstanding the fact that the new member purchases an interest in the entity for state law purposes, federal tax law recasts the transaction as an asset sale of one half of the SMLLC's property by the old member and a contribution by the two owners to a new partnership. This allows the entering member to obtain a basis step up for the asset purchase but also requires the existing member to recognize gain or loss. In Situation 2, federal tax law simply treats both parties as if they created a partnership with contribution of existing assets. The existing member contributes the assets of the SMLLC, and the new member contributes per the agreement. Unlike Situation 1, Situation 2 does not require the existing member to recognize gain or loss.

2. *Partnership Becoming an SMLLC*

Revenue Ruling 99-6 considers the tax consequences of decreasing membership in an eligible entity from two members to one and thereby moving from tax partnership to disregarded entity status. The ruling discusses two situations, and both situations begin with A and B as the LLC's two members. For both situations, the ruling assumes that all the LLC assets are either capital assets or Section 1231 assets and that the LLC has no outstanding indebtedness. In Situation 1, A sells its entire membership interest to B. In Situation 2, A and B sell their entire interest to third party C. In both cases, the old AB Partnership is deemed to liquidate to arrive at a single owner. Therefore, the partnership liquidates and distributes its assets to A and B with either B or C purchasing half or all of the partnership assets from the former member who "contributes" the assets to an SMLLC in a nontax event.

3. *Surprising Transformations*

Of course, these tax effects and transformations may not be intuitive to clients not sophisticated in tax matters. It also creates potential surprises for even the more sophisticated. For example, the issuance of noncompensatory or compensatory LLC options in a SMLLC may trigger the addition of a new member if the option holder is treated as a member prior to exercise of the option. Extensive treatment of either option form is beyond the scope of this presentation, but a brief description follows.

With regard to noncompensatory options, proposed regulations released in 2003¹⁵⁶ basically look to several factors to determine if at the time of grant, there exists a reasonable certainty the option will be exercised.¹⁵⁷ If so, then

156. Prop. Treas. Reg. § 1.761-3, 68 Fed. Reg. 2930 (Jan. 22, 2003). The proposed regulations were issued after the Service requested suggestions and guidance in this area. I.R.S. Notice 2000-29, 2000-1 C.B. 1241.

157. See generally Paul Carman & Sheldon I. Banoff, *Proposed Regulations on Noncompensatory Partnership Options: No Gain, Some Pain*, 98 J. TAX'N 197 (2003); Matthew P. Larvick, *Noncompensatory*

the option holder is treated as a member at the time of grant.¹⁵⁸

The treatment of compensatory options depends upon whether the option is a capital interest or a profits interest. A profits interest is generally not taxable upon receipt while the receipt of a capital interest is taxable. In either case, if the option is subject to a substantial risk of forfeiture, the option holder will not be treated as a member.¹⁵⁹

H. SMLLC Mergers

State LLC laws have evolved considerably in connection with mergers¹⁶⁰ (same entity types with one surviving), consolidations¹⁶¹ (same entity types with a new same type entity created and surviving), domestications¹⁶² (same entity to same entity in a different state), and conversions¹⁶³ (one entity type to a different entity type) generally involving the same entity type in or outside the state. For example, under these rules, an LLC can merge with another LLC in the same state or another state, if permitted by the other state's LLC merger law.¹⁶⁴ Now, such transactions are permitted in many states between LLCs and other business entity forms such as general and limited partnerships as well as corporations.¹⁶⁵ These transactions are often referred to as cross-species transactions.

Of particular importance to the SMLLC is the confluence of the development of cross-species merger transactions between an LLC and a corporation, coupled with the recognition and understanding attributable to the relationship between an owner and a disregarded entity. Corporate-to-corporate merger transactions now routinely involve an SMLLC because for federal tax purposes the SMLLC does not have a tax existence.

When an entity such as an SMLLC is disregarded for federal tax purposes and its owner is a corporation, other corporate merger transactions with the SMLLC are treated as made directly with the corporate owner. While generally tax-free merger transactions have been limited by Section 368(b) to corporations, the only entity that can be considered a "party to a reorganization" and qualify for tax-free treatment are corporations. In a series of important regulatory releases, the Service has expanded the term "party to a reorganization" from a corporation to include a disregarded entity owned by a corporation. While a detailed discussion of these rules and uses are well

Partnership Options: The Proposed Regulations, 99 TAX NOTES 271 (Apr. 14, 2003).

