

2000

## Limited Liability Companies in Kentucky, Second Edition

Office of Continuing Legal Education at the University of Kentucky College of Law

Scott W. Dolson

*Brown, Todd & Heyburn PLLC*

John S. Egan

*Brown, Todd & Heyburn PLLC*

Charles Fassler

*Greenbaum Doll & McDonald PLLC*

Glenn D. Gunnels

*Brown, Todd & Heyburn PLLC*

*See next page for additional authors*

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## Authors

Office of Continuing Legal Education at the University of Kentucky College of Law, Scott W. Dolson, John S. Egan, Charles Fassler, Glenn D. Gunnels, C. Bradford Harris, Charles R. Keeton, Charles J. (Chaz) Lavelle, Alan K. Macdonald, Debbie R. Reiss, Thomas E. Rutledge, James C. Seiffert, and William G. Strench



**UK  
CLE**

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**Monograph**

**Series**

**Limited Liability  
Companies in Kentucky**

**• Second Edition •**

**Scott W. Dolson  
Managing Editor**

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Scott W. Dolson	Chapters 9, 11, 14, 15
John S. Egan	Chapter 16
Charles Fassler	Chapters 3 & 8
Glenn D. Gunnels	Chapter 17
C. Bradford Harris	Chapter 12
Charles R. Keeton	Chapter 16
Charles J. Lavelle	Chapters 3 & 8
Alan K. MacDonald	Chapter 2 & 12
Debbie F. Reiss	Chapter 17
Thomas E. Rutledge	Chapters 4, 5, 6 & 7
James C. Seiffert	Chapters 1, 2 & 10
William G. Strench	Chapters 13 & 18

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(606) 257-CLE1  
Facsimile  
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## PREFACE

The Kentucky Limited Liability Company Act, KRS Chapter 275, went into effect July 15, 1994, allowing Kentuckians to conduct business under the LLC form. With over 10,000 LLCs formed in the Commonwealth since the Act's inception, this flexible business entity has become the most popular way to conduct business in Kentucky.

The LLC has become so pervasive that business law practitioners, accountants, tax advisors and estate planners must all be well-versed in the myriad of issues and creative applications that accompany this business entity. With flexible tax-treatment and the liability protection of a traditional corporation this entity is utilized not only for business formation and practice but also for business succession and estate planning, the structuring of joint ventures and strategic alliances, as venture capital vehicles, and as tax planning tools.

The goal of this monograph is to provide the practitioner with a concise and comprehensive approach to the tools necessary for lawyers to counsel and advise clients on this complex and efficient business entity form. Succinct chapters take the reader through an overview of the LLC entity and the Kentucky LLC Act; choice of entity considerations (both tax and non-tax); the formation, operation and statutory transaction issues which arise for the entity; as well as the new single-member LLC; the professional LLC; the use of the LLC in tax-exempt organizations; wealth transfer planning with LLCs; and securities law, commercial law and benefit issues arising under the LLC entity. Each chapter is set forth in separately numbered paragraphs, present running headers for easy access, and are cross-referenced to other relevant chapters and paragraphs contained in the monograph. Summary and comparative charts, a table of authorities and a statutory appendix are also presented. Finally, a comprehensive index has been created to aid the user in finding relevant subject treatments.

Managing Editor:	Kevin P. Bucknam
	Publications Director
	University of Kentucky College of Law
	Office of Continuing Legal Education

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Producing a quality publication requires a sequence of distinct activities. Conceiving, financing, structuring, writing, editing, typesetting, indexing, and proof-reading list only a few of them. Each activity involves thoughtful work and dedication on the part of many individuals. Their efforts in developing an accurate, well organized book belie the conventional wisdom that producing a publication of this type is a mere mechanical pursuit.

UK/CLE wishes to extend sincere appreciation to each of the individual authors of this volume. Their volunteer contribution of legal research, analyses, writing and scholarship is the foundation of this book and this office's efforts to provide quality legal publications to the practicing bar of Kentucky. Special thanks is owed to Managing Editor, **Scott W. Dolson** of Brown, Todd & Heyburn PLLC who managed the multi-disciplinary teams of talented authors and edited their work into a single, uniform publication. Mr. Dolson has returned as both an author and as the Managing Editor from the first edition of this popular monograph. Scott initiated the development of this book, was instrumental in the creation of its contents and offered his persistence, patience and consistent support toward the publication of this book.

The Editor's and authors' support for quality continuing legal education illustrates their commitment to professional education through voluntarism, and should be a source of pride to every attorney in the Commonwealth. Everyone who benefits from this book owes thanks to these individuals for their unselfish work. We also hope this publication will challenge each member of the Bar to work to improve the profession through diligent scholarship, public service and continuing legal education.

Over a period of eleven (11) months, countless hours were dedicated to the production of this handbook. A large portion of those hours were invested in typesetting and composing by Editorial Assistant Beth Haendiges, without whose diligence, patience and perseverance this book would not have been possible. Her skills have helped UK/CLE maintain its position as one of the top legal publishers in the Commonwealth. Numerous hours were also spent proof-reading and editing the substantive text of this volume by Publications Assistant Melinda Rawlings. Ms. Rawlings' work in this regard serves as the back-bone for this high quality publication.



## CONTRIBUTING AUTHORS

**SCOTT W. DOLSON** is with the law firm of Brown, Todd & Heyburn PLLC, where he has split his practice between the Firm's Lexington and Louisville, Kentucky offices. Mr. Dolson's practice focuses on business transactions, with an emphasis in the tax, partnership, entrepreneurial services and business planning areas. He is a graduate (*cum laude*) of Harvard College and was awarded his J.D. degree from the University of Virginia Law School. Mr. Dolson served on the KBA committees which drafted the Kentucky Business Corporation Act, KRS Chapter 271 B, the Kentucky Limited Liability Company Act, KRS Chapter 275, and registered limited liability partnership legislation. He chaired the LLC committee's efforts with respect to the enactment of legislation authorizing the use of limited liability companies by professionals. Mr. Dolson is a co-author of two chapters in the 1989 UK/CLE practice handbook, Kentucky Business Organizations, the sole author of the 1993 UK/CLE monograph, Professional Service Corporations in Kentucky, and the Managing Editor and contributing author for the 1994, first edition of the UK/CLE monograph, Limited Liability Companies in Kentucky. He has also served as the Handbook Chair and an author for the 1997 UK/CLE practice handbook, Kentucky Corporation Law, and as a Co-Managing Editor and author for the 1998 UK/CLE monograph, Business Succession Planning. He serves as legal counsel to the Louisville Free Public Library Foundation.

**JOHN S. EGAN** is with the Louisville, Kentucky office of Brown, Todd & Heyburn PLLC where he concentrates his practice in the areas of commercial law, bankruptcy law and tax-exempt financing. Mr. Egan received his B.A. and M.A. degrees from The Johns Hopkins University and was awarded his J.D. (*with honors*) from Duke University where he served as Editor of the *Consumer Law Letter*. He is a member of the Louisville (Chairman, Bankruptcy Section, 1995-1997), Kentucky and American (Member: Corporation, Banking and Business Law Section; Regulation of Securities Committee, 1985-1992; Litigation Section, Bankruptcy and Insolvency Committee 1993-) Bar Associations. Mr. Egan is also a member of the South Carolina Bar and the National Association of Bond Lawyers. He is widely published and a frequent lecturer at continuing legal education programs.

**CHARLES FASSLER** is a member of the Louisville office of Greenebaum Doll & McDonald PLLC where he concentrates his practice in the areas of federal income taxation, partnership, limited liability company, and corporation law. Mr. Fassler is a graduate of Brooklyn College, was awarded his J.D. degree from the University of Wisconsin, and received his LL.M. from New York University. He is also admitted to practice in New York and before the U.S. Tax Court. Mr. Fassler is widely published and is a frequent presenter at continuing legal education seminars on tax and business law topics. He is an author for the 1994, first edition of UK/CLE monograph, Limited Liability Companies in Kentucky; the 1996 UK/CLE practice handbook, Kentucky Partnership Law; and the Kentucky Limited Liability Company Forms and Practice Manual.

**GLENN D. GUNNELS** is a Corporate Associate in the law firm of Brown, Todd & Heyburn PLLC, concentrating in the area of employee benefits and executive compensation. Mr. Gunnels is a graduate of Northwestern University School of Law and holds an M.B.A. from the University of Memphis. He regularly advises clients on the design, implementation, and administration of retirement and incentive compensation plans. Much of his work centers on the regulatory requirements of the Internal Revenue Service and the Department of Labor. Mr. Gunnels is currently a member of the American, Illinois, Kentucky, Louisville, and Chicago Bar Associations. He is also a member of the Louisville Employee Benefits Council.

**C. BRADFORD HARRIS** is associated with the law firm of Brown, Todd & Heyburn PLLC in Louisville, Kentucky, where he concentrates his practice in the areas of securities law and mergers and acquisitions. Mr. Harris received his Bachelors, MBA and J.D. degrees from the University of Kentucky. He

is a co-author on the chapter addressing initial public offerings of securities in the UK/CLE monograph, Business Succession Planning (1998).

**CHARLES R. KEETON** is a member of the law firm of Brown, Todd & Heyburn PLLC where he has concentrated his practice in commercial law; finance law; equipment leasing law; bankruptcy reorganizations; and the corporate area and serves as Chairman of Brown, Todd & Heyburn's Bankruptcy, Commercial Transactions and Finance Group. Mr. Keeton received his A.B. degree (*summa cum laude*) from Marshall University and was awarded his J.D. degree (*with distinction*) from the University of Kentucky College of Law where he was Order of the Coif and Lead Articles Editor for the *Kentucky Law Journal*. He has played a significant role on an American Bar Association committee that initiated new Uniform Commercial Code legislation dealing with the equipment leasing industry (Article 2A) and is currently playing an important role with the ABA and the National Conference of Commissioners on Uniform Law as NCCUSL considers revising Article 2A, and also revising Article 2 and drafting new uniform legislation dealing with technology licensing. Charley is widely published and is a frequent lecturer at continuing legal education programs. He was a contributing author for the first edition of the UK/CLE monograph Limited Liability Companies in Kentucky; and served as the author for the chapter on *Non-Financial Considerations For Conducting A Campaign* in the UK/CLE practice handbook, Election Law in Kentucky.

**CHARLES J. (CHAZ) LAVELLE** is with the Louisville, Kentucky office of Greenebaum Doll & McDonald PLLC. He received a B.S. (*with high honors*) from the University of Notre Dame, a J.D. degree from the University of Kentucky College of Law where he served on the *Kentucky Law Journal*, and was awarded his LL.M. in Taxation from New York University. Mr. Lavelle was tax counsel in Humana Inc. v. Commissioner, 811 F.2d 247 (6th Cir. 1989) and Ocean Drilling & Exploration Company v. United States, 988 F.2d 1135 (Fed. Cir. 1993). He concentrates his practice in federal income tax law, is a frequent lecturer at legal education programs and is listed in *Best Lawyers in America*. He served on the KBA committee which drafted the Kentucky Limited Liability Company Act, KRS Chapter 275, and general registered limited liability partnership legislation. He is a Director of the Kentucky Chamber of Commerce, President of Leadership Kentucky Alumni, a Director of Leadership Kentucky, past Chair of the Kentucky and Louisville Bar Tax Sections, former chair of the Central Region IRS - Bar Liaison and former member of the IRS Regional Counsel Advisory Group. He is on the University of Kentucky College of Law Visiting Committee and is past President, current Director and Treasurer of the University of Kentucky Law Alumni Association.

**ALAN K. MACDONALD** is a member of the Louisville office of the law firm of Brown, Todd & Heyburn PLLC where he concentrates his practice in the corporate area with special emphasis in securities law and strategic corporate planning. Mr. MacDonald is a graduate of Dartmouth College and was awarded his J.D. degree from Vanderbilt University's College of Law. He served as a member of the KBA committee that drafted the Kentucky Business Corporations Act, enacted in 1988, with specific responsibility for provisions affecting the standards of conduct for directors and officers and indemnification. He was also co-chair of the KBA committee which drafted the Kentucky Limited Liability Company Act and limited liability partnership legislation. He is an editor of Baldwin's Office Edition of the Kentucky Business Corporation Act, was a contributing author for the first edition of UK/CLE's monograph, Limited Liability Companies in Kentucky, and is a co-author on the chapter, *Selected Securities Law Issues For The Corporate Practitioner*, for the UK/CLE practice handbook, Kentucky Corporation Law. Mr. MacDonald is widely published and a frequent lecturer at continuing legal education programs on business entity and securities law.

**DEBBIE F. REISS** is a member of the law firm of Brown, Todd & Heyburn PLLC. She is a graduate of Newcomb College of Tulane and received her J.D. degree from Tulane University Law School. Ms. Reiss has concentrated her practice in tax areas, with special emphasis on the taxation of employee benefits. She spends much of her time designing and implementing retirement plans, stock options plans, incentive bonus programs and counseling and advising executives and professionals in all areas

of employee benefits. Prior to joining Brown, Todd & Heyburn PLLC, Ms. Reiss served as an adjunct professor at Tulane. She has spoken at various seminars on small businesses, partnerships, employee benefits and general taxation issues, including issues of welfare benefit discrimination, dependent care plans, numerous retirement plan design issues, and fiduciary roles under ERISA. She co-authored the seventh edition of ALI-ABA's popular seller — The Drafting of Partnership Agreements (ALI-ABA 1986), and is a contributing author for UK/CLE's practice handbook, Kentucky Corporation Law. She is also a Co-Managing Editor and author for the UK/CLE monograph, Business Succession Planning. Ms. Reiss is included in the 1993-1994 edition of *The Best Lawyers in America*.

**THOMAS E. RUTLEDGE** is a member of the Louisville, Kentucky law firm of Ogden Newell & Welch where he concentrates his practice in the areas of business law, securities law, limited liability company law and the alcoholic beverage industry. Mr. Rutledge received his B.A. degree from St. Louis University and was awarded his J.D. degree from the University of Kentucky where he served as Associate Editor of the Kentucky Law Journal and was a member of Phi Delta Phi. He served on the committee which drafted the Limited Liability Company Act, KRS Chapter 275, and limited liability partnership legislation. Tom is a frequent lecturer at continuing legal education programs and is widely published, having articles published in the *Kentucky Law Journal*, the "LLC Advisor"; the "Bench and Bar"; and "Bar Briefs". He served as an author for the 1994, first edition UK/CLE monograph, Limited Liability Companies in Kentucky, and is a contributor to the Clark-Boardman-Callaghan, Limited Liability Company Handbook.

**JAMES C. SEIFFERT** is a partner in the Louisville, Kentucky office of Stites & Harbison where he concentrates his practice on business transactions with an emphasis in the tax, partnership and general corporate areas. Mr. Seiffert is a graduate of the University of Iowa, and was awarded his J.D. degree from the University of Louisville School of Law, and his LL.M. in taxation from the University of Miami, Coral Gables, Florida. He served as co-chair of the KBA committee which drafted the Limited Liability Company Act and registered limited liability partnership legislation. Mr. Seiffert is the author of Kentucky Corporation Law, Harrison Company (1993), and is a contributing author for UK/CLE's 1994, first edition monograph, Limited Liability Companies in Kentucky. Jim has also served as an author for the 1997 UK/CLE practice handbook, Kentucky Corporation Law and as a planning committee member, co-chair and speaker for UK/CLE's Biennial Business Associations Institute. An active member of the Louisville; Kentucky; Iowa State and American Bar Associations, Mr. Seiffert is widely published and is a frequent lecturer at continuing legal education programs.

**WILLIAM G. STRENCH** is a member of the Louisville, Kentucky law firm of Brown, Todd & Heyburn PLLC. He is a graduate (*summa cum laude*) of Vanderbilt University and received his J.D. degree from Yale Law School. His practice focuses on securities and corporate law with an emphasis on public and private offerings and mergers and acquisitions. In this capacity, Mr. Strench has represented numerous public and private companies. He has also served as counsel for several mutual funds and investment advisory firms and has represented a number of venture capital funds. Following law school, Mr. Strench served as a law clerk for the Hon. Robert F. Chapman, a judge on the United States Court of Appeals for the Fourth Circuit. Mr. Strench served on the KBA Committee which drafted the Limited Liability Company Act and registered limited liability partnership legislation. He has served as an author for the UK/CLE monographs, Limited Liability Companies in Kentucky and Business Succession Planning, as well as the UK/CLE practice handbook, Kentucky Partnership Law, 2nd Edition. Mr. Strench has written and spoken on numerous continuing legal education topics and has served as an Adjunct Professor of Law (Corporate Finance) at the University of Louisville School of Law.



# **LIMITED LIABILITY COMPANIES IN KENTUCKY**

• Second Edition •

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| 1. <b>Introduction To Limited Liability Companies</b><br><i>James C. Seiffert</i>                                  | 11. <b>Wealth Transfer Planning Using Family Partnerships and Family Limited Liability Companies</b><br><i>Scott W. Dolson</i> |
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| 10. <b>Tax-Exempt Organizations and LLCs</b><br><i>James C. Seiffert</i>   | <b>Comparative &amp; Summary Charts</b><br><b>Table Of Authorities</b><br><b>Statutory Appendix</b><br><b>Index</b>            |



## TABLE OF CONTENTS

<b>1.1</b>	<b>INTRODUCTION TO LIMITED LIABILITY COMPANIES .....</b>	<b>1</b>
1.2	Background .....	2
1.3	Basic Characteristics of the LLC .....	3
1.4	Formation .....	3
1.5	Management .....	4
1.6	Allocations and Distributions .....	5
1.7	Liability of Members and Managers .....	5
1.8	Transfers of Membership Interests .....	6
1.9	Dissolution .....	6
1.10	Federal Income Tax Classification .....	7
1.11	Foreign Limited Liability Companies and Interstate Transactions .....	8
1.12	Professional Limited Liability Companies .....	8
1.13	Single-Member LLCs .....	8
1.14	Family Wealth Transfers .....	9
1.15	Conclusion .....	10
	Endnotes to Chapter 1 .....	11
<b>2.1</b>	<b>NONTAX CONSIDERATIONS IN THE CHOICE OF ENTITY .....</b>	<b>15</b>
2.2	The Role of the Business Lawyer .....	15
2.3	Analyzing the Client's Options .....	16
2.4	The Importance of Tax Considerations .....	18
2.5	Limited Liability .....	18
2.6	Participation in Management .....	20
2.7	Continuity of Existence .....	21
2.8	Transferability of Ownership Interests and Access to Capital .....	21
2.9	Formality of Operation and Other Practical Considerations .....	22
2.10	Estate Planning .....	23
<b>3.1</b>	<b>CHOICE OF ENTITY—INCOME TAX CONSIDERATIONS .....</b>	<b>25</b>
3.2	Overview of Tax Aspects of Choice of Entity .....	25
3.3	Corporate Income Tax Rates .....	26
3.4	Individual Income Tax Rates .....	26
3.5	Taxation of C Corporations .....	27
3.6	Taxation of Contributions to C Corporations .....	27
3.7	Basis in C Corporation Stock .....	28
3.8	Taxation of C Corporation Distributions .....	28
3.9	Taxation on Dispositions of C Corporation Stock .....	29
3.10	Compensation of C Corporation Shareholders .....	29
3.11	S Corporations and Their Limitations .....	30
3.12	Taxation of Contributions to S Corporations; Basis .....	30
3.13	Allocation of Income, Gain, Loss, Deduction and Credit by an S Corporation .....	31
3.14	Limitations on a Shareholder's Ability to Deduct S Corporation Losses .....	31
3.15	Taxation of S Corporation Distributions .....	32
3.16	Taxes Imposed at the S Corporation Level .....	32
3.17	Taxation of Partnerships .....	33
3.18	Taxation of Contributions to Partnerships .....	33
3.19	Basis in Partnerships .....	33

3.20	Allocations of Income, Gain, Loss, Deduction and Credit by Partnerships .....	34
3.21	Limitations on Partner's Ability to Deduct Partnership Losses .....	35
3.22	Taxation of Partnership Distributions .....	35
3.23	Partnership Termination .....	36
3.24	Abusive Partnerships .....	36
3.25	Additional Considerations .....	36
3.26	Introduction to the Taxation of LLCs .....	36
3.27	Comparison of LLCs and C Corporations .....	37
3.28	Differences Between S Corporations and LLCs .....	38
3.29	Comparison Between LLCs and Partnerships .....	39
<b>4.1</b>	<b>PARTNERSHIP CLASSIFICATION .....</b>	<b>41</b>
4.2	Classification Overview .....	41
4.3	The History of the Kintner Regulations .....	41
4.4	The First LLC and the Early Classification Challenge .....	42
4.5	The Continuing Classification Challenge: Application of the Kintner Regulations to LLCs .....	43
4.6	Seeking Partnership Classification, Revenue Procedure 89-12, and Revenue Procedure 95-10 .....	43
4.7	But All Is Not Well .....	44
4.8	Check-the-Box Classification—An Overview .....	44
4.9	Notice 95-14 and the Proposed Regulations .....	44
4.10	By What Authority Did the Service Issue Check-the-Box? .....	45
4.11	Is There Anything There to Classify? .....	46
4.12	Corporations Need Not Apply .....	46
4.13	Foreign Per Se Corporations .....	46
4.14	The "Eligible Entity" .....	46
4.15	Default Classification of Domestic Eligible Entities .....	46
4.16	Default Classification of Foreign Eligible Entities .....	47
4.17	Grandfather Rules—Classification Safe Harbor for Certain Foreign Entities .....	47
4.18	Grandfather Rules—Classification Safe Harbor for Certain Eligible Entities .....	48
4.19	Form 8832 .....	48
4.20	Cleaning Up After the Party .....	49
4.21	Conversion Guidance .....	49
4.22	And What Does This Mean for Kentucky State Classification of LLCs? .....	51
4.23	Conclusion .....	51
	Endnotes to Chapter 4 .....	53
<b>5.1</b>	<b>BASICS OF LLC FORMATION .....</b>	<b>65</b>
5.2	Organization and Qualification of LLCs .....	65
5.3	Articles of Organization .....	65
5.4	Statutory Conversion .....	66
5.5	The Operating Agreement .....	67
5.6	Purposes and Powers .....	68
5.7	Name .....	69
5.8	Pre-Organization Liabilities .....	69
5.9	Registered Office, Registered Agent and Service on an LLC .....	70
5.10	Foreign LLCs .....	70
5.11	Law Governing Foreign LLCs .....	70



5.12	Authority to Transact Business Required .....	70
5.13	Transacting Business Without Authority .....	71
5.14	Application for and Effect of a Certificate of Authority to Transact Business .....	71
5.15	Names of Foreign LLCs .....	72
5.16	Registered Office, Registered Agent and Service on a Foreign LLC .....	72
5.17	Withdrawal from Qualification to do Business .....	73
5.18	Annual Reports .....	73
	Endnotes to Chapter 5 .....	75
<b>6.1</b>	<b>THE OPERATIVE PROVISIONS OF THE LLC ACT .....</b>	<b>81</b>
6.2	Members, Managers & Agency .....	81
6.3	Voting .....	84
6.4	Duties, Limitation of Liability and Indemnification of Members and Managers .....	85
6.5	Records and Information .....	85
6.6	Notice To and Admissions By an LLC .....	86
6.7	Limited Liability to Third Parties .....	86
6.8	Interstate Application of the Limited Liability Provision .....	88
6.9	Contributions to Capital & Liability for Contribution .....	89
6.10	Allocation of Profits and Losses .....	89
6.11	Distributions of Profits .....	91
6.12	Distributions On an Event of Disassociation .....	92
6.13	Distribution In Kind .....	92
6.14	Restrictions on Distributions & Liability Upon Wrongful Distribution .....	93
6.15	Ownership of LLC Property .....	93
6.16	Transfer of LLC Property .....	94
6.17	Admission of Members .....	94
6.18	Assignment of LLC Interests .....	94
6.19	Right of Assignee to Become a Member .....	95
6.20	Rights of Judgment Creditor .....	96
6.21	Rights of Estate of a Deceased or Representative of an Incompetent Member .....	96
6.22	Dissolution .....	96
6.23	Events of Disassociation .....	97
6.24	Dissolution and Winding Up .....	97
6.25	Voluntary Dissolution .....	98
6.26	Judicial Dissolution .....	98
6.27	Administrative Dissolution .....	98
6.28	Winding Up .....	99
6.29	Agency Power of Managers or Members after Dissolution .....	99
6.30	Distribution of Assets During Winding Up .....	100
6.31	Articles of Dissolution .....	100
6.32	Known and Unknown Claims Against a Dissolved LLC .....	100
6.33	Parties to Actions By and Against an LLC .....	101
6.34	Authority to Sue on Behalf of an LLC .....	101
6.35	Consequence of Lack of Authority to Bring Suit .....	101
	Endnotes to Chapter 6 .....	103
<b>7.1</b>	<b>BASICS OF STATUTORY TRANSACTIONS .....</b>	<b>119</b>
7.2	Benefits of Conversion and Merger Provisions .....	119
7.3	Conversion of Partnership to LLC .....	119

7.4	Parties to Conversion and Approval Matters .....	119
7.5	Conversion Filing Requirements .....	120
7.6	Effect of Conversion .....	120
7.7	Personal Liability of Former Partners .....	121
7.8	Inter-Entity Mergers .....	121
7.9	Approving the Merger .....	122
7.10	Merger Filing and Documentation Requirements .....	122
7.11	Effects of a Merger .....	123
7.12	Effect of Merger on Personal Liabilities .....	124
	Endnotes to Chapter 7 .....	125
<b>8.1</b>	<b>FEDERAL INCOME TAX ASPECTS OF OPERATION OF AN LLC .....</b>	<b>127</b>
8.2	Comparison of Partnerships to LLCs .....	127
8.3	Contributions to an LLC .....	128
8.4	Basis in an LLC .....	128
8.5	Allocations of Income, Gain, Loss, Deduction and Credit in an LLC .....	128
8.6	Limits on the Ability of a Member to Deduct the Losses of an LLC .....	128
8.7	Distributions from the LLC .....	129
8.8	Payments to Members Upon Withdrawal .....	129
8.9	Treatment for Self-Employment Tax Purposes .....	130
8.10	Deduction of Self-Employment Tax .....	130
8.11	TEFRA Audits and Tax Matters Partner .....	131
8.12	Taxable Year .....	131
8.13	Cash Method of Accounting .....	131
8.14	Additional Considerations in Using and LLC .....	133
8.15	Conversion of an Existing Business into an LLC .....	133
8.16	Conversion of Partnership into LLC .....	133
8.17	Conversion of C Corporation into LLC .....	134
8.18	Conversion of S Corporation into LLC .....	134
8.19	Conversion of LLP into LLC .....	135
8.20	Conversion of Partnership to LLP .....	135
8.21	Conversion of a Single Member LLC to a Multi-Member LLC .....	135
8.22	Conversion of Multi-Member LLC to Single Member LLC .....	135
8.23	Contrast of Transfer of a Corporate Interest vs. LLC Interest on Death .....	136
8.24	Use of Life Insurance .....	136
8.25	Additional Considerations in Selecting an LLC .....	137
8.26	Kentucky Income Tax Treatment of LLCs .....	137
8.27	Kentucky License Tax Treatment .....	137
<b>9.1</b>	<b>SINGLE MEMBER LLCs .....</b>	<b>139</b>
9.2	Liability Shield/Firewall Protection .....	139
9.3	Avoiding Transfer Taxes .....	140
9.4	Like-Kind Exchanges .....	140
9.5	Bankruptcy-Remote SMLLCs .....	140
9.6	SMLLCs for Financing Flexibility with Single-Asset Entities .....	141
9.7	SMLLCs as an Alternative to Corporate Subsidiaries .....	141
9.8	Avoiding Ancillary Probate .....	141
9.9	Formation; Use of Operating Agreements .....	141
9.10	Preserving the SMLLC Liability Shield .....	142
9.11	Conversion of SMLLCs to Multiple Member LLCs — Rev. Rul. 99-5 .....	142

9.12	Conversion of Multiple Member LLCs to SMLLCs — Rev. Rul. 99-6 .....	143
9.13	Parting Thoughts .....	143
<b>10.1</b>	<b>TAX-EXEMPT ORGANIZATIONS AND LLCs .....</b>	<b>145</b>
10.2	Introduction .....	145
10.3	LLCs as Joint-Venture Vehicles .....	145
10.4	Prior History - The Limited Partnership Model .....	145
10.5	Charitability .....	146
10.6	Structure .....	146
10.7	The LLC and Rev. Rul 98-15—In General .....	147
10.8	Fiduciary Duties .....	147
10.9	Rev. Rul. 98-15 .....	148
10.10	Situation 1 .....	148
10.11	Situation 2 .....	149
10.12	LLCs as Tax-Exempt Corporations .....	152
10.13	State Law Questions .....	152
10.14	Qualifying an LLC for Exemption .....	153
10.15	Conclusion .....	153
	Endnotes to Chapter 10 .....	155
<b>11.1</b>	<b>WEALTH TRANSFER PLANNING USING FAMILY PARTNERSHIPS AND FAMILY LIMITED LIABILITY COMPANIES .....</b>	<b>159</b>
11.2	Importance of Integrating FLP and FLLC Planning into Overall Estate and/or Business Succession Planning Process .....	159
11.3	Why are FLPs and FLLCs a Hot Planning Technique? .....	159
11.4	Nuts and Bolts of FLPs and FLLCs .....	160
11.4.1	State of Formation .....	161
11.4.2	Federal and State Tax Classification .....	161
11.4.3	The Formation Process .....	161
11.4.4	The Importance of Appraisals .....	163
11.4.5	Types of Assets held by Family Entities .....	163
11.4.6	Use of Family Entities to Hold Real Estate .....	164
11.4.7	Use of Family Entities as a Business Succession Planning Vehicle .....	164
11.4.8	Use of Family Entities to Hold Life Insurance .....	165
11.4.9	Preferred FLP and FLLC Interests .....	166
11.4.10	Combining FLPs/FLLCs with GRATs .....	166
11.4.11	Charitable FLPs/FLLCs .....	167
11.4.12	Conversion of Family Corporations into FLLCs .....	167
11.4.13	Comparing FLPs and FLLCs .....	168
11.5	Estate Planning Fundamentals; The Importance of Lifetime Gifts .....	169
11.6	Discount Planning .....	170
11.7	Asset Protection .....	172
11.7.1	Liability Shield Provided by the Family Entity .....	172
11.7.2	Asset Protection Planning .....	172
11.7.3	Fraudulent Conveyance Issues .....	173
11.8	FLP and FLLC Tax Issues .....	173
11.8.1	Importance of Appraisals .....	173
11.8.2	The Application of IRC § 2704(b) .....	174
11.8.3	The IRS' Latest Weapon and Greatest? Weapon— IRC § 2703. ....	175
11.8.4	IRC §§ 2036 and 2038 .....	176

	11.8.5	The IRC § 704(e) Family Partnership Rules .....	176
	11.8.6	The Gift Tax Annual Exclusion .....	177
	11.8.7	IRC § 2704(a) .....	177
	11.8.8	IRC § 2701 .....	178
	11.8.9	Business Purposes for FLPs and FLLCs .....	178
	11.8.10	Potential Roadblock to Tax-Free Contribution of Appreciated Assets to FLP or FLLC— The Partnership Investment Company Rules .....	178
	11.8.11	Louisville and Jefferson County Occupational Fees .....	179
11.9		The IRS Turns up the Heat on FLPs and FLLCs .....	181
	11.9.1	New Gift Tax Return; Proposed Regulations .....	181
	11.9.2	Pre-Audit Questionnaire .....	181
	11.9.3	IRS National Office Directive .....	181
	11.9.4	Treasury Department Business Plan .....	182
	11.9.5	Death Bed Gifting Under Attack .....	182
	11.9.6	The IRS Sham Argument .....	183
	11.9.7	The IRC § 2703 Argument .....	183
	11.9.8	Rebuttal to the IRS' IRC § 2703 Argument .....	184
	11.9.9	The Road Ahead for FLPs and FLLCs .....	185
		Exhibit A: Internal Revenue Service Questionnaire Family Limited Partnerships .....	187
12.1		<b>SECURITIES LAW ISSUES FOR LIMITED LIABILITY COMPANIES .....</b>	<b>189</b>
	12.2	Federal Securities Laws .....	189
	12.3	Member-Managed Versus Manager-Managed LLCs .....	189
	12.4	State Securities Laws .....	190
	12.5	Consequences of Issuing a Security .....	190
	12.6	Exemptions from Registration .....	190
13.1		<b>THE USE OF LLCs IN VENTURE CAPITAL TRANSACTIONS .....</b>	<b>193</b>
	13.2	Reasons for Using LLCs for Venture Capital Transactions .....	193
	13.3	Description of Venture Capital Transactions .....	193
	13.4	Advantages of LLCs .....	193
	13.4.1	Pass Through Taxation .....	193
	13.4.2	Special Tax Allocations .....	193
	13.4.3	Distribution of Appreciated Property .....	194
	13.4.4	State Tax Issue .....	194
	13.4.5	Structural Flexibility .....	194
	13.5	Disadvantages .....	194
	13.5.1	Self-Employment Taxes .....	194
	13.5.2	Tax-Free Mergers .....	194
	13.5.3	Unavailability of Stock Options and Other Employee Benefits .....	195
	13.5.4	Unrelated Business Taxable Income .....	195
	13.6	Comparison to S Corporations .....	195
	13.7	Adapting the Corporate Structure to LLCs .....	195
	13.8	Capital Structure .....	195
	13.8.1	Dividends .....	195
	13.8.2	Conversion Rights .....	195
	13.8.3	Liquidation Preference .....	196
	13.8.4	Voting Rights .....	196
	13.8.5	Put Rights .....	196
	13.8.6	Tax Treatment .....	196

13.9	Adapting Corporate Management Structure to the LLC Form .....	196
13.10	Board of Directors .....	196
13.11	Officers .....	197
13.12	Manager or Member-Managed Designation .....	197
13.13	Fiduciary Duties .....	197
13.14	Other Modification to Corporate Rules .....	197
13.15	Access to Company Records .....	197
13.16	Shareholder Meetings .....	198
13.17	Indemnification and Limitation of Liability .....	198
13.18	Related Party Transactions .....	198
13.19	Miscellaneous Issues .....	198
13.20	Conversion to C Corporation .....	198
13.21	Pre-IPO Distributions .....	198
13.22	Securities Laws Holding Period .....	199
<b>14.1</b>	<b>NEW STRATEGIES FOR STRUCTURING SUCCESSFUL BUSINESS JOINT VENTURES AND STRATEGIC ALLIANCES .....</b>	<b>201</b>
14.2	Business Joint Ventures — Background .....	201
14.3	Comparing Entity Choices .....	201
14.4	Negotiating and Drafting the Joint Venture Agreement .....	203
14.5	Accounting Treatment for Joint Ventures .....	204
14.6	Antitrust Filing Requirements .....	204
<b>15.1</b>	<b>PLLCs AND THE PLLC LIABILITY SHIELD .....</b>	<b>207</b>
15.2	Use of the PLLC .....	207
15.3	Use of the PLLC by Lawyers .....	208
15.4	Multiple Services .....	212
15.5	Governing Boards .....	213
15.6	Name; Articles .....	213
15.7	Tax Issues .....	213
15.8	Formation of PLLCs; Practice Conversions .....	214
15.9	PLLCs and the Liability Shield .....	215
15.10	Liability Shield Statutory Framework .....	215
15.11	Professional Liability Generally .....	216
	Endnotes to Chapter 15 .....	219
<b>16.1</b>	<b>COMMERCIAL LAW ISSUES: LOANS TO LLCs .....</b>	<b>221</b>
16.2	Loan Structuring and Documentation .....	221
16.3	Guarantees from LLC Members .....	221
16.4	Distribution of Earnings .....	221
16.5	Representations and Warranties .....	221
16.6	Granting of Security Interests in Personal Property and Real Property .....	221
16.7	Perfection of Security Interests in Personal Property and Real Property .....	222
16.8	Pledges of Ownership Interest in the LLC .....	222
16.9	Effect of Pledge of Ownership Interests .....	223
16.10	Waiver of the LLC's Right of Offset Against Distributions to Members .....	223
16.11	Due Diligence – General .....	224
16.12	Articles of Organization .....	224
16.13	Operating Agreement .....	225
16.14	Certificate of Existence .....	225
16.15	Authorization by Licensing Boards .....	226
16.16	Authorization to Do Business as an LLC in Other States .....	226

16.17	Resolutions .....	226
16.18	Charging a Member's Interest .....	227
16.19	Events of Dissolution .....	227
16.20	Merger and Conversion .....	227
16.21	Opinions of Counsel .....	228
16.22	Use of the LLC as a Bankruptcy-Remote Entity .....	228
	Endnotes to Chapter 16 .....	229
<b>17.1</b>	<b>RETIREMENT AND FRINGE BENEFIT PLANNING .....</b>	<b>231</b>
17.2	Qualified Retirement Plans .....	231
17.3	Defined Benefit Plans .....	231
17.4	Defined Contribution Plans .....	232
17.5	Profit Sharing Plans .....	232
17.6	Money Purchase Plans .....	232
17.7	401(k) Plans .....	233
17.8	Target Benefit Plans .....	233
17.9	Thrift and Tax Savings Plans .....	233
17.10	Qualification and Administration of Plans .....	233
17.11	Nonqualified Plans .....	234
17.12	Retirement Plans: Advantages of the Corporate Form and Unanswered LLC Questions .....	234
17.13	Welfare (Fringe Benefit) Plans .....	235
17.14	Health and Accident Insurance .....	235
17.15	Life Insurance .....	236
17.16	Disability Insurance .....	236
17.17	Cafeteria Plans .....	237
17.18	Dependent Care Assistance Plan .....	237
17.19	COBRA Continuation Coverage .....	237
	Endnotes to Chapter 17 .....	239
<b>18.1</b>	<b>REGISTERED LIMITED LIABILITY PARTNERSHIPS .....</b>	<b>241</b>
18.2	Historical Background .....	241
18.3	Liability Protection Afforded by LLP Status .....	241
18.4	Liabilities Not Eliminated .....	241
18.5	Name of the LLP .....	242
18.6	Formation of an LLP .....	242
18.7	Foreign LLPs .....	243
18.8	Conclusion .....	243
	<b>SUMMARY AND COMPARATIVE CHARTS .....</b>	<b>245</b>
	<b>TABLE OF AUTHORITIES .....</b>	<b>249</b>
	<b>STATUTORY APPENDIX .....</b>	<b>275</b>
	<b>INDEX .....</b>	<b>321</b>

## 1.1 INTRODUCTION TO LIMITED LIABILITY COMPANIES

by  
James C. Seiffert

It has been over five years since the enactment of the Kentucky Limited Liability Company Act (the "LLC Act").<sup>1</sup> Since that time, the limited liability company has become the preferred form of doing business among Kentucky entrepreneurs. In response to the natural evolution of limited liability companies across the nation as well as both federal legislative and regulatory tax developments, Kentucky amended its Act for the first time in 1998.<sup>2</sup> With all 50 states and the District of Columbia having enacted LLC legislation and with the IRS issuing the Check-the-Box regulations, many of the problems associated with LLCs in the past have been eliminated. As a result of these events and the corresponding changes that occurred on the state level (all which will be discussed throughout this Chapter), Kentucky LLCs find themselves on par with those from other states and serve to enhance the LLC's appeal among Kentucky entrepreneurs.

