

New business entity limits liability, taxability

By Charles Herbst

The Limited Liability Company (LLC), a new form of doing business that combines some of the advantages of a partnership and a corporation, has arrived in Indiana. Indiana's new Limited Liability Company Act¹ took effect July 1, 1993. Foreign LLCs, however, have been registering with the secretary of state to do business in Indiana since 1990.²

The first LLC legislation was passed in Wyoming in 1977.³ That statute was designed to make it possible to circumvent S corporation restrictions, while limiting investor liability and incurring just one level of federal income tax.⁴

Interest in the LLC began to spread nationwide when the Internal Revenue Service issued Rev. Rul. 88-76,⁵ holding that Wyoming LLCs would be classified as partnerships for federal income tax purposes — thereby eliminating the threat of entity-level federal taxation.

Since the IRS ruling, about half of all states have passed legislation making it possible to form LLCs in their respective jurisdictions. These states recognize the status of LLCs organized according to the laws of other jurisdictions. Indiana is the latest state to join this parade.

When choosing the appropriate entity for a business, Indiana practitioners will want to consider the LLC as an alternative to the now-popular S corporation. As mentioned, the LLC has characteristics of both partnerships and corporations. An LLC resembles a limited partnership, but lacks a general partner. At the same time, the LLC provides limited investor liability. Because it can qualify for classification as a partnership for federal income tax purposes, an LLC

can avoid entity-level income taxation. In addition, an LLC offers a host of other tax benefits.

Offering greater flexibility than traditional S corporations, LLCs can be used for a variety of businesses. They are particularly suitable for closely-held businesses. This article presents a summary of choice-of-entity considerations for closely-held businesses and discusses the highlights of how to form and operate a Hoosier LLC. In addition, this article identifies important points to consider when contemplating formation of an LLC.

Choice of entity

When a business entity is formed, two goals predominate:

1. Avoid investor liability at all costs.
2. Avoid a corporate-level tax, if possible.

Investors now can achieve both these goals by choosing either the S corporation or the limited liability company as a suitable entity.⁶

S corporations

For some organizations, the S corporation remains the easier and more

practical choice. An S corporation is created by forming an ordinary corporation under state law, and then filing an election with the IRS to be taxed under subchapter S of the Internal Revenue Code. Investor liability is limited to the amount of the investment; S corporations are not subject to federal or Indiana corporate-level income taxes. Shareholders are taxed on the S corporation's income via a pass-through method that is similar to the taxation of partnerships.⁷

However, there are major limitations to electing subchapter S treatment — the eligibility restrictions imposed by the Internal Revenue Code. They fall into three categories:

1. Restrictions on ownership — S corporations may not have more than 35 shareholders. Corporations, partnerships and nonresident aliens may not be shareholders.⁸

2. Restrictions on capital structure — An S corporation may have only one class of stock.⁹ This restriction precludes the use of special allocations and preferred stock.¹⁰

3. Restrictions on activities — S corporations may not engage in certain businesses, chiefly banking and insurance.¹¹ (These activity restrictions also apply to LLCs.)

Limited liability companies

For many closely-held businesses, the flexibility of partnership taxation and absence of S corporation restrictions will make the tax advantages of the LLC irresistible.

While an LLC is a distinct type of entity, it is a hybrid between a corporation and a partnership. The greatest difference between an LLC's partnership-style taxation and S corporation taxation involves the ability to alter the capital structure of the organization. The possibilities are endless, but the following examples should suffice to illustrate the greater usefulness of LLCs:

1. LLCs may adopt special profit and loss allocations and differences

among members in voting rights.

2. Tiered interests are possible in an LLC.

3. Foreign investors can finally enjoy limited liability and one level of taxation.

4. Special profit allocations allow an investor to "advance funds" to an LLC. The advancing member can be given a special allocation of LLC profits¹² until his or her "advance" is repaid, and possibly avoid debt treatment, stated interest and original issue discount requirements.

5. Simply by forming an LLC, two C corporations that want to form a 50-50 joint venture can avoid an additional level of taxation without being exposed to additional liability in the venture.

6. Employees can be given a profits interest without a voting interest in the business.¹³

Formation and operation of an Indiana LLC

Indiana's LLC statute provides for tremendous flexibility, but also provides "default" conditions for fail-safe tax planning.