158. Prop. Treas. Reg. § 1.761-3(a), 68 Fed. Reg. 2930 (Jan. 22, 2003).

159. Prop. Treas. Reg. § 1.761-1(b), 68 Fed. Reg. 2930 (Jan. 22, 2003).

160. REVISED UNIF. LTD. LIAB. CO. ACT § 1102 (2006).

161. *Id.*

162. *Id.* § 1010.

163. *Id.* § 1106.

164. See REVISED UNIF. LTD. LIAB. CO. ACT § 1102(a)(1).

165. See *id.* § 1001(1)-(2) (various "constituent" entity forms).

beyond the scope of these materials,¹⁶⁶ a discussion of their primary consequence and the progression of the Service releases is appropriate.

Generally, provided a target corporation merges into a disregarded entity owned by the acquiring corporation, the merger transaction will be treated as if the target corporation merged directly into the disregarded entity's corporate owner. Importantly, the transaction allows an acquiring corporation to accomplish what used to be accomplished as a forward triangular merger under Section 368(a)(2)(D) but without the normative limitations stated therein.

This means that the acquiring corporation need no longer create a new corporate subsidiary into which the target is merged. It also means that the truly flexible two-party statutory merger rules stated in Section 368(a)(1)(A) apply notwithstanding the fact that the merger is into a disregarded entity owned by the acquiring corporation. Finally, any pre-merger or post-merger mechanics between the acquiring corporation and its disregarded entity (now the surviving entity from the target merger) will also be disregarded and no longer used to potentially recast the merger into another form. All these advantages exist because the disregarded entity's assets are already treated as owned directly by its corporate owner.

The regulatory release pattern has been hectic. On May 16, 2000, the Service released a notice of proposed rulemaking and proposed regulations.¹⁶⁷ The 2000 Proposed Regulations provided that neither a merger of a corporation into a disregarded entity nor a merger of a disregarded entity into a corporation would be considered a statutory merger under Section 368(a)(1)(A) because the Owner's assets (other than those held in the Disregarded Entity) are not transferred to the acquiring corporation and the Owner does not cease to exist as a result of the state or federal law merger transaction.¹⁶⁸

Following the receipt of comments that merger of a corporation into a disregarded entity should be allowed as an "A" reorganization, on November 15, 2001, the Service withdrew the 2000 Proposed Regulations¹⁶⁹ and released new proposed regulations reversing position at least with regard to disregarded entities.¹⁷⁰ The 2001 Proposed Regulations were later clarified¹⁷¹ under regulations released on January 24, 2003 (2003 Proposed Regulations).¹⁷²

Under the 2001 Regulations as clarified by the 2003 Proposed Regulations, a

166. See BISHOP & KLEINBERGER, *supra* note 5, ¶ 12.11A.

167. Prop. Treas. Reg. § 1.368-2, 65 Fed. Reg. 31115 (May 16, 2000).

168. Prop. Treas. Reg. § 1.368-2(b)(1), 65 Fed. Reg. 31115 (May 16, 2000) ("In order to qualify as a reorganization under section 368(a)(1)(A), the transaction must be a merger or consolidation involving two corporations effected pursuant to the laws of the United States or a State or territory, or the District of Columbia.").

169. Prop. Treas. Reg. § 106186, 66 Fed. Reg. 57400-01 (Nov. 15, 2001).

170. Prop. Treas. Reg. § 126485, 66 Fed. Reg. 57400-02 (Nov. 15, 2001).

171. See Immerman & Ashraf, *Tax-Free Corporate Mergers Have Been Redefined for the LLC Era*, 30 J. CORP. TAX'N 3, 4 (2003).

172. Prop. Treas. Reg. § 1.368-2T, 68 Fed. Reg. 3384 (Jan. 24, 2003).

transaction will qualify as a Section 368(a)(1)(A) statutory merger notwithstanding that the target corporation or the acquiring corporation affects the transaction through a disregarded entity. The 2003 Proposed Regulations attached several conditions to the application of the permissive rule: the transaction is affected under applicable state law,¹⁷³ the disregarded entity is organized under applicable state law,¹⁷⁴ all the assets of each corporation and all owned disregarded entities (defined as a “combining unit”)¹⁷⁵ become the assets of another combining unit,¹⁷⁶ and each corporation that is not a disregarded entity (defined as a “combining entity”)¹⁷⁷ and is a member of the transferring combining unit ceases to exist.¹⁷⁸