The limited liability company ("LLC") is a unique statutory creature. It is a hybrid business entity which incorporates the organizational and operational characteristics of both a closely-held corporation and a partnership. For federal and state tax purposes, an LLC will likely be treated as a "flow through" entity with the items of income, loss, deductions and credits passing directly through to its owners. The personal liability of owners of an LLC, like shareholders of a corporation, is generally limited to their capital investment in the LLC. Finally, the LLC offers its owners the flexibility of entering into a business contract which allows them to "make their own rules," as to both the financial and management rights.

On balance, the LLC offers its owners significant business and income tax advantages over C corporations and pass-through entities such as general partnerships, limited partnerships or S corporations. From a personal liability point of view, all partners in a Kentucky general partnership are liable for the obligations, debts, and claims of the partnership.<sup>3</sup> A Kentucky limited partnership is required by law to have at least one general partner who is personally liable for the limited partnership's debts and obligations.<sup>4</sup> In order to maintain their limited liability, limited partners in a Kentucky limited partnership are severely restricted in their ability to participate in the management of the limited partnership's business.<sup>5</sup> This is not the case with an LLC. A Kentucky LLC limits the personal liability of all of its owners without requiring any of them to relinquish their right to manage.<sup>6</sup>

The LLC also possesses certain advantages over both the C corporation and the S corporation. While a C corporation, by law, limits the liability of its shareholders<sup>7</sup>, the corporation and its shareholders will find their income subject to double taxation.<sup>8</sup> An S corporation, on the other hand, which protects its shareholders as well as avoids the double taxation problem, is burdened with a number of organizational and operational requirements which, if not satisfied and/or maintained, can result in the termination of its pass-through tax treatment.<sup>9</sup>

For these reasons, the LLC is generally considered as the "entity of choice" for closely-held business enterprises in Kentucky.

This second edition of the Limited Liability Companies in Kentucky monograph continues to examine both the important tax and business aspects of organizing and operating a Kentucky LLC, highlighting the significant changes which have occurred over the past five years. This chapter begins by providing a short historical background to the enactment of the Kentucky LLC. It then outlines the basic business characteristics of the Kentucky LLC and then compares the LLC's tax attributes to other pass-through business forms. Finally, it focuses on several of the more interesting aspects of an LLC, such as operating as a single member LLC and utilizing the LLC as a wealth transfer vehicle for estate planning purposes. Chapters 2 and 3 focus on non-tax and tax issues associated with the selection of a business entity. Chapter 4 examines the tax classification of the LLC, with the focus on the significant changes brought about as a result of recent legislative and regulatory tax developments. Chapters 5, 6, and 7 address all aspects of the organization, operation and dissolution of the LLC, with reference to the

relevant new technical changes to the LLC Act. Chapter 8 focuses on income tax aspects which will be common to LLCs, including those associated with the single member LLC. Chapter 9 examines the use of the single-member limited liability company. Chapters 12, 16 and 17 focus on securities law, commercial law and bankruptcy, and employee benefit issues arising in connection with the formation and operation of LLCs. Chapter 15 examines the use of LLCs by professionals. Chapter 18 focuses on the registered limited liability partnership (the "RLLP"), an "entity" created through amendments to KRS Chapter 362 during the 1994 session of the Kentucky General Assembly. The monograph has added several new chapters which highlight the use of LLCs in a variety of different business settings; the LLC and tax-exempt organizations (Chapter 10), the LLC as an estate planning tool (Chapter 11), LLCs and joint ventures (Chapter 14), and raising venture capital through LLCs (Chapter 13).

## **1.2      Background**

The popularity of LLCs in the United States can be traced to the desire of entrepreneurs to create the perfect business entity that limits the liability of its owners to their investment in the business enterprise while exposing the entity's income to a single level of tax. The evolution of the business entity has seen the development of the S corporation and the limited partnership as the "answers" to the drawbacks inherent in operating in the corporate and partnership forms of doing business. However, while these two business vehicles have generally served their purpose, they have done so at the expense of flexibility as well as simplicity. The LLC is a further refinement of the corporation and partnership absent the unappealing characteristics associated with S corporations or limited partnerships.

Wyoming passed the first limited liability company act in 1977.<sup>10</sup> Five years later, in 1982, Florida enacted similar legislation.<sup>11</sup> Due in large part to the continued uncertainty as to both the income tax treatment of the entity as well as the extent of the limited liability afforded a member of an LLC, it was not until 1990, some eight years later that two additional states enacted LLC legislation. The increased interest in LLCs can be directly attributable to the clarification of the federal income tax status of an LLC by the IRS in Revenue Ruling 88-76, 1988-2 C.B. 360. With the certainty that an LLC could avoid an entity level tax like that imposed on a Subchapter C corporation, the momentum of LLC legislation picked up to the point where, by 1993, 18 states had passed LLC statutes, and as of August, 1994, a total of 44 states recognized LLCs. Today, all 50 states and the District of Columbia have enacted limited liability company statutes.

As the 42nd state to enact LLC legislation, Kentucky had the benefit of examining the various state statutes that came before it and tailoring many of the more favorable provisions in order to gain flexibility for its members while preserving partnership tax treatment. The LLC Act, like other state LLC statutes, relies heavily on the Uniform Partnership Act, the Revised Uniform Limited Partnership Act, and the Model Business Corporation Act. In addition, the LLC Act relied on the ABA Prototype Limited Liability Company Act<sup>12</sup> and the National Conference of Commissioners on Uniform State Laws' Uniform Limited Liability Company Laws.<sup>13</sup> Consequently, the Kentucky LLC is truly a hybrid business entity, possessing the organizational and operational characteristics of both a closely-held corporation and partnership, the result of which provides its members with limited liability, a flexible business relationship, and the opportunity to be treated as a partnership for federal and state tax purposes.

In 1998, the LLC Act was amended for the first time<sup>14</sup> (the "1998 Amendments"). In response to the federal regulatory and legislative changes, principally the Check-the-Box Regulations as well as the need to update the LLC Act itself in light of the general evolution of state LLC statutes across the nation, Kentucky proceeded to make significant changes to the LLC Act. These changes included among others: (1) the use of the single member LLC, (2) the simplification of forming an LLC by removing the cumbersome federal partnership classification provisions and (3) a change from "per capita" to "per capital" as the default rule for purposes of voting, allocations of distributive shares and both interim and liquidating distributions.



### 1.3 Basic Characteristics of the LLC

Even though the LLC is universally recognized as a corporate-partnership hybrid, the specific provisions of the various state statutes can differ significantly from one state to another. The early LLC statutes were designed to ensure that every LLC formed would be classified as a partnership for federal income tax purposes. These statutes are known as "bullet-proof" statutes.<sup>15</sup> This simply meant that, the organizer of the LLC was guaranteed partnership tax treatment by forming an LLC under that state's LLC statutes. On the other hand, other states adopted LLC legislation which contained sufficient flexibility and discretion which, when exercised, resulted in the LLC being classified as either a corporation or a partnership for federal income tax purposes. This type of LLC legislation was known as a "flexible" statute.<sup>16</sup> Kentucky's LLC Act fell somewhere in between the bullet-proof and the flexible statutes. The LLC Act contained a number of "default provisions," which governed the relations among the members only where the members declined to exercise their discretion in formulating their business relationship. Consequently, members of a Kentucky LLC were given the opportunity of structuring their own business contract among themselves, and only where they decline to address certain governing issues in the operating agreement or the articles of organization would the LLC Act govern their conduct. The advantages of having a flexible statute which offered the members a substantial degree of discretion are obvious. However, the drawbacks, subtle as they were, could be quite costly. By straying from the default provisions of the LLC Act, organizers would run a risk that the LLC would be classified as a corporation, rather than a partnership, for federal income tax purposes. Accordingly, before a decision was made to depart from the LLC Act's default provisions, the organizers would have to closely analyze the impact of their selections upon the LLC's tax status.

The difficulties experienced by organizers in ensuring that their LLCs partnership tax treatment were eliminated completely by the adoption of the Check-the-Box regulations. On December 17, 1996, the IRS issued final regulations that permitted taxpayers to treat domestic unincorporated entities and certain foreign entities as "partnerships" for all federal tax purposes without complying with the four-factor partnership classification test under IRC §7701.<sup>17</sup> As a result of the Check-The-Box Regulations, it was unnecessary for an organizer to restrict the continuity of life, free transferability of interests or the centralized management of the LLC. A LLC formed under the LLC Act will now automatically be treated as a "partnership" for federal and state income tax purposes.<sup>18</sup> Equally significant was the recognition of the single-member LLC by the Check-the-Box Regulations. Under the Regulations a single-member unincorporated entity (*i.e.* an LLC, for example) will be "disregarded" and treated as a sole proprietorship, branch or division.<sup>19</sup> In response to this significant change, the 1998 Amendments recognize a single-member LLC.<sup>20</sup> See chapter 4 for a complete discussion of partnership classification issues.

### 1.4 Formation

An LLC, like a corporation or limited partnership, is a creature of statute.<sup>21</sup> In order to form an LLC, the relevant statutory provisions must be satisfied. A Kentucky LLC, like a corporation or limited partnership, is formed by filing its articles of organization with the Kentucky Secretary of State.<sup>22</sup> The articles of organization are much like a corporation's articles of incorporation or a limited partnership's certificate of limited partnership, in that it is nothing more than a "notice" filing. Only general, non-confidential information is required to be made public.

The 1998 Amendments modified the content of the articles of organization removing the following: (i) the statement that the LLC have at least two members<sup>23</sup> and (ii) the reference to a specific dissolution date.<sup>24</sup> Since favorable tax treatment is afforded both multi-owner and single member LLCs by way of the Check-the-Box Regulations, the 1998 Amendments removed these provisions. Now, the articles of incorporation must contain only the following statements: (1) A name that satisfies KRS § 275.100; (2) the street address of the LLC's initial registered office and the name of its initial registered agent at that office; (3) the mailing address of its principal office; and (4) a statement that the LLC is to be

managed by its members or designated managers.<sup>25</sup> In addition, the articles of organization of a professional LLC must designate the professional services to be rendered.<sup>26</sup> The articles of organization may, but are not required to, include any other provision which is permitted to be set forth in an operating agreement as long as such provision is not inconsistent with the law.<sup>27</sup> The articles of organization, once completed, are to be filed by one or more persons who may or may not be members of the LLC.<sup>28</sup> A consent to serve as registered agent must be filed with the articles of organization. Typically, the existence of a Kentucky LLC begins once the articles of organization are filed with the Kentucky Secretary of State's office.<sup>29</sup>

A Kentucky LLC has one or more members.<sup>30</sup> A member in an LLC is the equity holder similar to a partner or a shareholder. A member interest is comprised of both economic and management rights.<sup>31</sup> As with a corporation or limited partnership, membership in a Kentucky LLC is not restricted merely to individuals: a corporation, general or limited partnership, LLC, trust, estate, or other legal entity may be a member of a Kentucky LLC.<sup>32</sup>

The Kentucky LLC is afforded more flexibility in its capital structure and its capital contributions than a Kentucky corporation. The LLC, unlike a corporation, need not comply with a number of specific rules concerning the issuance of ownership interests or the prohibition against discriminating among classes or series of interests. The structuring of capital is left to the discretion of its members. While an LLC may, and often does utilize ownership certificates,<sup>33</sup> it need only record a member's contributions in its articles of organization or its operating agreement.<sup>34</sup> Capital contributions may be made in the form of cash, property, services rendered, a promissory note, or other binding obligations to contribute cash, property, or perform services.<sup>35</sup> In this respect, the capital contributions are similar to that afforded a Kentucky limited partnership.

At the core of the LLC Act is the provision of limited liability. An LLC member, like a corporate shareholder or limited partner, is not personally liable to the LLC by reason of being a member.<sup>36</sup> This liability shield is available regardless of the degree to which a member is involved with the management of the LLC. The status of a person as a member will not subject a member to personal liability for the acts or omissions of other members.<sup>37</sup> A member's personal liability extends only to any capital contribution(s) the member committed contractually to make to the LLC. This personal liability extends to creditors who may have relied on the contribution obligation, even if the obligation itself has been compromised among the members.<sup>38</sup> The 1998 Amendments created a new section which allows members or managers to, by reason of their status, elect to be personally liable for the debts and obligations of the LLC, resulting, in effect, in waiving limited liability.<sup>39</sup> See chapter 5 for a complete discussion of issues relating to the organization of a Kentucky LLC.

## 1.5 Management

A Kentucky LLC operates its business affairs in accordance with the provisions of its articles of organization and/or operating agreement. The operating agreement, which can be oral or written, is an agreement among the Company and its member(s) regarding its affairs, the conduct of its business, and the relationship of its members. The operating agreement is the counterpart to the partnership agreement or the corporate bylaws. The contents of an operating agreement will contain provisions concerning the affairs and business of the LLC, as long as they are not inconsistent with the LLC Act or the LLC's articles of organization.<sup>40</sup> Since the LLC Act contains numerous "default" provisions, which come into play only if the articles of organization or operating agreement do not provide otherwise, the operating agreement can be customized to achieve the members' objectives. The 1998 Amendments amended the definition of operating agreement to address single member LLCs.<sup>41</sup> While not required, it is recommended that a single member LLC enter into operating agreements with its member.

As a general rule, the management of an LLC vests in its members.<sup>42</sup> The 1998 Amendments made a significant change to the rules on voting. Under the LLC Act, as adopted in 1994, each member of an LLC was entitled to one vote (*i.e.* per capita) unless the articles of organization or the operating

agreement provide otherwise.<sup>43</sup> Now, unless modified by the written operating agreement, each member votes on a "per capital basis" (*i.e.*, in proportion to their respective capital contributions to the LLC).<sup>44</sup> In addition to the per capital default rule for voting, the 1998 Amendments introduce the term "majority-in-interest" which provides that "majority" will now be determined based on each member's capital contribution rather than each individual.<sup>45</sup>

The LLC's management authority can be delegated to one or more managers by the articles of organization.<sup>46</sup> Any natural person, regardless of age, or a corporation, partnership, LLC or other entity may be a manager.<sup>47</sup> Moreover, a manager does not have to be a member of the LLC unless the operating agreement or the articles of organization so require.<sup>48</sup> A "manager-managed" management structure will reflect many of the same characteristics of a corporation's board of directors. Usually, a fixed number of managers will be established, or a manner in which the number of managers will be determined will be set out in the operating agreement. Like the corporate board of directors, managers will be elected by members. Under the default provisions, a majority-in-interest vote of the members is required to elect, remove or replace a manager.<sup>49</sup>

The 1998 Amendments allow a member or manager to delegate to one or more individuals their powers to manage or control the business, including without limitation, the power to delegate to agents and employees of a member, manager or limited liability company or to delegate by agreement to a third party. The delegation of this power by a member or manager will not result in the member or manager ceasing to be a member or manager of the limited liability company.<sup>50</sup> See Chapter 6 for a complete discussion of the issues relating to management and ownership of the LLC.

#### 1.6 Allocations and Distributions

Members are given the discretion to "customize" both the allocations of profit and losses<sup>51</sup> and the distributions of cash and property<sup>52</sup> to its members through its operating agreement and/or the articles of organization. The 1998 Amendments made a material change to the allocation of profits and losses and distributions provisions of the Act. Prior to 1998, the default rule allocated profits and losses as well as distributions on a "per capita" basis. Each member was to be treated equally regardless of capital contributions. The 1998 Amendments abandoned the "per capita" rules and substituted rules that provide for profits and losses and distributions to be allocated on a "per capital" basis unless otherwise set forth in the articles of organization or the operating agreement.<sup>53</sup> As a result of these changes, the default rules are now based on a "per capital" rather than "per capita" basis which means that the members must take some affirmative action if they intend to now be bound by the "per capita" rules.

One of the advantages an LLC holds over an S corporation is its right to establish, by way of the operating agreement or the articles of organization, two or more classes of membership interests with different rights to profits and losses and distributions. An S corporation is prohibited by statute from having more than one class of equity.<sup>54</sup> This is not true of an LLC: an LLC has the flexibility of creating multiple equity interests to satisfy the demands of its members.

A member of a Kentucky LLC does not have a right to demand or receive any distribution other than in cash unless otherwise provided in the articles of organization or the operating agreement.<sup>55</sup> On the other hand, a member is not required to accept a distribution of any property other than cash unless the member receives an undivided ownership interest in the property that has a value equal to the cash distribution at the time of distribution.<sup>56</sup> See chapter 6 for a complete discussion of issues relating to LLC distributions and allocations.

#### 1.7 Liability of Members and Managers

One of the key attributes of an LLC is its ability to provide liability protection to its members without having to resort to operating in the corporate form. The fundamental rule of a Kentucky LLC is

that a member or manager merely by reason of being a member or manager is not personally liable for the debts or liabilities of the LLC whether arising in tort, contract or otherwise, or for acts or omissions of others associated with the LLC.<sup>57</sup> This remains true even if the member actively participates in the day to day management of the LLC.

A member's protection from personal liability is not absolute; it is subject to certain important exceptions. First, a member or manager will be personally liable for his or her own acts or omissions; the LLC cannot and will not shield an individual member or manager from his or her own wanton or reckless misconduct.<sup>58</sup> Second, a member will remain personally responsible for any capital contribution to the LLC or the guarantee of any LLC obligation.<sup>59</sup> Third, an individual purporting to act on behalf of an LLC shall be liable for all debts and liabilities incurred if such person knew that no LLC existed at the time.<sup>60</sup> Fourth, a member or manager may be personally liable for an unlawful distribution.<sup>61</sup> Fifth, the common law equitable doctrine of "piercing the corporate veil," may be applicable to LLCs resulting in the entity being disregarded and thus exposing its members to personal liability. This doctrine can be invoked in the corporate setting where the corporation fails to maintain its separate identity and is viewed as the alter ego for its shareholders and/or where some fraud or misrepresentation is perpetrated. The LLC Act does not contain statutory language which incorporates this type of analysis. To the contrary, the LLC Act provides that the failure to maintain the required records of an LLC will not constitute grounds for imposing personal liability on any person for the obligations of the LLC.<sup>62</sup> Finally, in an effort to clear up an ambiguity in the LLC Act, the 1998 Amendments added KRS § 275.150(2), which permits a member or manager to elect, by reason of such status, to be personally liable for any of the debts and obligations of the LLC, thereby waiving limited liability.<sup>63</sup> See chapters 2, 7 and 15 for further discussion of liability in the context of LLCs.

## 1.8 Transfers of Membership Interests

The LLC Act relies heavily on a corresponding provision in the Revised Uniform Limited Partnership Act when addressing the transfer of a member's interest. Unless the operating agreement or the articles of organization provide otherwise, an LLC's membership interest is assignable in whole or in part.<sup>64</sup> If the entire membership interest is transferred, the assignor ceases to be a member of the LLC while the assignee may or may not become a member. This distinction is important. An assignment or transfer of a membership interest in whole or in part entitles the assignee only to the right to receive (to the extent assigned) distributions from an LLC to which the assignor would otherwise be entitled.<sup>65</sup> It does not necessarily allow the assignee to participate in the management and affairs of the LLC. In simple terms, this means the assignee may not get to vote.<sup>66</sup> Unless the articles of organization or the operating agreement provide to the contrary to exercise such management rights, the remaining members must by a majority-in-interest consent to the admission of an assignee as a member.<sup>67</sup> One of the more significant revisions to the LLC Act was the change to KRS § 275.280(3). Under the LLC Act as originally passed in 1994, absent to a contrary provision in the operating agreement, a member had the right to withdraw from the LLC on 30 days prior notice. Upon withdrawal, the member was entitled to receive fair value for his or her membership interest. The 1998 Amendment changed the default rule to preclude any member from withdrawing from the LLC unilaterally.<sup>68</sup> A change such as this will require a review by the members of all existing operating agreements to assure themselves that the terms meet their objectives. See chapter 6 for a complete discussion of the transfer of LLC interests.

## 1.9 Dissolution

A Kentucky LLC will be dissolved on the first to occur of any of the following events: (a) the time or events specified in the articles of organization or the operating agreement; (b) unless otherwise set forth in the operating agreement, the written consent of a majority in interest of the members; or (c) the entry of a judicial decree based under KRS § 275.290 on a finding that it is not reasonably practical to carry on the LLC's business in accordance with its articles of organization or its operating agreement or

the filing of a certificate of dissolution by the Secretary of State under KRS § 275.295.<sup>69</sup> As a result of the Check-the-Box Regulations, which eliminated the partnership classification rules for federal tax purposes, the 1998 Amendments removed an event of disassociation (*i.e.* death, bankruptcy, withdrawal, resignation or expulsion) as a dissolution event.<sup>70</sup> Consequently, there is no longer a need to terminate the LLC on the death, bankruptcy or withdrawal of a member. As noted, an LLC may have a perpetual duration even though a member may withdraw as a result of an event of disassociation. *See* Section 1.10 for further discussion.

In addition to the voluntary and judicial dissolution procedures, an LLC, like a corporation, can be administratively dissolved by the Kentucky Secretary of State where the LLC fails to (a) file a timely annual report, (b) maintain a registered agent or registered office, or (c) timely notify the Secretary of State of a change in the registered office or registered agent.<sup>71</sup>

Once dissolved, the LLC undergoes the winding up process, similar to that experienced by a Kentucky corporation culminated by the filing of articles of dissolution with the Secretary of State's office.<sup>72</sup> *See* chapter 6 for a complete discussion of events of disassociation and the dissolution of the LLC.

## 1.10 Federal Income Tax Classification

The driving force behind the emergence of LLC legislation was the favorable tax treatment afforded partnerships by the Internal Revenue Service. It was easy for Wyoming in 1977 to legislate "limited liability" through the enactment of its limited liability company act, but it was not until 1988 that the IRS, in Revenue Ruling 88-76, recognized the Wyoming LLC as a partnership for federal income tax purposes. From that point forward, the partnership classification requirements dictated the characteristics of the various LLC statutes. In an effort to insure the beneficial "pass through" tax treatment of a partnership, the default provisions of the original Kentucky LLC Act were structured to satisfy the IRS classification guidelines. All of this changed with the enactment of the Check-the-Box Regulations. The Check-the-Box Regulations revolutionized tax classification of unincorporated business entities. On December 17, 1996, the Internal Revenue Service issued final regulations that permit taxpayers to treat domestic unincorporated entities and certain foreign entities as partnerships for all federal tax purposes without having to comply with the prior four factor test under IRC § 7701.<sup>73</sup> Consequently, it was no longer necessary to restrict the continuity of life, free transferability of interests or centralized management of the entity to obtain partnership classification. In order to take advantage of these rules, the Kentucky LLC Act required amending. The 1998 Amendments made the appropriate changes to the LLC Act by eliminating the default rules which originally guaranteed partnership tax treatment. Consequently, an LLC can now be formed based on business factors without concern for preserving the appropriate tax treatment. *See* chapters 4 and 8 for more on the federal tax classification of a Kentucky LLC.

Once an LLC is classified as a partnership for federal income tax purposes, that classification will have an effect on the LLC's treatment for state income tax purposes. The 1998 Amendments also adopted the federal classification rules for state tax purposes, thereby ensuring that the LLC will receive the same tax treatment at the state level.<sup>74</sup> Consequently, if a Kentucky LLC is treated as a partnership for federal income tax purposes, it will be recognized as such for state income tax purposes.

The Check-the-Box Regulations also acknowledged the tax treatment of a single-owner entity. Under the Check-the-Box Regulations, a single-member entity will be taxed for federal income tax purposes as a sole proprietorship, branch or division.<sup>75</sup> The tax treatment of the single-owner entity precipitated the creation of single-member LLCs by those states that had previously enacted LLC legislation. The 1998 Amendments recognized single-member LLCs and their beneficial tax treatment for state income tax purposes.<sup>76</sup>

### **1.11 Foreign Limited Liability Companies and Interstate Transactions**

All 50 states and the District of Columbia have now enacted LLC legislation. Like most, if not all states, Kentucky recognizes foreign (LLCs formed in other states) LLCs transacting business within the Commonwealth.<sup>77</sup> Under the LLC Act, a foreign LLC must first register with the Kentucky Secretary of State before transacting business within the Commonwealth.<sup>78</sup> The procedure for applying for authorization is very similar to that procedure used for registering foreign corporations. Subject to the Kentucky Constitution, the LLC Act specifically recognizes the laws of the foreign LLC's jurisdiction as to its organization, internal affairs and liability of its members.<sup>79</sup>

A foreign LLC will not be denied registration even though the laws of its jurisdiction differ from the Kentucky provisions. The one limitation placed on a foreign LLC is that it is prohibited from exercising any powers or engaging in any business that a domestic LLC is forbidden from exercising or engaging in.<sup>80</sup> Accordingly, a foreign LLC will not find much in the way of limitations on its ability or right to transact business in Kentucky. A Kentucky LLC intending to transact business in a state or jurisdiction which has enacted LLC legislation should receive similar treatment.

### **1.12 Professional Limited Liability Companies**

Kentucky, along with a number of other states, expressly authorizes the use of professional LLCs.<sup>81</sup> In particular, professionals have a keen interest in practicing as an LLC in order to limit their personal liability for the negligence of others they work with and to avoid the tax disadvantages associated with operating in a professional service corporation.

Even though the LLC Act allows professionals the right to practice in an LLC, the regulatory boards of the various professions will retain their authority to regulate the practice of that profession within the LLC form.<sup>82</sup> The power of the regulatory board, however, should not extend to the issue of whether the professional may practice in and through an LLC, as that issue was dealt with specifically in the LLC Act. With respect to attorneys, however, the Kentucky Supreme Court, under the Kentucky Constitution, has the authority to dictate how the practice of law should be conducted, which may extend to the basic question of whether the profession may be practiced in a given entity.<sup>83</sup>

A Kentucky professional LLC is formed in the same manner as a non-professional LLC with minor exceptions. First, the articles of organization require a statement which identifies the professional services to be rendered by a professional LLC.<sup>84</sup> Second, a professional LLC must identify itself as such by including within its name the words "professional limited liability company," "professional limited company" or the abbreviations "PLLC" or "PLC." Finally, the LLC Act is clear that the mere formation of a professional LLC will not restrict nor expand the authority and duty of any regulatory body to license individuals providing such services as well as regulate the practice.<sup>85</sup> If the conditions are satisfied, the members of the Kentucky professional LLC will be protected under the law from vicarious liability for the acts and omissions of other members, employees, managers, and agents (*i.e.*, professional malpractice), as well as nonprofessional claims such as contracts, leases, and other commercial liabilities.<sup>86</sup> See chapter 15 for a complete discussion of professional LLCs.

### **1.13 Single-Member LLCs**

The Kentucky LLC Act previously required LLCs to have two members at all times in order to ensure that the entity would be taxed as a partnership rather than as an association taxable as a corporation. The 1998 amendments eliminate this requirement.<sup>87</sup> The IRS' issuance of the final "Check-The-Box" Regulations opened the door to tax and business planning with single member LLCs. Under Check-The-Box Regulations, an LLC with only one member will now be "disregarded" as an entity separate from its owner for federal tax purposes unless an election is made to be treated as an association taxable as a corporation.<sup>88</sup> An individual can form a single member LLC and treat it as a sole proprietorship, or

a corporation can set up a single member LLC and treat it as a division or branch. This transparency for income tax purposes does not affect the liability protection afforded the LLC's single member under state laws. In addition to permitting single member LLCs, the 1998 amendments provide that an LLC will be treated for Kentucky income tax purposes in the same manner as its tax treatment for federal tax purposes.<sup>89</sup> This provision confirms that a single member LLC will also be "transparent" for Kentucky income tax purposes. The combination of owner liability protection and tax transparency opens the door for exciting planning opportunities.

There are a number of possible uses for single member LLCs besides its obvious advantages (*i.e.*, liability protection) as an alternative to the unincorporated sole proprietorship on the one hand or corporate subsidiary on the other hand. Single member LLCs may become a useful substitute for creating separate corporate divisions as a substitute for a consolidated tax return in an affiliated group. In the international context, single member entities may facilitate the shifting of foreign income to lower tax countries and assist generally in planning efforts to reduce the foreign tax base of an American business. Professionals will now have the flexibility to form a professional LLC rather than a professional service corporation, thereby avoiding filing annual corporate tax returns. Finally, lenders may consider the single member LLC as a vehicle for creating a bankruptcy remote, special purpose entity without the tax complications of a separate entity for tax purposes. A bankruptcy remote, special purpose entity is an entity which is unlikely to become insolvent as a result of its own activities and which is adequately insulated from the consequences of any other party's insolvency. Lenders will impose limitations on the activities of the LLC and its ability to dissolve. Undoubtedly, additional creative uses for single member LLCs will be developed in the coming years. *See* chapter 9 for a complete discussion of single-member LLCs.

#### 1.14 Family Wealth Transfers

One of the more popular estate planning strategies in recent years involves the transferring of family wealth between generations through the use of the family limited partnership (FLP) or family LLC (FLLC). Transferring family wealth through family LPs or LLCs involves a two-step process: first, parents transfer appreciated assets into the entity in exchange for ownership interests in such entity; and, second, the parents then gift the equity interests to their children. These gifts are structured to take advantage of each parent's annual gift tax exclusion and/or each parent's lifetime unified credit. The entity is designed so that the parents retain control over the assets even though the children may hold a substantial equity stake. In addition, FLPs and FLLCs are structured so that the children are unable to liquidate (*i.e.*, cash out) their ownership interests because they are incapable of forcing a liquidation of the entity or the repurchase of their ownership interests. As a result of this type of structure, the equity interests transferred by the parents to the children are eligible for substantial valuation discounts. It is quite common to find family wealth transfers discounted for tax purposes at substantially less (*i.e.*, 40% to 50%) than 100¢ on the dollar.

On the whole, the LLCs possess certain advantages over LPs as the vehicle for structuring family wealth transfers. For example, every limited partnership must have one or more general partner that is personally liable for the LP's liabilities.<sup>90</sup> In contrast, LLCs are not required to have anyone assume personal liability and still all members, including the parents in control of managing the entity, are shielded from the LLC's debts and liabilities.<sup>91</sup> Prior to the 1998 Amendments, a Kentucky LLC, however, could not be utilized since the LLC Act had a fatal flaw.

Under the original LLC Act, an LLC member had the statutory right to withdraw either voluntarily or involuntarily and demand the fair value of his ownership interest.<sup>92</sup> While LLC operating agreements contain a provision prohibiting such a withdrawal, this type of self-imposed restriction was not respected by the IRS for valuation purposes.<sup>93</sup> As a result, any restrictions imposed by the parties on the right to withdraw from a Kentucky LLC would be ignored for transfer tax purposes. Valuations of the transferred ownership interests had to take into account the fact that the individual member could simply withdraw after 90 days and demand the fair value of his interest, effectively eliminating any

lack of marketability discounts. Consequently, Kentuckians were forced to forum shop for a state where LLC members could not withdraw.

The 1998 amendments specifically eliminated the right of an LLC member to withdraw unless the operating agreement provides otherwise.<sup>94</sup> Consequently, if an LLC member cannot withdraw, valuation discounts should be available.

To further bolster the Kentucky LLC as a state-of-the-art vehicle for obtaining transfer tax discounts, the amendments also eliminate various events, including the death of a member, that previously caused the dissolution of the LLC.<sup>95</sup> Eliminating the various dissolution triggering events was possible because they were no longer necessary to qualify the Kentucky LLC for partnership tax treatment in the aftermath of the IRS' adoption of the Check-The-Box Regulations.<sup>96</sup>

#### 1.15 Conclusion

The Kentucky LLC Act, as amended by the 1998 Amendments, represents the greatest advancement in the creation of the "ideal" business entity for Kentucky entrepreneurs. Its reliance on the Revised Model Business Corporation Act, the Revised Uniform Partnership Act and Revised Uniform Limited Partnership Act should be of some comfort to practitioners when dealing with LLCs. The recent changes enacted by the 1998 Amendments have further enhanced its appeal. By incorporating the changes brought about by the Check-the-Box Regulations and by making the LLC Act fall in line with normal business objectives, the LLC Act keeps pace with national trends. There still remain a few issues regarding their utility, all of which should be favorably resolved in due time and none of which should effect its overall use. Whenever individuals and now existing businesses consider a new business venture, the LLC should be seriously considered as the entity of choice. The benefits of structural flexibility, limited liability and flow-through or "disregarded" taxation far outweigh any detrimental features.



## Endnotes to Chapter 1

- <sup>1</sup> Chapter 275 of the Kentucky Revised Statutes enacted as Senate Bill 184, 1994 Reg. Sess., signed into law on April 11, 1994, effective July 15, 1994. As of April 11, 1994, Kentucky was the 42nd state to enact LLC legislation.
- <sup>2</sup> H.B. 666, Chapter 341, 1998 Reg. Sess.: signed into law on March 7, 1998, effective July 15, 1999.
- <sup>3</sup> KRS § 362.220.
- <sup>4</sup> KRS § 362.401(7); KRS § 362.447(2).
- <sup>5</sup> KRS § 362.437.
- <sup>6</sup> KRS § 275.150.
- <sup>7</sup> See KRS Chapter 271B.
- <sup>8</sup> See IRC §§ 11, 1201 and 301.
- <sup>9</sup> IRC § 1361(b), Reg. § 1.1361-1(b).
- <sup>10</sup> Act of March 4, 1977, ch. 155. 1977 Wyom. Sess. Laws 512, Wyom. Stat. §§ 17-15-101 to 17-15-136 (1977).
- <sup>11</sup> Fla. Stat. Ann. §§ 608.401 to 608.471 (West, 1992 Cum. Supp.).
- <sup>12</sup> See Subcommittee on Limited Liability Companies, ABA Business Law Section, Partnership Committee, Prototype LLC Act dated November 19, 1992.
- <sup>13</sup> See Draft, Uniform Limited Liability Company Act, National Conference of Commissioners on Uniform State Laws, dated July 29-August 5, 1993.
- <sup>14</sup> See *ftn. 2, supra*.
- <sup>15</sup> Bullet-proof statutes include Colorado (Colo. Rev. Stat. § 7-80-101 through 913); Nevada (Nev. Rev. Stat. §§ 86.276 through .322 (1991)); West Virginia (W.Va. Code §§ 31-1A-1 through 31-1A-69) and Wyoming (Wyo. Stat. §§ 17-15-101 through -136 (1977)).
- <sup>16</sup> Flexible statutes include Delaware (Del. Code Ann §§ 18-101 through -1107; Illinois (Ill. Compiled Stat. Ann. Art. 805 §§ 180/1-1 *et seq.*); Maryland (MD-Corps & Assoc'n Code Ann §§ 4A-101 through 4A-1103), and Texas (Tex. Bus. Corp. Code Ann. Art. 1528n - 101, *et seq.* Las H.B. § 46-1991).
- <sup>17</sup> Treas. Reg. § 301.7701 TD 8697, 12-18-96, Notice 97-1, 1997-2 IRB 22.
- <sup>18</sup> See KRS § 141.208.
- <sup>19</sup> Reg. § 301.7701-3(b)(1)(ii).
- <sup>20</sup> H.B. 666 Chap. 341; 275.015(8).
- <sup>21</sup> KRS §§ 275.001 through 275.455.
- <sup>22</sup> KRS § 275.045 - One original and two exact conformed copies along with a \$40.00 filing fee must be submitted to the Kentucky Secretary of State's Office. The Articles of Organization, once filed, must then be recorded in the clerk's office of the county in which the LLC's registered office is located.
- <sup>23</sup> See *ftn. 20, supra*.
- <sup>24</sup> H.B. 666, § 23, adding new KRS § 275.025(2).
- <sup>25</sup> KRS § 275.025.

26 KRS § 275.025(3).

27 KRS § 275.025(4).

28 KRS § 275.020.

29 KRS § 275.060. The articles of organization will be effective once filed with the Kentucky Secretary  
of State even though they are not filed with the county clerk's office.

30 KRS § 275.015(8).

31 See KRS §§ 275.165 and 275.210.

32 KRS §§ 275.275 and 275.015(15).

33 KRS § 275.255(2).

34 KRS § 275.185(1).

35 KRS § 275.195.

36 KRS § 275.150.

37 KRS § 275.170.

38 KRS § 275.200.

39 H.B. 666, Chap. 341 § 26, adding new section KRS § 275.150(2). Note that this is an ab initio  
waiver of limited liability and should be contrasted with a member's personal guarantee of obligations.

40 KRS § 275.095.

41 H.B. 666 Chap. 341 § 21, amending KRS § 275.015, which after other amendments to KRS §  
275.015, is codified at KRS § 275.015(14).