Investors in an LLC are generally known as members. Unless the operating agreement provides otherwise, the unanimous consent of the other members is required for acceptance into membership.¹⁴ Members may transfer their profits and capital interest in the LLC. However, unless the operating agreement specifies otherwise, the transferee may not become a member without the unanimous consent of all other members — nor is the transferee entitled to voting rights or other rights related to governing of the LLC.¹⁵

An LLC may adopt an operating agreement, similar to a partnership agreement, to facilitate regulation of its affairs.¹⁶ The operating agreement is the basis for LLC operation and governance. Within certain limitations, the agreement may alter members' profit and loss allocations as well as alter members' voting rights.

The governing officials of an LLC are generally known as managers. If the articles of organization do not provide for managers, each member will be considered an agent of the LLC. If the articles of organization provide for managers, then members, acting in their capacity as members, will not be considered agents of the LLC.¹⁷ Managers need not be natural persons or members.¹⁸ Except as provided in a written operating agreement, or unless they engage in willful misconduct or recklessness, managers are not liable to the LLC or to its members for their performance.¹⁹

To form an LLC in Indiana, the articles of organization must be filed with the Indiana Secretary of State.²⁰ These articles must include: (1) the name and address of the LLC; (2) the period of its duration (which may be in perpetuity);²¹ (3) the name and address of its registered agent in Indiana; (4) a statement that manage-

ment of the LLC is vested in a manager or managers²² (if applicable); and (5) any other matters that members agree to include, including any matters that are required to be or may be included in the operating agreement.²³

Like the names of partnerships and corporations, names for LLCs may be reserved in advance.²⁴ The name of an LLC must include the words "limited liability company" or "LLC."²⁵

Each LLC is also required to file an annual report with the secretary of state. This document reports the LLC's name, the name and address of the LLC's registered agent and the address of the LLC's principal office.²⁶

An LLC is dissolved upon an event of dissociation, which may be either a member's death, retirement, resignation, expulsion or dissolution. It is

New business entity

continued

possible for the operating agreement to provide members with the right to continue the LLC when an event of dissociation occurs.²⁷ Also, an LLC is dissolved when the period of duration designated in its articles of organization expires or by written consent of all its members.²⁸

Existing entities

Existing sole proprietorships and partnerships will find it fairly easy to convert to an LLC.²⁹ Similarly, an LLC that is taxed as a partnership can later incorporate without difficulty.³⁰

Existing corporations that attempt to disincorporate and form LLCs may recognize significant adverse tax consequences, including recognition of gains at both the shareholder and corporate level.³¹ For this reason, LLCs will generally be an option only for new or unincorporated entities.³²

Limitation of member liability

For businesses operating exclusively in Indiana, member liability should not be a problem. Indiana's Act provides: "A member . . . of a limited liability company is not per-

sonally liable for the debts, obligations or liabilities of the limited liability company, whether arising in contract, tort or otherwise, or for the acts or omissions of any other member, manager, agent or employee of the limited liability company. A member . . . may be personally liable for the member's own acts or omissions."³³ A member is liable to the extent of his or her contribution.³⁴

Other states with LLC laws also recognize members' limited liability for obligations of "foreign" LLCs.³⁵ It is not yet clear what the prevailing standard for piercing the "corporate" veil will be, either in Indiana or elsewhere.³⁶

In states without LLC laws, the liability of members for LLC obligations is not clear. Although a number of arguments favor interstate recognition of the LLC,³⁷ the LLC is too new for the question to have been conclusively resolved either by statute or litigation.

Given the present ambiguity, an S corporation should be a safer alternative for those who plan immediate interstate operations in nonadopting jurisdictions. Adoption of some version of the LLC by all 50 states, which

should be soon, will eliminate this concern.

Avoiding corporate-level income tax

The four-question test

Not every LLC qualifies for classification as a partnership. Classification of LLCs as partnerships for federal income tax purposes is based upon the underlying characteristics of the LLC rather than any labels applied by a taxpayer or state law. Because Indiana's Act is so flexible, drafting the operating agreement requires considerable care in order to achieve the desired tax classification.

The appropriate standard for classification of an entity as a corporation or partnership for federal income tax purposes is the "four-question test" found in Treas. Reg. § 301.7701-2. This regulation enumerates four attributes that are common to corporations, but not found in partnerships and trusts. These attributes are Limited Liability, Continuity of Life, Centralized Management and Free Transferability of Interests. An entity that has three or more of these attributes is classified as a corporation and subject to corporate income tax. An entity that has two or fewer of these attributes qualifies for treatment as a partnership.