The net effect of the 2001 and 2003 clarifications allowed two essential forms viewed from the perspective of the target and acquiring corporations. First, a target could drop assets into a disregarded entity and cause the disregarding entity to merge into the acquiring corporation. Second, the acquiring corporation could drop its stock into a disregarded entity and cause that disregarded entity to merge with the target corporation where the disregarded entity would be the surviving entity. On January 26, 2006, the 2003 Proposed Regulations were made final with few revisions.¹⁷⁹

Along the way, on January 5, 2005, the Service also released proposed regulations determining the applicability of disregarded entities in transactions and the implications for Section 368(d) and Section 355.¹⁸⁰ Essentially, the Service had earlier ruled¹⁸¹ that a corporation could “tack” the holding period of the time it held an interest in a member-managed LLC for purposes of satisfying the five-year active business requirement required for Section 355(b). These provisions are incorporated into the final regulations as well.¹⁸²

IV. CLASSIFICATION AND OTHER SERIES LLC ISSUES

A limited liability company series is not like a different class of stock in the same company and assets. In such a case, each class claim to corporate assets depends upon corporate creditors that could wipe out one or all of the class series. Rather, a series limited liability company is a single limited liability company with more than one internal series each with separate assets and liabilities and each of those with separate owners. Thus, unlike a corporate

173. Temp. Treas. Reg. § 1.368-2(b)(1)(ii) (2003).

174. *Id.* § 1.368-2(b)(1)(iii).

175. Temp. Treas. Reg. § 1.3862(b)(1)(i)(C) (2008).

176. *Id.* § 1.3862(b)(1)(ii)(A).

177. *Id.* § 1.3862(b)(1)(i)(B).

178. *Id.* § 1.3862(b)(1)(ii)(B).

179. T.D. 9242, 2006-1 C.B. 422 (2006).

180. Prop. Treas. Reg. § 125628, 70 Fed. Reg. 749 (Jan. 5, 2005).

181. Rev. Rul. 2002-49, 2002-2 C.B. 288.

182. *See generally* Treas. Reg. § 1.368-2(b) (2007).

class of stock, a series limited liability company protects the series owners from the assets and liabilities of the other series liabilities.

A. *State Series Laws*

In 1996, Delaware adopted the first series statute incorporated into a limited liability company statute.¹⁸³ Any series may have a separate business purpose, business objective, rights, and powers or duties with respect to specified property or obligations of the limited liability company (including profits or losses associated with such series).¹⁸⁴ A Delaware private limited liability company agreement may create one or more series.¹⁸⁵ However, the public certificate of formation must reference a limitation of liability in order for the debts and obligations of each series to belong only to that series.¹⁸⁶ The notice is sufficient “whether or not the limited liability company has established any series when such notice is included in the certificate of formation, and there shall be no requirement that any specific series of the limited liability company be referenced in such notice.”¹⁸⁷

Also, the records for each series must separately reflect the assets and liabilities of each series in order for the internal liability shield to exist.¹⁸⁸ The records must reasonably identify the assets and liabilities of each series.¹⁸⁹ The right to vote each series may be allocated in any manner among its members and managers.¹⁹⁰ Management is vested in members according to the profits-sharing ratio.¹⁹¹ A member ceases to be a series member upon assignment of their interest in a particular series.¹⁹² Such a cessation, however, does not cause the member to cease to be a member of another series or the limited liability company.¹⁹³

A series may be terminated without causing dissolution of the limited liability company.¹⁹⁴ A series is terminated on the earliest of the following occurrences: the time specified in the limited liability company agreement,¹⁹⁵

183. DEL. CODE ANN. tit. 6, § 18-215 (2006). Six other states have adopted series legislation. See 805 ILL. COMP. STAT. ANN. § 180/37-40(b) (2006); IOWA CODE § 490A. 305 (1999); NEV. REV. ANN. STAT. § 86.296.3 (2004); OKLA. STAT. ANN. 18, § 2054.4B (1999); TENN. CODE ANN. § 48-249-309 (2001); UTAH CODE ANN. § 48-2c-606 (2007).

184. DEL. CODE ANN. tit. 6, § 18-215(a).

185. *Id.* § 18-215(a).

186. *Id.* § 18-215(b).

187. *Id.*

188. DEL. CODE ANN. tit. 6, § 18-215(b).

189. DEL. CODE ANN. tit. 6, § 18-215(b) (2006).

190. *Id.* § 18-215(f).

191. *Id.* § 18-215(g).

192. *Id.* § 18-215(j).