42 KRS § 275.165.

43 KRS § 275.175(1).

44 KRS § 275.175(3) added by H.B. 666 Chap. 341 § 29.

45 KRS § 275.175(1), amended by H.B. 666, Chap. 341 § 29.

46 KRS § 275.165(2).

47 KRS § 275.165(2)(b)

48 *Id.*

49 KRS § 275.165(2)(a).

50 KRS § 275.135(5), added by H.B. 666, § 25.

51 KRS § 275.205.

52 KRS § 275.210.

53 See KRS § 275.205 amended by H.B. 666, Chap. 341 § 31 (allocation of profits and losses) and  
KRS § 275.210 amended by H.B. 666, Chap. 341 § 32.

54 See § 1.12 herein.

55 KRS § 275.220.

56 *Id.*

57 KRS § 275.150(1).

58 *Id.*

59 KRS § 275.200.

60 KRS § 275.095.

61 KRS § 275.230.

62 KRS § 275.185(4).

63 KRS § 275.150(2), added by H.B. 666, Chap. 341 § 26.

64 KRS § 275.255(1)(a).

65 KRS § 275.255(1)(b).

66 KRS § 275.255(1)(c).

67 KRS § 275.265(1).

68 KRS § 275.280(3) as amended by H.B. 666, Chap. 341 § 37.

69 KRS § 275.285.

70 *See* H.B. 666, § 38.

71 KRS § 275.295.

72 KRS § 275.315.

73 *See* note 17, *supra*.

74 KRS § 141.208, amended by H.B. 666, Chap. 341 § 1.

75 *See* note 17, *supra*.

76 *See* note 73, *supra*.

77 KRS § 275.385.

78 KRS § 275.395.

79 KRS § 275.405(3).

80 KRS § 275.405(2).

81 KRS § 275.015(19).

82 KRS § 275.010.

83 *See* Kentucky Constitution Section 116.

84 KRS § 275.025(3). The term “professional services” is identical to that used in KRS § 274.005(3).

85 KRS § 275.010.

86 KRS § 275.150(1).

87 *See* note 20, *supra*.

88 Treas. Reg. 301.7701

89 *See* note 74, *supra*.

90 *See* note 4, *supra*.

<sup>91</sup> See note 6, *supra*.

<sup>92</sup> See note 68, *supra*; under old KRS § 275.280(3) a member was allowed to withdraw upon giving 30 days notice.

<sup>93</sup> See IRC § 2401.

<sup>94</sup> KRS § 275.280(3) as amended by H.B. 666, Chap. 341 § 37.

<sup>95</sup> See note 70, *supra*.

<sup>96</sup> See note 70, *supra*.

## 2.1 NONTAX CONSIDERATIONS IN THE CHOICE OF ENTITY

by  
Alan K. MacDonald<sup>1</sup>

### 2.2 The Role of the Business Lawyer

Rarely will a business lawyer be expected merely to follow the client's instructions and prepare the necessary legal documents to establish a business organization. The decision as to what form a new business venture should take involves legal, economic, and personal questions. In almost all cases a client should (and usually will) ask the business lawyer to evaluate personal and business considerations as well as the strictly legal issues involved in the selection of the most suitable business organization for the client's venture.

While starting a new business requires faith and self-confidence, a client's optimism sometimes turns out to be unreasonable. The business lawyer can often render great assistance by asking questions that cause the client to recognize important issues not previously considered. Initial points the lawyer might raise include:

- How well does the client know the other parties involved? If their association has been brief, a credit check may be useful. If there are plans to offer interests to outside investors, a background check with securities regulators might be prudent.
- Will the client own a minority interest in the venture? If so, has the client considered how to exit from the venture? A minority owner needs to plan in advance how to avoid being "locked in" with an interest that can only be disposed of at a fraction of what the client believes it is worth.
- Does the venture depend on the availability of specific assets, the involvement of certain individuals, or the performance of certain services? Assurances as to the availability of critical assets should be obtained in writing, and the consequences of the assets not being available should be considered. What are the credentials of any "key person" upon whom the venture's success depends?
- Is the feasibility of the venture based on market research or other analysis? How reputable is the person who prepared the report?
- How risky is the venture? Can the client bear the loss of the entire investment?
- What are the personal interests of the various persons involved in the venture? How do they differ? What are the consequences of potential conflicts of interest? A promoter may be motivated less by the success of the new venture than by the opportunity the new venture presents as a customer for goods or services provided by another business affiliated with the promoter.

Obviously, many other similar questions will occur to an experienced business lawyer in the course of reviewing the proposed venture with the client.

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<sup>1</sup> Original article was revised by James C. Seiffert to reflect H.B. 666, Chapter 341, which made significant changes to KRS Chapter 275, the Kentucky Limited Liability Company Act.

### 2.3 Analyzing the Client's Options

Choosing the business organization most suitable for a venture requires the business lawyer not only to know the legal and tax differences between the various business forms, but also to acquire a reasonably thorough understanding of specific aspects of the proposed venture. It is unwise to assume "one size fits all" and that, for example, every real estate venture should be an LLC or every multigenerational family business should be a limited partnership. Each new venture requires a fresh evaluation of all the factors.

Often, the client has identified a form of business organization for the new venture before engaging an attorney. An experienced business attorney will always evaluate the client's decision before proceeding to organize the venture. Frequently, an entrepreneur may want to emulate in all respects, including organizational form, a business concept that has been successful in other markets. Articulate, well educated persons may believe they have a more complete understanding of the tax and legal characteristics of business organizations and related planning issues than in fact is the case. The business lawyer who fails to evaluate the client's understanding of the available choices and reasons for the selection can do the client a great disservice.

When taxation is not a factor, many lawyers routinely advise their clients to incorporate. This may be based on the perception that limited liability is always the paramount consideration, the lower cost of incorporating (due to the use of standard forms), or the lawyer's personal desire to use familiar forms. However, a partnership or even a proprietorship often has offsetting advantages in terms of privacy, informality, simplicity of records and of operation, ease of interstate operation, and immunity from state franchise taxes. An LLC can offer most (if not all) of these advantages as well as limited liability. Lawyers are sometimes too quick to suggest incorporation of a small business.

The following list attempts to identify several preliminary questions that the business lawyer should weigh when considering the form of business organization that best suits a specific business enterprise.

- Are there legal limitations on the choice of business form? Bodies governing the practice of a particular profession may have the authority to approve or deny practice in a particular organizational form. For example, the Kentucky Constitution authorizes the Kentucky Supreme Court to oversee all aspects of the practice of law in the Commonwealth. Ky. Const. § 116.
- Does state or federal law require the business to be incorporated? For example, state-chartered banks and insurance companies must be incorporated. *See* KRS § 287.030(2) and KRS § 304.3-070(1).
- What degree of organizational formality best suits the client's personality, culture and budget? Possible advantages of conducting business in partnership or proprietorship form (which require little or no formal organization) include the lower cost of formation and operation, informality of operation, no need for meetings and elections, privacy, and greater freedom from legal restrictions on powers and business.
- Is it prudent to insulate the client's personal assets from claims by creditors of the business? The corporation and LLC limit, in general, the investor's personal risk to the funds actually invested in the business. A limited partnership (possibly with a corporate general partner) might also be considered in this regard. However, this risk may be covered by insurance. In addition, the advantage of limited

liability is diminished to the extent creditors require personal guarantees of indebtedness by owners.

- Are the other participants untrustworthy or unreliable? If so, a partnership may be dangerous as each partner will generally have the ability to bind the partnership and its partners.
- What financial resources are available to the client? If the venture expects to need outside financing in the near future, will the entity seek to borrow funds or sell additional equity interests? In the case of a business with a relatively short operating history, and all things otherwise being equal, a lender may be most comfortable lending to a corporation because foreclosing on pledged stock would allow the lender to participate in managing the business. A corporation is also the most suitable entity for any venture that anticipates going public. Investors will also be reluctant to put their personal assets at risk by investing in a business without limited liability. On the other hand, a business organized as an S corporation may also have difficulty attracting outside investors. Tax rules limit an S corporation to only one class of stock, and in most cases only natural persons can be shareholders. Therefore, the S corporation cannot accommodate most venture capital investors (which are usually partnerships or corporations) or persons with financial and tax objectives different from those of the founding shareholders. *See* chapter 3 for a more detailed analysis of tax factors that affect outside investment.
- Is centralized management desirable? If the venture is large or is likely to grow rapidly, a corporation may be desirable. An LLC is also a viable alternative if the number of equity owners remains relatively small.
- Will it be necessary to award ownership interests in the business to key employees to attract and retain them? Ownership of stock in a corporation may be more readily understood and nonvoting stock can be easily created. However, the value of this advantage seems relatively small, particularly when nonvoting equity interests can be created as easily in an LLC as in a corporation.
- Will the client need to borrow on the strength of his or her interest in the business? As noted before, stock may sometimes be more acceptable as collateral than interests in a partnership or LLC.
- Does the client wish to create interests in the profits of the business (*e.g.*, for family members) while retaining exclusive control of managing the business? Although a limited partnership has often been used for this purpose, the LLC can accomplish the same goal equally well, and provide limited liability to all participants.
- Is there agreement on distribution policies if some participants have much greater outside income than others? If a limited liability company, partnership or other “pass-through” entity is chosen, the equity owners will owe tax on business earnings—whether or not any earnings are distributed to the owners. If the business intends to retain all earnings to finance growth, “phantom income” could be a problem for owners without other sources of income available to pay taxes.
- Is continuity of existence desirable? If the client is to be a minority shareholder in a corporation, some provision should be made to permit

the client to terminate the investment at an adequate price in the event of a personal disagreement. Considerable continuity may be provided in a partnership or LLC.

## **2.4      The Importance of Tax Considerations**

In most cases, the most important single factor in the choice of entity is the impact of state and federal income taxes. Kentucky and federal income tax laws are largely the same, but some states have income tax laws that differ radically from federal law, while some states have no state income tax. The tax considerations material to the selection of a business organization are the subject of chapter 3.

Before the emergence of the LLC, balancing tax and nontax objectives often resulted in an imperfect trade off. In situations where tax considerations clearly dictated a specific organizational form, it was often necessary to use multi-entity structures to attempt to achieve the nontax attributes of the venture desired by the client (hopefully without sacrificing the desired tax treatment). For example, a limited partnership with a corporate general partner provides flow-through taxation and limited liability for all investors. The obvious drawback of multi-entity structures is the added complexity and cost of each additional organizational layer. *See* paragraph 2.5.

One of the most useful features of the LLC is its ability to achieve most tax and nontax objectives directly and thereby avoid a cumbersome multi-entity structure.

## **2.5      Limited Liability**

Historically, the ability to shield the personal assets of investors from the creditors of the business has been offered as the primary non-tax reason for incorporating a business. If all other things were equal (and often they were not), this advantage usually tipped the scales toward incorporating. The decision often involved sacrificing some tax or non-tax objectives, so the final product was usually not a perfect solution.

Another solution, albeit one more complex and costly to create, is a multi-entity structure. Generally one layer involves a corporation to provide limited liability and another layer involves a partnership to provide either flow-through tax treatment, a flexible management structure, or both. For example, a corporation often will serve as the general partner of a limited partnership, so no individual will be personally liable for business obligations. Similarly, joint ventures between large corporations often have wholly owned subsidiaries of the parent corporations serving as partners of a general partnership. This way the parent's assets are shielded from venture liabilities, while representatives of both parties can fully participate in managing the business.

With the emergence of the multiple or single member LLC, the perceived advantage of incorporating should be greatly reduced particularly for small businesses. The business can now have both limited liability for the equity owners, as well as the largely unfettered tax and structural flexibility of a partnership or a proprietorship. Therefore, the LLC may well become the predominant form of organization for small businesses over the next decade. Businesses with large numbers of owners, where continuity of life and the freely transferable ownership interests become the paramount considerations, most likely will continue to be organized as corporations.

In addition, the use of a LLC should largely eliminate the need for a multi-entity structure in most situations. The ability of the LLC to achieve most tax and non-tax objectives and adaptability to most business circumstances would allow a client to achieve in one step what previously required additional organizational layers.

The importance of limited liability in the choice of entity tends to be diminished in practice. Most businesses, however organized, will usually buy liability insurance against claims based on tort



and fire, theft, and other risks to protect the investment in the business, regardless of the absence or presence of limited liability. Employees with access to large amounts of money are bonded. Thus, many of the largest business risks can usually be transferred to others. Nevertheless, if the amount of a judgment in a tort claim exceeds the insurance coverage, the unlimited liability of a general partner would be a distinct disadvantage.

Banks, lessors and other providers of financing routinely insist that the owners of the business (however organized) give their personal guarantees if the creditor believes the value of assets of the business is insufficient to provide reasonable security. Only the owners of a business with sustained profitable operations can reasonably expect to rely on limited liability alone to protect their personal assets from the business's largest financing obligations. However, small creditors usually rely on corporate credit exclusively and do not require personal guarantees. Since the amounts owed to all of a business's small creditors may be substantial in the aggregate, it is here that limited liability is advantageous. Employee and tax claims (except tax withholding obligations, for which officers are personally liable) are also typically unguaranteed. Having the limited liability shield in place essentially allows equity owners, particularly those not involved in day-to-day management, to voluntarily choose the business obligations for which they will be personally liable.

Another factor that tends to diminish the importance of limited liability has been the increasing frequency with which statutes have been enacted to permit administrative and criminal sanctions and civil suits to be brought directly against owners and employees of the business. Statutes and regulations governing environmental compliance, securities, banking and certain other regulated industries expressly authorize disregard of the corporate shield to subject directors, officers, and other individuals deemed to be "controlling persons" to direct liability for their actions (or the actions of others) in their official capacities with the company. For businesses in these fields, the selection of the organizational form only can marginally increase the owners' insulation from personal liability.

All things considered, limited liability is a distinct advantage for a business, but should not be the determinative factor in deciding the form of organization. Certainly with the option to use an LLC, practitioners should not automatically assume that incorporating a small business is the best choice in most situations.

Finally, it would be inappropriate to discuss limited liability without briefly mentioning the registered limited liability partnership ("RLLP"). KRS Chapter 362 now permits a general partnership to obtain a measure of limited liability for its partners by registering with the Kentucky Secretary of State and paying an annual \$200 fee. Upon registration, the partners will not be personally liable for liabilities arising out of any negligence, wrongful act or misconduct subsequently committed by another partner or an agent or employee of the partnership. KRS § 362.220(2). This limited liability does not extend to contracts in the ordinary course of business or similar business obligations. *Id.* An unanswered question is whether department heads or managing partners not otherwise involved in a wrongful act might nevertheless be held personally liable under a broad application of a "failure to supervise" theory. See Chapter 18 for a more detailed discussion of RLLPs.

The RLLP was intended principally for large, multi-state professional practices currently conducted as general partnerships. These businesses, particularly the "national" accounting firms, may prefer not to convert into LLCs because of the need to rewrite complex partnership provisions and several unresolved concerns about the possible application of federal labor and civil rights statutes to an LLC having several hundred members. The RLLP would seemingly meet the objective of a national professional practice to protect the partner in Lexington, Kentucky from personal liability for malpractice committed in an office located elsewhere.

There is no need to organize a new business as a RLLP when the LLC offers equal flexibility and protection from personal liability for all claims, not just claims arising from wrongful acts. See chapter 15 for a more complete discussion of the issue of liability.

## 2.6 Participation in Management

One of the first and most critical decisions the business organizers must face is determining who will hold the power to manage the business. The decision involves balancing the vision of the promoters, the desire of investors to protect their stake in the business, personal compatibility, tax limitations, and other factors.

As a general rule, a management structure in which all owners participate becomes less and less feasible as the number of owners increases. For this or other reasons, it may be desirable to vest the power to manage the enterprise in the hands of fewer than all the participants, or in the hands of a person who is not a participant. In such circumstances, a corporation or LLC would ordinarily be preferable to a general partnership.

In a corporation, management is vested in the directors and officers, not the shareholders. KRS § 271B.8-010(2). In a general partnership, on the other hand, the power to exclude specific partners from participating in management is limited. The Kentucky Uniform Partnership Act provides that "subject to any agreement between them" each partner has power to participate in management. KRS § 362.235. However, an agreement that delegates authority to manage the business to certain partners may be ineffective if an excluded partner negotiates on behalf of the partnership with third persons who are unaware of the restriction on his authority. KRS § 362.190(4). It is also possible to designate certain partners as "managing partners." It is not clear, however, that this necessarily limits the authority of the other partners to bind the partnership.

A unique feature of the LLC is that management authority can be retained by all the members like a general partnership, or it can be formally delegated to one or more "managers," akin to a corporation's board of directors. The choice the LLC makes must be set forth in its articles of organization and therefore is a matter of public record. KRS § 275.025(1)(e). If the members delegate management authority to managers, they surrender the authority to act for and bind the LLC. KRS § 275.135(2). If, on the other hand, the members formally retain management authority, they may still delegate management authority to selected "managing members" by agreement, but as in the general partnership this delegation would not necessarily prevent an unauthorized member from entering the LLC into a binding agreement with an unknowing third party. *See* KRS § 275.135(4).

There may be circumstances when a limited partnership may be useful to restrict the power to manage to a few participants. Under the Revised Uniform Limited Partnership Act, only the general partners have the power to manage the business, and for that privilege they have unlimited liability for business obligations. KRS § 362.220. Limited partners can have narrowly prescribed participation rights, generally limited to voting on specified structural changes to the limited partnership. KRS § 362.437(2). A limited partner who exceeds those limits forfeits limited liability. KRS § 362.437(1). With the advent of LLCs, the limited partnership will probably lose much of its appeal. If investors can have significant participation rights along with partnership tax treatment and limited liability, it is reasonable to expect them to demand to have some say over their investment. However, certain situations may call for strictly limiting the participatory rights of owners, and having statutory restrictions in those situations rather than contractual restrictions (which can be repealed by agreement) may be preferable. For example, the limited partnership is still a viable option for dividing control and economic rights in a family business, where finding investors willing to put up with these restrictions is not an issue.

As an enterprise increases in size and in the number of investors, a partnership or LLC (for reasons other than management) becomes increasingly unwieldy. For this reason most large enterprises have been, and will likely continue to be, conducted in corporate form.

## 2.7 Continuity of Existence

A partnership, for state law purposes, lacks the attribute of continuity of existence in the sense that the death or withdrawal of a partner dissolves the partnership. On the other hand, a corporation has this attribute because corporate existence is unaffected by the departure of a shareholder.

A distinction should be made between practical continuity and legal continuity. In many businesses, the death or retirement of the key person may render it impossible to continue the business as a practical matter. In such situations the business will (or should) in fact end upon the death or retirement of the key person, regardless of the form of organization. Only when the death or retirement of an owner will not have such a devastating impact will the legal differences in continuity of existence among the corporation, partnership, and LLC become significant. *See* paragraph 2.10.

Continuity of existence as a legal matter no longer takes on practical importance with respect to an LLC. Prior to the Check-the-Box Regulations, achieving income tax treatment as a partnership was presumably the most important reason for forming an LLC. Qualification as a partnership was, in the past, predicated on the LLC lacking continuity of existence. *See* chapter 4. This is no longer the case, pursuant to the Check-the-Box Regulations, all domestic unincorporated entities, which includes LLCs, will be treated as a pass-through entity unless the owners elect to be taxed as a corporation. Consequently, the lack of continuity of existence into the LLC to gain partnership tax treatment is gone.

As a practical matter, the lack of continuity of existence in a partnership is important when the partners did not have the foresight to plan for the death or withdrawal of a partner. It is possible to provide substantial continuity in a partnership by including buy-sell provisions in the partnership agreement or in a separate agreement, perhaps funded with insurance. This would allow the remaining partners to continue the business free of interference from representatives of the deceased or retiring partner, and liquidate the interest of the departed partner in an orderly way.

Continuity of existence should not prevent use of the corporation in situations when this attribute is not desired. Appropriate provisions requiring dissolution upon the occurrence of specified events may be included in the articles of incorporation or an agreement among the shareholders.

## 2.8 Transferability of Ownership Interests and Access to Capital

The importance of this attribute in the choice of business entity will often depend on the need for and the plan to raise capital for the business.

Shares of corporate stock are usually freely transferable. On the other hand, the ability to transfer interests in a partnership or, in most cases, an LLC are substantially restricted. The transferability of interests in any organization can always be modified by agreement or by appropriate provision in the organic documents such as corporate bylaws or articles of incorporation.

The power to choose one's business associates is a fundamental principle of partnership and is generally desired in any small business. Therefore, the participants will usually want veto power over who is admitted to the enterprise. This veto power is automatically present in the partnership, and, as a practical matter incorporated into the LLC. A corporation can provide appropriate share transfer restrictions in an agreement among the shareholders or in the articles of incorporation or bylaws. However, particularly in the case of corporations, it may be necessary for the entity or its continuing owners to raise capital to purchase the interest of the person desiring to withdraw. Although absolute prohibitions on transfer of corporate shares are against public policy, the Kentucky Business Corporation Act authorizes reasonable transfer restrictions necessary to meet legal requirements or for any other legitimate corporate purpose. KRS §§ 271B.6-270.

Borrowing is a customary source of capital for a small business. In this regard, there is little difference in borrowing ability among a partnership, a corporation, or an LLC. Creditors will generally

rely primarily on the personal guarantees of the owners to secure the indebtedness. If it is contemplated that additional capital will be raised by selling equity interests in the venture, the corporation has historically been preferred. Partnership interests carry with them unlimited liability and may be unattractive to investors. An LLC would be a perfectly suitable vehicle for raising capital, provided the number of investors does not become too large. Regardless of the form of the enterprise, interests in any closely held business are usually unsalable as a practical matter except to other participants in the venture. Therefore, ownership interests in a small business are likely to be unattractive to investors unless those interests include a voice in the enterprise and specific buyback protections.

If it is contemplated that the business will raise capital by selling equity interests to the public, then a corporation is the most practical choice of organization. A public company must have freely transferable ownership interests and continuity of existence. While there are numerous publicly held limited partnerships (although limited partnership interests cannot be traded on a securities market without being treated as a corporation for federal income tax purposes), a corporation is the obvious choice of entity for a business going public.

## **2.9      Formality of Operation and Other Practical Considerations**

The factors discussed in this section generally favor informal business arrangements such as the partnership. These advantages may not outweigh the other offsetting advantages, particularly limited liability, of organizations that require more formalities, but they nevertheless should be taken into account. When the proposed venture involves an uncomplicated business and few detail-oriented personalities, simple and informal may be better.

Filing fees for new business organizations rarely total more than \$100. See KRS §§ 271B.1-220, 275.055, 362.425. The annual filing fee for a RLLP is \$200.

The amount of legal work involved in drafting a comprehensive partnership or operating agreement normally will not differ significantly from that required to draft the articles of incorporation, bylaws and stock restriction and repurchase agreement for a closely held corporation. The cost of forming a partnership or LLC may be somewhat greater because of the complexity of those portions of the Internal Revenue Code dealing with partnership taxation. The largest factor affecting organizational costs, regardless of organizational form, is the complexity and uniqueness of the particular arrangements desired by the parties to the business enterprise.

A partnership is formed simply by oral or written agreement (sometimes unintentionally). It need not issue shares, keep a share transfer book, hold meetings, keep minutes, conduct elections, or file reports as a corporation is required to do. It may operate extremely informally. The only records a partnership is required to keep are business records sufficient to satisfy the Internal Revenue Service. While corporate recordkeeping and formality can be minimized, there is some danger that the separate corporate existence will be disregarded under a "piercing the corporate veil" theory if the appropriate formalities are not maintained.

The LLC has only a few more legal requirements than a partnership and can also be operated with a minimum of formality. Although the operating agreement can be oral, it would almost always be prudent to discourage a client from having an oral operating agreement. An LLC must file an annual report with the Secretary of State and must keep certain records at the principal office of the business. KRS §§ 275.185 and .190. It remains to be seen whether the courts will recognize a "veil piercing" theory to find members of an LLC personally liable based on the failure to observe formalities or other factors.

Maintaining organizational formalities can be a nuisance for a person accustomed to handling matters directly. Additional legal expense can be incurred if a lawyer periodically reviews the organization's formal affairs.

Banks and insurance companies must be organized as corporations. *See* KRS § 287.030(2) and KRS § 304.3-070(1). On the other hand, some businesses are prohibited from being organized as corporations. Some professions, for example, can only be conducted in corporate form as “professional service corporations,” a hybrid entity. *See* KRS § 274.015 and chapter 15.

General partnerships may engage in virtually any type of business other than banking and insurance. LLCs can also conduct almost any business, including professions, subject to the ultimate authority of the regulatory board governing the profession. *See* KRS § 275.010 and chapter 15.

Partnerships may generally conduct business in any number of states with the same ease as an individual. On the other hand, a corporation, limited partnership, or LLC must obtain authorization to operate in each state in which it is deemed to be transacting business, and thereby becomes subject to suit in the state. Qualification to do business in another state may also subject a corporation to taxation by that state.

While the difference is not great, the partnership offers somewhat greater privacy in operation than a corporation or an LLC. Corporations and LLCs must file annual reports with the Secretary of State that identify individual officers and members, and each must maintain a registered office and registered agent. The articles of incorporation and articles of organization are a public record. None of these are required of a partnership. The certificate of limited partnership on file with the Secretary of State need only contain relatively little information chiefly names and addresses of the general partners. KRS § 362.415. However, a considerable degree of privacy may be maintained in the corporation through the use of nominees or straw parties. The requirement that an assumed name certificate be filed by a partnership also tends to reduce the significance of privacy as a factor.

#### **2.10      Estate Planning**

While it may be unrealistic to expect the founders of a business to select a form of organization based on the consequences that result from their deaths, the choice of entity will affect the owners' ability to transfer their ownership to succeeding generations of family members.

Reorganizing a family business as a “family limited partnership” is one popular estate planning technique. Generally, this involves the formation of a limited partnership with a corporate general partner. The limited partnership units are allocated the right to receive a high percentage of the partnership distributions. Over time, the owner could make tax free gifts of limited partnership units to family members carrying with them the right to receive most of the business income, while the owner retains the power to manage the business. The LLC now can achieve the same estate planning objective without the need for a multiple entity structure.

A deceased partner's partnership interest may pass by will or intestacy to his beneficiaries. The beneficiary's tax basis in the deceased partner's partnership interest will equal the fair market value of the interest at the date of death. The possible termination of a partnership upon the death of a partner, however, may have adverse tax consequences. A buy-out of a retiring or deceased partner's interest can be structured as the sale of the partner's interest to the other partners or a redemption of the partner's interest by the partnership. The tax consequences of these two approaches may differ depending upon the type of assets held by the partnership and the presence or absence of goodwill.

The corporation can also provide significant flexibility for estate planning. Prior to death, the owner can shift income among family members by transferring share ownership and thus the right to receive dividend income. This is also a useful way to divide ownership of a business among several beneficiaries. Moreover, different classes of common and preferred stock may be used to shift voting control and economic benefits among various individuals before or upon death.

Shares of a corporation that pass under a shareholder's will or by intestacy will receive a stepped-up basis to the value on the owner's date of death. If shares must be sold to settle an estate, however,

valuation problems may arise. If a public market for the shares exists, estate sales can be relatively simple, whereas establishing the value of shares of a closely held corporation may require a third party appraisal. The need for an appraisal can usually be avoided if the owners of a closely held corporation enter into an agreement providing for the repurchase of the shares from the estate of the deceased by the corporation or other shareholders. The corporation can obtain insurance on the life of its shareholders to fund any required repurchases.

The sole proprietorship affords the owner little opportunity for constructive estate planning. A sole proprietorship's assets will generally pass to the owner's beneficiaries by will or intestacy, and the assets will receive a stepped-up basis to their value of the date of death. The sole proprietorship lacks a convenient mechanism such as the transfer of shares of a corporation to transfer ownership before or at death to one or more successors. The sole proprietorship also lacks the ability to structure voting and economic rights among different persons by creating different classes of stock or interests.

### 3.1 CHOICE OF ENTITY—INCOME TAX CONSIDERATIONS

by

Charles J. Lavelle and Charles Fassler

In examining the income tax considerations in choosing an entity, the first decision is whether to select an entity with corporate tax patterns or a pass through entity. An entity taxed as a corporation will pay tax at the entity level; the owners will generally not pay any tax on the corporation's undistributed earnings, but will normally pay tax on distributions from the corporation. A pass through entity does not generally pay tax at the entity level; however, the owners will generally report the entity's income, gain and loss on their individual returns in the year earned.

C corporations are taxed as corporations, as are public limited partnerships and entities (such as business trusts or other associations) that elect to be treated as corporations under the check-the-box regulations. See chapter 4. They are called C corporations because they are chiefly governed by Subchapter C of Chapter 1 of Subtitle A of the IRC.

S corporations, general partnerships, limited partnerships, LLPs and LLCs, unless they elect otherwise, are pass through entities. See chapter 4. Most taxpayers will want their LLCs to be taxed as partnerships; accordingly, unless otherwise indicated in this chapter and in chapter 8, we will assume that the LLC will be taxed as a partnership.

For purposes of this chapter, we will address the typical situation of several owners conducting a business and not discuss publicly traded entities. We will generally not discuss an affiliated group of corporations that file a consolidated return. The special taxation of trusts and estates, foreign entities operating in the United States, insurance companies, real estate investment trusts, foreign sales corporations and other special entities are also beyond the scope of this chapter.

#### 3.2 Overview of Tax Aspects of Choice of Entity

Before concentrating on the details, this paragraph discusses the broad tax considerations in selecting an entity. Depending on the entity selected, there may be markedly different tax treatment to the entity and the owners relating to: contributions to the entity; basis in the entity's assets and the entity's ownership interests; operations at a profit or a loss; recognition and utilization of losses; distributions by the entity; dispositions of ownership interests, etc. These are discussed below for each entity in detail.

In the broadest terms, a C corporation pays tax on its income and the shareholders pay tax on the C corporation's after-tax earnings when they are distributed to the shareholders. Also, in broad terms, the owners of general partnerships, limited partnerships, S corporations, LLPs and LLCs pay personal tax on the earnings of these entities as they are earned; these entities generally do not pay an entity level income tax. Beyond these very general statements, there can be very different tax consequences among the various entities on the wide variety of transactions involved in the establishment, operation and liquidation of a business entity.

In most circumstances, organizing the business is tax-free, although there are circumstances when tax will result at the business' creation. The entity's bases in the contributed assets and the owners' bases in their entity interests may vary depending on the entity. While C corporations are generally permitted to pay a tax on income and retain the earnings, there are limits which ultimately compel distributions. The taxability of distributions varies widely depending on the circumstances and the entity involved. The ability to recognize and utilize losses also depends on the circumstances and the entity. Depending on the facts and the entity, periodic distributions may be taxable or nontaxable, capital or ordinary. Finally with some entities, even liquidating distributions of property may not result in a final tax reckoning; that may await a cashing out of the property received.

Thus, while each of the pass through entities will ultimately impose approximately the same amount of income tax on the same amount of income, careful selection and planning may create such a significant disparity among the entities as to when the taxes must be paid, that one form is superior to the others. Further, if the owners are individuals, some of that deferral can become permanent because of the step up in basis to fair market value upon death. Because each business has unique circumstances, there is no single answer to which entity should be selected; and, because LLCs are relatively new, certain of the issues have not been resolved. However, in many respects LLCs combine most of the advantages of the various entities, without some of the disadvantages that some of the entities have.

### **3.3      Corporate Income Tax Rates**

The tax rates of a C corporation are as follows (IRC § 11):

- 15% for taxable income through \$50,000
- 25% for taxable income between \$50,001 through \$75,000
- 34% for taxable income between \$75,001 through \$10,000,000 plus 5% of taxable income between \$100,001 through \$335,000
- 35% for taxable income above \$10,000,000 plus 3% of taxable income between \$15,000,000 and \$18,333,333

Capital gains are taxed at the same rates as ordinary income, not to exceed 35 percent. IRC § 1201. Personal service corporations are taxed at a uniform 35 percent rate on all taxable income. IRC § 11(b)(2). The alternative minimum tax is imposed to the extent that 20 percent of alternative minimum taxable income exceeds the regular tax; in computing alternative minimum taxable income, the corporation is entitled to an exemption of \$40,000, which phases out at the rate of 25 percent of the amount by which the alternative minimum taxable income exceeds \$150,000. Alternative minimum taxable income is computed by modifying taxable income for certain tax preferences and adjustments. The purpose of the alternative minimum tax is to require each corporation to pay a minimum amount of tax, even if it would not have any tax liability under the regular tax.

An environmental tax equal to .12 percent is imposed on so much of the alternative minimum taxable income (without taking into account the alternative minimum tax net operating loss or the environmental tax) as exceeds \$2,000,000. IRC § 59A. C corporations are also generally subject to an accumulated earnings tax, if they are formed or availed of for the purpose of avoiding tax at the shareholder level by accumulating profits rather than distributing them. The accumulated earnings tax is equal to 39.6 percent of the corporation's accumulated taxable income. IRC §§ 531-537. A personal holding company tax is imposed upon personal holding companies equal to 39.6 percent of undistributed personal holding company income. IRC §§ 541-565. The tax is generally imposed on closely held corporations (where 50 percent of the value of the stock is directly or indirectly owned by five or fewer individuals) that earn too great a portion of their income from personal holding company income (such as dividends, interest, certain royalties, certain rents, etc.) and do not distribute sufficient dividends. IRC § 542(a). Closely held C corporations are subject to the at risk and passive activity loss rules described in paragraph 3.14. IRC §§ 465(a)(1)(B) and 469(a)(2)(B).

### **3.4      Individual Income Tax Rates**

The individual income tax rates generally consist of five graduated rates: 15 percent, 28 percent, 31 percent, 36 percent and 39.6 percent. The levels at which the income tax rates change differ for married taxpayers filing jointly; married taxpayers filing separately; heads of households; and single tax-



payors. The brackets are adjusted annually for inflation. For 1998, the rates for each category were imposed on the following amounts of taxable income:

	<b>Married Filing Joint</b>	<b>Head of Household</b>	<b>Unmarried Individuals</b>	<b>Married Filing Separately</b>
<b>15%</b>	0 to \$42,350	0 to \$33,950	0 to \$25,350	0 to \$21,175
<b>28%</b>	\$42,351 to \$102,300	\$33,951 to \$87,700	\$25,351 to \$61,400	\$21,176 to \$41,150
<b>31%</b>	\$102,301 to \$155,950	\$87,701 to \$142,000	\$61,401 to \$128,100	\$51,151 to \$77,975
<b>36%</b>	\$155,951 to \$278,450	\$142,001 to \$278,450	\$128,101 to \$278,450	\$77,976 to \$139,225
<b>39.6%</b>	above \$278,450	above \$278,450	above \$278,450	above \$139,225

Most long-term capital gains are taxable at no more than 20 percent. IRC § 1(h).

The alternative minimum tax discussed above for corporations also applies to individuals, although some of the preferences and adjustments differ from those applicable to corporations. IRC §§ 55-59. The alternative minimum taxable income in excess of an exemption amount is taxed at a 26 percent rate on the first \$175,000 and a 28 percent rate above that. The \$45,000 exemption amount used in computing alternative minimum taxable income for joint returns or surviving spouses is phased out beginning at alternative minimum taxable income of \$150,000. The exemption amount and phase out levels are different for single taxpayers and married taxpayers filing separately.

### **3.5      Taxation of C Corporations**

C corporations pay a tax on their taxable income at the rates set forth in paragraph 3.3. Corporations that are members of an affiliated group and file a consolidated return pay a single tax at those rates. As noted above, individual shareholders do not include any of the income or loss of C corporations in their individual returns.

### **3.6      Taxation of Contributions to C Corporations**

Under IRC § 351, when shareholders contribute property to a C corporation solely in exchange for stock of that corporation, there generally is no gain or loss to the shareholders, if, after the exchange, the contributing shareholders own 80 percent of the stock of the corporation. There is an exception to nonrecognition treatment in the case of an investment company. IRC § 351(e)(1). If the provisions of IRC § 351 are met, then the shareholders will have a basis in their stock equal to the basis in the property contributed; the corporation will receive bases in the assets received equal to their bases in the shareholders' hands.

If the transferors also receive "boot" (money or property in addition to stock), they recognize gain (but not loss) to the extent of the money and fair market value of the property. The basis in the stock is reduced by the money and value of property received and increased by the gain recognized. IRC § 358. If the shareholder receives stock for services, the stockholder has income taxable under IRC § 83.

If the requirements of IRC § 351 are not met, then the transferors generally recognize gain or loss equal to the difference between the value of the stock received and the basis in the assets contributed; however, the loss may be disallowed under IRC § 267, for any transferor treated as owning more than 50 percent of the stock of the corporation after application of the attribution rules. The corporation has a basis in the assets received equal to the fair market value of the stock exchanged. B. Bittker and J. Eustice, Federal Income Taxation of Corporations and Shareholders, ¶ 3.12[4] at 3-63 n. 286 (6th ed. 1994). However, the corporation does not recognize gain or loss on issuance of stock for property. IRC § 1032.

There are often liabilities assumed by the corporation in an incorporation. With two exceptions, a transaction otherwise qualifying under IRC § 351 will remain tax-free to the transferor even if the corporation assumes the transferor's liabilities, or takes property subject to a liability. IRC § 357(a). The two exceptions are (1) if the liabilities exceed the total bases of the properties transferred, then gain is recognized to the transferor equal to such excess (IRC § 357(c)), and (2) if the principal purpose of a liability was either not a bona fide business purpose or was to avoid Federal income tax, then all of the liabilities will be treated as money received by the taxpayer in the exchange (IRC § 357(b)).

### 3.7 Basis in C Corporation Stock

A shareholder has a basis in his or her stock equal to the basis determined for his or her stock as set forth in paragraph 3.6. This basis is unaffected by the operating income or loss of the corporation. The basis is reduced if the C corporation's distributions are nontaxable to the shareholder, as set forth in paragraph 3.8. If the shareholder lends money to the C corporation, the shareholder has a basis in the debt equal to the amount loaned.