In Rev. Rul. 88-76, the IRS considered a Wyoming LLC and concluded that a Wyoming LLC is a partnership because it possesses Limited Liability and Centralized Management, but lacks Free Transferability of Interests and Continuity of Life.

State LLC laws vary considerably and Rev. Rul. 88-76 analyzed only the Wyoming formulation.³⁸ In other jurisdictions, including Indiana, a detailed analysis of the LLC must be undertaken to make sure that an LLC organized under another state's laws qualifies for federal partnership classification:

Limited Liability — Like a Wyoming LLC, an Indiana LLC will have Limited Liability.³⁹

Choose only one:

Centralized Management — Both Wyoming law⁴⁰ and Indiana's LLC Act⁴¹ make centralized management optional. In Rev. Rul. 88-76, the IRS held that if a Wyoming LLC is managed by designated managers, it will be considered to have Centralized Management. If governance by all of the members of the LLC is acceptable and Free Transferability of Interests or Continuity of Life is desired, the articles of organization should not provide for managers.

Free Transferability of Interests — Wyoming law provides that a member may transfer his or her economic rights in the LLC to a third party, but the transferee may only participate in the management or become a member of the LLC with the **unanimous** consent of the other members.⁴² In Rev. Rul. 88-76, the IRS concluded that the Wyoming LLC lacked Free Transferability of Interests.⁴³

The Indiana Act provides this restriction as well, but allows an LLC to have Free Transferability by superseding this restriction in its operating agreement.⁴⁴

Continuity of Life — Wyoming law provides that the LLC shall be dissolved upon the expiration of the period designated for the LLC's existence, or the death, retirement, resignation, expulsion, bankruptcy or dissolution of a member unless there is **unanimous** consent by all of the remaining members to continue. Such a right must be provided for in the LLC's articles of organization.⁴⁵

In Rev. Rul. 88-76, the IRS decided

the requirement of unanimous consent to continue the LLC after the death or withdrawal of a member was adequate to defeat Continuity of Life.⁴⁶ The Indiana Act provides for dissolution if an event of dissociation occurs, but allows an LLC to maintain Continuity of Life by superseding this provision in its operating agreement.⁴⁷

Actual continuity can be enhanced without triggering corporate status by providing in the articles of organization that the members have a right to continue the LLC upon an event of dissociation and impose a contractual obligation on each member to exercise this right. Such an obligation should be included in the written operating agreement. It is crucial that the remedy for breach of this obligation specifically exclude specific performance. While the IRS has not ruled on this technique in the LLC context, its use has been upheld in case law dealing with classification of a limited partnership.⁴⁸

Finally, in addition to passing the four-question test, to be taxed as a partnership for federal income tax purposes, an entity must have at least two members.⁴⁹ Indiana's Act allows one-member LLCs.⁵⁰ To qualify for

partnership classification, an Indiana LLC's operating agreement must be modified to require a minimum of two members at all times.

State income taxation

LLCs that are treated as partnerships for federal tax purposes will be treated as partnerships for Indiana state income tax purposes.⁵¹

State tax treatment in other jurisdictions may be inconsistent. Although many states follow the federal classification scheme or statutorily classify LLCs as partnerships for tax purposes,⁵² there are exceptions. For example, Florida taxes an LLC like a corporation and subjects the LLC to a 5.5 percent entity-level income tax.⁵³

Other LLC tax considerations

Once an LLC has qualified for tax treatment as a partnership, two other issues warrant consideration:

1. Passive activity limitations. The *per se* loss limitation restrictions on limited partnership interests do not apply to LLCs. A taxpayer can claim losses related to membership in an

New business entity *continued*

LLC if he or she "materially participates" in the management and activities of the LLC.⁵⁴

2. Master limited partnership rules will apply to LLCs if interests in the LLC are publicly traded. Such publicly traded partnerships are taxed like C corporations.⁵⁵ This should not affect closely-held LLCs, provided they lack Free Transferability of Interests.