193. DEL. CODE ANN. tit. 6, § 18-215(j).

194. *Id.* § 18-215(k).

195. DEL. CODE ANN. tit. 6, § 18-215(k)(1) (2006).

an event specified in the agreement,¹⁹⁶ the vote of two thirds of controlling voting members,¹⁹⁷ or by the Chancery Court when it is not reasonably practicable to carry on the business of the series.¹⁹⁸

B. Series Tax Classification

Until recently, the tax classification of a separate internal series as a sole proprietorship or partnership has been in doubt because the Service has not directly ruled on the matter. This tax uncertainty, along with the unknown regarding the enforceability of the internal liability shield, has limited the use of the series for operating businesses. Rather, a limited liability company might create a separate single-member limited liability company for the same purpose for each series.

Assuming a series is a legal entity separate from a limited liability company under Delaware law, that conclusion does not control whether the series should be treated as a separate entity for federal tax purposes.¹⁹⁹ Such an assumption predicts the direction of the federal tax law analysis. Where a relationship is not a separate legal entity under state law, federal tax law nonetheless tends to elevate the relationship to that of separate entity status when a certain quantum of business activity and purpose exists for the relationship.

While series issues are novel, the Service has adopted a similar approach in the context of a statutory trust series. In numerous private letter rulings, the Service has ruled that the several series of a single trust may be considered distinct taxable entities and separate taxpayers.²⁰⁰ The rulings all refer to two base authorities: *National Securities Series—Industrial Stock Series v. Commissioner*²⁰¹ and Revenue Ruling 55-416.²⁰² First, all the rulings treated the trust series as a separate taxable entity. Second, where the trustee did not have the power to vary the investments, the trusts were treated like an ordinary investment trust. Where the power to vary existed along with a business purpose, the series were treated like a partnership.²⁰³ Each ruling also concluded that regardless of classification each series was required to file a separate tax return.

The *National Securities* case is the seminal base authority. That case involved regulated investment companies that held property in trust consisting

196. *Id.* § 18-215(k)(2).

197. *Id.* § 18-215(k)(3).

198. *Id.* §§ 18-215(k)(4), 18-215(m).

199. Treas. Reg. § 301.7701-1(a)(1) (2006).

200. See, e.g., I.R.S. Priv. Ltr. Ruls. 20-03-030-17 to 20-03-030-19 (Jan. 17, 2003); I.R.S. Priv. Ltr. Rul. 98-47-013 (Nov. 20, 1998); I.R.S. Priv. Ltr. Rul. 98-37-005 (Sept. 11, 1998); I.R.S. Priv. Ltr. Ruls. 98-19-002 to 98-19-022 (May 8, 1998); I.R.S. Priv. Ltr. Rul. 94-35-015 (Sept. 2, 1994).

201. Nat'l Secs. Series—Indus. Stock Series v. Comm'r, 13 T.C. 884 (1949), *acq.* 1950-1 C.B. 4.

202. I.R.S. Rev. Rul. 55-416, 1955-1 C.B. 416.

203. See F. Richard Losey, *Publicly Traded Partnerships Treated as Corporations*, 12 J. PARTNERSHIP TAX'N 85, 85-86 (1995).

mostly of different types of securities. The funds were open-ended investment trusts whose shareholders were entitled, at their own option, to surrender shares and receive a value determined by a proportionate part of the underlying trust assets and net earnings. The court determined that each series was a separate entity. Revenue Ruling 55-416 later cited and followed the *National Securities* case rationale.

Other authorities support this “separateness” position. Revenue Ruling 55-39²⁰⁴ considered the tax consequences of a partner’s investment control over partnership assets and concluded that the terms of the partnership agreement made it clear that the securities would be treated as partnership property and subject to the claims of creditors. Given that each series exercises similar control under Delaware law, it appears this ruling suggests an alternative but equally persuasive reason to treat each series as a separate taxable entity.

Finally, tax commentators also suggest that a series should be taxable as a separate business entity under the check-the-box regulations. For example, the separate legal entity status of an Illinois series suggests such treatment.²⁰⁵ Indeed, the separate legal entity language of the Illinois series legislation was intended to influence the Service to classify an Illinois series as a separate business entity.