### 3.8 Taxation of C Corporation Distributions

A corporation that distributes money or property to its shareholders in respect of their stock does not receive a deduction. If property is distributed, the corporation recognizes income (but not loss) equal to the amount by which the value of the property exceeds the corporation's basis in it. IRC § 311(b)(1). The corporation's earnings and profits are increased by the amount of the excess of the fair market value of such property over its basis for determining earnings and profits, and reduced by the fair market value of such property. IRC §§ 312(a)(3) and (b). If the property's basis exceeds its value, the earnings and profits are reduced by the adjusted basis of the property. IRC § 312(a)(3). A distribution is taxed as a dividend to the individual shareholder, if the corporation has either accumulated earnings and profits or earnings and profits during the year of distribution, computed at the end of the year. IRC §§ 301(c) and 316. To the extent the distributing corporation does not have such earnings and profits, then the distributions are nontaxable returns of capital to the extent of basis, then capital gain distributions thereafter. IRC § 301(c).

If the distribution is in redemption of shares, it will be treated as described in the preceding sentence (generally as ordinary income without reduction for the basis of the redeemed shares under IRC § 301(c)), unless it is treated as a payment in exchange for stock under IRC § 302(b). IRC § 302(b) will apply if any of four criteria are met: (1) the redemption is not essentially equivalent to a dividend; (2) after the redemption, the shareholder has less than 50 percent of the stock and less than 80 percent of the percentage of the stock the stockholder previously held; (3) the redemption terminates the shareholder's interest in the corporation; or (4) it is in partial liquidation of a noncorporate shareholder's interest. Each of these categories has additional rules and require that attribution rules apply.

If a corporation liquidates, it will generally recognize gain or loss as if it had sold all its property to its shareholders at fair market value. IRC § 336(a). There are limitations on the loss if the distribution is non pro rata or if the property was received under IRC § 351 within five years of the distribution. IRC § 336(d). The taxation of the liquidating corporation was instituted in the Tax Reform Act of 1986. Before

that, such liquidations were not taxable under IRC § 336; the nontaxability codified the decision in General Utilities & Operating Co. v. Helvering, 296 U.S. 200 (1935). The adoption of corporate level tax in 1986 is generally referred to as the repeal of the General Utilities doctrine.

### 3.9 Taxation on Dispositions of C Corporation Stock

Shareholders recognize losses on their stock when shares are sold for less than their basis or if the shares become worthless. IRC §§ 165(g)(1) and (2). The losses are capital losses and will be long or short term depending upon whether the holding period is more or less than one year. Worthless stock is treated as sold on the last day of the year. Under IRC § 1244, up to \$50,000 (\$100,000 for married taxpayers filing jointly) of such loss on stock in small corporations may be deducted as an ordinary loss. Among other limitations, such stock must have been issued by the corporation to the shareholder in exchange for money or property; the corporation must be in an active business and may not have paid or contributed capital exceeding \$1,000,000. The gain on the sale of stock may be treated as ordinary income under certain circumstances. See, e.g., IRC §§ 306 and 341 (relating to collapsible corporations).

Under certain circumstances, a shareholder may exclude up to 50 percent of the gain from the sale of shares of "qualified small business stock" held for more than five years. IRC § 1202. "Qualified small business stock" is generally C corporation stock issued after August 10, 1993, by a corporation meeting size limitations and conducting an active business, which was acquired at the time the corporation initially issued the stock for money or property (other than stock). The stock of a small business investment company under section 301(d) of the Small Business Investment Act of 1958 will meet the active business requirement. IRC § 1202 describes the additional rules applicable to this exclusion.

A taxpayer may defer gain on the sale of publicly traded stock, if he or she reinvests the proceeds into a specialized small business investment company under section 301(d) of the Small Business Investment Act of 1958 within 60 days. IRC § 1044. The deferred gain is limited to \$50,000 per year, not to exceed \$500,000 for a lifetime for individuals and \$250,000 per year, \$1,000,000 in total, for C corporations.

Shareholders will generally be able to receive, tax-free, stock in a corporation which is part of a reorganization under IRC § 368 or distributions of stock of a controlled corporation under IRC § 355 (such as spin-offs, split-offs and split-ups). The general tax-free character of many of these transactions may be retained, even if property is distributed in addition to the stock, but the property will be taxed under IRC § 356(a).

### 3.10 Compensation of C Corporation Shareholders

Salaries paid to C corporation shareholder employees are deductible by the corporation if they are reasonable for the services rendered; they are includable in the income of the shareholder. By being deductible to the corporation, the payments escape the two levels of tax generally applicable to payments to C corporation shareholders. For this reason, the IRS has often challenged the deductibility of compensation paid to shareholders. It is extremely difficult to generalize in this area because the cases are so fact specific. Some corporations paying large salaries have been successful, while others (even those with a large proportion of professional income) have not. Compare, e.g., Home Interiors & Gifts, Inc. v. Commissioner, 73 T.C. 1142 (1980) with Richlands Medical Association v. Commissioner, T.C. Memo 1990-660 (1990), *aff'd* without published opinion, 953 F.2d 639 (4th Cir. 1992). This issue is avoided completely if a pass through entity is used. Similarly, the \$1,000,000 cap on compensation under IRC § 162(m) is only applicable to publicly traded corporations.

The opposite issue arises for S corporations. The shareholders will pay income tax on their distributive share of income plus their salary. However, only the salary is subject to social security tax; there is no self-employment tax on their distributive share of income. Rev. Rul. 59-221, 1959-1 C.B. 225.

The IRS has ruled that an S corporation may not pay an unreasonably low salary in order to avoid the self-employment tax. Rev. Rul. 74-44, 1974-1 C.B. 287. The uncertain treatment of self-employment tax with an LLC is discussed below in paragraph 8.9.

### **3.11      S Corporations and Their Limitations**

If a corporation meets certain qualifications, it and its shareholders may elect under Subchapter S of Chapter 1 of Subtitle A of the IRC to have the corporation generally taxed as a pass through entity, with no tax at the corporate level, and with the gain or loss passed through to the shareholders. Initially there were very stringent restrictions on S corporations. While these limitations have been relaxed over time, they can still pose a substantial burden on some entities.

S corporations may only have 75 shareholders. IRC § 1361(b)(1)(A). Each of the shareholders must be an individual, estate or certain specified trusts, including a "qualified subchapter S trust" ("QSST") and an "electing small business trust" ("ESBT"), and certain tax-exempt entities. IRC §§ 1361(b)(1)(B), (c)(2), (c)(6), (d)(1) and (e). Thus, an S corporation may not have a shareholder that is a corporation (unless the corporation is an S corporation, owns all of the stock of the S corporation and makes a qualified subchapter S subsidiary election for the subsidiary), partnership or trusts other than the permitted trusts. Further, nonresident aliens may not be shareholders of S corporations. IRC § 1361(b)(1)(C). A husband and a wife are treated as one shareholder for purposes of counting the number of shareholders. IRC § 1361(c)(1).

In a reversal of policy, the IRS has approved a strategy that may effectively relax the 75 shareholder limitation. Rev. Rul. 94-43, 1994-2 C.B. 198, reconsidered and revoked Rev. Rul. 77-220, 1977-1 C.B. 263, a ruling involving thirty individuals who formed three identical S corporations, each of which had ten different shareholders; the three S corporations formed a partnership to conduct a single business. The principal purpose for forming three corporations instead of one was to avoid the then ten shareholder limitation of S corporations. The IRS ruled in Rev. Rul. 77-220 that the S corporation elections were invalid because the three corporations would be treated as one for purposes of the S corporation election. Rev. Rul. 94-43 revoked Rev. Rul. 77-220 stating that the shareholder limit is to obtain administrative simplicity in the corporation's affairs. Because administrative simplicity is not undermined by being a partner with other S corporations, the S corporation election should be respected.

S corporations must be domestic corporations and cannot be financial institutions that use the reserve method for computing bad debts, insurance companies or certain other special corporations. An S corporation election by a corporation which was previously a C corporation and which has C corporation earnings and profits will terminate if more than 25 percent of the corporation's gross receipts are from passive sources for three consecutive profitable years, if at the end of each of those years, the corporation had C corporation earnings and profits. IRC § 1362(d)(3).

An S corporation may only have a single class of stock. Thus all stock must be identical in income, distribution and liquidation rights. However, the shares may differ in voting rights without constituting a second class of stock. IRC § 1361(c)(4). This means that income, loss and distributions are allocated in exact proportion to stock ownership. Unlike partnerships, S corporations may not make any special allocations. It also means that taxpayers must assure themselves that purported debt is not reclassified as equity. There is a safe harbor for nonconvertible debt with noncontingent interest. IRC § 1361(c)(5).

### **3.12      Taxation of Contributions to S Corporations; Basis**

The tax consequences of a contribution of property to an S corporation in exchange for stock are similar to those for a C corporation. When the shareholder of an S corporation contributes property to the S corporation in exchange for stock qualifying under IRC § 351, he or she has no gain or loss on the

transfer; the S corporation has no gain or loss; the shareholder takes a basis in such stock equal to the amount of money and basis of property contributed and the corporation has a basis in the contributed assets equal to their bases in the contributor's hands.

A shareholder's basis in stock is generally increased by income passed through to the shareholder, realized gains on the contribution, contributions to capital, and depletion deductions in excess of the property's basis; and is decreased by losses passed through to the shareholder, by nontaxable distributions to the shareholder, by nondeductible, noncapital expenses and by certain depletion. IRC § 1367(a).

### 3.13 Allocation of Income, Gain, Loss, Deduction and Credit by an S Corporation

An S corporation passes through its income, gain, loss, deduction and credit to its shareholders in direct proportion to their stockholdings; however, if a family S corporation is involved and a family member provides services or capital to the corporation without compensation, the IRS can reallocate to reflect the value of the services and capital. IRC § 1366(e). Income is reported by shareholders with the same character as in the hands of the S corporation. Losses (with the same character as in the hands as the S corporation) are passed through to the shareholders, but the shareholder's ability to currently deduct the losses is subject to three limitations: (1) basis; (2) at risk; and (3) passive activity.

### 3.14 Limitations on a Shareholder's Ability to Deduct S Corporation Losses

A shareholder cannot deduct losses which exceed his or her basis; any excess is carried over into the first subsequent year where there is sufficient basis. IRC § 1366(d). Basis for this purpose includes the shareholder's basis in both stock and loans from the shareholder to the corporation. IRC § 1366(d)(1). Thus, a shareholder may deduct losses from operations against not only the shareholder's equity investment, but also the shareholder's debt. This is contrasted with a partnership where a partner may deduct losses against not only the equity basis, but also a portion of all the partnership's debts, not solely the debts by the partnership to that partner. A shareholder cannot generally receive basis for S corporation debts to others, even if the shareholder guarantees them. *Perry v. Commissioner*, 47 T.C. 159 (1966), *aff'd on other issue* 392 F.2d 458 (8th Cir. 1968); *cf. Selfe v. United States*, 778 F.2d 769 (11th Cir. 1985). See paragraph 3.19.

IRC §§ 465(a) and (b) limit an S corporation shareholder's ability to deduct losses from the corporation to the amount the shareholder has "at risk": the shareholder's investment, debts relating to the activity on which the shareholder is personally liable or has pledged property other than stock in the borrower, and his or her share of qualified nonrecourse financing. Qualified nonrecourse financing means a nonrecourse mortgage on real estate used in an activity of holding real property and generally borrowed from a bank, other commercial lender or government.

If the taxpayer has sufficient basis to deduct the loss and is at risk with respect to the activity, then the passive activity loss rules of IRC § 469 must be applied. Treas. Reg. § 1.469-2T(d)(6). The passive activity rules permit deductions of losses in ongoing passive activities only against passive activity income. Portfolio income, such as interest and dividends, is not passive income. Passive losses may not be deducted against active trade or business income. Disallowed losses may be carried over and, if not used before, may be deducted when the taxpayer disposes of his or her entire interest in the activity. An activity is not passive if the taxpayer materially participates in it. Material participation requires that the taxpayer participation be regular, continuous and substantial. IRC § 469(h). The regulations contain seven alternative tests, satisfaction of any one of which will constitute material participation: (1) more than 500 hours of participation; (2) the taxpayer and spouse perform substantially all of the participation anyone has in the activity; (3) the taxpayer participates more than anyone else and more than 200 hours; (4) the taxpayer significantly, but not materially, participates in a number of activities, for a total of more than 500 hours; (5) material participation in five of the last ten years; (6) material participation

in any three prior years in a personal service activity; and (7) regular, continuous and substantial involvement under a facts and circumstances test. Treas. Reg. § 1.469-5T.

Rental activities are always passive activities, except for rental real estate. Rental real estate activities will not be treated as per se passive for an individual devoting more than 750 hours to real property trades or businesses in which he or she materially participates and more than half of his or her services are for such trades or businesses. One's activities as an employee are not counted towards this test, unless the employee is at least a five percent owner of the employer. If the 50 percent and 750 hours tests are met, then each interest of the taxpayer in rental real estate will be treated as a separate activity, unless the taxpayer elects to aggregate them. Further, for all years, if a taxpayer actively participates in rental real estate, then up to \$25,000 of losses are allowable, reduced by 50 percent of the amount by which the taxpayer's adjusted gross income exceeds \$100,000. Both the \$25,000 and \$100,000 limits are halved if filing separately. See IRC § 469(i) for additional rules.

### **3.15      Taxation of S Corporation Distributions**

An S corporation generally recognizes gain on the distribution of appreciated property equal to the difference between the fair market value of the property and its basis. This is true whether the distribution is as a result of a dividend, a partial liquidation or complete liquidation, but not in the case of a reorganization or spin-off. IRC §§ 311, 336, 354 and 355.

The taxation to the S corporation shareholder of distributions involves the accumulated adjustment account ("AAA") and the determination of whether the S corporation has C corporation earnings and profits. If the S corporation has no C corporation earnings and profits, distributions are nontaxable to the extent of stock basis and capital gain thereafter. IRC § 1368(b). If the S corporation has C corporation earnings and profits, then the distribution will be treated in the same manner as set forth in the previous sentence, but only to the extent of the AAA. IRC § 1368(c)(1). The AAA generally reflects the amount of undistributed profits which shareholders have previously reported in their tax returns, and is a corporate level account, not a shareholder account. IRC § 1368(e)(1). Any distributions that are in excess of AAA are treated as dividends to the extent of C corporation earnings and profits; thereafter, they are nontaxable to the extent of any remaining stock basis and then capital gain. IRC §§ 1368(c)(2) and (3). An S corporation will not create earnings and profits while it is an S corporation (IRC § 1371(c)(1)), but it may have earnings and profits for a number of reasons, including the fact it was previously a C corporation or a C corporation merged into the S corporation.

### **3.16      Taxes Imposed at the S Corporation Level**

While an S corporation generally pays no tax, there are circumstances where S corporations must pay income tax at the corporate level. First, S corporations must pay tax at regular income rates, on certain net passive income if the corporation has C corporation earnings and profits at year end and if more than 25 percent of its gross receipts are from passive investment income. IRC § 1375. The tax is imposed on the result obtained by multiplying the net passive income by a fraction, the numerator of which is the amount of passive investment income that exceeds 25 percent of gross receipts and the denominator of which is the year's passive investment income. The IRS can waive this tax if the taxpayer believed in good faith it had no C corporation earnings and profits at the close of the year and distributed them reasonably quickly after it determined they did exist. IRC § 1375(d). Secondly, if a C corporation converts to an S corporation and has net unrealized appreciation on the date of conversion, then the S corporation pays tax at corporate rates on the realization of any such net built-in gains during the next ten years. IRC § 1374. Thirdly, it may be subject to investment tax credit recapture under IRC § 1371(d)(2). Fourthly, if a C corporation converts to an S corporation, there will be a tax on recapture of any LIFO (last-in first-out) inventory reserve, spread over four years. IRC § 1363(d). The first three items are subject to corporate estimated tax payments. IRC § 6655(g)(4).

### 3.17 Taxation of Partnerships

There is no income taxation at the partnership level, whether it be a general partnership or a limited partnership. In a partnership, the income, gains, losses, deductions and credits of the partnership generally are passed through to the partners. Unlike S corporations, there are generally no limits on the identity of the partners, the permissible sources of revenues or the method of conducting business. Partnerships must have at least two partners. Limited partnerships must have at least one general partner. The general partner of a limited partnership may be a corporation which would result in all of the ultimate owners having limited liability.

### 3.18 Taxation of Contributions to Partnerships

Generally, no gain or loss is recognized to a partnership or any of its partners upon the contribution of property to a partnership in exchange for an interest in the partnership, assuming the partnership is not an investment company. IRC § 721(a). This contrasts with the incorporation of, or transfer to, a corporation under IRC § 351, which requires that the transferors must hold 80 percent of the stock after the transfer in order to qualify for nonrecognition treatment. If the partnership assumes liabilities, or takes property subject to liabilities, the contributing partner will recognize income if these liabilities exceed the partner's portion of the partnership's liabilities, plus the basis of the property contributed by that partner. IRC §§ 723 and 752. The partner receives a basis in the partnership interest equal to the money and the adjusted bases in the contributed property less any decrease in the partner's share in liabilities associated therewith. IRC §§ 705, 722 and 752. The partnership has a basis in the assets equal to the basis the partner had before the contribution. IRC § 723. If the partnership makes a distribution to a partner that contributes property to the partnership, the contribution will be treated as a sale if that is the substance of the transaction. IRC § 707(a)(2)(B).

The IRS has clarified an issue that had generated much controversy: What is the consequence to a partner of receiving a partnership interest in exchange for services? The traditional view had been that granting a capital interest was taxable, but granting a profits interest was not taxable. Thus, assume Partner A contributes \$100 in cash and Partner B contributes services and they agree to split profits and losses equally, but A gets his initial capital back upon liquidation. Since B has no interest in the original capital if the partnership is liquidated, and B only builds up equity from undistributed profits, B would have no income upon the receipt of the profits interest. This is the approach taken in Rev. Proc. 93-27, 1993-2 C.B. 343, unless the profits interest is a substantially certain and predictable income stream, is disposed of within two years of receipt or is a limited partnership interest in a publicly traded partnership. Prior case law is illustrated by *Campbell v. Commissioner*, 943 F.2d 815 (8th Cir. 1991), *aff'g in part, rev'g in part*, T.C. Memo 1990-162 (1990); *St. John v. United States*, 84-1 USTC ¶ 9158 (C.D. Ill. 1983); and *Diamond v. Commissioner*, 56 T.C. 530 (1971), *aff'd* 492 F.2d. 286 (7th Cir. 1974).

### 3.19 Basis in Partnerships

The taxpayer's basis in the partnership interest includes the basis received upon the contribution of property (paragraph 3.18 and IRC § 722), plus basis in interests acquired from others (IRC § 742), income passed through to the partner (both taxable and nontaxable) and the excess of depletion over the property's basis; less distributions, losses passed through to the partner and certain depletion. IRC § 705. An increase in a partner's share of the partnership's liabilities is treated as a contribution to capital, thus increasing the partner's basis. IRC § 752(a). A decrease in a partner's share of the partnership liabilities is treated as a distribution of cash, thus decreasing the partner's basis. IRC § 752(b). If the loan is recourse, *i.e.*, at least one partner or related party is personally liable for it, then there is allocated to each partner the portion of the loan with respect to which the partner or related party bears the economic risk of loss. Treas. Reg. §§ 1.752-1(a)(1) and 1.752-2. A limited partner will only share in recourse liabilities to the extent the partner is obligated, directly or indirectly, to pay the liability. Treas.

Reg. § 1.752-2. Thus, in a typical limited partnership, only general partners will normally be allocated liabilities, unless they are nonrecourse liabilities. A nonrecourse liability is one where no partner or related party bears the economic risk of loss. Treas. Reg. § 1.752-1(a)(2). If the partnership incurs a nonrecourse debt, but a partner guarantees the debt, then the debt is treated as a recourse loan and generally all the basis attributable to such debt is allocated to the guarantor.

Nonrecourse liabilities are allocated to the partner in the following manner: first, equal to his or her share of minimum gain under the § 704(b) regulations, secondly, equal to the partner's share of gain allocable under IRC § 704(c) (special allocation of gain or loss on contributed property) and finally, in accordance with the partner's profits interest (where the partnership agreement provides for different profit sharing allocations, the partners generally may choose which one to use). Treas. Reg. § 1.752-3(a). Thus, if a limited partnership borrows money on a nonrecourse basis and no partner or related party guarantees such debt, then the limited partners will have basis associated with a portion of the liabilities.

### 3.20 Allocations of Income, Gain, Loss, Deduction and Credit by Partnerships

The partners have wide discretion in allocating the income, gain, loss, deduction and credit in the partnership agreement, subject to certain restrictions. IRC § 704(a). If a partner contributes property to the partnership that has a value different than its basis, then, under IRC § 704(c)(1)(A), the depreciation, gain or loss will be shared among the partners to take that into account. Thus, if the property were sold the next day, all the gain would be allocated to the contributing partner. If there is a contribution of property by a partner and that property is distributed to another partner within seven years, the contributing partner will generally be allocated the gain or loss to the extent of the gain or loss at the time of contribution. IRC § 704(c)(1)(B). If a contributing partner receives a distribution within seven years of the contribution, then the contributing partner will be subject to tax to the extent of the precontribution gain. IRC § 737.

The general rule is that the parties have great flexibility in allocating income, gain, loss, deduction or credit, or any item of any of these, among the partners, so long as the allocation has "substantial economic effect." IRC § 704(b). The allocation of income does not have to be on the same basis as loss, nor need it remain static; for instance, a partner may be allocated 1 percent of losses and 20 percent of the income until certain events occur, then 50 percent of the income. To have economic effect, the partnership agreement must provide that: (1) the partners must maintain capital accounts in the manner set forth in the § 704 regulations; (2) liquidating distributions must be made in accordance with the capital accounts; and (3) partners must either (i) be obligated to make-up deficits in capital accounts, or (ii) have a qualified income offset provision as provided in § 704 regulations. Treas. Reg. § 1.704-1(b)(2)(ii). The guiding principle of these allocations is that the person who is allocated losses must ultimately bear the economic burden of those losses; *i.e.*, if one is allocated \$1 of loss, that person will get \$1 less in money upon the final liquidation of the partnership. Thus, if one had invested \$1,000 in a partnership that has sold all its assets and is about to distribute cash, and over the term of the partnership that partner had been allocated \$990 of losses on a net basis, then the partner would only receive \$10 of the final distribution.

The allocations must be substantial, in that the allocations will substantially affect the dollars received by the partners independent of tax consequences. Treas. Reg. § 1.704-1(b)(iii).

If there are nonrecourse liabilities and the prior losses and deductions have reduced the basis of the asset below the amount of the nonrecourse debt, then an additional set of rules apply. This is done because if the property were sold for its basis, no one will economically bear the forgiven debt (*i.e.*, the amount of debt the lender will not collect because it is nonrecourse.) Accordingly, no such allocation can have economic effect. The regulations permit allocations of nonrecourse debt if (1) the provisions of Treas. Reg. § 1.704-1(b)(2) (discussed two paragraphs above) are met; (2) they are made in a manner reasonably consistent with the allocations that do have substantial economic effect; (3) the agreement



provides a minimum gain chargeback provision, which generally means that the persons to whom the nonrecourse deductions were allocated will be allocated an equal amount of income; and (4) the other material allocations and capital adjustments are recognized. Treas. Reg. § 1.704-2(e).

IRC § 704(e) imposes family partnership rules designed to reallocate income within a family partnership from those who own the title to the interests to those to whom the income should really be allocated. *See* Treas. Reg. § 1.704-1(e).

### 3.21 Limitations on Partner's Ability to Deduct Partnership Losses

As with S corporations, there are three limitations on the ability to deduct losses allocated to the partner by the partnership: (1) basis; (2) at risk rules; and (3) passive activity loss rules. A partner has a basis in the partnership interest described in paragraph 3.19. A partner may not deduct losses allocated in excess of basis remaining at the end of the taxable year. Any unused losses may be carried over until the taxpayer has basis in the partnership at a taxable year end. IRC § 704(d).

The taxpayer must also avoid the at risk limitations. In order for a taxpayer to be able to deduct a loss allocated by a partnership, the taxpayer must be at risk; *i.e.*, the taxpayer must ultimately bear the loss. The at risk limitation amount equals the amount contributed plus the amounts borrowed with respect to the activity. Amounts borrowed include not only debts for which the partner is personally liable, but also debts for which property not used in the activity is pledged (up to the property's fair market value.) In addition, a partner is also deemed at risk for the partner's share of "qualified nonrecourse financing." Qualified nonrecourse financing is generally nonrecourse debt that is not guaranteed, which is attributable to a real estate activity and which was borrowed from a lender that is in the business of lending money.

Even if a partner has sufficient basis and amounts at risk to take a loss, there are additional limitations if the partner is a passive investor. To avoid the application of the passive activity limitations, the partner must materially participate in the enterprise. As described in paragraph 3.14, material participation must be regular, continuous and substantial. There are seven specific tests that may be met to meet the material participation standard. The same rules apply to general partners that apply to S corporation shareholders. However, under IRC § 469(h), no limited partner can materially participate with respect to his or her limited partnership interest, except as provided in the regulations. The regulations provide that a limited partner will be treated as materially participating if he or she meets any of the tests under Treas. Reg. §§ 1.469-9 5T(a)(1), (5) or (6). Treas. Reg. § 1.469-5T(e)(2). These three tests are: (1) more than 500 hours of participation; (5) material participation in five of the last ten years; and (6) material participation in any three prior years in a personal service activity. Treas. Reg. §§ 1.469-5T(a)(1), (5) and (6), respectively. Rental activities are generally presumed to be passive, but a partner will be deemed to materially participate in rental real estate if (a) more than one-half of the taxpayer's services are performed in real property trades or businesses in which the taxpayer materially participates and (b) those trades or businesses account for at least 750 hours. As explained in more detail in paragraph 3.14, if the taxpayer actively participates, the taxpayer may deduct up to \$25,000 (one-half that amount if married filing separately) of the losses in any taxable year, subject to a phase out.

### 3.22 Taxation of Partnership Distributions

Distributions reduce basis by the amount of money distributed and the partnership's basis in the property; however, if the distribution of property other than cash would exceed the taxpayer's basis in the partnership, then the distributed property takes the taxpayer's basis in the partnership and the partner's basis in the partnership is eliminated. IRC § 732. No gain or loss is recognized to the partnership on a distribution, unless there is a disproportionate distribution of unrealized receivables or substantially appreciated inventory. IRC §§ 731(b) and 751(b). The partnership may elect under IRC § 754 to adjust the basis of partnership property as set forth in IRC § 734. Generally, no gain or loss is recognized

to the partners on a distribution unless a distribution of money exceeds the partner's remaining basis, in which case the excess is income to the partner. IRC §§ 731(a)(1), 735 and 751. No loss is recognized to the partner upon any distribution, except upon liquidation where only cash, unrealized receivables and substantially appreciated inventory are distributed. IRC § 731(a)(2).

### **3.23      Partnership Termination**

If 50 percent or more of the total interest in partnership capital and profits are sold or exchanged within a 12 month period, the partnership will be treated as terminated for Federal income tax purposes. IRC § 708(b)(1).

### **3.24      Abusive Partnerships**

In December, 1994, the Treasury issued Treas. Reg. § 1.701-2 which provides that the IRS may disregard a transaction if a partnership is formed with a principal purpose of substantially reducing the present value of the partners' aggregate federal tax liability in a manner inconsistent with the intent of subchapter K [the IRC's partnership provisions], even if the literal language of the IRC or Treasury Regulations are complied with. The IRS has stated that this is designed to be used in only rare circumstances and only with respect to public partnerships that present truly abusive situations, but its language is broader. To date, there is no authority interpreting this regulation. Where an LLC is treated as a partnership, this regulation would apply to it.

### **3.25      Additional Considerations**

The previous paragraphs in this chapter 3 discussed some of the major tax consequences of selecting and operating an enterprise as a C corporation, S corporation or partnership (general or limited). In addition there are additional consequences which may have more limited application, but which are critical to those affected. Some of these are also addressed in chapter 8 in connection with the discussion of the tax consequences of an LLC, as well as in the remaining paragraphs of this chapter.

### **3.26      Introduction to the Taxation of LLCs**

Having discussed the tax consequences of operating as a C corporation, S corporation and partnership (both general and limited), it is time to consider the LLC. LLCs were created to simultaneously achieve three goals: (1) obtain limited liability for the members; (2) obtain pass through tax treatment; and (3) avoid the limitations of operating as an S corporation or a limited partnership.

As discussed in detail in chapter 2, there are numerous non-tax considerations involved in selecting an entity. One major advantage is that members of an LLC are not liable for the debts or obligations of the LLC, except for each member's liability for his or her own acts or omissions. See chapter 15. Both C corporations and S corporations fully accomplish this goal. A limited partnership partially accomplishes this goal: the limited partners have limited liability, the general partners do not.

The second consideration is that in addition to limited liability, the owners often wish for pass through tax treatment; *i.e.*, the entity pays no tax and the owners include the entity's gain or loss in the owners' respective tax returns. The S corporation, general partnership and limited partnership accomplish pass through treatment. Accordingly, the only entities that accomplish both goals are an S corporation and, to a more limited extent, a limited partnership.

The S corporation and limited partnership each have limitations, which are discussed above in this chapter 3; for instance, the S corporation has no ability to specially allocate gain and loss and has a

number of limitations on the scope and method of operation and the identity and number of owners. Maintaining a fully liable general partner, even if it is a corporation, is a disadvantage of the limited partnership not present in the LLC, as is the fact that limited partners may not control the limited partnership without jeopardizing their limited liability. Further, as detailed in paragraph 8.4, members of an LLC will generally be able to include their portion of all the LLC's liabilities in the basis of their interest in the LLC, while limited partners are unable to include any of such liabilities in their basis in their limited partnership interests unless the general partners (and all other partners) have no liability for them or that limited partner has guaranteed such liabilities.

### **3.27      Comparison of LLCs and C Corporations**

As set forth above in detail, C corporations generally require the payment of tax on two levels in order to get the corporation's earnings into the hands of its shareholders. This is often a significant deterrent to the use of a C corporation. The most crucial determinant in the selection of the entity is often whether to select a pass through entity or an entity taxed as a corporation. Because most taxpayers operating a small business want pass through treatment, a C corporation is often not selected. There are, however, a number of areas in which a C corporation would be superior to an LLC, and there are circumstances under which the C corporation should be the entity of choice.

The individual tax rates are generally higher than corporate rates, so if there is a limited amount of profit in the business and the owners do not need a return on their investment, nor money from the business other than from their salaries, a C corporation will often result in a lower tax liability. If one desires to reinvest all of the entity's earnings into the business and not take out more than a reasonable amount of compensation for his or her work, then a C corporation may be the most desirable choice. If, however, the corporation is a professional service corporation ("PSC"), the individual rates may not be higher than those of the corporation because the PSC carries a uniform 35 percent rate, which is not graduated. PSCs will often pay a large percentage of the pre-compensation earnings as compensation.

There are additional areas in which the C corporation receives better tax results than an LLC (and other entities.) For instance, loans from a qualified pension and profit sharing plan of a C corporation to a shareholder/employee are often exempted from being prohibited transactions. However, those exemptions do not apply to loans to a more than 5 percent shareholder in an S corporation or to a partner who owns more than 10 percent of the capital interests or profits interests, and thus those loans would be prohibited transactions under IRC § 4975(d).

A C corporation may generally select any calendar or fiscal year that ends on the last day of a month (or may elect a 52/53 week year.) IRC § 441. Under IRC § 441(i), C corporations that are PSCs must generally use a calendar year unless the corporation establishes, to the IRS' satisfaction, a business purpose for another fiscal year. The PSC may also elect a September 30, October 31 or November 30 fiscal year, but, if so, the PSC is prohibited from manipulating the timing of deducting payments made by the PSC and includible in the income of the shareholder. IRC §§ 280H and 444. S corporations must generally select the calendar year and partnerships must generally select the fiscal year of their majority owners. IRC §§ 706(b) and 1378. Partnerships or S corporations may elect to have a September 30, October 31 or November 30 fiscal year, if the entities pay an additional amount to reflect the benefit of the deferral received by using the earlier year end. IRC §§ 444(c)(1) and 7519. An S corporation or partnership may select any fiscal year if the IRS is satisfied that there is a good business purpose.

A C corporation may deduct 100 percent of health insurance premiums (and such premiums need not be included in the employee's income). Employee-partners and S corporation shareholders are limited in the amount of their health insurance premiums which they may deduct. The percentage (which is 60% in 1999) increases until 2003, when they become fully deductible.

Life insurance premiums for up to \$50,000 of nondiscriminatory group term life insurance are excludible for employee-shareholders of C corporations. IRC § 79. This exclusion does not apply to self-

employed individuals, which would presumably include partners. Treas. Reg. §§ 1.79-0 and 31.3401(c)-1. Thus, the exclusion would not apply to members of an LLC.

Cancellation of indebtedness income is excludible from gross income if, among other things, it is subject to the bankruptcy or insolvency exception. IRC §§ 108(a)(1)(A) and (B). The insolvency exception is limited to the amount of insolvency, which is tested at the entity level for C corporations and S corporations, but at the partner level for partnerships. There is no current authority as to whether the amount of insolvency will be tested at the member level or the LLC level in the case of an LLC, but it appears fairly certain that it will be at the member level.

Although there is nothing definitive, the commentators generally assume that members of an LLC will not be able to participate in cafeteria plans and will not be eligible for the \$5,000 death benefit exclusion of IRC § 101(b)(3).

A C corporation is generally not subject to the passive loss rules, except where (i) it is a personal service corporation or (ii) five or fewer individuals own more than 50 percent of the value of the corporation.

A single shareholder may own a C corporation or an S corporation, and since July 15, 1998, a single person may be the sole member of a Kentucky LLC. *See* KRS § 275.015(8). If an LLC only has a single member, it may be taxed as a C corporation, an S corporation or as a disregarded entity. Treas. Reg. § 301.7701-2(c)(2)(i). An LLC which is a disregarded entity is treated as a sole proprietorship if it is owned by an individual and as a branch or a division if it is owned by an entity. An LLC is the only entity (with the exception of a qualified subchapter S subsidiary and special REIT subsidiaries) which can be treated as a disregarded entity. The ability to be treated as a disregarded entity has a number of benefits. First, if owned by an individual, it enables the individual to obtain limited liability while still not being required to file a separate return for an entity. In the case of an LLC owned by an entity, it enables the separation of assets for liability purposes, while still being able to consolidate the activities of the owner and the LLC, but without being subject to the extremely complex consolidated return regulations.

### 3.28 Differences Between S Corporations and LLCs

As noted above in paragraph 3.11, S corporations have significant limitations on the number and identity of the owners (75 individuals, certain trusts, no nonresident aliens); scope of operations (not passive if there are C corporation earnings and profits); and capital structure (only a single class of stock.) LLCs (and other entities taxed as partnerships) have none of these restrictions, except that entities otherwise taxable as partnerships will be taxed as corporations if they are publicly traded. IRC § 7704. Partnerships must have more than one partner. Individuals, including non-resident aliens, C corporations, S corporations, general partnerships, limited partnerships, trusts, estates, LLPs and LLCs may all be members of LLCs. LLCs do not have passive income limitations. Somewhat because of these limitations, it is easier for an S corporation to fail to qualify as an S corporation, although the IRS can waive an inadvertent termination. IRC § 1362(f). On the other hand, unless an LLC affirmatively elects to be treated as a corporation, it will be treated as a partnership (assuming it has at least 2 members).

S corporations may only have a single class of stock: each share receives the same distributive share of income, gain and loss. *See* paragraph 3.13. LLCs (and other entities taxed as partnerships) may have special allocations of income, gain, loss, deduction or credit which have no relationship to equity ownership, so long as they have substantial economic effect. *See* paragraph 3.20. Thus, S corporations lack the tremendous flexibility in sharing the economic consequences among owners that the LLCs (and other entities taxed as partnerships) have. In addition to the fact that the owners in an LLC can voluntarily choose an allocation that differs from ownership interests, there are IRC provisions that may require a difference between S corporation and partnership allocations. If a member contributes appreciated property to an LLC (or other entities taxed as partnerships), the inherent gain (and depreciation) must be allocated to take into account the difference between basis and value; there is no, and

can be no, special allocation of this gain in an S corporation. IRC § 704(c)(1). LLCs may have different tiers of ownership while the only differentiation among S corporation shares is that there may be differences in voting rights.

Contributions of appreciated property will be taxable if made to an S corporation, unless all transferors as a group own 80 percent of the stock immediately after the transfer; there is no similar rule with LLCs. Paragraph 3.12. Both S corporation shareholders and LLC members may deduct losses up to their basis, at risk amounts and are subject to the passive activity loss rules. Paragraphs 3.14 and 3.21. For purposes of computing basis for deducting losses, a member of an LLC includes in basis a proportionate part of all of the liabilities of the LLC, in addition to the amount contributed for the ownership interest; while an S corporation shareholder's basis for loss limitation purposes is the stock basis plus loans made by that shareholder to the corporation. *See* paragraphs 3.12, 3.14, 3.19 and 3.21. An S corporation shareholder does not receive any basis for debts owed by the corporation to others.

Gain is normally recognized by the corporation if there is a distribution of appreciated property by an S corporation, but not by an LLC distributing appreciated property. Similarly, liquidations will generate gain for an S corporation shareholder, but not always for an LLC member. *See* paragraphs 3.15 and 3.22. S corporations are sometimes subject to tax at the corporate level, while LLCs never are. *See* Paragraph 3.16.

Under IRC § 754, the basis of LLC assets may be adjusted under two circumstances: if a member purchases an appreciated LLC interest, the LLC will be able to increase the basis in its assets that are attributable to that interest. A similar increase applies under the election if gain is recognized on the distribution of property to a partner. There is no similar election for S corporations.

As set forth in paragraph 8.9, it is uncertain if an LLC member's dissubject to self-employment tax, but salary is. Further, as set forth in paragraph 8.13, there is some question whether an LLC may use the cash method of accounting, although it is clear that an S corporation that otherwise qualifies may do so.