Federal reaction

Once legislation is enacted nationwide, the LLC has the potential to render most uses of the S corporation, partnerships and limited partnerships obsolete. The demise of these entities should have a fairly neutral effect on the federal and state treasury. But should a large number of entities that would otherwise incorporate as C corporations adopt LLC structures, federal and state tax revenues could be adversely

affected. Such a change could invite the scrutiny of Congress and others, particularly because of concern over the size of the federal deficit.

Statutes such as Indiana's may also cause an administrative nightmare for the IRS in attempting to classify entities as either partnerships or corporations. The IRS will have to consider each Indiana LLC on a case-by-case basis, unlike those in Wyoming, where all LLCs qualify.

To facilitate classification, the IRS could modify the requirements for classification as a partnership. Such a change would probably have a profound effect on limited partnerships as well as LLCs. Considerable taxpayer uproar and demand for congressional relief could be expected. But, even in a worst-case scenario, the LLC could restructure itself, incorporate, and probably elect S corporation status.

Unlike a C corporation, the structural transferability, continuity and management restrictions placed on LLCs prevent them from becoming large.⁵⁶ By not placing an entity-level tax on S corporations, Congress appears to have made the decision to apply entity-level tax only to larger businesses. Given such a policy, further liberalization of S corporation rules, rather than congressional

action against the LLC, seems the more likely outcome.

Conclusion

Here in Indiana, we now have a new and tremendously flexible vehicle for organizing closely-held businesses. The LLC should be considered whenever a new business is formed. The rapid, national rise of the LLC ensures that dramatic changes are on the horizon. The financial incentives this form offers motivate taxpayers in every state to demand that legislation be passed to enable LLC formation or at least recognize foreign LLCs. Such a development will provide much greater security for Hoosier LLCs in the conduct of interstate business. Widespread use of the LLC should simplify the business formation process and provide clearer expectations for those who elect to use LLCs.

1. Indiana Business Flexibility Act, P.L. 8-1933; codified principally at Ind. Code § 23-18-1-1, et seq.

2. Ind. Code § 23-16-10-1-1 provided for registration of "foreign" LLCs with the Indiana Secretary of State. The new act repeals this statute and requires registration of foreign LLCs under Ind. Code § 23-18-11-2. Although the prior statute provided for registration, the limited liability status of LLCs in Indiana courts was not clear. LLCs registered under the old law are "grandfathered" into the new system. Ind. Code § 23-18-11-18(b).

3. 1977 Wyo. Sess. Laws ch. 158, § 1; W.S. 1957. Codified at Wyo. Stat. § 17-15-101 to 136 (1977).

4. Since the Wyoming statute was enacted, Congress has liberalized some of the S corporation restrictions. E.g., prior to 1981, S corporations were restricted to 15 shareholders.

5. 1988-2 C.B. 360.

6. Other possible entities fail to meet at least one of the goals: Sole proprietorships and partnerships fail to limit investors' liability. Even in limited partnerships, the general partner remains personally liable for the debts of the partnership. C corporations provide limited lia-