State taxing authorities have begun to consider the matter independent of federal consideration. The same classification issue exists with respect to state tax classification of a series. Ordinarily, states piggyback the federal tax classification rules.²⁰⁶ Massachusetts has released a state tax ruling that treats a Delaware series as a separate taxable entity.²⁰⁷ The ruling considered a Delaware series that would be a successor entity to a Massachusetts business trust. The ruling recognized that future series may be created. The ruling requested that each Delaware series be treated as a separate entity for Massachusetts income tax purposes, that each series (and further series created) be classified as a separate entity for Massachusetts income tax purposes, and that each series consequently be classified for Massachusetts income tax purposes in accordance with its federal classification. Issuing its own analysis, Massachusetts Letter Ruling 08-2 determined that a Delaware series should be classified as a disregarded entity or partnership, depending upon the number of owners of a particular series. The ruling cited three principal authorities, including the *National Securities* case,²⁰⁸ Revenue Ruling 55-416,²⁰⁹ and

204. I.R.S. Rev. Rul. 55-39, 1955-1 C.B. 403.

205. Michael E. Mooney, *Series LLCs: The Loaves and Fishes of Subchapter K*, 116 TAX NOTES 663 (2007); Charles T. Terry & Derek D. Samz, *An Initial Inquiry into the Federal Tax Classification of Series Limited Liability Companies*, 110 TAX NOTES 1093 (2006).

206. Michael W. McLoughlin & Bruce P. Ely, *Series LLCs: Many State Tax Questions Are Raised but Few Answers Are Yet Available*, 9 J. BUS. ENTITIES 36 (2007).

207. Mass. Ltr. Rul. 08-2 (Feb. 15, 2008).

208. Nat’l Sec. Series-Indus. Stock Series v. Comm’r, 13 T.C. 884 (1949), *acq.* 1950-1 C.B. 4.

209. I.R.S. Rev. Rul. 55-416, 1955-1 C.B. 416.

numerous Service private letter rulings regarding the tax classification of trust series. The ruling also indicated that Massachusetts will follow the entity's federal income tax classification. While the letter ruling was definitive for Massachusetts's income tax purposes, it leaned upon an, as of then, nonexistent federal tax ruling that a series will be classified as a separate business entity under the check-the-box regulations.

Fortunately, the Service recently released the first series federal tax classification ruling.²¹⁰ In Private Letter Ruling 200803004, the Service determined that a series formed under an unnamed state law was treated as a separate entity for tax purposes.²¹¹ The ruling considers the tax classification of an open-end management investment company organized as a series limited liability company. The beneficial interests in the limited liability company's properties are segregated into separate series or portfolios of assets. A portfolio series limited liability company with one member and not electing to be taxed as a corporation are treated as a disregarded entity. Portfolios with multiple owners are treated as partnerships unless they elect to be treated as corporations. Importantly, the ruling relies on the architecture of the CTB regulations to determine the outcome of the classification question. As such, each series must be considered a separate independent taxable entity under the CTB regulations.

V. CONCLUSION

The connection between tax law and business law is particularly evident in the series and SMLLC. Until the tax questions are adequately resolved, the business form is sparingly adopted by state legislatures and seldom utilized by practitioners. Before Revenue Ruling 88-76, only Wyoming and Florida adopted limited liability company statutes. Once the ruling was released, all fifty states and the District of Columbia had adopted legislation by 1996. Because Revenue Ruling 88-76 did not address the tax classification of an SMLLC, only a few states, like Texas, even permitted a limited liability company to be formed with a single member. After the 1977 CTB regulations clarified the tax treatment of the SMLLC, every state amended its laws to permit a limited liability company to be formed with one member. Once again, because the CTB regulations did not address the tax classification of a series limited liability company, only Delaware had adopted series legislation by late 1996. In the last twelve years, only six more states have adopted series legislation. With the 2008 release of Private Letter Ruling 200803004, it can be expected that more states will amend their state laws to permit a series limited liability company. This pace will certainly accelerate if the Service

210. See *IRS Issues Private Letter Ruling on the Classification of a Series Limited Liability Company for Tax Purposes*, 11 J. PASSTHROUGH ENTITIES 24 (2008).

211. I.R.S. Priv. Ltr. Rul. 20-08-030-04 (Jan. 18, 2008).

amends the CTB regulations to clarify the federal tax classification of a series consistent with Private Letter Ruling 200803004. One final caveat does distinguish the series. A significant nontax issue remains as to whether and to what extent courts will pierce the corporate veil internally collapsing the series together to reach assets allocated to separate series. But then again, early concerns regarding state enforcement of the limited liability shield did not measurably slow the growth and use of that entity form. Perhaps the same will be true with regard to the series.