### 3.29 Comparison Between LLCs and Partnerships

As set forth in chapter 4, an LLC having more than one member may be taxed either as a corporation or as a partnership. Most LLCs will seek partnership treatment. However, as alluded to above, the treatment of general partnerships is sometimes different than limited partnerships and the treatment of their respective owners also differs. There is no uniform treatment of LLCs as either general partnerships or limited partnerships or members of an LLC as either general partners or limited partners. The tax treatment of LLCs is discussed in chapter 8.



## 4.1 PARTNERSHIP CLASSIFICATION

by

Thomas E. Rutledge

### 4.2 Classification Overview

Broadly speaking, the Internal Revenue Code recognizes and provides rules for the income taxation of four categories of taxpayers:<sup>1</sup> individuals,<sup>2</sup> corporations (including "associations" taxable as corporations),<sup>3</sup> partnerships<sup>4</sup> and trusts.<sup>5</sup> Unincorporated business entities, such as joint stock companies, business trusts, partnership associations and LLCs, are placed into these categories by way of classification rules embodied in Treasury Regulations, and taxed accordingly. Prior to January 1, 1997, those classification regulations were referred to as the "*Kintner*" regulations.<sup>6</sup> The *Kintner* regulations distinguished between partnerships, corporations and trusts by reference to six characteristics deemed common to statutory corporations:<sup>7</sup>

- associates;
- an objective to carry on a business and divide the gains therefrom;
- limited liability;
- free transferability of interests;
- continuity of life; and
- centralized management.<sup>8</sup>

For purposes of distinguishing a structure taxed as a corporation from one taxed as a partnership, the two characteristics common to both, associates<sup>9</sup> and an objective to carry on a business and divide the gains thereof, were ignored.<sup>10</sup> Thereafter, the structure was reviewed to determine the number of the four remaining characteristics the entity exhibited. If the structure had a preponderance, *i.e.* more than two, of the four characteristics, it was classified as an association taxable as a corporation.<sup>11</sup> If, on the other hand, the structure had two or fewer of these characteristics, it was classified as a partnership. Under this classification regimen, no characteristic was given greater weight than any other characteristic.<sup>12</sup>

An appreciation of the classification regime in general, and the LLC's place in that regime, must begin with an understanding of the business and tax environment in which the Treasury Department drafted the *Kintner* regulations.

### 4.3 The History of the Kintner Regulations

Until relatively recently, professionals were forbidden by state statute and professional rules from incorporating. Throughout the 1940s and 1950s, in order to use tax-favored employee benefit plans that were available only to corporations, professionals sought to practice through entities that, while not incorporated under state law, would be treated as corporations under the tax law.<sup>13</sup> During this time, the Service unsuccessfully fought a series of court battles seeking to treat these structures as partnerships.<sup>14</sup> In *Kintner*, a group of physicians, barred by state law from incorporating, formed an unincorporated association through which to practice medicine. In order to be classified as an association taxable as a corporation and thereby take advantage of tax-favored pension plans, the association's organizers ensured that it had centralized management, the ability to hold property in its own name, and continuity of life.<sup>15</sup> The Service sought to classify the association as a partnership, but was unsuccessful.

cessful at both the trial and appellate levels. Unwilling to accept its loss, the Service refused to acquiesce.<sup>16</sup>

A year later, without acquiescing in *Kintner*, the Service stated that so-called “*Kintner* associations” would be classified under the “usual tests,” and that a subsequent revenue ruling would further explain the “usual tests.”<sup>17</sup> The promised revenue ruling was never issued; rather, the *Kintner* regulations were proposed, requiring an entity to embody a preponderance of the corporate characteristics in order to be classified as an association taxable as a corporation.<sup>18</sup>

This historical background suggests why the *Kintner* regulations manifested a bias in favor of partnership classification.<sup>19</sup> Under the *Kintner* regulations, because limited liability could be attained only through a state organization statute, corporate classification of *Kintner* associations could be attained only if the association had continuity of life, free transferability of interests and centralized management. In short, the *Kintner* regulations presume, in effect, that an association is a partnership; the association can prove, of course, that it is a corporation by demonstrating the presence of a preponderance of the relevant characteristics.

The response of professionals seeking to be taxed as corporations was to persuade state legislatures to authorize professional service corporations.<sup>20</sup> Unwilling to accept the treatment of professional practices as corporations, in 1965 the Service amended the original 1960 regulations by adding a provision applicable only to professional service businesses, the effect of which was to make it virtually impossible for such entities to be classified as corporations.<sup>21</sup> That amendment was repeatedly held to be invalid,<sup>22</sup> and was withdrawn in 1977.<sup>23</sup>

Eventually, the tax laws were revised to provide for substantially equal treatment of retirement plans maintained by corporations and non-corporate businesses. With that development, the primary tax impetus for the incorporation of professional practices vanished. Concurrently, it often became more advantageous to conduct business in the form of an entity with pass-through taxation (to avoid corporate double taxation). Thus, in 1977, the Service issued proposed regulations that would have substantially altered the *Kintner* regulations by rejecting the preponderance test and determining that an entity would be classified as an association “when it resembles a corporation with respect to two or more of the four characteristics ....”<sup>24</sup> This proposal was withdrawn after only one day.<sup>25</sup> It was into this environment that the LLC was first introduced.

#### 4.4 The First LLCs and the Early Classification Challenge

The first LLC statute was considered, and in turn rejected, by the Alaska legislature in 1975.<sup>26</sup> At that time, guidance from the Service was sought on the classification of the LLC. However, no determination was rendered on the proposed legislation.<sup>27</sup>

Two years later Wyoming adopted the first LLC statute.<sup>28</sup> Then, in 1980, the development of LLCs was dealt a near death blow when the Service announced proposed amendments to the *Kintner* regulations that would have classified as a corporation any entity in which no member would be personally liable for debts of the organization.<sup>29</sup> Curiously, these proposed regulations were published only one day before the release of a private letter ruling stating that a Wyoming LLC would be classified as a partnership.<sup>30</sup> Despite the cloud of uncertainty raised by the proposed amendments to the *Kintner* regulations, Florida passed the second LLC statute in 1982.<sup>31</sup> Finally, after several announced postponements of the effective date of the proposed amendments, the Service bowed to negative comments and withdrew the proposed changes in 1983.<sup>32</sup> At the same time, however, the Service announced that it would conduct a study of the criteria applied in the classification test.<sup>33</sup> This announcement triggered more uncertainty in the LLC community as to whether limited liability would become the touchstone for corporate classification. Thus, further adoption of LLC statutes languished until 1988, when the Service issued long-awaited Revenue Ruling 88-76,<sup>34</sup> which reinforced the preponderance test of the original *Kintner* regulations and ruled that a Wyoming LLC would be treated as a partnership for federal income tax purposes.



After the publication of Revenue Ruling 88-76, a virtual tidal wave of LLC legislation began to sweep the country. Beginning in early 1993, the Service issued a series of revenue rulings, addressing LLCs formed pursuant to the Virginia,<sup>35</sup> Colorado,<sup>36</sup> Nevada,<sup>37</sup> Delaware,<sup>38</sup> Illinois,<sup>39</sup> West Virginia,<sup>40</sup> Florida,<sup>41</sup> Rhode Island,<sup>42</sup> Utah,<sup>43</sup> Oklahoma,<sup>44</sup> Arizona,<sup>45</sup> Louisiana,<sup>46</sup> Alabama,<sup>47</sup> Kansas,<sup>48</sup> New Jersey,<sup>49</sup> Connecticut<sup>50</sup> and South Dakota<sup>51</sup> statutes.<sup>52</sup> The Service also issued numerous private letter rulings indicating whether or not a particular LLC qualifies for partnership classification.<sup>53</sup>

This history should not suggest, however, that Rev. Rul. 88-76 and the subsequent classification rulings closed the chapter on LLC classification. Congress indicated an interest in reviewing the issue and possibly addressing it through legislation. On February 2, 1993, the Subcommittee on Select Revenue Measures of the House Ways & Means Committee of the United States House of Representatives announced that it would schedule a hearing to "review the revenue impact of LLCs, their effect on the two-tier corporate tax structure and the adequacies of the current classification analysis."<sup>54</sup> Those hearings were never held.

#### 4.5 The Continuing Classification Challenge: Application of the Kintner Regulations to LLCs

The Service's grudging acceptance of the LLC as a pass-through entity did not fully resolve the classification issue. Rather, the focus shifted from whether such classification is possible to how each of the four Kintner characteristics should be analyzed and applied to LLCs and how partnership classification may be achieved for a particular entity. These issues are addressed below.

#### 4.6 Seeking Partnership Classification: Revenue Procedure 89-12 and Revenue Procedure 95-10

One of the chief challenges facing LLCs seeking a private letter ruling on classification was Revenue Procedure 89-12.<sup>55</sup> An unincorporated entity seeking classification as a partnership was required to comply with this revenue procedure.<sup>56</sup> However, Revenue Procedure 89-12 was drafted primarily to address the classification of general and limited partnerships, and contains only minimal direction on its application to other structures.<sup>57</sup> Thus, compliance by LLCs with Revenue Procedure 89-12 was difficult. In fact, the Service was itself inconsistent in requiring LLCs seeking a classification ruling to comply with the requirements of Revenue Procedure 89-12.<sup>58</sup>

Several requirements of Revenue Procedure 89-12 were inapplicable to LLCs. For example, sections 4.01<sup>59</sup> and 4.03,<sup>60</sup> respectively, relate to allocations to and the capital accounts of the "general partners." However, these requirements are irrelevant to LLCs that have chosen to be managed by a non-member. Furthermore, in LLCs for which the default rule of per capita allocation applies, allocation fluctuations that occur as the number of members increases and decreases would make section 4.01 nearly impossible to satisfy.<sup>61</sup>

Another ambiguity was the safe harbor for a finding of the absence of centralized management in section 4.06 of Revenue Procedure 89-12.<sup>62</sup> Section 4.06 provides that the Service will rule that a partnership lacks centralized management if the managers hold at least twenty percent of the interests in the entity. However, no private letter ruling issued referenced section 4.06, and the Service has issued no guidelines on whether this safe harbor is available to LLCs.<sup>63</sup>

The Service recognized the problems involved in requiring LLCs to comply with Revenue Procedure 89-12 and the need for a classification regime tailored to the structure of LLCs, and committed to craft a responsive revenue procedure.<sup>64</sup> An ABA Task Force submitted a draft revenue procedure to the Service.<sup>65</sup> Revenue Procedure 95-10 was crafted and released to deal with this problem. This revenue procedure specifies the conditions under which the Internal Revenue Service (Service) will consider a

ruling request that relates to classification of a domestic or foreign limited liability company (LLC) as a partnership for federal tax purposes.

Rev. Proc. 89-12 no longer applies to LLCs.<sup>66</sup>

#### **4.7 But All Is Not Well**

Even with the release of Revenue Procedure 95-10, significant classification problems continued to arise. While practitioners received greater guidance on how to construct LLCs within the confines of the *Kintner* regulations, organizational documents still needed to be written to satisfy a largely form over substance classification regimen, and continuing ambiguities, as well as statutory developments, often required either a private letter ruling or counsel opinion letters, either of which drove up transaction costs. Further, the Service was devoting significant time and energy to analyzing and responding to private letter ruling requests, preparing Revenue Rulings and tracking statutory developments.

In response, recognizing that classification had become largely elective, the Service proposed "Check-the-Box."

#### **4.8 Check-the-Box Classification—An Overview**

The "Check-the-Box" classification regulations<sup>67</sup> generally provide an elective regimen under which an unincorporated association, either domestic or foreign, may elect its classification for federal tax purposes. This classification election, save as constrained by very minimal limitations imposed with respect to the number of members, may be made entirely without reference to the organizational characteristics of the entity in question. Therefore, it is no longer necessary to craft organizational documents to satisfy classification limitations or for those limitations to impact upon the economic relationship desired by the owners and other participants. The regulations provide default classifications for both domestic and foreign entities. To the extent these default provisions are generally applicable, the "Check-the-Box" label is somewhat inappropriate as an affirmative effort to choose classification is necessary only to the extent the owners desire to depart from the default classification. They also address the classification of single member unincorporated associations, a situation not addressed by the previous classification system.<sup>68</sup>

#### **4.9 Notice 95-14 and the Proposed Regulations**

In April, 1995, the Service raised the possibility of revising the classification regulations to provide for an elective regimen, and requested comments upon the feasibility and desirability of such a system.<sup>69</sup> In Notice 95-14, the Service stated:

The existing classification regulations are based on the historical differences under local law between partnerships and corporations. However, many states recently have revised their statutes to provide that partnerships and other unincorporated organizations may possess characteristics that have traditionally been associated with corporations, thereby narrowing considerably the traditional distinctions between corporations and partnerships. For example, some partnership statutes have been modified to provide that no partner is unconditionally liable for all of the debts of the partnership. Similarly, almost all states have enacted statutes allowing the formation of limited liability companies. These entities are designed to provide liability protection to all members and to otherwise resemble corporations, while generally qualifying as partnerships for federal tax purposes ....

One consequence of the narrowing of the differences under local law between corporations and partnerships is that taxpayers can achieve partnership tax classification for a non-publicly traded organization that, in all meaningful respects, is virtually indistinguishable from a corporation. Taxpayers and the Service, however, continue to expend considerable resources in determining the proper classification of domestic unincorporated business organizations.

In addition, small unincorporated organizations may not have sufficient resources and expertise to apply the current classification regulations to achieve the tax classification they desire.

The comments received on the simplification concept set forth in Notice 95-14 were almost without exception favorable. As set forth in the Notice, domestic unincorporated associations would be allowed to elect their classification without regard to the presence or absence of the *Kintner* regulations. Of particular import were the requests in the Notice for comments on whether an elective regimen should apply to foreign business organizations and the proper treatment of unincorporated, single member organizations. A hearing on these points was held on July 20, 1995.<sup>70</sup>

In May, 1996, the Service released proposed entity classification rules incorporating an elective regimen for both domestic and foreign entities which also addressed the classification of single member unincorporated organizations.<sup>71</sup> Those proposed regulations provided:

- (i) An elective regimen between partnership and corporate classification for domestic unincorporated associations with two or more members and a default classification as a partnership;
- (ii) An elective regimen regarding the classification of domestic single member unincorporated associations between sole proprietorships/branches and corporations with a default classification as a sole proprietorship/branch;
- (iii) The designation of certain foreign organizations as *per se* corporations;
- (iv) An elective regimen for all other foreign organizations with default classification being dependent upon the number of members and the presence or absence of limited liability for all owners with the opportunity to elect a contrary classification.

The comments received on the proposed regulations were almost without exception supportive of the general check-the-box strategy, suggesting only minor revisions. The one exception to the unanimity of support was the California Franchise Tax Board, which objected to the proposed regulations on the basis that California would treat all single member entities as corporations, and that if Check-the-Box were adopted there would be different classifications under federal and state law.<sup>72</sup>

The final Check-the-Box regulations were released on December 17, 1996, with an effective date of January 1, 1997.<sup>73</sup> The final regulations adopted the elective system contained in the proposed regulations.<sup>74</sup>

#### 4.10 By What Authority Did the Service Issue Check-the-Box?

Raising the specter of not only the invalidity of the Check-the-Box regulations but also Congressional intervention in the matter is the Joint Committee on Taxation Review of Selected Entity Clas-

sification and Partnership Tax Issues.<sup>75</sup> The Committee Report notes that the Check-the-Box regulations were issued pursuant to the interpretative regulation authority of the Secretary of the Treasury under Code § 7805, and goes on to discuss what standard of review should be applied by a court in assessing whether the Treasury had the authority to promulgate Check-the-Box. The Committee Review goes on to note that the long life of the *Kintner* regulations may indicate tacit Congressional approval of those regulations, thereby preempting any agency ability to significantly modify the regulations.<sup>76</sup> Another question raised was whether the matter of classification has already been addressed by the Supreme Court's opinion in *Morrissey v. Commissioner*,<sup>77</sup> a case which applied a multi-factor resemblance test to determining the tax classification of various business entities and which was incorporated into the *Kintner* regulations.<sup>78</sup> In addition to other issues relating to the propriety of the Check-the-Box regulations, the Committee Review discussed the pros and cons of having Congress explicitly approve the Check-the-Box regime.<sup>79</sup>

#### 4.11 Is There Anything There to Classify?

The first step in applying the Check-the-Box regulations is the determination of whether there is a business entity which needs to be classified.<sup>80</sup> As did the *Kintner* regulations, Check-the-Box recognizes that certain joint undertakings do not themselves create a business organization which has a distinct tax identity. For example, holding property as tenants in common (other than for business or trade) and certain state owned entities are not afforded a separate tax identity. Nothing about Check-the-Box changes this rule.<sup>81</sup>

#### 4.12 Corporations Need Not Apply

It is important to note that Check-the-Box has done nothing to change the rule present under the *Kintner* regulations that domestic incorporated entities are *per se* corporations.<sup>82</sup> There is no need to classify such entities. Other entities are also *per se* classified as corporations include joint stock companies and joint stock associations, insurance companies, banks and entities which are taxable as corporations other than by the application of IRC § 7701(a)(3).<sup>83</sup>

#### 4.13 Foreign Per Se Corporations

In a departure from the practice under the *Kintner* regulations, Check-the-Box defines certain foreign entities as *per se* corporations which are not eligible entities and which may not avail themselves of the Check-the-Box elective classification system.<sup>84</sup> Under the *Kintner* regulations, there were no foreign defined analogs to the state law corporation, and all foreign entities were subjected to the classification test under the *Kintner* regulations.<sup>85</sup>

Modifications to this list will be made by amendments to the regulations following requests for comments.<sup>86</sup>

#### 4.14 The "Eligible Entity"

If an unincorporated entity is both subject to classification as a business entity and is not *per se* classified as a corporation, it is an "Eligible Entity."<sup>87</sup> Only Eligible Entities may avail themselves of Check-the-Box.

#### 4.15 Default Classification of Domestic Eligible Entities

The Check-the-Box regulations provide that a domestic Eligible Entity having at least two members may be classified either as a partnership or as a corporation.<sup>88</sup> The rules go on to provide a default classification of such an entity as a partnership.<sup>89</sup> The entity need take no affirmative action in order to be classified as a partnership. If the entity desires to be classified as a corporation, it may file Form 8832 (discussed below) to do so.

Breaking important new ground in classification, the Check-the-Box regulations also address the classification of single member unincorporated associations. The appropriate classification of such entities was an oft debated and never solved question under the *Kintner* regulations.<sup>90</sup> The Check-the-Box regulations expressly recognize and address the classification of single member unincorporated associations. Such organizations have the option of either being classified as corporations or, in the alternative, treated as either a sole proprietorship, where the sole member is an individual, or as a branch/division, where the owner is a corporation or other business entity.<sup>91</sup> In either case, the separate entity, while existing for purposes of state law, will be afforded no separate tax identity.<sup>92</sup> Under the default rule, a single member unincorporated entity is treated as having no separate tax identity.<sup>93</sup> As such, in parallel with the system applied to unincorporated associations with more than one member, an affirmative election is required to have the domestic unincorporated association taxed as a corporation. Such an election would be made with Form 8832.

It is doubtful that it is possible to overstate the importance of the Service's effort in this area. While Revenue Ruling 88-76<sup>94</sup> signified the acceptance of the LLC as a viable business structure with a predictable tax classification, the Check-the-Box regulations initiate the practical use of the single member LLC.<sup>95</sup> One common application of this structure will be to provide limited liability for businesses that now operate as a sole proprietorship and would continue to seek to avoid the disadvantages and complexities of either C or S corporation status. Another common application will be in the creation of wholly owned LLCs to serve as joint venture vehicles or as baskets in which to hold particular assets. In addition, there are international and state tax planning opportunities.<sup>96</sup> Keep in mind, however, that Check-the-Box addresses only the federal tax classification of single member LLCs. The individual states are not bound to follow that classification. Therefore, you may find yourself in situations in which your single member LLC, while at the federal level being a Tax-Nothing, will be taxed as a corporation at the state level.<sup>97</sup>

#### 4.16 Default Classification of Foreign Eligible Entities

All foreign Eligible Entities, namely those entities which do not fall within the list of foreign *per se* corporations, may avail themselves of Check-the-Box.<sup>98</sup> However, the default classification of foreign Eligible Entities is somewhat more complicated than for domestic Eligible Entities. Default classification is dependent upon two factors. The first is whether or not the entity has a single member or at least two members. This distinction parallels that which exists with respect to classification of domestic entities. However, in addition, the default classification of foreign Eligible Entities is in part dependent upon whether the characteristic of limited liability is enjoyed by all members.<sup>99</sup> A foreign Eligible Entity shall have a default classification as a partnership if the entity has at least two members and at least one member does not have limited liability.<sup>100</sup> If the entity does not provide limited liability and it has a single member, it will be classified as a Tax-Nothing.<sup>101</sup> A foreign Eligible Entity will be classified as a corporation if all members have limited liability.<sup>102</sup> Contrary elections, using Form 8832, may be made provided that unincorporated entities with at least two members elect from either partnership or corporate classification, and that single member entities elect from either corporate or Tax-Nothing classification.<sup>103</sup>

#### **4.17      Grandfather Rules—Classification Safe Harbor for Certain Foreign Entities**

There is a broad classification safe harbor for entities organized under the *Kintner* regulations. Provided certain other conditions are satisfied, a foreign entity on the list of *per se* corporations which existed on May 8, 1996, and was classified other than as a corporation may retain that classification.<sup>104</sup> A special provision addresses entities formed after May 8, 1996, pursuant to binding agreements in place and in effect on that day.<sup>105</sup>

Any entity grandfathered out of its *per se* classification will lose that status when it undergoes an IRC § 708(b)(1)(B) termination or IRC § 708(b)(2)(B) division.<sup>106</sup>

#### **4.18      Grandfather Rules—Classification Safe Harbor for Certain Eligible Entities**

Generally, Eligible Entities in existence prior to January 1, 1997, are “grandfathered” into their classification on the date prior to that day.<sup>107</sup> An exception to this rule is that a single member entity which claimed partnership classification is defaulted into Tax-Nothing classification.<sup>108</sup>

Foreign Eligible Entities may take advantage of this grandfather provision only if its classification was relevant<sup>109</sup> during the sixty months prior to January 1, 1997.<sup>110</sup>

These grandfather provisions are available only if:

- (1) the classification claimed prior to January 1, 1997 was reasonable;
- (2) the entity and its owners recognized the tax consequences of any change in classification which took place in the sixty months prior to January 1, 1997; and
- (3) neither the entity nor any of its owners had received, prior to May 8, 1996, written notice from the Service that the claimed classification was under examination.<sup>111</sup>

#### **4.19      Form 8832**

By means of an affirmative election, an Eligible Entity may elect classification other than that provided by the default rules. This election is made on the new Form 8832, Entity Classification Election.<sup>112</sup> Note that no filing is required if the Eligible Entity is satisfied with its default classification. If the entity must file a tax or information return in the year in which an election is made, it must attach a copy of the Form 8832 to that return.<sup>113</sup> If no such filing is required by the entity, each direct or indirect owner of the entity must file a copy of the Form 8832 on its return for that year.<sup>114</sup> However, the failure of any entity or owner to attach a copy of the Form 8832 to the return will not invalidate or otherwise impact upon the election.<sup>115</sup>

The commentary released with the final regulations makes it clear Form 8832 may also be used to file a protective classification claim where default classification is in doubt.

Form 8832 is effective on its filing date or a date specified which is not more than seventy-five days prior to or twelve months after the filing date.<sup>116</sup>

Addressing concerns raised by certain commentators, the Service has expressly provided that the Form 8832 may be executed by either all members of the entity in question or by an agent authorized to make that election and who represents to such authority under the penalties of perjury.<sup>117</sup> Retroactive elections must be executed by each member during the retroactive period.<sup>118</sup>

Eligible Entities which file an election to change this classification may not do so again for the following sixty months.<sup>119</sup> The Commission may grant relief from this limitation where at least a majority of the interest in the Eligible Entity has been transferred to persons who were not owners on the filing or effective date of the earlier election.<sup>120</sup>

#### 4.20 Cleaning Up After the Party

With the final regulations the Service issued Notice 97-1,<sup>121</sup> stating that the new classification rules "have rendered existing revenue rulings and revenue procedures obsolete to the extent they use the earlier classification regulations to differentiate between partnerships and associations." The notice went on to state that the Service would in the future issue a listing of those now obsolete documents. Likely candidates for declared obsolescence included:

- Rev. Proc. 89-12<sup>122</sup> (classification of unincorporated associations);
- Rev. Proc. 92-3<sup>123</sup> (free transferability of interests);
- Rev. Proc. 95-10<sup>124</sup> (classification of LLCs);
- Rev. Rul. 71-434<sup>125</sup> (continuity of life);
- Rev. Ruls. 77-214<sup>126</sup> and 93-4<sup>127</sup> (separate interests test);
- Rev. Rul. 88-8<sup>128</sup> (classification of foreign business entities);
- Rev. Ruls. 88-79<sup>129</sup> and 94-30<sup>130</sup> (free transferability of interests);
- Rev. Ruls. 88-76,<sup>131</sup> 93-5,<sup>132</sup> 93-6,<sup>133</sup> 93-30,<sup>134</sup> 93-38,<sup>135</sup> 93-49,<sup>136</sup> 93-50,<sup>137</sup> 93-53,<sup>138</sup> 93-81,<sup>139</sup> 93-91,<sup>140</sup> 93-92,<sup>141</sup> 93-93,<sup>142</sup> 94-5,<sup>143</sup> 94-6,<sup>144</sup> 94-30,<sup>145</sup> 94-51,<sup>146</sup> 94-79,<sup>147</sup> 95-9<sup>148</sup> (classification under various state LLC acts); and
- Rev. Proc. 94-46<sup>149</sup> (continuity of life and continuation vote).

In Rev. Rul. 98-37, the Service promulgated a listing of now obsolete entity classification revenue rulings. All of the Revenue Rulings listed above, but not the listed Revenue Procedures, have been declared obsolete.

#### 4.21 Conversion Guidance

On October 28, 1997,<sup>150</sup> the Service issued a notice of proposed rulemaking detailing a proposed amendment to the Treas. Reg. § 301.7701-3 to specifically provide what transactional steps the IRS will deem to have taken place when entities convert their tax status under the check-the-box regime. Under the proposed changes to the Check-the-Box regulations, there are four possible changes in classification by election:

- (i) a partnership elects to be an association taxable as a corporation;
- (ii) an association taxable as a corporation elects to be a partnership;
- (iii) an association elects to be a disregarded entity (*i.e.*, a Tax-Nothing);  
and
- (iv) a disregarded entity (*i.e.*, a Tax-Nothing) elects to be an association.

There are two other possible ways in which an entity's classification could change as a result of a change in the number of members:

- (i) a partnership converts to a disregarded entity (*i.e.*, a Tax-Nothing); or

- (ii) a disregarded entity (*i.e.*, a Tax-Nothing) converts to a partnership.

Regarding changes in the number of members in an entity and its impact on classification, the preamble to the proposed regulations provides:

The proposed regulations address the effect of a change in the number of members on the classification of an entity. Under the proposed regulations, if there is a change in the number of members of an association, the classification of the entity is not affected. If an eligible entity classified as a partnership subsequently has only one member (and is still treated as an entity under local law), the entity will be disregarded as an entity separate from its owner. If a single member entity that is disregarded as an entity separate from its owner subsequently has more than one member, the entity is classified as a partnership as of the date the entity has more than one member.

The preamble to the proposed regulations goes on to provide:

The proposed regulations also provide that the tax treatment of an elective change in classification is determined under all relevant provisions of the Internal Revenue Code and general principles of tax law, including the step transaction doctrine. This provision in the proposed regulations is intended to ensure that the tax consequences of an elective change will be identical to the consequences that would have occurred if the taxpayer had actually taken the steps described in the proposed regulations.

The proposed regulations do not address the form of these two possible types of changes because they are not the result of an elective change.

- (i) Association to partnership. If an association elects to be classified as a partnership, two transactions are deemed to take place:
  - (a) association is deemed to liquidate by distributing its assets and liabilities to its shareholders; and
  - (b) the shareholders are deemed to contribute all of the distributed assets and liabilities to the partnership.<sup>151</sup>
- (ii) Partnership to association. If a partnership elects to be classified as a corporation, two transactions are deemed to take place:
  - (a) the partnership is deemed to contribute all of its assets and liabilities to the association in exchange for stock in the association; and
  - (b) the partnership is deemed to liquidate by distributing stock in the association to its partners.<sup>152</sup>
- (iii) Association to disregarded entity. If an association elects to be disregarded as an entity separate from its owner, the association is deemed to liquidate by distributing its assets and liabilities to its sole owner.
- (iv) Disregarded entity to association. If an eligible entity that is disregarded as an entity separate from its owner elects to be classified as an association, the owner of the eligible entity is deemed to contribute all of the assets and liabilities of that entity to the association in exchange for stock of the association.



Subsequently, in January, 1999, Revenue Rulings 99-5<sup>153</sup> and 99-6<sup>154</sup> were issued, which address these conversion matters.

#### 4.22 And What Does This Mean for Kentucky State Classification of LLCs?

KRS § 141.208, which adopted § 109 of S.B. 184 (1994), provides in part:

- (2) Any limited liability company which is treated as a partnership for federal income tax purposes shall be treated as a partnership in accordance with the provisions of KRS § 141.206 for Kentucky income tax purposes.
- (3) Any limited liability company which is treated as a corporation for federal income tax purposes shall be treated as a corporation in accordance with the provisions of KRS § 141.040 for Kentucky income tax purposes.

KRS § 141.208(1) defines a "limited liability company" as a company subject to the provisions of KRS Chapter 275. KRS § 141.010(24) defines a corporation as such as "defined in Section 7701(a)(3) of the Internal Revenue Code." KRS § 141.010 does not contain definitions of the terms "partnership" or "unincorporated entity." KRS § 141.050(1) provides in part:

Except to the extent required by differences between this Chapter and its application and the federal income tax law and its application, the administrative and judicial interpretations of the federal income tax law ... for purposes of this Chapter shall be as nearly as practicable identical with those required for federal income tax purposes.

As the Check-the-Box regulations constitute an administrative interpretation of federal tax law, specifically the definition of what constitutes a corporation versus an unincorporated association taxed as a partnership, there is no need to amend KRS § 141.208. Rather, the Check-the-Box regulations have already been incorporated into Kentucky law by means of KRS § 141.050(1). The only question is whether Kentucky will similarly adopt the "Tax-Nothing" classification of single member LLCs. KRS § 141.208 is silent with respect to such an organization. However, the directive of KRS § 141.050(1) regarding consistency of interpretation with federal regulations, when combined with a statutory directive of consistency between the federal and state classification of LLCs, directs a conclusion that, for Kentucky income tax purposes, the classification of an unincorporated entity with a single member should be consistent with that for federal law.

H.B. 666, passed by the 1998 General Assembly, amended KRS § 141.208, deleting the above referenced subsections (2) and (3), replacing them with a new subsection (2) which provides:

Any limited liability company shall be treated for Kentucky income tax purposes in the same manner as its treatment for Federal income tax purposes.<sup>155</sup>

#### 4.23 Conclusion

As noted above, Check-the-Box constitutes a fundamental development in the question of classification of business entities. By removing the uncertainty of the multi-factor *Kintner* regulations, LLCs and other unincorporated entities are now more user-friendly as (a) practitioners need not deal with a complicated classification test and (b) business owners need not conform their economic arrangement to the requirements of the *Kintner* regulations. While Check-the-Box has done nothing to simplify Subchapter K, it does lower the entry barriers to pass-through taxation. By doing so, the to-date explosive

growth of LLCs, often at the expense of S-corporations, is likely to continue.<sup>156</sup> An interesting question is, had Check-the-Box been adopted in 1936 in response to the Supreme Court's opinion in *Morrissey*,<sup>157</sup> how would the Code look today.<sup>158</sup>

## Endnotes to Chapter 4

<sup>1</sup> This generality does not consider the rules governing special structures such as REITS, REMICS, RICS, FSC's, CFC's and insurance companies

<sup>2</sup> IR.C. Subchapters A and B.

<sup>3</sup> IR.C. Subchapter C.

<sup>4</sup> IR.C. Subchapter K.

<sup>5</sup> IR.C. Subchapter J.

<sup>6</sup> Treas. Reg. § 301.7701-2(a)(1) *et seq.*, T.D. 6503, 1960-2 C.B. 409 (*replaced* Jan. 1, 1997). These regulations may be traced to United States v. Kintner, 216 F.2d 418 (9th Cir. 1954), *aff'g*, 107 F.Supp. 976 (D. Mont. 1952) (classifying an unincorporated association as an association taxable as a corporation), and before that to Morrissey v. Comm'r, 296 U.S. 344 (1935) (classifying a "trust" as an association taxable as a corporation).

The only significant legislative intrusion on the application of the Kintner regulations in recent years was the adoption in 1987 of I.R.C. § 7704, which directs that publicly traded (so-called "master") limited partnerships, as well as other vehicles publicly traded on an established securities market or on a secondary market, with exceptions for those whose income is primarily passive, will be treated as associations taxable as corporations.

<sup>7</sup> While the Kintner regulations stated that "other factors" may be relevant in distinguishing partnerships from associations taxable as corporations, in only three decisions have "other factors" been discussed in detail Larson v. Comm'r, 66 T.C. 159, 184 (1976), *acq.* 1979-1 C.B. 1; Zuckman v. U. S., 524 F.2d 729, 744 (Ct. Cl. 1975); Bush #1 c/o Stone Street Lands Co. v. Comm'r, 48 T.C. 218, 234 (1967), *acq.*, 1968-2 C.B. 2. In Zuckman, the Court of Claims ignored the "other factors" argued by the Service because the entity in question was clearly a partnership due to the absence of the four standard corporate characteristics. In Larson, the Tax Court held that seven "other factors" argued by the Service were not relevant to the classification question. Shortly thereafter, the Service published Rev. Rul. 79-106, 1979-1 C.B. 448, ruling that it would not consider the seven "Larson factors" as having relevance independent of their effect on the six regulatory characteristics of a corporation.

<sup>8</sup> Defined at Treas. Reg. § 301.7701-2(b) - (d) (*replaced* Jan. 1, 1997).

<sup>9</sup> The term "associates" does not necessarily imply more than one owner Corporations and associations taxable as corporations, which are deemed to have the characteristic of "associates," may exist with but a single shareholder or investor. *See, e.g., Hynes v. Comm'r*, 74 T.C. 1266 (1980) (trust with a single beneficiary classified as an association taxable as a corporation.). In Gen. Couns. Mem. 39,395 (Aug. 5, 1985), it was stated that while a single member organization can be deemed to have associates so as to be treated as an association taxable as a corporation, a single member organization cannot have associates so as to be classified as a partnership.

Whether an LLC could have only one member and be classified other than as a corporation remained an unresolved issue. The Kentucky LLC Act requires that an LLC have at least two members. LLC statutes which permit the formation of an LLC having only one member include those of Alabama, Delaware, Florida, Nevada and Texas. One-member LLCs are also allowed by § 201 of the ULLCA. A one-member LLC provides an alternative to the S corporation for instances in which a limited liability, pass-through structure is sought by a sole equity owner. For reviews of the classification of single member LLCs under *Kintner*, *see generally*, Francis J. Wirtz & Kenneth L. Harris, Tax Classification of the One-Member Limited Liability Company, TAX NOTES TODAY, June 28, 1993, *available in* LEXIS, 93 TNT 140-53. *See also*,

BORIS I. BITTKER & JAMES S. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS*, ¶ 2.05[2], (6th ed. 1994) (hereinafter "FED. TAX'N OF CORPS"). The Service has stated that it is reviewing this question and will issue guidance.

<sup>10</sup> See Treas. Reg. § 301.7701-2(a)(2) (replaced Jan. 1, 1997). As distinguished from a corporation or a partnership, a trust is deemed to lack both associates and an objective to carry on a business and divide the gains thereof. See Treas. Reg. § 301.7701-2(a)(2) (replaced Jan. 1, 1997).

<sup>11</sup> Treas. Reg. § 301.7701-2(a)(3) (replaced Jan. 1, 1997). Entities that are formally incorporated under state law are *per se* taxed as corporations, and are not subjected to the classification process. See Gen. Couns. Mem. 37,127 (May 18, 1977), as modified by Gen. Couns. Mem. 37,953 (May 14, 1979).

<sup>12</sup> See *Larson*, *supra* note 7

<sup>13</sup> See FED. TAX'N OF CORPS. ¶ 2.06: "The urge to incorporate personal service enterprises generally reflected the desire to take advantage of Code provisions that granted more generous deductions or other tax allowances for corporate employee benefit plans than for similar plans created by self-employed individuals."

<sup>14</sup> *Kintner*, 216 F.2d 417 (9th Cir. 1954), *aff'g*, 107 F.Supp 976 (D. Mont. 1952).

<sup>15</sup> *Kintner*, 107 F.Supp. at 979.

<sup>16</sup> Rev. Rul. 56-23, 1956-1 C.B. 598, *obsolete by* Rev. Rul. 72-92, 1972-1 C.B. 407.

<sup>17</sup> See Rev. Rul. 57-546, 1957-2 C.B. 886.

<sup>18</sup> See *T.D. 6503*, 1960-2 C.B. 409.

<sup>19</sup> As observed by Judge Dawson in *Larson*, "I think the current regulations were drafted with an objective of *limiting* the ability of a partnership or other entity to qualify as a corporation for tax purposes. In fact, it might even be said that the [*Kintner*] regulations are weighed against qualification for corporate status." 66 T.C. at 187 (emphasis in original) (Dawson, J., concurring). No emphasis on Westlaw.

<sup>20</sup> See MCKEE, NELSON & WHITMIRE, *FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS* ¶ 306[1] (1994 ed.) (hereinafter "FED. TAX'N OF PARTNERSHIPS").

<sup>21</sup> *T.D. 6797*, 1965-1 C.B. 553. See also Rev. Proc. 65-27, 1965-2 C.B. 1017 (setting forth procedures to be followed by the Service in applying the professional service organization amendments).