- bility, but are assessed income tax at a 34 percent federal statutory rate and a 3.4 percent Indiana tax on adjusted gross income.
7. There are a number of differences in taxation of partnerships and S corporations. A thorough review of the taxation of these two entities is beyond the scope of this article. For an excellent discussion of these topics, see W. McKee, W. Nelson & R. Whitmire, *Federal Taxation of Partnerships and Partners* (2nd ed. 1990); and B. Bittker & J. Eustice, *Federal Income Taxation of Corporations and Shareholders* (5th ed. 1987).
 8. IRC § 1361(b)(1).
 9. IRC § 1363(b)(1)(D).
 10. Taxpayers and their counsel have created ingenious schemes to defeat this rule. One example consists of using a partnership of S corporations to defeat the maximum shareholder requirement. In Rev. Rul. 77-220, 1977-1 C.B. 263, the IRS disallowed the S election and found the structure to be a "sham" and lacking a business purpose other than circumventing the tax laws. Other examples include the use of subordinated debt or call options. The IRS has since drafted regulations greatly restricting these techniques. See *Treas. Reg. § 1.1361-1(1)(4)*(1992).
 11. IRC § 1361(b)(2).
 12. Special allocations must qualify under the "substantial economic effect" test. See IRC § 704(b) and Regs.
 13. Such an arrangement is subject to ERISA and securities laws and regulations.
 14. Ind. Code § 23-18-6-1(a)(1). If, for tax classification purposes, free transferability of interests is undesirable, the operating agreement should not be modified to require a less than unanimous vote for admission as a member.
 15. Ind. Code §§ 23-18-6-4(a). If, for tax classification purposes, free transferability of interests is undesirable, the operating agreement should require that such consent be unanimous and in writing. See footnote 44 and accompanying text.
 16. Ind. Code § 23-18-4-5.
 17. Ind. Code § 23-18-3-1.
 18. Ind. Code § 23-18-4-1(b)(2).
 19. Ind. Code § 23-18-4-2(a).
 20. Ind. Code § 23-18-2-4.
 21. The possible tax consequences of perpetual duration should be considered before making this specification. See footnote 47 and accompanying text.
 22. Failure to provide such a clause makes each member an agent of the LLC and allows each member to bind the LLC. See Ind. Code § 23-18-3-1. If, for tax classification purposes, centralized management is undesirable, the articles of organization should not contain this statement.
 23. Ind. Code § 23-18-2-4.
 24. Ind. Code § 23-18-2-9.
 25. Ind. Code § 23-18-2-8(a)(1).
 26. Ind. Code § 23-18-12-11.
 27. Ind. Code § 23-18-9-1(3). If, for tax classification purposes, continuity of life is undesirable, the operating agreement should require a unanimous vote to continue the LLC if an event of dissociation occurs. See footnote 47 and accompanying text.
 28. Ind. Code § 23-18-9-1.
 29. I.R.C. § 721.
 30. I.R.C. § 351.
 31. I.R.C. §§ 331, 336.
 32. Provided the LLC is classified as a partnership, either C or S corporations should be able to invest in LLCs without adverse tax consequences.
 33. Ind. Code § 23-18-3-3(a).
 34. Ind. Code § 23-18-5-1.
 35. Because these states recognize similar organizations in their own states, constitutional obligations to grant full faith and credit to the laws of another state would also apply.
 36. Colorado has provided for application of corporate case law to answer this question. See *Colo. Rev. Stat. § 7-80-107*.
 37. Arguments promoting recognition of the LLC and limitation of members' liability include interstate commerce, comity, analogies to some of the early limited partnership cases, and the equities of holding a member liable when the creditor was "on notice" by the plain meaning of the words "limited liability company" that the creditor could not conclusively rely on the assets of individual members when transacting business with the LLC. At this time, however, there is no assurance that a state court would necessarily accept these assertions.
 38. The IRS has since issued Rev. Rul. 93-5 and Rev. Rul. 93-6, ruling that Virginia and Colorado LLCs are partnerships for federal tax purposes. The Colorado and Virginia Acts are similar to the Wyoming law and do not contain the flexibility of the Indiana act.
 39. See footnote 33 and accompanying text.
 40. Wyo. Stat. § 17-15-116.
 41. Ind. Code § 23-18-3-1.
 42. Wyo. Stat. § 17-15-122.
 43. The unanimity requirement is beginning to weaken. In PLR 9210019, the Service held that a Texas LLC which required merely the approval of the manager (if the manager is a member) or a majority of membership approval to effect a transfer of interests was lacking free transferability of interests.
 44. Ind. Code §§ 23-18-6-3; -4.
 45. Wyo. Stat. § 17-15-123(a)(iii).
 46. This unanimity requirement is weakening as well. For example, in PLR 9226035, the Service concluded that a Utah LLC which required the consent of all managers and merely a majority of remaining members to continue lacked continuity of life.
 47. Ind. Code § 23-18-9-1(3).
 48. See *Zuckman*, 524 F.2d 729,735 (Ct. Cl. 1975). See also Note, 91 Harv. L. Rev. 745, 750 (1977).
 49. *Treas. Reg. § 1.708-1(b)(1)(i)*.
 50. Ind. Code § 23-18-2-4(a).
 51. Ind. Code § 6-3-1-19 (a). Presumably LLCs treated as corporations for federal tax purposes will be treated as corporations under Indiana tax law.
 52. *Colo. Rev. Stat. § 39-22-201.5*.
 53. *Fla. Stat. Ann. § 220.02; 220.11; 608.471*.
 54. See I.R.C. § 469(h) and Regs.
 55. See I.R.C. § 7704 and Regs.
 56. Ultimately, the Master Limited Partnership Rules would apply to the LLC. See I.R.C. § 7704.