<sup>22</sup> See, *eg.*, *Kurzner v. U.S.*, 413 F.2d 97, 106 (5th Cir. 1969), wherein the court observed:

In 1965 the IRS responded to the new [PSC] statutes with amendments to the Kintner Regulations which, rather incredibly, isolate professional groups and state in no uncertain terms that they cannot be corporations for federal tax purposes. Since the adoption of the 1965 amendments, the IRS has attempted in a number of cases to enforce the new rules. The judicial response has been unanimous: the courts have invalidated the amended regulations as being arbitrary and discriminatory legislation by an administrative agency which is only authorized to interpret congressional acts.

<sup>23</sup> *T.D. 7515*, 1977-2 C.B. 482.

<sup>24</sup> Prop Treas. Reg. §§ 301.7701-2(a)(1), 42 Fed. Reg. 1038 (Jan. 5, 1977).

<sup>25</sup> 42 Fed. Reg. 1489 (Jan. 7, 1977). Originally submitted to the Federal Register on December 30, 1976, but not published until January 5, 1977, the withdrawal of the proposed regulations was filed with the Federal Register at 11:15 a.m. on January 6, 1977. This short-lived proposal was said to be based on a decade of study. See 3 DAILY TAX. REP. (BNA) at G-5 (Jan. 5, 1977). The proposed regulations eschewed the "preponderance" test, providing instead for a "corporate resemblance" analysis of the four corporate

characteristics. Under the corporate resemblance test, an organization possessed of only two of the corporate characteristics could be classified as a corporation depending on the nature of those characteristics; a preponderance of corporate characteristics was not required. The proposed rules indicated that corporate classification would likely result if one of the two corporate characteristics possessed by the organization was limited liability. In the face of overwhelming objection from the oil and gas industry, real estate concerns and the Department of Housing and Urban Development, the regulations were withdrawn only one day after publication. 42 Fed. Reg. 1489 (1977). See generally Richard Reichler, Implications of the IRS's Withdrawal of its Proposals to Amend the Kintner Regs., 6 J. TAX'N 138 (1977); Richard A. Fisher, Classification Under Section 7701: Yesterday, Today and Tomorrow, 30 TAX LAW. 627 (1977).

<sup>26</sup> Alaska HB 403 (introduced April 9, 1975); SB 354 (introduced April 8, 1975). The primary support for the Alaska LLC bill was to generate filing fees from LLCs organized to do business in Alaska and elsewhere with the desire that Alaska become the "Delaware of limited liability companies." See Minutes of Hearing before Alaska Senate Judiciary Committee (Feb. 3, 1976) regarding S.B. 354 (hereinafter "February 3 Minutes").

<sup>27</sup> See Joseph A Rodriguez, Wyoming Limited Liability Companies: Limited Liability and Taxation Concerns in Other Jurisdictions, 27 LAND AND WATER L. REV. 539, 544 (1992). See also February 3 Minutes ("IRS has written an 'information letter' regarding this bill. They will not issue a revenue ruling because the bill is in proposed form only. The letter states that they will use the same four tests when looking at such companies, indicating that there will be tax benefits in forming one.")

<sup>28</sup> The proponents of the Wyoming LLC bill were those who had been unsuccessful in Alaska. See Thomas E. Geu, Understanding the Limited Liability Company: A Basic Comparative Primer, (Part One), 37 S. D. L. REV. 44, 48 (1992) (hereinafter Basic Primer I).

<sup>29</sup> Prop Treas. Reg. § 301.7701-2(a), 45 Fed. Reg. 75,709 (Nov. 17, 1980). The proposed regulations failed to note that refusing partnership classification solely on the basis of limited liability had been rejected by the Board of Tax Appeals in Glensder Textile Co. v. Comm'r, 46 B.T.A. 176 (1942), *acq.* 1941-2 C.B. 8. The principle is consistent, however, with very early classification efforts. See, e.g., Treas. Reg. 33 art. 62 (rev. 1918) (classifying limited partnerships as corporations, limited partnerships being defined as a "partnership having one or more special partners who may share in the profits of the firm but whose liability for the debts of the company is limited to the amount of capital invested by such special partner or partners ....").

<sup>30</sup> Priv. Ltr. Rul. 81-06-082 (Nov. 18, 1980).

<sup>31</sup> This uncertainty impacted not only the adoption of additional LLC statutes; it apparently dissuaded the use of the statutes in place. As of February 22, 1988, only twenty-six Wyoming, and sixty-three Florida, LLCs had been formed. See Ernest A. Seemann, The Florida Limited Liability Company: An Update, 14 NOVA L. REV. 902, 903 (1990).

<sup>32</sup> See Announcement 81-166, 1981-43 IR.B. 21 (Oct. 26, 1981); Announcement 82-60, 1982-17 I.R.B. 23 (Apr. 26, 1982); Announcement 82-140, 1982-45 I.R.B. 30 (Nov. 8, 1982); Announcement 83-4, 1983-2 I.R.B. 31 (Jan. 10, 1983). See also, Proposed Regulations on 'Limited Liability Companies' Are Criticized As Contrary to Congressional Intent and Detrimental To Overseas Investment, 15 TAX NOTES (Tax Analyst) 187 (Apr. 19, 1982).

<sup>33</sup> Announcement 83-4, 1983-2 IR.B. 31 (Jan. 10, 1983). The study was to focus upon the Service's acquiescence in Larson, *supra* note 7, in which the Tax Court held that each of the four corporate characteristics would be given equal weight in distinguishing partnerships from associations taxed as corporations. The Service also announced it would not issue further private letter rulings on the classification of LLCs until the completion of the study. Rev. Proc. 83-15, 1983-1 C.B. 676, *superseded by* Rev. Proc. 83-22, 1983-1 C.B. 680, and Rev. Proc. 85-22, 1985-1 C.B. 550, *superseded by* Rev. Proc. 86-3, 1986-1 C.B. 416, *superseded by* Rev. Proc. 87-3, 1987-1 C.B. 147, *superseded by* Rev. Proc. 88-3, 1988-1 C.B.

579, *modified by* Rev. Proc. 88-44, 1988-2 C.B. 634. Prior to the withdrawal of the proposed regulations, the IRS released Priv. Ltr. Rul. 83-04-138 (Oct. 29, 1982), classifying an LLC as a corporation because it possessed limited liability, centralized management and continuity of life.

<sup>34</sup> 1988-2 C.B. 360 (Sept. 19, 1988). Announcement 88-118, 1988-38 I.R.B. 25 (Sept. 2, 1988), released with Rev. Rul. 88-76, albeit cryptically, announced the results of the five-year classification study, indicating the Service's continued acquiescence in Larson, as well as the Service's intention to review its advance ruling procedures for entities seeking partnership classification and the possible application of minimum net worth standards to certain entities classified as partnerships. This study led to the promulgation of Rev. Proc. 89-12, 1989-1 C.B. 798.

<sup>35</sup> Rev. Rul. 93-5, 1993-1 C.B. 227 (Dec. 24, 1992).

<sup>36</sup> Rev. Rul. 93-6, 1993-1 C.B. 229 (Dec. 24, 1992).

<sup>37</sup> Rev. Rul. 93-30, 1993-1 C.B. 231 (Apr. 19, 1993).

<sup>38</sup> Rev. Rul. 93-38, 1993-1 C.B. 233 (May 24, 1993).

<sup>39</sup> Rev. Rul. 93-49, 1993-2 C.B. 308 (July 19, 1993).

<sup>40</sup> Rev. Rul. 93-50, 1993-2 C.B. 310 (July 19, 1993).

<sup>41</sup> Rev. Rul. 93-53, 1993-2 C.B. 312 (Aug. 2, 1993).

<sup>42</sup> Rev. Rul. 93-81, 1993-2 C.B. 314 (Nov. 29, 1993).

<sup>43</sup> Rev. Rul. 93-91, 1993-2 C.B. 316 (Dec. 20, 1993).

<sup>44</sup> Rev. Rul. 93-92, 1993-2 C.B. 318 (Dec. 27, 1993).

<sup>45</sup> Rev. Rul. 93-93, 1993-2 C.B. 321 (Dec. 27, 1993).

<sup>46</sup> Rev. Rul. 94-5, 1994-1 C.B. 312 (Jan. 10, 1994).

<sup>47</sup> Rev. Rul. 94-6, 1994-1 C.B. 314 (Jan. 18, 1994).

<sup>48</sup> Rev. Rul. 94-30, 1994-1 C.B. 316 (May 9, 1994).

<sup>49</sup> Rev. Rul. 94-51, 1994-2 C.B. 407 (Aug. 8, 1994).

<sup>50</sup> Rev. Rul. 94-79, 1994-2 C.B. 409 (Dec. 19, 1994).

<sup>51</sup> Rev. Rul. 95-9, 1995-3 I.R.B. 17 (Jan. 17, 1995).

<sup>52</sup> *See generally*, Rutledge, Comparison of LLC Revenue Rulings, LL.C. Rep, Jan.-Feb. 1995.

<sup>53</sup> *See, eg.*, Priv. Ltr. Rul. 89-37-10 (June 16, 1989) (Florida); Priv. Ltr. Rul. 90-3-13 (Apr. 25, 1990) (Florida); Priv. Ltr. Rul. 92-1-19 (Dec. 6, 1991) (Texas); Priv. Ltr. Rul. 92-27-33 (Apr. 8, 1992) (Nevada); Priv. Ltr. Rul. 92-18-78 (Jan. 31, 1992) (Texas); Priv. Ltr. Rul. 92-42-25 (July 22, 1992) (Texas); Priv. Ltr. Rul. 93-21-47 (Feb. 25, 1993) (Arizona); Priv. Ltr. Rul. 93-2-45 (Feb. 24, 1993) (Utah); Priv. Ltr. Rul. 93-8-39 (Dec. 2, 1992) (West Virginia); Priv. Ltr. Rul. 93-2-19 (Feb. 18, 1993) (Utah); Priv. Ltr. Rul. 93-21-70 (Mar. 3, 1993) (Utah); Priv. Ltr. Rul. 93-25-48 (Mar. 30, 1993) (Utah); Priv. Ltr. Rul. 93-3-32 (May 4, 1993) (Illinois); Priv. Ltr. Rul. 93-35-32 (June 4, 1993) (Delaware); Priv. Ltr. Rul. 94-4-21 (Nov. 1, 1993) (Louisiana).

<sup>54</sup> *See, eg.*, Ways & Means Select Revenues Subcommittee Report on Referred Tax Issues, TAX NOTES TODAY, Feb. 3, 1993, available in LEXIS, 93 TNT 25-22; Kirchheimer, Barbara, Revenue Constraints and Lack of Momentum May Hinder S Corp Reform, Danforth Aide Says, TAX NOTES TODAY (Tax Analyst), Dec. 22, 1993, available in LEXIS, 93 TNT 259-2; Surge In Limited Liability Co. Laws Seen Driving Move to Corporate Integration, 100 DAILY TAX RPT. (BNA) D-4 (May 26, 1993); Congress May Examine IRS'

Position on LLCs in Future; Subchapter S Bill Gains Speed, 72 DAILY TAX RPT. (BNA) D-13 (Apr. 15, 1994); Tax Aide Discusses LLCs, S Corporations, and Health Care, TAX NOTES TODAY (Tax Analyst), Apr. 15, 1994, available in LEXIS, 94 TNT 73-5.

<sup>55</sup> 1989-1 C.B. 798.

<sup>56</sup> Rev. Proc. 89-12, § 1.02, provided in part:

Organizations covered by this revenue procedure include both those formed as partnerships and other organizations seeking partnership classification.

<sup>57</sup> While Rev. Proc. 89-12 was drafted in terms of "limited" and "general partners," section 1.02 offered *de minimus* direction on the application of those categories to non-partnership entities. Section 1.02 of Rev. Proc. 89-12 stated in part:

In the case of an organization not formed as a partnership, references to "partnership" documents, including the "partnership agreement," apply to the organization's comparable documents, however designated. Any reference to "limited partnership" includes an organization formed as a limited partnership under applicable state law and any other organization formed under a law that limits the liability of any member for the organization's debts and other obligations to a determinable fixed amount. References to "general partners" and "limited partners" apply (sic) also to comparable members of an organization not designated as a partnership under controlling law and document; the "general partners" of such an organization will ordinarily be those with significant management authority relative to the other members.

<sup>58</sup> The private letter rulings ruled as follows with respect to Rev. Proc. 89-12: (a) did not mention Rev. Proc. 89-12 (Priv. Ltr. Ruls. 92-1-19, 92-19-22, 92-42-25); (b) required compliance with Rev. Proc. 89-12 (Priv. Ltr. Ruls. 89-37-10, 90-1-27, 91-19-29, 91-47-17, 92-26-35); (c) required compliance "to the extent applicable" (Priv. Ltr. Ruls. 93-08-27, 93-13-9, 93-08-39, 93-18-11, 93-25-39, 93-31-10, 93-5-13); (d) required compliance, "in particular §§ 4.01 and 4.03" (Priv. Ltr. Ruls. 90-29-19, 92-18-78); and (e) required compliance "except § 4" (Priv. Ltr. Ruls. 90-3-13, 92-27-33, 93-21-47, 93-2-45, 93-2-19, 93-21-70, 93-25-48).

<sup>59</sup> Section 4.01 of Rev. Proc. 89-12, in part, provides:

[A]ll the general partners' interests, taken together, in each material item of partnership income, gain, loss, deduction, or credit must be equal to at least 1 percent of each such item at all times during the existence of the partnership, and the partnership agreement must expressly so provide.

<sup>60</sup> Section 4.03 of Rev. Proc. 89-12, in part, provides:

Unless section 4.04 applies, the general partners, taken together, must maintain a minimum capital account balance equal to either 1 percent of total positive capital account balances for the partnership or \$500,000, whichever is less.

<sup>61</sup> While sections 4.05 and 4.06 of Rev. Proc. 89-12 need not be satisfied in order to receive a classification ruling, there was no similar exception for sections 4.01 or 4.03. Section 4.07 of Rev. Proc. 89-12, dealing with the corporate characteristic of limited liability, does not apply to LLCs. Gen. Couns. Mem. 39,798, n.3 (Oct. 24, 1989).

<sup>62</sup> Section 4.06 of Rev. Proc. 89-12 provides:

The Service will rule that a partnership lacks the corporate characteristic of centralized management only if limited partner interests, excluding those held

by general partners, do not exceed 80 percent of the total interests in the partnership. In addition, the Service will consider all the facts and circumstances, including limited partner control of the general partners (whether direct or indirect), in determining whether the partnership lacks centralized management.

<sup>63</sup> Note that section 1.02 of Rev. Proc. 89-12, in describing parties or entities equivalent to general partners, addresses only the "management authority," and does not mention the issue of personal liability, of the general partner analogues. Additionally, the *Kintner* regulations do not discuss or even reference personal liability in discussing centralized management. Therefore, there is no authority in either Rev. Proc. 89-12 or the *Kintner* regulations that would deny application of the section 4.06 safe harbor to LLCs on the grounds that LLC managers are not subject to the personal liability of a general partner. See Lady E. Booth and Thomas E. Rutledge, Centralized Management and Revenue Procedure 89-12: The Search for a Consistent Answer, 2 L.L.C. RPT. 94-209 (Mar.-Apr. 1994). See also Letter from American Bar Association Section on Taxation, Committee on Partnerships, to the Honorable Shirley D. Peterson, Commissioner, Internal Revenue Service, February 27, 1992, available in LEXIS, 92 TNT 60-42 ("Further guidance is needed concerning the extent to which anything less than complete reservation of management to all the members would cause centralized management to exist. For example, the Service has adopted a ruling position for limited partnerships providing that management by persons holding 20 percent or less of the ownership interest is centralized management .... Consideration might be given to developing a similar position for LLCs, if they are to be analogized to limited partnerships for the purposes of determining centralized management.") The Service is reviewing this issue. See [Jackel Guidance] "Though the presence of elected managers points to centralized management, a corporate characteristic, Treasury is studying whether an organization managed by elected members who own 20 percent or more of its interests will lack centralized management, Jackel said.")

<sup>64</sup> The Service's 1993 business plan included the publication of a revenue procedure providing advance rules and guidelines for LLCs. I.R.S. News Release NB-2142, Partnerships, item 6 (January 5, 1993). See also, [Jackel Guidance] ("Monte Jackel, an attorney-adviser in Treasury's Office of Tax Legislative Counsel, told participants at a November 12 seminar on limited liability companies that within the next few months the government would issue an LLC counterpart to Rev. Proc. 89-12, 1989-2 C.B. 798, explaining how to get a ruling on partnership tax classification").

<sup>65</sup> See Draft revenue procedure prepared by the Limited Liability Company Task Force of the American Bar Association Section on Taxation, Ruling Guidelines for Determining Whether a Limited Liability Company is a Partnership or an Association Taxable as a Corporation (dated Sept 14, 1993), reprinted in LIMITED LIABILITY COMPANIES AND LIMITED LIABILITY PARTNERSHIPS at 92 (Prentice-Hall 1993).

<sup>66</sup> Rev. Proc. 95-10 § 101, 1995-1 C.B. 501.

<sup>67</sup> Treas. Reg. § 301.7701-2 (effective Jan. 1, 1997).

<sup>68</sup> See section 4.16 *infra*.

<sup>69</sup> Simplification of Entity Classification Rules, I.R.S. Notice 95-14, 1995-1 C.B. 297. See also Thomas E. Rutledge, IRS Considers End to Kintner Analysis of Unincorporated Associations, 18 L.L.C. ADVISOR 4 (June, 1995).

<sup>70</sup> See, e.g., AICPA Strongly Supports Check-the-Box Proposal for Domestic and Foreign Entities, TAX NOTES TODAY, July 28, 1995, available in Westlaw, 95 TNT 147-42; ABA Tax Lawyers Embrace Check-the-Box Proposal and Say Extend it to Foreign Organizations, TAX NOTES TODAY, July 26, 1995, available in Westlaw, 95 TNT 145-25; IRS Approval of Simplified Business Classification System Urged at Hearing, DAILY TAX. REP., July 21, 1995, available in Westlaw, 1995 DTR 140 d12.

<sup>71</sup> Internal Revenue Service Notice of Proposed Rulemaking and Hearing on Simplification of Entity Classification Rules, PS. 43-95, 1996-24 I.R.B. 20 (May 9, 1996). See also Thomas E. Rutledge & James B. Martin, Jr., The Proposed Check-the-Box Classification Regulations: What Might They Mean



For You, 1 LLC ADVISOR 4 (June 1996); Roger F. Pillow et al., Check-the-Box Proposed Regs Simplify the Entity Classification Process, 85 J. TAX'N 72 (1996).

<sup>72</sup> See California Franchise Tax Board Opposes Single-Member Business Entity Election, TAX NOTES TODAY, Aug 21, 1996, available in Westlaw, 96 TNT 164-23.

<sup>73</sup> T.D. 8697, 1997-1 C.B. 348. In addition to simplifying entity classification, by delinking state law organizational characteristics and tax classification, Check-the-Box will likely have the salutary benefit of eliminating the drive to create an ever increasing menu of entities, entities which have been oft proposed to address perceived gaps in the weave of available organizations. See, e.g., Dale A. Oesterle & Wayne M. Gazur, What's In a Name?: An Argument for a Small Business "Limited Liability Entity" Statute (With Three Subsets of Default Rules), 32 WAKE FOREST L. REV. 215 (1997); John H. Matheson & Brent A. Olson, A Call for a Unified Business Organization Law, 65 GEO. WASH. L. REV. 1 (1996); Coleman & Keatinge, UNIVERSAL [CONTRACTUAL] ORGANIZATION ACT, paper presented to the ABA Section of Business Law, Committees on Taxation and Partnerships and Unincorporated Business Organizations (Aug. 7, 1995).

<sup>74</sup> See Thomas E Rutledge & James B. Martin, Jr., Yes Virginia, There is a Santa Clause: The Service Delivers Check-the-Box, 1 LLC ADVISOR 4 (Dec. 1996).

<sup>75</sup> JCT Reviews Entity Classification Partnership Issues, JCS-6-97, TAX NOTES TODAY, Apr 8, 1997, available in Westlaw, 97 TNT 68-8 (hereinafter the "Committee Review"). See also Joan Pryde, IRS' Check-the-Box Rules Under Scrutiny By Joint Tax Committee Staff, Kies Says, DAILY TAX. REP., Nov. 15, 1996, available in Westlaw, 1996 DTR 221 d10; Congress May Need to Codify Check-the-Box Rules, Kies Says, DAILY TAX. REP., Nov. 26, 1996, available in Westlaw, 1996 DTR 228 d5; JCT to Review "Check-the-Box" Rules, TAX NOTES TODAY, Nov. 15, 1996, available in Westlaw, 96 TNT 223-1.

<sup>76</sup> In this regard, the Committee Review (§ IIB.1) states:

Other factors are relevant to an analysis of the validity of the check-the-box regulations as a way to determine whether an entity is an association treated as a corporation. The *Kintner* regulations, which preceded the check-the-box regulations, were in effect for nearly thirty-six years. It could be argued that Congress tacitly approved the four-factor test set forth in the *Kintner* regulations, or that Congress implicitly reserved to itself the power to modify that test, and that the Treasury Department's authority to replace the *Kintner* regulations was thereby restricted. The 1987 legislation treating publicly traded partnerships as corporations for Federal tax purposes could be viewed as implicit support for those regulations. On the other hand, it could be argued that no such Congressional intent can be presumed without a specific indication of approval of the *Kintner* regulations. It could also be argued that "sharp breaks" with a long-standing regulatory interpretation may be consistent with the agency's administrative ability to respond to changing circumstances. (Emphasis added.)

<sup>77</sup> Morrissey, 96 US. at 344.

<sup>78</sup> As set forth in the Committee Review (§ IIB.1):

A related question involves whether any interpretation of what constitutes an "association" taxable as a corporation is already governed by the Supreme Court's decision in Morrissey v. Commissioner, 296 U.S. 344 (1935). That case involved an organization established as a trust under State law and reclassified by the Service as an association taxable as a corporation. Beneficial interests in the entity were evidenced by transferrable share certificates, representing both common and preferred interests, held by hundreds of persons. The Supreme Court concluded that the organization was properly taxed as a corporation, given the entity's centralized control and continuity of life, the limited liability of the shareholders, and the fact that the entity essentially was

conducting a business enterprise. The Court reasoned that the entity resembled a corporation. The case is said to have set forth the corporate resemblance task referred to in the *Kintner* regulations that were in effect prior to the check-the-box regulations. (Emphasis added.)

<sup>79</sup> The Committee Review (§ IIB.1) noted:

To resolve the issue of the Treasury Department's authority to promulgate the check-the-box regulations, it has been suggested that Congress ought to establish by specific legislation that the regulations are authorized. The New York State Bar Association Tax Section's analysis of the authority issue, while concluding that there is adequate authority for an elective system even in the absence of specific legislation authorizing the check-the-box regulations, recommended such legislation to avoid disputes as to authority, "because situations undoubtedly will arise where taxpayers will be tempted to take the position that the regulations are invalid."

Concern has been expressed that any specific legislative re-enactment of the regulations would be undesirable, for several reasons. A specific legislative re-enactment would limit the flexibility of the Treasury Department to respond to issues that may arise in the future under the elective regime. Another concern is that any delay in such specific re-enactment might cast doubt on the ability of taxpayers to rely with certainty on the final check-the-box regulations. Similarly, the certainty and simplicity provided to taxpayers by the regulations could be reduced if the legislative version of the regime were substantially different from the rules set forth in the final regulations.

On the matter of the authority to issue the Check-the-Box regulations, as observed in ¶ 3.08 of McKEE, *supra* note 20:

[I]t is probably only a matter of time before an aggrieved taxpayer challenges the validity of these rules.

Subsequently, the Service announced that it is not considering revisions to the Check-the-Box regulations to address matters raised in the Committee Review. Changes to Check-the-Box Regs Not Being Considered, IRS Official Says, DAILY TAX. REP., Aug. 4, 1997, available in Westlaw, 149 DTR G-6.

<sup>80</sup> The Check-the-Box regulations, as did the *Kintner* regulations, distinguish business associations from true (as contrasted with business) trusts on the basis of whether the organization in question lacks associates and an objective to carry on a business and divide the gains therefrom. All business organizations are deemed to enjoy both associates as well as an objective to carry on business and the gains thereof. A "non-business trust" does not have one or both of these characteristics. Reg. § 301.7701-4(a).

<sup>81</sup> Reg. §§ 301.7701-1(a)(2)-(3).

<sup>82</sup> Reg. § 301.7701-2(b)(1). *See also* Priv. Ltr. Rul. 79-21-84, which stated, "[a]n entity that is 'incorporated' as that term was used at common law cannot be a partnership within the meanings of Code § 761(a) and Code 7701(a)(2)." Kleinsasser v. United States, 707 F.2d 1024, 1027 (9th Cir. 1983) (a corporation cannot be a partnership for federal income tax purposes).

<sup>83</sup> Reg. §§ 301.7701-2(b)(1)-(7). Examples of entities reached by the "entities which are taxable as corporations other than by the application of Code § 7701(a)(3)" include publicly traded partnerships classified as corporations by Code § 7704 and taxable mortgage pools subject to Code § 7701(i).

<sup>84</sup> Regs. § 301.7701-2(b)(8)(i). The Service received numerous comments on the incorporation of specific entities in the list of foreign *per se* corporations after the list was released in the proposed Regulations. *See, e.g., Attorney Says Proposed Norwegian Law Could Affect Per Se Corporation List*,

TAX NOTES TODAY, Oct. 24, 1996, *available in* Westlaw, 96 TNT 208-21; Lawyers Suggest Changes to Per Se Corporation List, TAX NOTES TODAY, Oct. 3, 1996, *available in* Westlaw, 96 TNT 194-22; Netherlands Antilles Banks Object to Per Se Corporation List in Regs., TAX NOTES TODAY, Aug. 22, 1996, *available in* Westlaw, 96 TNT 165-18; Netherlands Antilles Asks IRS to Reconsider Mandatory Corporate Classification, TAX NOTES TODAY, Aug. 22, 1996, *available in* Westlaw, 96 TNT 165-20; Electric Industry Group Says Some Per Se Corporations Should be Partnerships, TAX NOTES TODAY, Aug. 22, 1996, *available in* Westlaw, 96 TNT 165-26; Lawyer Recommends Changes to Per Se Corporation List, TAX NOTES TODAY, Aug. 21, 1996, *available in* Westlaw, 96 TNT 164-22; Lawyer Wants Turkish Entity Removed From Per Se Corporation List, TAX NOTES TODAY, Aug. 21, 1996, *available in* Westlaw, 96 TNT 164-24; Chamber of Commerce Wants Indonesian Entity Removed from Per Se Corporation List, TAX NOTES TODAY, Aug. 8, 1996, *available in* Westlaw, 96 TNT 155-26; Halifax Attorneys Seek Modification in Entity Classification Regs., TAX NOTES TODAY, July 25, 1996, *available in* Westlaw, 96 TNT 145-39. Even with the adoption of the final rules, criticism of its incorporation of certain entities still continues. *See, e.g.,* Lawyer Says Egyptian Entity Should Be Removed From Per Se Corporation List, TAX NOTES TODAY, Jan. 2, 1997, *available in* Westlaw, 97 TNT 1-37. Linguistic ambiguities in the application of this list are already arising. *See, Mexican Entity and Malaysian Entity Off List of Per Se Corporate Entities, Official Says*, TAX NOTES TODAY, Mar. 6, 1997, *available in* Westlaw, 97 TNT 44-10.

<sup>85</sup> Rev. Rul. 88-8, 1988-1 C.B. 403.

<sup>86</sup> *See* Preamble to T.D. 8697, part B, 61 Fed. Reg. 66584-01.

<sup>87</sup> Reg. § 301.7701-3(a).

<sup>88</sup> Reg. § 301.7701-2(a).

<sup>89</sup> Reg. § 301.7701-2(b)(i).

<sup>90</sup> *See, e.g.,* Francis J. Wirtz & Kenneth L. Harris, Tax Classification of the One-Member Limited Liability Company, TAX NOTES TODAY, June 28, 1993, Westlaw, 93 TNT 140-53.

<sup>91</sup> Reg. § 301.7701-3(a). *See also* Reg. § 301.7701-2(c)(2). Such organizations are sometimes referred to as "Tax-Nothings," and will be referred to as such in the balance of this outline.

<sup>92</sup> Reg. § 301.7701-2(a).

<sup>93</sup> Regs. § 301.7701-3(b)(ii). Such Tax-Nothings are not required to have a separate federal taxpayer identification number.

<sup>94</sup> 1988-2 C.B. 360. In Rev. Rul. 88-76, the Service determined that a Wyoming LLC would be classified as a partnership. Between the passage of Wyoming's LLC statute in 1977 and the 1988 release of Rev. Rul. 88-76, the Service had issued proposed amendments to the *Kintner* regulations that would have classified as a corporation any entity in which all members enjoyed limited liability and a general study of the criteria applied in the classification of noncorporate entities. During the pendency of that study, the Service would not issue private letter rulings on LLC classification. *See* Rutledge & Booth at pp. 59-65.

<sup>95</sup> While Rev. Proc. 95-10, 1995-1 C.B. 501, § 4.01 acknowledged that single member LLCs, under certain statutes, could be formed, it also provided that such an entity could not request an advance classification ruling.

<sup>96</sup> For excellent discussions of the single member unincorporated entity with no tax identity and its use in various situations, *see* David S. Miller, The Tax-Nothing, TAX NOTES TODAY, Feb. 3, 1997, *available in* Westlaw, 97 TNT 22-69; Christopher Barton, Much Ado About a Nothing: The Taxation of Disregarded Entities, TAX NOTES TODAY, June 30, 1997, *available in* Westlaw, 97 TNT 125-98; William S. McKee & Mark A. Kuller, Issues Relating to Choice of Entity, Entity Characterization and Partnership Anti-Abuse Rules, TAX PLANNING FOR DOMESTIC AND FOREIGN PARTNERSHIPS, LLCs, JOINT VENTURES, AND OTHER STRATEGIC ALLIANCES, PLI Handbook, *available in* Westlaw, 398 PLI/Tax 9.

<sup>97</sup> See generally Scott D. Smith, What Are States Doing on the Check-the-Box Regs? TAX NOTES TODAY, Aug. 18, 1997, available in Westlaw, 97 TNT 159-41; Check-the-Box Chaos? The State Tax Treatment Factor, TAX NOTES TODAY, May 29, 1997, available in Westlaw, 97 TNT 103-1. See also Sindhu G. Hirani, States Must Address Business Entity Issue Following IRS Check-the-Box Rules, 22 DAILY TAX REPORT G-8, Feb. 3, 1997, available in Westlaw, 1997 DTR 22 d12. See also California Groups Discussing Conforming to Federal Entity Classification Rules, DAILY TAX. REP., Feb. 24, 1997, available in Westlaw, 1997 DTR 36 d18.

<sup>98</sup> Reg. § 301.7701-3(a).

<sup>99</sup> "Limited liability" is defined at Reg. § 301.7701-3(b)(2)(ii).

<sup>100</sup> Reg. § 301.7701-3(b)(2)(i)(A).

<sup>101</sup> Reg. § 301.7701-3(b)(2)(i)(C).

<sup>102</sup> Reg. § 301.7701-3(b)(2)(i)(B).

<sup>103</sup> Reg. § 301.7701-3(a).

<sup>104</sup> Reg. § 301.7701-2(d)(1). In addition to having been in existence of May 8, 1996, this grandfather rule requires that: the entity's classification was "relevant" (a term defined in Treas. Reg. § 301.7701-3(d)) on May 8, 1996; that all owner's for whom classification was relevant on May 8, 1996 treat the entity as a corporation; if a reorganization took place within the 60 months before May 8, 1996, the members must have recognized the tax consequences of that reorganization; that the claimed classification was reasonable (within the meaning of Code §6662); and that on or prior to May 8, 1996, either the entity nor any owner had received written notice from the Service that the claimed classification was under examination. Reg. § 301.7701-2(d)(1)(ii)-(vi).

<sup>105</sup> Reg. § 301.7701-2(d)(2).

<sup>106</sup> Reg. §§ 301.7701-2(d)(3)(i)(B)-(C), (ii).

<sup>107</sup> Reg. § 301.7701-3(b)(3)(i).

<sup>108</sup> Reg. § 301.7701-3(b)(3)(i).

<sup>109</sup> Relevant is defined at Reg. § 301.7701-3(d).

<sup>110</sup> Reg. § 301.7701-3(b)(3)(ii). This regulation goes on to provide for the treatment of foreign entities whose classification was changed in the sixty months prior to January 1, 1997. If classification was relevant but not clearly indicated, the *Kintner* regulations are applied to make that determination.

<sup>111</sup> Reg. § 301.7701-3(f)(2)(i) -(iii).

<sup>112</sup> Reg. § 301.7701-3(c)(1)(i).

<sup>113</sup> Reg. § 301.7701-3(c)(1)(ii).

<sup>114</sup> Reg. § 301.7701-3(c)(1)(ii).

<sup>115</sup> Reg. § 301.7701-3(c)(1)(ii).

<sup>116</sup> Reg. § 301.7701-3(c)(1)(iii).

<sup>117</sup> Reg. § 301.7701-3(c)(2)(i)(A)-(B).

<sup>118</sup> Reg. § 301.7701-3(c)(2)(ii).

<sup>119</sup> Reg. § 301.7701-3(c)(1)(iv).

<sup>120</sup> Reg. § 301.7701-3(c)(1)(iv). This relief will take the form of a private letter ruling. Preamble to T.D. 8697, part C.

- 121 1997-1 C.B. 348 (Jan. 13, 1997).
- 122 1989-1 C.B. 798.
- 123 1992-1 C.B. 776.
- 124 1995-1 C.B. 501.
- 125 1971-2 C.B. 430.
- 126 1971-2 C.B. 408.
- 127 1993-1 C.B. 225.
- 128 1988-1 C.B. 403.
- 129 1988-2 C.B. 361.
- 130 1994-1 C.B. 316.
- 131 1988-2 C.B. 360.
- 132 1993-1 C.B. 227.
- 133 1993-1 C.B. 229.
- 134 1993-1 C.B. 231.
- 135 1993-1 C.B. 233.
- 136 1993-2 C.B. 308.
- 137 1993-2 C.B. 310.
- 138 1993-2 C.B. 312.
- 139 1993-2 C.B. 314.
- 140 1993-2 C.B. 316.
- 141 1993-2 C.B. 318.
- 142 1993-2 C.B. 321.
- 143 1994-1 C.B. 312.
- 144 1994-1 C.B. 314.
- 145 1994-1 C.B. 316.
- 146 1994-1 C.B. 407.
- 147 1994-2 C.B. 409.
- 148 1995-1 C.B. 222.
- 149 1998-2 C.B. 133 (Aug. 10, 1978).

150 Treatment of Changes in Elective Entity Classification (Reg-105162-97), 1997-48 I.R.B. 13 (Dec. 1, 1997). For a general review of the proposed conversion guidance regulations, *See, e.g.*, Monte A. Jackel & Glenn E. Dance, Selected Federal Income Aspects of Changing the Tax Status of Business Entities, TAX STRATEGIES FOR CORPORATE ACQUISITIONS, DISPOSITIONS, SPIN-OFFS, JOINT VENTURES, FINANCINGS, REORGANIZATIONS AND RESTRUCTURINGS (PLI, Westlaw, 405 PLI/Tax 251); Roger F. Pillow, et al., Changing an Entity's Classification by Election: The First Modifications to Check-the-Box, 88 J. TAX'N 143 (1988).

<sup>151</sup> This treatment is consistent with Rev. Rul. 63-107, 1963-1 C.B. 71

<sup>152</sup> The preamble to the proposed regulations note that this regulation does not affect Rev. Rul. 84-11, 1984-2 C.B. 88, wherein the Service ruled that it would respect the form used by the taxpayers in converting a partnership into a corporation.

<sup>153</sup> Rev. Rul. 99-5, 1999-1 C.B. 434 (Jan. 14, 1999).

<sup>154</sup> Rev. Rul. 99-6, 1999-1 C.B. 432 (Jan. 14, 1999).

<sup>155</sup> H.B. 666, § 1, Reg. Sess. (Ky. 1998)

<sup>156</sup> See generally, Bruce D. Bernard, Recent Developments Affect Choice of Entity Decision, 58 TAX'N FOR ACCT. 4 (1997); Arlene M. Hibscheiler & Marion Kopin, LLCs are Generally — But Not Always — The Right Choice, 58 TAX'N FOR ACCT., 159 (1997); William S. McKee & Mark A. Kuller, Issues Relating to Choice of Entity, Entity Characterization and Partnership Anti-Abuse Rules, TAX PLANNING FOR DOMESTIC AND FOREIGN PARTNERSHIPS, LLCs, JOINT VENTURES, AND OTHER STRATEGIC ALLIANCES (PLI, Westlaw, 398 PLI/Tax 9). As noted in the Committee Review (§ II.B.2):

If an LLC can provide limited liability to all owners and achieve pass-through status as a partnership under the check-the-box regulations (or under the Service's prior revenue rulings on LLCs), the need for S corporations could be questioned. Particularly in light of the growing use of LLCs, it could be argued that the great flexibility of the partnership tax rules outweigh the principal advantage of S corporations: relative simplicity. Thus, it is argued that the rules for S corporations could be repealed without detriment to taxpayers.

(citing Walter D. Schwidetzky, Is It Time to Give the S Corporation a Proper Burial?, 15 VA. TAX REV. 591 (1996)).

<sup>157</sup> Morrissey, 296 U.S. at 344.

<sup>158</sup> This question has been asked and answered in Taylor, Beyond Check-the-Box — Neglected Issues, 75 TAXES 671 (1997), wherein he observes:

If this had happened in 1936, it would have been likely that, instead of the RIC provisions now in the Code, the securities investment and trading activities of those companies would have been excepted from Code Sec. 7704(a). In other words, there would have been an exception in the 1936 version of Code Sec. 7704(a), as there is to some degree today, for income derived from investing and trading in securities. If the RIC provisions had not been enacted, it seems likely that the REIT provisions would likewise not have been enacted—the real estate activities permitted to REITs would also have been covered by in Code Sec. 7704(c). And, if states had shown the same prescience in 1936 with respect to the need for pass-through entities and enacted statutes that conferred more (or, indeed, all) “corporate” attributes on unincorporated entities, it seems likely that there would never have been subchapter S. Finally, if the check-the-box regulations had been issued in 1936, it is at least arguable that we would not have the present rules for real estate mortgage investment conduits (REMICs) and financial asset securitization investment trusts (FASITs).

## 5.1 BASICS OF LLC FORMATION

by  
Thomas E. Rutledge

With the passage of the Kentucky Limited Liability Company Act (the "LLC Act"), Kentucky became the 41st state to provide for the formation of these structures,<sup>1</sup> a business entity which uniquely combines flexibility of structure and limited liability to investors.<sup>2</sup>

The LLC Act was introduced to the 1994 General Assembly on February 7, 1994 as Senate Bill 184. The LLC Act, drafted by a joint task force of the Kentucky Bar Association Sections on Taxation and Business Law and the Kentucky Society of Certified Public Accountants, was substantially based upon the Prototype Limited Liability Company Act, primarily the draft dated November 19, 1992,<sup>3</sup> and the Kentucky Business Corporation Act.<sup>4</sup> Also consulted were the draft Uniform Limited Liability Company Act<sup>5</sup> prepared by the National Conference of Commissioners of Uniform State Laws and a number of previously adopted LLC statutes, including those of Virginia, Maryland and Delaware.

Senate Bill 184 was signed into law by Governor Jones on April 11, 1994, with an effective date of July 15, 1994, and has been codified in Kentucky Revised Statutes at chapter 275.<sup>6</sup>

The 1996 General Assembly considered two bills which would have amended the LLC Act.<sup>7</sup> Neither bill was approved.

The 1998 General Assembly, by means of H.B. 666, did approve significant amendments to the LLC Act. Those amendments are referred to herein as the "1998 Amendments." H.B. 666 was signed by Governor Patton on April 7, 1998 with an effective date of July 15, 1998.<sup>8</sup>

The 2000 General Assembly considered a single bill which would have amended the LLC Act.<sup>9</sup> This bill was not approved.

This chapter will examine the issues incident to the formation of LLCs in Kentucky and the qualification of foreign LLCs to do business in Kentucky.<sup>10</sup> Chapters 6 and 7 will, respectively, review those provisions of the LLC Act dealing with the ongoing operation of an LLC,<sup>11</sup> turning then to an examination of those sections of the LLC Act dealing with transactions such as mergers, conversions and dissolutions.<sup>12</sup>

### 5.2 Organization and Qualification of LLCs

A prime objective in drafting those provisions of the LLC Act dealing with the organization and qualification of LLCs was to build upon and take advantage of the procedures and experiences built up by practitioners and the Office of the Secretary of State. As such, these sections largely copy the filing and procedural requirements set forth in the Kentucky Business Corporation Act and, to the extent they are similar, the Kentucky Revised Uniform Limited Partnership Act.

### 5.3 Articles of Organization

An LLC is formed by delivering executed Articles of Organization to the Kentucky Secretary of State.<sup>13</sup> Unless a delayed effective date is requested, the existence of the LLC begins with the filing of the Articles.<sup>14</sup> The Articles of Organization must also be filed with the county clerk for the county in which the LLC has its registered office.<sup>15</sup> There is no requirement that the organizer be a member of the LLC.<sup>16</sup>

The Articles of Organization of an LLC must include:

- the name of the LLC;<sup>17</sup>
- the name and street address of the initial registered office and registered agent of the LLC;
- the mailing address of the initial principal office of the LLC;
- a statement as to whether the LLC will be managed by managers or by its members;<sup>18</sup>
- if the LLC has been organized to render professional services, what professional service or services will be practiced through the professional LLC.<sup>19</sup>

The 1998 Amendments removed the requirement that the Articles of Organization state that the LLC has at least two members. The requirement had previously applied in order that a LLC could enjoy tax classification as a partnership. The adoption of the Check-the-Box classification regulations eliminated any confusion regarding the tax classification of single-member LLCs.<sup>20</sup> In a corresponding amendment, the definition of a "limited liability company" was revised to expressly note that it includes LLCs with a single member.<sup>21</sup>

The 1998 Amendments also deleted the requirement that, if the LLC is to have a specific date of dissolution, the Articles of Organization set forth the latest date on which the LLC is to dissolve.<sup>22</sup> In replacement thereof, the 1998 Amendments to the LLC Act added a new section to the LLC Act, expressly stating that:

The term of a limited liability company shall be perpetual unless a period of duration other than perpetual is set forth in the articles of organization.<sup>23</sup>

The Articles of Organization may, but are not required to, include any matters permitted to be set forth in the operating agreement.<sup>24</sup> Articles of Organization must be accompanied by a statement of the registered agent consenting to serve in such capacity.<sup>25</sup>

For those LLCs formed by the statutory conversion of a general or limited partnership, additional information must be set forth in the Articles of Organization; these requirements are discussed below in Section 5.5, as well as in chapter 7 of this Monograph.

Articles of Amendment may be filed to add or modify a provision required or permitted in the Articles of Organization or to delete a provision not required.<sup>26</sup> Unless the Articles or the Operating Agreement of the LLC provide otherwise, a majority vote of the members, voting on a pro rata (one man, one vote) basis, is required to amend the Articles of Organization.<sup>27</sup>

Any manager, in a manager managed LLC, or any member, in a member managed LLC, may cause the amendment of the Articles of Organization to delete the name and address of the initial registered agent or registered office if a change in the registered office and registered agent is otherwise on file with the Secretary of State, or to delete the mailing address of the initial principal office if the change in that office is otherwise on file with the Kentucky Secretary of State.<sup>28</sup>

The Articles of Organization may be restated.<sup>29</sup>

If the LLC changes its principal place of business, notice of the change may be made by an amendment to the Articles of Organization<sup>30</sup> or by a separate filing with the Secretary of State.<sup>31</sup> While the former provision is phrased as a permissive "may," the latter contains the mandatory "shall." Caution would suggest that both filings be made upon a change in the principal place of business. Documents containing errors may be corrected.<sup>32</sup>

The requirements for documents and the filing fees were taken from the Corporate Act.<sup>33</sup>



#### 5.4 Statutory Conversion

The LLC Act includes a statutory procedure for converting a partnership, general or limited, into an LLC.<sup>34</sup>

A general partnership may convert to an LLC simply by filing Articles of Organization. The conversion must be approved by all of the partners in the general partnership, unless the partnership agreement provides for a different number or percentage.<sup>35</sup> In addition to the information otherwise required for Articles of Organization, those of a converting general partnership must set forth:

- a statement that the LLC was formed by the conversion of a general partnership;
- the name of the former partnership;
- the number of votes cast for and against the conversion and, if not unanimous, the number or percentage interest required under the partnership agreement to approve the conversion; and
- a statement that any assumed names of the former partnership have been canceled.<sup>36</sup>

A limited partnership may convert to an LLC by using this same procedure. However, notwithstanding any provision to the contrary in the limited partnership agreement, all partners must approve the conversion.<sup>37</sup> In addition to those requirements set forth for the conversion of a general partnership to an LLC and the additional matters required in the Articles of Organization, the limited partnership must cancel its certificate of limited partnership.<sup>38</sup>

The converting general or limited partnership is not deemed to dissolve upon conversion. KRS § 275.375(1).<sup>39</sup> Rather, upon conversion, the LLC becomes vested with all property owned by the converting partnership, the obligations of the converting partnership become obligations of the LLC and any proceeding pending against the partnership, and its partners, shall continue as if the conversion had not taken place.<sup>40</sup>

This conversion process enables a partnership, simply by filing a single document, to eliminate the personal liability of its general partners for obligations that arise after the conversion. However, the general partners of the converting partnership shall remain liable, to the extent they were prior to the conversion, for the pre-conversion debts and obligations of the partnership.<sup>41</sup>

Note that the LLC Act contains provisions for mergers of LLCs, mergers between LLCs and corporations and mergers between LLCs and limited partnerships. These provisions are addressed in chapter 7.

#### 5.5 The Operating Agreement

The operating agreement is the core document controlling the operation of the LLC.<sup>42</sup> Analogous in certain respects to a partnership or limited partnership agreement, and in other ways to corporate bylaws, the operating agreement serves to spell out the rights, duties and responsibilities amongst the members.<sup>43</sup> The operating agreement may set forth any provision that does not conflict with the Articles of Organization or the LLC Act.

The initial adoption of an operating agreement requires the unanimous consent of all members of the LLC.<sup>44</sup> Unless it provides otherwise, amendment of the operating agreement requires the approval of a Majority-in-Interest of the members.

The 1998 Amendments to the LLC Act include an expansion of the definition of an Operating Agreement to address single-member LLCs, stating:

If a limited liability company has only one (1) member, an operating agreement shall be deemed to include:

- (a) A writing executed by the member that relates to the affairs of the limited liability company and the conduct of its business regardless of whether the writing constitutes an agreement; or
- (b) If the limited liability company is managed by a manager, any other agreement between the member and the limited liability company as it relates to the limited liability company and the conduct of its business, regardless of whether the agreement is in writing.<sup>45</sup>

The LLC Act does not require the operating agreement be in writing. However, certain of the default rules may be modified only by a written operating agreement. These include:

- the requirement of a Majority-in-Interest of the Members to amend a written operating agreement;<sup>46</sup>
- the requirement of a Majority-in-Interest of the Members to authorize an action in contravention of a written operating agreement;<sup>47</sup>
- the requirement of a Majority-in-Interest of the Members to amend the articles of organization to change the management structure from member managed to manager managed or vice versa;<sup>48</sup>
- the allocation of profits and losses on a per capita basis;<sup>49</sup>
- the requirement of a vote of a Majority-in-Interest of the members to admit a transferee as a member;<sup>50</sup> and
- the requirement of a vote of a Majority-in-Interest of the members to continue the LLC after an event of disassociation.<sup>51</sup>

The operating agreement may require that any amendments to itself be in writing, and that oral modifications of such a written agreement are not enforceable.<sup>52</sup>

Unlike the Corporation Act, the LLC Act does not address such procedural matters as notice for the calling of meetings, waiver of notice, agenda requirements, voting by proxy, telephonic attendance, record dates, voting requirements for sales of assets, addressing potential conflicts of interests, dissenter's rights, derivative actions and similar matters. Therefore, these issues should be addressed in drafting the operating agreement. However, it may be unwise to adopt without criticism the rules set forth, for example, in the Corporation Act (and widely available in form by-laws) as they may impose a level of formality not necessary in a closely held business, especially one in which all members are actively involved in the day-to-day business.

Unlike the Articles of Organization, the operating agreement is not publicly recorded. However, any written operating agreement must be retained as a record at the LLC's principal office.<sup>53</sup>

An LLC may exist without an operating agreement, in which case it will be governed by the default rules of the LLC Act.<sup>54</sup>

## 5.6 **Purposes and Powers**

LLCs may be formed for any lawful purpose, including the provision of professional services,<sup>55</sup> and are granted broad and all inclusive powers.<sup>56</sup> Irrespective of the broad range of powers granted to LLCs, those organized to render professional services are not exempted from oversight by the regulatory authorities charged to oversee the profession.<sup>57</sup>

## 5.7 Name

The name of an LLC must be distinguishable, on the records of the Secretary of State, from the name of any other business entity formed or registered to do business in Kentucky,<sup>58</sup> and must clearly place third parties on notice that they are dealing with an LLC.<sup>59</sup> The name of any LLC must contain the words "limited liability company" or "limited company" or the abbreviations "LLC" or "LC."<sup>60</sup> An LLC formed to render professional services must also include "professional" in its name, or use the abbreviations "PLLC" or "PLC."<sup>61</sup>

LLC names may be reserved.<sup>62</sup> Foreign LLCs may register their names provided such conform to the requirements of the LLC Act and are distinguishable upon the records of the Secretary of State.<sup>63</sup>

Failure to use an approved name, under the law of an undisclosed principal, could subject those doing business through the unidentified LLC to liability for its debts and obligations. In Perry v. Ernest R. Hamilton Associates, Inc.,<sup>64</sup> an individual retained an engineering firm to layout a proposed subdivision but did not disclose that proposed subdivision was owned by a corporation. When that engineering firm sued to collect on the fees, the individual cited the existence of the corporation, and claimed personal immunity from the corporation's debts. The court held the individual personally liable for the fees as he had failed to disclose the existence of the corporation or to put the engineering firm on notice that it was dealing with a corporation.<sup>65</sup>

The LLC Act, as adopted in 1994, did not address the use of assumed names by LLCs,<sup>66</sup> and the filing of certificates of assumed names by LLCs was not addressed in KRS § 365.015. The difficulty was that KRS § 365.015(1) does not define what shall be the "real name" of an LLC. Therefore, lacking any statutory authority for determining the accuracy of certain of the statements which would be set forth in an application for use of an assumed name, the Secretary of State's office would not accept such from LLCs. Bills submitted to the 1996 General Assembly to, among other things, address filing of assumed name certificates by LLCs, were not approved.<sup>67</sup> The necessity for an effective assumed name filing was made clear in Munday v. Mayfair Diagnostic Laboratory,<sup>68</sup> the Kentucky Supreme Court held that, where a partnership failed to file the appropriate certificate of assumed name, the statute of limitations on causes of action against the partnership for acts it committed under the unfiled assumed name did not begin to run until the assumed name certificate was properly filed.

Fortunately, the 1998 General Assembly considered and passed amendments to the LLC Act permitting assumed name filings by LLCs.<sup>69</sup> These amendments define the "real name" of an LLC as the name set forth on the Articles of Organization.<sup>70</sup> The Certificate of Assumed Name for an LLC is filed with the Secretary of State and with the county in which the LLC is deemed resident for purposes of KRS ch. 355.<sup>71</sup>

## 5.8 Pre-Organization Liabilities

The LLC Act imposes liability upon those purporting to act on behalf of an LLC, knowing that in fact no LLC exists, stating:

All persons purporting to act as or on behalf of a limited liability company, knowing there has been no organization under this chapter, shall be jointly and severally liable for all liabilities created while so acting.<sup>72</sup>

This provision parallels the Corporate Act.<sup>73</sup> The degree to which liability should be imposed upon organizers who, with full disclosure of the current non-existence of the LLC, act on its behalf, is open to dispute. However, based upon authorities from other jurisdictions, the imposition of such personal liability is problematic.<sup>74</sup>

## **5.9      Registered Office, Registered Agent and Service on an LLC**

An LLC must at all times maintain a registered office and a registered agent in Kentucky.<sup>75</sup> Service of process is made on an LLC through its registered agent,<sup>76</sup> or, where service cannot be accomplished through the registered agent, by registered or certified mail to the principal office of the LLC.<sup>77</sup> Failure to maintain a registered agent and registered office will subject an LLC to administrative dissolution.<sup>78</sup>

## **5.10      Foreign LLCs**

A foreign LLC is defined as an unincorporated association, organized under the laws of a jurisdiction other than Kentucky, which provides for limited liability for each of its members from the liabilities of the entity.<sup>79</sup> This broad definition is intended to encompass not only entities formed as LLCs pursuant to the laws of the various states, but also to permit the registration of non-U.S. entities such as the German Gesellschaft mit beschränkter Haftung ("GmbH").<sup>80</sup>

## **5.11      Law Governing Foreign LLCs**

Subject to the Kentucky Constitution, the internal operation and liability of the members of a foreign LLC shall be governed by the laws of its jurisdiction of organization.<sup>81</sup> However, irrespective of the law of the jurisdiction of formation, no foreign LLC may have greater rights or powers than would an LLC organized under Kentucky law.<sup>82</sup> The LLC Act provides that foreign LLCs will not be denied registration in Kentucky because of differences between the laws of its organizational jurisdiction and those of Kentucky.<sup>83</sup>

## **5.12      Authority to Transact Business Required**

A foreign LLC seeking to transact business in Kentucky is required to first obtain a certificate of authorization from the Secretary of State.<sup>84</sup> The LLC Act sets forth a non-exhaustive list of activities which will not be deemed to constitute doing business:

- maintaining, defending or settling an action, suit or proceeding;
- holding meetings of the members or managers or other activities concerning the internal operations of the LLC;
- maintaining bank accounts;
- maintaining facilities for the transfer, exchange or registration of the LLC's securities or maintaining trustees or depositories for those securities;
- selling through independent contractors;
- soliciting or obtaining orders by mail, employees, agents or otherwise, if the orders must be accepted outside of Kentucky before a contract comes into existence;
- creating or acquiring indebtedness, mortgages or security interests in property, real or personal;
- securing or collecting debts or enforcing mortgages and security interests in property securing the debts;

- owning, without more, real or personal property;
- conducting an isolated transaction that is completed within 30 days that is not part of a repeating pattern of similar transactions; or
- transacting business in interstate commerce.<sup>85</sup>

As this provision mirrors that set forth in the Corporation Act,<sup>86</sup> the case law developed on what constitutes "doing business" should apply to LLCs.

### 5.13 Transacting Business Without Authority

While the failure to qualify to do business in Kentucky will not impair any contract or act of the foreign LLC or prevent it from defending a proceeding in Kentucky, a foreign LLC that is not qualified to do business may not bring or maintain an action to enforce its rights in Kentucky.<sup>87</sup> In addition, a foreign LLC that transacts business in Kentucky without a certificate of authority is subject to a fine of \$2.00 per day, not to exceed \$500.00 per annum.<sup>88</sup>

The LLC Act, unlike the Prototype<sup>89</sup> and the LP Act,<sup>90</sup> does not expressly provide that the members, managers, employees and agents of a foreign LLC that fails to qualify will retain their limited liability with respect to claims arising against the LLC. However, the failure to qualify to do business should not subject the members and managers to personal liability. In *Virginia Partners, Ltd. v. Day*,<sup>91</sup> the Court held that where a foreign limited partnership failed to qualify to do business, the limited partners would not be held jointly and severally liable on a tort claim. As observed in the commentary to § 1007 of the Prototype:

Because registration is required to provide information to third parties dealing with foreign LLCs, particularly including notice as to the state of formation, some penalties are necessary to insure that the firm will register. However, denial of any recognition of the existence of the firm and the limited liability of the members has been deemed too severe a penalty for LLCs, just as it has for corporations and limited partnerships.

The LLC Act does not contain a provision similar to KRS § 362.507(3) appointing the Secretary of State agent for service of process against an LLC transacting business without authority.

### 5.14 Application for and Effect of a Certificate of Authority to Transact Business

An application to transact business is filed with the Secretary of State, and must set forth:

- the name of the LLC;
- its jurisdiction of organization;
- its date of organization and the last date on which it is to dissolve, if any;
- the street address of the office it is required to maintain in its jurisdiction of organization, if any;
- the street address of its principal office;
- the name and address of its registered agent in Kentucky;
- the names and usual business addresses of its current managers, if any; and

- a statement that, as of the date of filing, the foreign LLC validly exists under the laws of its jurisdiction of formation.<sup>92</sup>

Paralleling the requirement for the Articles of Organization of a Kentucky LLC, the application must be accompanied by the consent of the registered agent to serve in that capacity.<sup>93</sup>

The statement of valid organization<sup>94</sup> may be filed by a member or manager of the LLC, and need not be an official document from the jurisdiction of organization. This flexibility with respect to the statement of valid organization is an accommodation to non-United States organized LLCs which may be unable to obtain an official "certificate of good standing" because such does not exist under the laws of their jurisdiction of organization.

Note that the application for a certificate of authority must set forth the names and business addresses of the managers of a foreign LLC, a requirement not imposed on a domestic LLC when filing Articles of Organization.

A copy of the application for certificate of authority must also be filed with the county clerk for the county in which the foreign LLC is maintaining its registered office.<sup>95</sup>

A foreign LLC is required to obtain an amended certificate of authority if it changes its name, the last date on which it is to dissolve, or its jurisdiction of organization.<sup>96</sup> A request for an amended certificate of authority must set forth the same information required for an original certificate.<sup>97</sup>

A certificate of authority authorizes a foreign LLC to transact business in Kentucky, granting to that LLC the same, but no greater, rights and privileges afforded LLCs organized in Kentucky.<sup>98</sup> However, the granting of a certificate of authority does not authorize Kentucky to regulate the organization or internal affairs of a foreign LLC.<sup>99</sup>

#### **5.15      Names of Foreign LLCs**

The name of a foreign LLC must meet the content requirements for domestically formed LLCs,<sup>100</sup> and must be distinguishable upon the records of the Secretary of State from the names of other organized or registered entities.<sup>101</sup> If the real name of a foreign LLC is unavailable in Kentucky, it may apply for the use of a fictitious name, which must itself be distinguishable upon the records of the Secretary of State.<sup>102</sup> In addition to the filing of the application for a certificate to use an assumed name, the foreign LLC must also file a written certificate with the Secretary of State attesting that, in accordance with its organizational law, articles of organization and operating agreement, the use of the fictitious name has been authorized.

#### **5.16      Registered Office, Registered Agent and Service on a Foreign LLC**

Each foreign LLC must continuously maintain a registered office and a registered agent in Kentucky.<sup>103</sup> The statute provides for a change in the registered office or registered agent of a foreign LLC<sup>104</sup> and for the resignation of a registered agent.<sup>105</sup> Failure to maintain a registered office and a registered agent is grounds for revocation of the certificate of authority.<sup>106</sup>

The registered agent of a foreign LLC acts as its agent for service of process.<sup>107</sup> Foreign LLCs which have had their certificate of authority revoked, which have withdrawn from Kentucky or who otherwise have no registered agent or if, in reasonable diligence, the registered agent cannot be served, may be served by registered or certified mail at its principal office.<sup>108</sup>

### 5.17 Withdrawal from Qualification to do Business

Foreign LLCs seeking to withdraw from Kentucky must apply for and obtain a certificate of withdrawal from the Secretary of State.<sup>109</sup> The application for the certificate of withdrawal must set forth:

- the name of the LLC;
- its jurisdiction of organization;
- a statement that it is not transacting business in Kentucky and surrenders its authority to transact such business;
- a statement that the authority of its registered agent is revoked and an appointment of the Secretary of State as agent for service of process for proceedings based on a cause of action which arose while qualified to transact business in Kentucky;
- a mailing address to which any process served may be forwarded; and
- a commitment to notify the Secretary of State of any future changes in the mailing address.<sup>110</sup>

### 5.18 Annual Reports

Each LLC must file an annual report with the Secretary of State.<sup>111</sup> This same requirement is applicable to all foreign LLCs qualified to do business in Kentucky. The annual report must set forth:

- the name of the LLC and its jurisdiction of organization;
- the address and name of its registered office and agent in Kentucky;
- the address of its principal office; and
- the names and business addresses of its managers, if management is vested in managers, or of one member, if management is reserved to the members.<sup>112</sup>

Failure to file the annual report, in the case of Kentucky LLCs, will subject the LLC to administrative dissolution or, in the case of foreign LLCs, to revocation of the certificate of authority.<sup>113</sup>





## Endnotes to Chapter 5

<sup>1</sup> All states, as well as the District of Columbia, subsequently have enacted legislation authorizing the formation of LLCs, and all of the various LLC statutes now provide for recognition of and qualification to do business by foreign LLCs. For a more extensive review of the LLC Act as adopted by the 1994 General Assembly, see Rutledge and Booth, *The Limited Liability Company Act: Understanding Kentucky's New Organizational Option*, 83 KENTUCKY LAW JOURNAL 1 (1994-95). This outline also reviews the 1998 amendments to the LLC Act. Primary treatises on LLCs include: RIBSTEIN & KEATINGE, RIBSTEIN AND KEATINGE ON LIMITED LIABILITY COMPANIES (Shepherds McGraw Hill) and BISHOP & KLEINBERGER, LIMITED LIABILITY COMPANIES - TAX AND BUSINESS LAW (Warren Gorham & Lamont).

<sup>2</sup> The tax classification test and its application to LLCs is discussed in chapter 4.

<sup>3</sup> Hereinafter the "Prototype".

<sup>4</sup> KRS Chapter 271B.

<sup>5</sup> Hereinafter the "ULLCA".

<sup>6</sup> S.B. 184, in addition to the LLC Act, contained revisions to the Kentucky Uniform Partnership Act (KRS ch. 362) to authorize the formation of Registered Limited Liability Partnerships ("LLPs"), as well as conforming amendments to the Kentucky Business Corporation Act (the "Corporation Act") and the Kentucky adoption of the Revised Uniform Limited Partnership Act (the "LP Act").

<sup>7</sup> H.B. 850 (introduced March 1, 1996); H.B. 862 (introduced March 1, 1996).

<sup>8</sup> The text of H.B. 666 can be downloaded from: [HTTP://WWW.LRC.STATE.KY.US/RECORD/98RS/HB666.HTM](http://WWW.LRC.STATE.KY.US/RECORD/98RS/HB666.HTM).

<sup>9</sup> H.B. 796 (introduced February 23, 2000).

<sup>10</sup> Based upon information supplied by the Office of the Secretary of State, the following statistics outline the organization of domestic and qualification of foreign LLC's, as well as corporations, partnerships and limited partnerships, in Kentucky from 1994 through 1998:

<b><u>Business Entity</u></b>	<b><u>1994</u></b>	<b><u>1995</u></b>	<b><u>1996</u></b>	<b><u>1997</u></b>	<b><u>1998</u></b>	<b><u>1999</u></b>	<b><u>2000</u></b>
Domestic Corporation Incorporated	8,406	8,193	9,371	9,162	8,743	8,156	7,823
Domestic Corporation Dissolved	667	707	734	788	905	878	878
Domestic Corp. Administratively Dissolved	5,554	7,283	7,233	7,901	7,899	7,747	7,633
Foreign Corporation Qualified	2,024	2,325	2,516	2,661	2,455	2,726	3,036
Foreign Corporation Withdrawal	551	556	560	687	723	808	786
Foreign Corporation Revoked	904	1,606	1,752	1,178	1,197	1,378	1,362
Domestic LLC Organized	415	1,355	1,917	2,265	3,462	5,314	6,226
Domestic LLC Dissolved	0	17	42	55	99	150	202
Domestic LLC Administratively Dissolved	0	37	197	432	672	990	1,485
Foreign LLC Qualified	28	150	273	382	493	715	823
Foreign LLC Withdrawal	0	1	4	23	48	68	81
Foreign LLC Revoked	0	0	0	46	84	129	197
Domestic Limited Partnership Formation	122	212	318	272	333	384	381
Domestic Limited Partnership Cancellation	NA	16	33	29	32	30	63
Foreign Limited Partnership Registration	100	41	52	109	166	101	111
Foreign Limited Partnership Cancellation	NA	10	21	37	49	35	41
Domestic LLP Registration	33	102	90	87	77	69	84
Domestic LLP Withdrawal	0	2	0	2	3	10	6
Foreign LLP Registration	9	2	8	10	13	14	14
Foreign LLP Withdrawal	0	0	0	0	0	0	21

<sup>11</sup> Chapter 6.

<sup>12</sup> Chapter 7.

<sup>13</sup> KRS § 275.020. *Accord*, Prototype § 201. The articles need not be executed by a member of the LLC, and as such an organizer, equivalent to an incorporator, may execute the articles. *See* KRS § 271B.2-010.

<sup>14</sup> KRS §§ 275.020, 275.060. *Accord*, KRS § 271B.2-030(1). The Louisiana case of *Advanced Orthopedics, L.L.C. v. Moon*, 656 So. 2d 1103 (La. App. 1995), dealt, in part, with whether Advanced Orthopedics, LLC validly existed as an entity. The Company had been organized by Keith and Moon, who subsequently had a falling out, from which litigation ensued. Moon argued that he had no subjective intent to form an LLC, that he did not understand the concept of an LLC and that he did not sign an operating agreement, and on that basis sought to reject the formation of the business. These arguments were rejected by the court, noting that Moon did not question the viability of the LLC during the year it was operated. The court stated that “[a]ttaining a certain level of understanding regarding LLC is not a prerequisite to the formation of and participation in one.” The court went on to note that it was not aware of a requirement that an LLC have a written operating agreement in order to be viable.

<sup>15</sup> KRS § 275.045(11). The failure to file the articles of organization with the county clerk does not impact on the effect of the filing with the Secretary of State and the proper formation of the LLC. KRS § 275.060(3).

<sup>16</sup> KRS § 275.020. While it is required that there be only a single organizer, analogous to a corporate incorporator, this is a separate distinction from the minimum number of members, a point addressed below.

<sup>17</sup> The requirements relating to LLC names are addressed below in section 5.7.

<sup>18</sup> Issues relating to the management structures of LLCs and the distinctions between member managed and manager managed are reviewed in chapter 6.

<sup>19</sup> KRS § 275.020(2). Unlike the professional service corporation statute, which contains an open-ended definition of what services will constitute “professional services” (KRS § 274.005(3)), the LLC Act contains a limited definition of what services constitute “professional services.” *See* KRS § 275.015(18). However, despite the fact that the statute defines certain professions which are authorized to use the LLC form of organization, the various professional regulatory boards retained the authority to, at their option, prohibit the use of the LLC form. KRS § 275.010. With the exception of the Kentucky Supreme Court and its constitutional authority to regulate the bar, all of the professional regulatory boards for the professions set forth in KRS § 275.015(19) have either been silent on the matter or have affirmatively approved the use of the LLC format. For a discussion regarding the current controversy over the use of LLCs by attorneys, *see* Rutledge and Ballantine, *Kentucky Supreme Court Rejects Use of LLCs and LLPs by Attorneys*, BAR BRIEFS (December, 1995); Rutledge and Ballantine, *Kentucky Supreme Court Rejects Use of LLCs, LLPs and PSCs by Attorneys*, BENCH AND BAR (Winter, 1996). *See also*, Woodford, Elizabeth C., *The Ethical Implications of the Limited Liability Status in the Practice of Law*, 87 KY. L. J. 489 (1998-99).

<sup>20</sup> The Check-the-Box classification regulations are addressed elsewhere in this monograph.

<sup>21</sup> H.B. 666, § 21, amending KRS § 275.015(8).

<sup>22</sup> H.B. 666, § 23, deleting KRS § 275.025(1)(f). A fixed date of dissolution did not, under the classification regulations in effect prior to January 1, 1997, guarantee or impact upon whether the LLC will avoid the tax characteristic of continuity of life. *See* Rutledge, *It Just Doesn't Matter, Or Why You Don't Need a Definite Date of Dissolution*, 94 LLC RPT. 407 (July / August, 1994).

<sup>23</sup> H.B. 666, § 23, adding new KRS § 275.025(2).

<sup>24</sup> KRS § 275.025(3).

<sup>25</sup> KRS § 275.025(4). A bill (H.B. 918, introduced March 2, 1994) to add a similar requirement to filings of articles of incorporation and certificates of limited partnership failed to pass the 1994 General Assembly. Similar proposed legislation (H.B. 850, introduced March 1, 1996) failed to pass the 1996 General Assembly. H.B. 666 amended both the Corporation Act and the LP Act to require that Articles of Incorporation and Certificates of Limited Partnership include or be accompanied by a consent of the

registered agent to serve in that capacity. H.B. 666, § 5, amending KRS § 271B.2-020 by adding new subsection (4); H.B. 666, § 6, amending KRS § 271B.5-010; H.B. 666 § 49, amending KRS § 362.407; H.B. 666, § 51, amending KRS § 362.415.

26 KRS § 275.030.26 KRS §§ 275.030(2), 275.175(1), 275.175(2)(c).

27 KRS §§ 275.030(2), 275.175(1), 275.175(2)(c).

28 KRS § 275.030(3)(a)-(b).

29 KRS § 275.035.

30 KRS § 275.030(3)(b).

31 KRS § 275.040.

32 KRS § 275.065. *Accord*, KRS § 271B.1-240.

33 KRS §§ 275.045, 275.055; KRS §§ 271B.1-200, 271B.1-220.

34 The Prototype does not contain a conversion mechanism. These provisions of the LLC Act are based on sections 902 and 903 of the ULLCA.

35 KRS § 275.370(a)(2).

36 KRS § 275.370(3)(a)-(c).

37 KRS § 275.370(2).

38 KRS § 275.370(3)(d).

39 KRS § 275.375(1).

40 KRS § 275.375(2)(a)-(c). Therefore, unlike a merger, in which there are two distinct entities and one, by reason of the merger, takes on the rights and obligations of the other entity, that entity ceasing to exist, in a conversion there is no overlap between the existence of the former partnership/limited partnership and the LLC.

41 KRS § 275.370(5).

42 KRS § 275.015(13).

43 Form operating agreements have been published in a number of places. Examples include, RIBSTEIN AND KEATINGE ON LIMITED LIABILITY COMPANIES, appendix A; SARGENT, MARK A., LIMITED LIABILITY COMPANY HANDBOOK, ch. 6 (1996-97); BISHOP AND KLEINBERGER, LIMITED LIABILITY COMPANIES - TAX AND BUSINESS LAW; and Karsh, Randolph M. et al., *A Model Limited Liability Company Operating Agreement*, FORMING AND USING LIMITED LIABILITY COMPANIES AND LIMITED LIABILITY PARTNERSHIPS 1994 (Prac. L. Inst.) 698. *See also*, Wolf-Smith, Risa Lynn and Robert R. Keatinge, *Start with Limited Partnership Agreement*, 1 J. OF LIMITED LIABILITY COMPANIES 37 (1994). Unlike the Corporation Act, the LLC Act does not address such procedural matters as notice for the calling of meetings, waiver of notice, agenda requirements, voting by proxy, telephonic attendance, record dates, voting requirements for sales of assets, addressing potential conflicts of interests, dissenter's rights, derivative actions and similar matters. Therefore, these issues should be addressed in drafting the operating agreement. However, it may be unwise to adopt without criticism the rules set forth, for example, in the Corporation Act (and widely available in form by-laws) as they may impose a level of formality not necessary in a closely held business, especially one in which all members are actively involved in the day-to-day business.

44 KRS § 275.175.

45 H.B. 666, § 21, amending KRS § 275.015(13), which after other amendments to KRS § 275.015, will be codified at KRS § 275.015(14).

46 KRS § 275.175(2)(a), as amended by H.B. 666, § 29. Prior to the 1998 Amendments, this action required a unanimous vote of all members.

<sup>47</sup> KRS § 275.175(2)(b), as amended by H.B. 666, § 29. Prior to the 1998 Amendments, this action required a unanimous vote of all members.

<sup>48</sup> KRS § 275.175(2)(c), as amended by H.B. 666, § 29. Prior to the 1998 Amendments, this action required a unanimous vote of all members.

<sup>49</sup> KRS § 275.205.

<sup>50</sup> KRS § 275.265(1).

<sup>51</sup> KRS §§ 275.175(2)(a)-(c); 275.410; 275.265(1); 275.285(3)(a).

<sup>52</sup> KRS § 275.065(13).

<sup>53</sup> KRS § 275.185(1)(d).

<sup>54</sup> This rule differs from that applied to corporations, in which the incorporators or board are required to adopt initial bylaws. *See* KRS § 271B.2-060. Limited partnerships may have an oral partnership agreement. *See* KRS § 362.401(9).

<sup>55</sup> KRS § 275.005.

<sup>56</sup> KRS § 275.010. The LLC Act does not contain a non-exhaustive list of general powers equivalent to that set forth for corporations at KRS § 271B.3-020.

<sup>57</sup> KRS § 275.010. The LLC Act expressly recognizes the right of the various professional regulatory boards to continue to oversee the licensing of those rendering professional services, the transfer of interests in a professional LLC or the rendering of more than one professional service through the LLC. KRS §§ 275.010(1), (2), (3). Conversely, it is expressly provided that a regulatory board may not restrict or limit the provision of the LLC Act providing limited liability for members, managers, employees and agents of the LLC.

<sup>58</sup> KRS § 275.100(2).

<sup>59</sup> The name will also alert a third-party that they are dealing with an entity without a pre-determined management/agency structure, and that investigation as to who has the ability to bind the entity is warranted.

<sup>60</sup> KRS § 275.100(1). "Limited" may be abbreviated as "Ltd.", and "Company" may be abbreviated to "Co." The mere use of "Limited" or "Ltd." is not sufficient as a designation as it may confuse third parties into assuming they are dealing with a corporation (KRS § 271B.4-010(1)(a)) or a limited partnership (KRS § 362.403(1)).

<sup>61</sup> KRS § 275.100(1).

<sup>62</sup> KRS § 275.105.

<sup>63</sup> KRS § 275.110.

<sup>64</sup> 485 S.W.2d 505 (Ky. 1972).

<sup>65</sup> This rule has already found application to LLCs in the Colorado case of *Water, Waste & Land, Inc. v. Lanham*, Slip. Op., 97-SC-199 (March 9, 1998) (available on Westlaw, 1998 WL 112869). On facts quite similar to those present in *Perry*, the Colorado Supreme Court held Lanham, a member and a manager, personally liable for work done on behalf of an undisclosed LLC. This ruling is in accordance with the rule that when an agent acts on behalf of an undisclosed or partially-disclosed principal, the agent is personally liable on the obligation should the principal fail to perform. *See also* Rutledge, *Make Sure They Know You Are an LLC: Member Personally Liable When Acting on Behalf of an Undisclosed LLC*, LLC ADVISOR (July, 1998). *See also*, *Hopkins Advertising and Public Relations, Inc. v. Morris*, 1997 WL 306653 (Conn. Super. May 29, 1997) (where individual signed agreement without noting that he did so as agent for an LLC, and did not disclose the existence of the LLC principal, the agent took on personal liability on that obligation.)

<sup>66</sup> KRS § 275.100(5).

<sup>67</sup> H.B. 862 (introduced March 1, 1996); H.B. 850 (introduced March 1, 1996).

<sup>68</sup> 831 S.W.2d 912 (Ky. 1992).

<sup>69</sup> H.B. 666, § 56, amending KRS § 365.015.

<sup>70</sup> In the case of a foreign LLC, the “real name” is the name set forth on the articles of organization, or, if such was not available in Kentucky, the fictitious name adopted in accordance with KRS § 275.410.

<sup>71</sup> H.B. 666, § 56, amending KRS § 365.015(3).

<sup>72</sup> KRS § 275.095.

<sup>73</sup> KRS § 271B.2-040.

<sup>74</sup> See, e.g., *Quaker Hills, Inc. v. Parr*, 364 P.2d 1056 (Colo. 1961). In that case, Parr and his associates entered into a contract on behalf of a corporation which was not yet formed. The other party was aware that the individuals were acting on behalf of an entity to be formed, and that fact was noted in the contract. When problems arose, the plaintiff tried to subject the individuals to personal liability in part “based upon the fact that the corporation was not formed at the time the contract was made.” The court stated that the plaintiff had “made a sale to a corporation to be formed, and later accepted still another corporation after formation of the latter. The contract imposed no obligation on defendants to form the corporation nor did it name them as obligors on the note or as promisees in the contract. The question is whether under these circumstances personal liability can be imposed. The Colorado Supreme Court held that there should not be personal liability under those circumstances: “[I]f the contract is made on behalf of the corporation and the other party agrees to look to the corporation and not to the promoters for payment, the promoters incur no personal liability.” The court found it significant that the plaintiff was “well aware of the fact that the corporation was not formed,” but nevertheless proceeded with the contract without seeking to impose individual obligations on the promoters such as by requiring them to be guarantors. See also, *Canson v. International Business Machines Corp.*, 200 A.2d 33 (Ct. App. Md., 1964) (no personal liability where individual was shown executed articles of incorporation and advised by corporate attorney that articles had been filed).

<sup>75</sup> KRS § 275.115(1).

<sup>76</sup> KRS § 275.130(1). Accord, KRS § 271B.5-040(1).

<sup>77</sup> KRS § 275.130(2). Accord, KRS § 271B.5-040(2). Service on an LLC may be made pursuant to Kentucky Rule of Civil Procedure 4.04(4) relating to service on an “unincorporated association subject to suit under a common name.” Service is accomplished against the registered agent of the LLC, being “an agent authorized by appointment or by law to receive service on [the LLC’s] behalf” (KRCP 4.04(4)) or upon an officer or managing agent of the LLC.

<sup>78</sup> KRS § 275.295(1)(b). Administrative dissolution will also result if the LLC fails to notify the Secretary of State of a change in the registered agent or registered office, the resignation of a registered agent or the discontinuance of the registered office. KRS § 275.295(1)(c). Administrative dissolution is further discussed in section 6.27.

<sup>79</sup> KRS § 275.015(6)(a)-(c).

<sup>80</sup> However, this definition should not be interpreted to encompass situations which are more specifically addressed elsewhere in Kentucky Revised Statutes. For example, while a business trust would fall within this definition, the provisions of KRS §§ 386.370 through 386.440, specifically addressing business trusts, would continue to control their qualification and operation.

Note that the definition of a foreign LLC does not reference the tax classification of the foreign entity.

<sup>81</sup> KRS § 275.380(1)(a). See also, KRS § 275.405(3). Even without a statutory declaration that the law of the jurisdiction of organization would govern the limited liability of the members of a foreign LLC, principles set forth in the *Restatement of Conflicts* (2d) would dictate the same result. See Rutledge, *To Boldly Go Where You Have Not Been Told You May Go: The Restatement’s View of LLCs and LLPs in*

*Interstate Transactions*, LLC ADVISOR, (April, 1995) reprinted in STATE TAX REVIEW (May 1, 1995); Johnson, *Risky Business: Choice of Law and the Unincorporated Entity*, 1 J.S.E.B.L. 249 (1997); See Section 6.8 for further discussion of this point.

82 KRS § 275.380(2).

83 KRS § 275.380(1)(b).

84 KRS § 275.385(1).

85 KRS §§ 275.385(2)(a)-(k). *Accord*, KRS § 271B.15-010(2).

86 KRS § 271B.15-010(2).

87 KRS §§ 275.390(1),(5). *Accord*, KRS § 271B.15-020(1), (5).

88 KRS § 275.390(4). *Accord*, KRS § 271B.15-020(4).

89 § 1007(G).

90 KRS § 362.507(2).

91 738 S.W.2d 837 (Ky. App. 1987). This case pre-dates the adoption of KRS § 362.507(2).

92 KRS § 275.395(1)(a)-(g).

93 KRS § 275.395(2).

94 KRS § 275.395(1)(g).

95 KRS § 275.045(11).

96 KRS § 275.400(1).

97 KRS § 275.400(2).

98 KRS § 275.405(1),(2).

99 KRS § 275.405(3). *Accord*, KRS § 271B.15-050(3), § 275.380(2).

100 KRS § 275.410(1)(a).

101 KRS § 275.410(1).

102 KRS § 275.410(1)(b).

103 KRS § 275.415.

104 KRS § 275.420.

105 KRS § 275.425.

106 KRS § 275.440.

107 KRS § 275.415(1).

108 KRS § 275.415(2). Of course, this provision begs the question of making service of process on a foreign LLC that was doing business in Kentucky without qualification, there then being no filing identifying the principal office.

109 KRS § 275.435(1).

110 KRS § 275.435(2)(a)-(e). *Accord*, KRS § 271B.15-200.

111 KRS § 275.190(1).

112 KRS § 275.190(1)(a)-(d).

113 KRS §§ 275.295(1)(a), 275.440(1). *Accord*, KRS §§ 271B.14-200(1) and 271B.15-300(1).

## 6.1 THE OPERATIVE PROVISIONS OF THE LLC ACT

by

Thomas E. Rutledge

The previous chapter discussed the requirements of forming a domestic LLC and qualifying a foreign LLC in Kentucky. This chapter will examine the main body of the LLC Act, namely those sections which govern the day-to-day operation of the entity, as well as the rights, duties and responsibilities of the members and, if any, the managers.

Being a hybrid entity sharing characteristics of both corporations and partnerships, when considering the operation of an LLC, it is necessary that the practitioner appreciate where, at any particular time, the LLC falls on the continuum between the corporate model and the partnership model. As is apparent from the preceding chapter, with respect to formation and qualification, the LLC Act is based on the corporate model. That is, existence and recognition is dependent upon notice filings made with the Secretary of State. In contrast, a general partnership need not make a filing with the State in order to come into existence. Also, while a corporation is required to maintain a registered office and registered agent for service of process, no such requirement is applied to partnerships.

After its formation, consideration of the rights, duties and obligation of the members of the LLC necessitates that one shift to the partnership model, under which, excepting certain policy mandated limits, there exists maximum freedom of contract to structure the relationship between the LLC's owners. In a manner reminiscent of the Uniform Partnership Act, the LLC Act provides certain default rules which, in the absence of a contrary agreement of the members, will govern certain aspects of the LLCs operation.

These default provisions of the LLC Act, as originally drafted, in addition to providing rules of procedure when the members have not made a contrary agreement, were crafted to insure that the characteristics of continuity of life, free transferability of interests and centralized management would be avoided, thus insuring partnership classification under the Internal Revenue Service test in place at the time the LLC Act was passed. As such, these default provisions served a dual purpose of guiding the operation of the LLC, in an organizational sense, while providing a level of security with respect to tax classification. However, with revisions in the tax classification system effective as of January 1, 1997, those default provisions no longer have an impact on tax classification.<sup>1</sup>

This chapter will first examine those provisions dealing with the rights and duties of members and managers, as well as the limited liability provision. It will then turn to the economic issues of capital structure, allocations, distributions and LLC property. Next reviewed are the provisions dealing with the admission of new members to the LLC, and the rights of transferees of an interest. The last two sections, respectively, will review the dissolution of an LLC and those provisions touching upon suits by and against an LLC.

### 6.2 Members, Managers & Agency

Owners of an LLC are denominated "members."<sup>2</sup> Membership in an LLC is open to individuals, corporations, general and limited partnerships, other LLCs, trusts, estates, associations, and any other entities.<sup>3</sup> As such, membership in an LLC is open to a substantially larger group of potential owners than may qualify as shareholders in an S corporation.<sup>4</sup>

In order to qualify for classification as a partnership for federal income tax purposes, an LLC is required to have at least two members. Certain states, including Delaware, have always permitted the organization of LLCs with a single member. However, prior to January 1, 1997, such entities were seldom used due to uncertainty regarding their tax classification under the rules then in effect.<sup>5</sup> The LLC Act, as adopted in 1994, explicitly required that an LLC have at least two members,<sup>6</sup> thereby insuring that unsuspecting practitioners did not accidentally enter this tax classification quagmire. On January 1,

1997, new tax rules went into effect which expressly addressed the classification of single member LLCs, and generally provide that they will either be ignored for all tax purposes or will be taxed as corporations.<sup>7</sup> The 1998 Amendments to the LLC Act eliminated the requirement that the Articles of Organization state that the LLC have at least two members,<sup>8</sup> thereby permitting the organization of single-member LLCs.

The statutory rights of members include:

- the right to vote on certain amendments to the Articles of Organization;<sup>9</sup>
- the right to vote on the adoption of and amendments to the Operating Agreement;<sup>10</sup>
- the right to directly manage the LLC or, in the alternative, vote for managers of the LLC;<sup>11</sup>
- the right to approve or disapprove transfers of a member's interest to a non-member;<sup>12</sup>
- the right to vote upon the continuation of the LLC after the death, retirement, resignation, expulsion, bankruptcy or dissolution of a member;<sup>13</sup>
- the right to receive allocations of profits and losses;<sup>14</sup>
- the right to receive distributions, as made, from the LLC.<sup>15</sup>

The LLC Act provides maximum flexibility to the members to structure the management of the LLC. The LLC Act provides a default rule that the right to manage the LLC is retained by the members, and therefore that each member is an agent of the LLC for the purpose of carrying on its business and affairs.<sup>16</sup> By leaving the management of the LLC in the members, the governance and agency of the LLC will resemble that of a general partnership. The adoption of a default rule of direct management by the members, is a corollary to the general rule that interests in an LLC are not freely transferable by the unilateral action of the member. Therefore, unlike shareholders in public corporations who have an organized market in which they may dispose of their interest should they become dissatisfied with their investment or the manner in which the business is being operated, members will be obligated to resort to direct involvement in the management of the LLC.<sup>17</sup>

Alternately, the authority to manage the LLC may be vested in managers. Where management authority is vested in managers, each member, by virtue of that status alone, ceases to be an agent of or able to bind the LLC.<sup>18</sup> Rather, the agency power is exclusively vested in the managers, and only their acts, when carried on in the usual way of the business or affairs of the LLC, will bind the LLC.<sup>19</sup> Except where the Articles of Organization or the operating agreement have provided a different threshold, managers are elected and removed by a vote of a majority-in-interest of the members.<sup>20</sup> This provision was revised in the 1998 Amendments.<sup>21</sup> Under the prior law, the threshold was a majority of the members with all members voting on a per capita (one member, one vote) basis. "Majority-in-Interest of the members" is a term newly defined in the 1998 Amendments as:

those members entitled to cast a majority of the votes to be cast by the members on any matter under the terms of the operating agreement described in subsection (3) of Section 29 of this Act.<sup>22</sup>

Unlike corporate directors, who hold their office for one year from the date of their election, assuming such took place at the time of the annual shareholder meeting, and only as a default continue in office until their successors are elected and duly qualified,<sup>23</sup> managers of an LLC serve until their successors are duly elected and qualified, there being no presumption that the term of office shall be one year.<sup>24</sup> Managers need not themselves be members of the LLC.<sup>25</sup>



As the Articles of Organization require a declaration of whether the LLC will be managed by managers or by the members, and the terms and provisions of the Articles of Organization are of public record, all parties dealing with the LLC may ascertain the management structure and consequently the parties who may bind the LLC.<sup>26</sup>

Regardless of whether such is committed by a member or manager, an act that is not apparently for the carrying on in the usual business or the affairs of the LLC will not, without specific authorization, bind the LLC.<sup>27</sup> Of course, under general principles of contract law, it would be possible for an LLC to provide in its Articles of Organization that management authority and agency is reserved to the members, but then provide by contract amongst the members that management and agency authority will be exercised only by certain members. While such a limitation on the apparent authority of a member will be binding upon third parties with knowledge of that restriction, the LLC will be bound by the act of any member vis-a-vis a third party who lacks actual knowledge of the restriction.<sup>28</sup> However, an unauthorized action by a member would open that member to damages for breach of the contract with the other members. This flexibility with regard to the management will permit an LLC, while retaining the partnership model and allowing each member to serve as an agent of the LLC, to structure an "executive committee" to oversee day to day business operations and, on behalf of all members, make decisions within its delegated authority.

Some statutes clearly permit the members to divide power by vesting some power in managers while retaining some authority in members. Even without such an explicit provision, there is no reason why the members could not, in their operating agreement, allocate some management authority to members in a manager-managed firm. Moreover, the statutes apparently do not prevent the members from dividing power between managers and members differently *vis-à-vis* the members than with respect to third parties. For example, a provision in the operation agreement may limit the managers' or members' management rights within the firm but may not be binding on third parties. Accordingly the parties to an LLC conceivably, by certificate provision, could elect management by managers but delegate only ministerial tasks to the managers while the members retain significant powers among themselves. In this situation, the managers would be essentially business agents for the LLC.<sup>29</sup>

The 1998 Amendments added a new section to the LLC Act relating to the delegation of agency authority.<sup>30</sup> This new section provides:

Unless otherwise set forth in a written operating agreement, a member or manager of a limited liability company has the power and authority to delegate to one (1) or more other persons the member's or manager's powers to manage or control the business and affairs of the limited liability company, including without limitation the power to delegate to agents and employees of a member, manager, or limited liability company or to delegate by an agreement to other persons. This delegation by a member or manager of a limited liability company shall not cause the member or manager to cease to be a member or manager of the limited liability company.

A non-manager member in a manager directed LLC has no duties to the LLC or other members arising solely by reason of their status as a member.<sup>31</sup>

Under the Internal Revenue Service test in effect until January 1, 1997, the question of what management structure was adopted could impact upon the tax classification of the LLC. Under the default provision reserving management and agency authority to all members, the corporate characteristic of centralized management was avoided, a result desirable for partnership classification. By departing from this default, there was a risk that the LLC would be structured in such a manner that it would be classified as an association taxable as a corporation. Caution in this area was therefore war-

ranted.<sup>32</sup> However, under new Internal Revenue Service regulations in effect as of January 1, 1997, the management structure of an LLC will not impact upon its tax classification.<sup>33</sup>

### 6.3 Voting

The 1998 Amendments to the LLC Act enacted a substantial change to the default rule on member voting rights. Under the LLC Act as adopted in 1994, unless the operating agreement provided otherwise, as a general rule the vote of more than one-half of the members or managers, voting on a per capita basis, was necessary to pass on a matter relating to the business of the LLC.<sup>34</sup> The LLC Act, as adopted in 1994, also provided that, unless otherwise provided in a written operating agreement, the unanimous vote of all members was required to:

- amend a written operating agreement;
- authorize a member or manager to carry out an act on behalf of the LLC that contravenes a written operating agreement; or
- amend the articles of organization to change the management of the LLC from members to managers or from managers to members.<sup>35</sup>

Note that, as a default, voting rights were per capita, and as such might not be equivalent to the percentage of capital contributed by the member. The advantage of a per capita default was perceived to be that it provided a useable formula for those LLCs which lacked the sophistication to maintain the at times sophisticated records required to value and track contributions.

[T]he pro-rate rule raises problems concerning valuing and recording contributions and adjusting for returned contributions, particularly where members make substantial service contributions and give guarantees. This supports a per capita default rule subject to contrary customized agreement where there are suitable records of contributions.<sup>36</sup>

The 1998 Amendments to the LLC Act enacted new default rules on the voting rights of members. Rather than being per capita (one member = one vote), members will vote in proportion to their respective capital contributions. This new provision states:

Unless otherwise provided in the articles of organization, a written operating agreement, or this chapter, for all purposes of this chapter, the members of a limited liability company shall vote, approve, or consent in proportion to their contributions, based upon the agreed value as stated in the records of the limited liability company as required by KRS § 275.185, made by each member to the extent they have been received by the limited liability company and have not been returned.<sup>37</sup>

The 1998 Amendments go on to provide that, as a general rule, the vote of a majority-in-interest of the members shall pass on any matter presented to the members for consideration.<sup>38</sup> Managers will, unless otherwise provided in a written operating agreement, continue to vote on a per capita basis.<sup>39</sup> Further, the 1998 Amendments enacted an amendment to KRS § 275.175(2). As noted above, the rule set forth in the LLC Act as adopted in 1994 was that the actions described therein would, absent a contrary provision in a written operating agreement, require the unanimous consent of the members. Under the 1998 Amendments, each of these actions may be approved by a vote of a majority-in-interest of the members.<sup>40</sup>

Regardless of a per capita default voting rule, the member may, in an operating agreement, provide for a different allocation of voting rights. A common election will be to allocate voting rights in proportion to capital accounts or some similar measure of respective economic rights in the LLC. Note

that the LLC Act does not require that a departure from the default rule on allocation of voting rights be in a written operating agreement.<sup>41</sup>

In addition to the flexibility of defining how voting rights are generally allocated, there is the flexibility to allocate special voting rights to a group smaller than all members, to provide for non-voting interests, springing voting rights and other mechanisms for distributing control.

It is important to note that, unlike the Corporate Act, the LLC Act does not provide default rules regarding the calling of meetings of the members. As such, it is incumbent upon the drafter of the operating agreement to address such issues as notice, adjournment, agenda requirements, waiver of notice, proxies, actions by written consent, authority to call meetings and the obligation to maintain minutes.

#### **6.4 Duties, Limitation of Liability and Indemnification of Members and Managers**

Unless the operating agreement provides otherwise, a member or manager is not liable to the LLC for an action or failure to act unless that act or omission constituted wanton or reckless misconduct.<sup>42</sup> A member or manager must account to and hold as a trustee for the LLC any profit or benefit derived from the use of LLC property by that member or manager without the consent of at least one-half of the disinterested members or managers.<sup>43</sup>

The operating agreement may eliminate or limit the personal liability of a manager or member for breaches of duty and/or provide for indemnification of members and managers arising in connection with a proceeding in which they are a party because of that status.<sup>44</sup> A 1998 Amendment to this provision of the LLC Act requires that such a limitation or elimination of personal liability be in a written operating agreement.<sup>45</sup>

Unlike the Corporation Act, the LLC Act does not define the level of care imposed on those vested with management authority. For example, under Kentucky law, corporate directors are required to perform their duties in good faith, on an informed basis and in a manner they honestly believe to be in the best interests of the corporation.<sup>46</sup> KRS § 275.170(1), which parallels KRS § 271B.8-300(5)(b), merely defines the level of culpability required to hold a manager liable for monetary damages.<sup>47</sup> Neither does the LLC Act provide a mechanism for assessing the voidability of a manager's act alleged to be tainted by a conflict of interest, or what relationships will give rise to a conflict of interest.<sup>48</sup> Presumably, managers, including member-managers, of an LLC, will be held to a fiduciary standard akin to that imposed on the directors and officers of a corporation. However, the degree to which those standards can be modified by a written operating agreement is a subject of significant debate.<sup>49</sup>

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To date, there are no decisions on this aspect of the LLC Act. A very illustrative case was decided in Ohio, *McConnell v. Hunt Sports Enterprises*, 725 N.E.2d 1193 (Ohio App. 1999); following is a review of that decision:

This is apparently the first case to address the fiduciary duties of members of an LLC to any significant degree. In this case, the court stated that members of an LLC are in a fiduciary relationship that would generally prohibit competition with the business of the LLC. (The court did not directly address the management structure, but it appears that the LLC was member-managed. The opinion notes at one point that the operating agreement did not name any person or entity the operating or managing member of the LLC.) The court concluded, however, that members may contractually limit or define the scope of the fiduciary duties. Specifically, the court recognized the validity of a provi-

sion in the operating agreement of an Ohio LLC that permitted members to compete with the LLC. The court found support for its conclusion in the case law regarding partnerships and close corporations. The instant case involved a dispute between members of an LLC formed to pursue a professional hockey franchise for Columbus, Ohio. When some of the members objected to the proposed terms of a lease that was necessary to obtain ownership of the franchise, other members formed a separate ownership group that agreed to the lease and obtained the franchise. The court found the operating agreement clearly and unambiguously allowed the members to compete against the LLC and obtain the hockey franchise. The court rejected the argument that the provision in issue only allowed members to engage in other types of businesses. The court did indicate at a couple of points that action related to obtaining the franchise or "the method of competing" could constitute a breach of fiduciary duty if it amounted to "dirty pool," but the court noted the trial court's finding that the competing members had not engaged in any kind of willful misconduct, misrepresentation or concealment. The court discussed several other provisions of the operating agreement as noted below.

The court concluded that the competing members' conduct did not breach a provision of the operating agreement requiring unanimous consent of the members to do any act "that would make it impossible to carry on the ordinary business of the Company" because the provision only applied to actions taken "on behalf of the Company." Forming the competing ownership group was not an action taken on behalf of the LLC.

The court also addressed provisions of the operating agreement regarding additional capital contributions. The operating agreement required consent of all members to call for additional capital and stated that members would have the opportunity, but not the obligation, to contribute if the members determined that additional capital was required to preserve and maintain the business. The court found that the competing member's actions, including allegedly stating that he would attempt to block an effort to raise additional capital, did not breach the agreement.

The court found that the non-competing member breached the operating agreement by unilaterally undertaking litigation on behalf of the LLC without the requisite approval of the members. The member argued that his actions did not constitute willful misconduct and that the exculpation and indemnity provisions of the LLC protected him. However, the court found that the exculpation and indemnity provisions applied in the context of members carrying out their duties under the operating agreement and that there was no duty on the member's part to unilaterally file the actions at issue. Furthermore, the court found the evidence indicated willful misconduct on the member's part.

Finally, the court determined that the judicial dissolution of the LLC on the basis that it was no longer reasonably practicable to carry on the business in conformity with the LLC's articles of organization and operating agreement was not "wrongfully caused" by the member who acted wrongfully in breaching the operating agreement and usurping control of the LLC. The reason it was no longer practicable to carry on the business was the LLC's failure to obtain the hockey franchise rather than the wrongful conduct of a member. Thus, no member was precluded from participating in the winding up by the terms of the operating agreement that allowed only members who have not

wrongfully caused dissolution to participate in winding up. The issue was moot, however, because there was a liquidating trustee appointed by the court.<sup>51</sup>

## **6.5 Records and Information**

LLCs are required to maintain certain records relating to the structure, operation and finances of the LLC.<sup>52</sup> This provision requires that each LLC maintain:

- current and past lists of the names and last mailing address of each member and manager;
- copies of the articles of organization and amendments thereto, along with any powers of attorney pursuant to which those articles were executed;
- copies of the LLC's federal, state and local income tax returns and financial statements for the three most recent years or, if such were not prepared, copies of the information which was or should have been provided to the members to enable them to prepare their federal, state and local income tax returns; and
- copies of any effective written operating agreements and amendments thereto, along with copies of all previous written operating agreements.<sup>53</sup>

Unless such are contained in the written operating agreement, each LLC must also maintain:

- a record of the amount or agreed value of all contributions to the LLC;
- the times or events which will trigger additional contributions from the members;
- the events upon which the LLC will be dissolved and its affairs wound up; and
- any other writings required by the operating agreement.<sup>54</sup>

The failure to maintain the required records and information is not grounds for imposing personal liability on any member or manager for the debts and obligations of the LLC.<sup>55</sup>

Note that the LLC Act does not specify who within the LLC bears the burden of preparing and safe-guarding the required records. Unlike the Corporate Act, there is no requirement that a secretary of the LLC be appointed. Obviously, in a manager-managed LLC, the task would fall upon the managers as a group, with specific responsibilities to be apportioned among the managers as they see fit or as determined by the operating agreement. In a member-managed LLC, the members should apportion the obligation to maintain the records to one or more members, or appoint a third-party to maintain the records. Regardless, the duty to maintain the records should be addressed by the operating agreement. Further, the operating agreement should address who has authority to certify LLC documents.

Members may, upon a reasonable written request and at their own expense, inspect and copy any record of the LLC.<sup>56</sup> Members in a member-managed LLC, and managers in a manager-managed LLC, are required to give full information to all members on the matters affecting the members.<sup>57</sup> It is important to note that, with respect to the review and copying of business records, the LLC Act does not, as does the Corporation Act, divide records into classes, some of which may be reviewed only upon a showing of a proper purpose, or inquire as to the member's purpose for reviewing the records.<sup>58</sup>

## 6.6 Notice To and Admissions By an LLC

The admission of an agent of the LLC, be they a member or manager, when made within the scope of his or her authority, may be used as evidence against the LLC.<sup>59</sup> Notice to a member, in a member-managed LLC, or to a manager, in a manager-managed LLC, will constitute notice to the entity.<sup>60</sup>

In a manager-managed LLC, the admission of a member acting solely in that capacity is not evidence against the LLC,<sup>61</sup> and notice to or knowledge of any member, where such member receives the information solely in their capacity as a member, is not notice to the LLC.<sup>62</sup>

## 6.7 Limited Liability to Third Parties

At the core of the LLC Act is the provision for limited liability for the members and any managers, employees and/or agents from the debts and obligations of the LLC. The wording of this section of the LLC Act was modified by the 1998 Amendments. In its revised form, KRS § 275.150(1) provides:

Except as provided in subsection (2) of this section or as otherwise specifically set forth in other sections in this chapter, no member, manager, employee or agent of a [LLC], including a professional [LLC], is personally liable by reason of being a member, manager, employee or agent of the [LLC], under a judgment, decree or order of a court, agency or tribunal of any type, or in any other manner, in this or any other state, or on any other basis, for a debt, obligation or liability of the [LLC], whether arising in contract, tort or otherwise. The status of a person as a member, manager, employee or agent of a [LLC], including a professional [LLC], shall not subject such person to personal liability for the acts or omissions, including any negligence, wrongful act or actionable misconduct of any other member, manager, agent or employee of the [LLC].<sup>63</sup>

An LLC affords the level of personal liability protection associated with corporate shareholders and the limited partners of a limited partnership.<sup>64</sup> This liability shield is available regardless of the degree to which a member is involved in the active direction of the LLC.<sup>65</sup> Limited partners do not have their limited liability waived by reason of failures within the Certificate of Limited Partnership or failure to maintain the entity in good standing by annual filings with the Kentucky Secretary of State. The Kentucky Court of Appeals has held that where a foreign limited partnership failed to qualify to do business in Kentucky, such failure did not subject the limited partners to joint and several liability on a tort claim. *Virginia Partners, Ltd. v. Day*, 738 S.W.2d 837 at 840 (Ky. Ct. App. 1987).

In addition, the 1998 Amendments created a new section, KRS § 275.150(2), which, *inter alia*, permits a member or manager to, by reason of such status, elect to be personally liable for the debts and obligations of the LLC, in effect waiving limited liability.<sup>66</sup>

In the context of all LLCs, but especially professional LLCs, it is important to clarify what limited liability does and does not mean. Note that the liability shield will not protect a member from personal liability arising from his or her own acts, the liability shield being limited to protection from vicarious liability for the acts of other members or employees of the LLC. No business organization will shield an individual from his or her own malpractice.

It is important at the outset to define the phrase "limited liability." Lawyers will always be personally liable for their own acts. This result stems from the general theory that actors are always responsible for their personal actions even when carried out as agents for another entity.

Therefore, in the context of a law firm, the term "limited liability" can mean protection from (i) personal liability for the general business debts of the firm, such as bank loans, computer purchases, and office leases; (ii) personal liability for torts unrelated to the practice of law; or (iii) vicarious liability for malpractice or other wrongful acts committed by those with whom the lawyer is associated.<sup>67</sup>

This rule has been recognized in the drafting of LLC statutes. As noted in the comments to § 112 of the ULLCA:

By practicing as a limited liability company, professionals would continue to be personally liable for their own malpractice but could generally shield themselves from personal liability for the torts of business associates. This is contrasted with general partnership law under which all partners are responsible for their own torts as well as the torts of their partners.

Regardless of the limited liability afforded the members, the assets of the LLC are subject to the claims of creditors.

The LLC Act does not contain any provisions incorporating the law of piercing the corporate veil or other analysis of when the LLC liability shield should be ignored. There appears to be no policy reason the law of piercing the corporate veil should not be equally applicable to LLCs.<sup>68</sup> However, the LLC Act does provide that the failure to maintain the required records of an LLC will not constitute grounds from imposing personal liability on any person or entity for the debts and obligations of the LLC.<sup>69</sup>

Irrespective of the liability shield, individuals will be personally liable for the preorganization activities of the LLC, as well as personally liable for claims that arise while claiming to act on behalf of a nonexistent LLC.<sup>70</sup>

## **6.8      Interstate Application of the Limited Liability Provision**

The LLC Act provides that Kentucky LLCs are empowered to conduct business and carry out their operations in any foreign jurisdiction,<sup>71</sup> and the limited liability afforded to the members, managers, employees and agents of a Kentucky LLC, will, in any other state or foreign country, be governed by Kentucky law.<sup>72</sup> While the LLC Act provides that questions of liability arising in other jurisdictions will be governed by Kentucky law, there is no guarantee that a foreign jurisdiction will believe itself bound by this directive.<sup>73</sup> Rather, the court may investigate whether the law of that jurisdiction or that of Kentucky will control.<sup>74</sup>

The Restatement (2nd) of Conflicts<sup>75</sup> § 307<sup>76</sup> provides that, with respect to the liability of a shareholder to the creditors of the corporation, the "local law" of the state of incorporation will control. Reference may then be made to Restatement § 298<sup>77</sup> to determine whether § 307 should apply to LLCs in assessing the liability of LLC members.<sup>78</sup>

For claims against a partnership, the Restatement directs that the controlling law is that of the jurisdiction with the most significant contacts with the parties and the events giving rise to the claim.<sup>79</sup> The rule applying the law of the jurisdiction with most significant contacts is likewise applied to the liability of limited partners.<sup>80</sup> If the court determined that these provisions governed the personal liability of the LLC members, it could (a) determine that the law of the situs of the injury should control and (b) hold that, due to the absence of an LLC statute in that jurisdiction, the LLC should be viewed as an unincorporated association for which there exists joint and several liability amongst the members.

Restatement § 298 provides that an entity will be considered a "corporation" if it enjoys various attributes of a corporation. Comment a to this section provides in part that:

A court will sometimes be faced with the task of determining whether an organization formed in another state should be considered a corporation within the meaning of a local statute or rule. In deciding this question, the court will first determine what attributes an organization must possess to be a corporation for purposes of the statute or rule. If the organization possesses such attributes under local law of the state of its formation, it will be considered a corporation within the meaning of the statute or rule.

Illustration 1 to § 298 notes that a joint stock association will be viewed as a corporation as it: (i) has limited liability; (ii) can sue in its own name; and (iii) is governed by duly elected representatives. An LLC would satisfy points (i) and (ii), and if manager-managed would likely satisfy point (iii). Other "corporate attributes" might include: (a) interests that may be represented by a certificate; (b) the ability to hold and transfer property in its own name; (c) the recognition by the state of organization that the LLC is a legal entity distinct from its members; (d) formation by a filing with the state; and (e) a requirement of annual filings with the state to maintain entity in good standing status.

Based on the application of Restatement § 298 and Illustration 1 thereof, an LLC should, for purposes of determining the personal liability of a member outside of the LLC's jurisdiction of formation, be viewed as a corporation to which section 307 applies. Therefore, LLC members in any foreign jurisdiction, even a non-LLC jurisdiction, should enjoy the limited liability afforded by the jurisdiction of organization.

In addition to the Restatement, the courts may look to principles such as comity, as well as the Full Faith and Credit Clause and Commerce Clause of the Constitution for guidance.

The case law governing this issue does not set forth a general rule. In the past, courts have refused to recognize the limited liability granted by a foreign jurisdiction to avant garde business structures.<sup>81</sup> More recent cases have deferred to the law of the jurisdiction of organization in order to assess investor's liability.<sup>82</sup>

With the adoption of LLC statutes in all 50 states as well as the District of Columbia, as well as provisions authorizing foreign LLCs to transact business in states outside that of their formation, this question has become largely academic. However, it may still arise in situations where there is a dispute regarding whether limited liability should be available, questions which may arise especially in the context of professional liability.<sup>83</sup>

## 6.9 Contributions to Capital & Liability for Contribution

The transfer of an ownership interest directly from the LLC to a member requires a contribution. That contribution may take the form of cash or property, services performed, or an obligation to contribute services, cash or property.<sup>84</sup>

It was the determination of the LLC Act drafting committee that the constitutional requirement that "stock" be issued only for services performed or value paid would not apply to interests in an LLC,<sup>85</sup> and that future services or future obligations could serve as consideration for LLC interests. This determination was made with the realization that the Kentucky Constitution defines "corporation" to include joint stock companies and associations,<sup>86</sup> and that "corporation" may include a "partnership, joint stock company or association."<sup>87</sup>

A promise to make a contribution is not enforceable unless set out in a writing signed by the member, and neither the death nor disability of the member will render this obligation unenforceable.<sup>88</sup>

This rule with respect to the continued enforceability of a contribution obligation on the death or disability of a member may be modified by the operating agreement.<sup>89</sup> Note that the LLC Act does not require that an operating agreement departing from this default rule be in writing. In order to



protect the LLC from a claim by the representative of a disabled or deceased member that, by means of an oral operating agreement, it was provided that such obligations would not be enforced, a prudent drafter would include a provision in the operating agreement requiring that this rule may only be revised pursuant to an express written term.

Should a member fail to make a promised contribution of property or services, the LLC may demand the contribution of an equal value of cash.<sup>90</sup> Save where the Articles of Organization or operating agreement provide a lower voting requirement, a promise to make a contribution to the LLC may be compromised by the unanimous consent of the members, but no compromise will be effective against a creditor who has relied upon the obligation to contribute.<sup>91</sup>

#### 6.10 Allocation of Profits and Losses

As provided by the LLC Act as adopted in 1994, the default provision for the allocation of profits and losses between members of an LLC was on a per capita basis.<sup>92</sup> The selection of per capita allocations of profits and losses was made in order to accommodate unsophisticated LLCs in which the members would not maintain and track capital accounts or even develop an operating agreement addressing the sharing of profits and losses. Per capita allocation of profits and losses also avoided the question of valuation of services, know-how and financing guarantees which will often be incident to the formation of small, especially service related, LLCs. Of course, more sophisticated LLCs were free to provide for different allocations of profits and losses in a written operating agreement. As observed in the introductory comments to the Prototype LLC Act:

An LLC statute, like a partnership or corporation statute, contains many provisions that may be varied by agreement among the member-owners. These provisions (commonly called "default rules") constitute a sort of standard form contract that simplifies the task of forming a firm. The statutory contract should be adapted to suit the parties who are most likely to accept the statute's provisions rather than to craft their own agreements. The Committee believes that LLC statutes should include default rules that are appropriate for smaller, more informal firms, because such firms are least able and least likely to incur the costs of drafting fully customized agreements. For example, the statute should provide, subject to contrary agreement, for per capita voting and financial rights (*i.e.*, members share equally in management and distributions) because the Committee believes that in closely-held, informally operated firms, the parties make approximately equal total contributions, whether of cash, property or services, and the firm may lack records necessary to adequately allocate interest according to the members' contributions. Although most large and sophisticated firms will prefer capital-based voting and financial rights, such firms can readily provide for such rights in their operating agreements.

Note that the per capita default rule departed from the limited partnership model which provides a default rule for the allocations of profits and losses in proportion to the values of the contributions.<sup>93</sup> It is this ability to customize the allocation of profits and losses amongst the members that, from the standpoint of tax flexibility, is one of the prime advantages of the LLC.

One tax benefit of partnerships is the partner's ability to agree on how to allocate partnership tax items. For example, a partner can be allocated a specified share of one type of income or loss and a different share of another type of income or loss. Similarly, partnership allocations can "flip-flop" such that the allocations of income or losses among the partners can change during the life of the partnership. This flexibility makes the partnership form particularly useful for businesses, such as tax shelters, when it is desirable to specially allocate tax

items among the partners or to change the tax allocations during the life of the partnership.<sup>94</sup>

Note that the LLC Act did not require that an operating agreement departing from the default rule of per capita allocations of profits and losses be in writing.<sup>95</sup>

The 1998 Amendments to the LLC Act enacted a material change to this rule. The per capita allocation rule has been abandoned. In its place has been substituted a rule providing that profits and losses shall be allocated on a per capital basis. The LLC Act now provides:

Profits and losses of a limited liability company shall be allocated among the members and among classes of members in the manner provided in the operating agreement. If a written operating agreement does not otherwise provide, profits and losses shall be allocated on the basis of the agreed value, as stated in the records of the limited liability company as required by KRS § 275.185, of the contributions made by each member to the extent they have been received by the limited liability company and have not been returned.<sup>96</sup>

The decision on the part of the members with respect to the allocation of profits and losses must be consistent with the mandate of IRC § 704, which requires that allocations of profits and losses have "substantial economic effect."

#### **6.11         Distributions of Profits**

As provided by the LLC Act as adopted in 1994, the default rule for distributions of the cash and other assets of the LLC was on a per capita basis, and as such paralleled the default rule for the allocation of profits and losses.<sup>97</sup> However, a written operating agreement could provide that distributions be allocated among the members in a manner other than on a per capita basis.<sup>98</sup>

It should be recognized that, under the principles of partnership taxation, the sharing of profits is an issue of allocation (who bears tax liability for income earned) while distributions are the means by which members receive the profits. An allocation, which will give rise to a tax liability to the individual partner, need not be accompanied by a distribution.

Each partner must include on his or her individual tax return the partner's distributive share of partnership income, gain, loss, deduction, or credit relating to partnership taxable years ending with or within the partner's taxable year. [I.R.C. §§ 702(a), 706(a).] The partner is taxed on his or her distributive share of partnership income regardless of whether distributions are made. The character of each item of income, gain, loss, deduction, or credit in the partner's distributive share is the same as the character of the item at the partnership level. [I.R.C. § 702(b); Treas.Reg. § 1.702-1(b)]. For example, if a partnership sells property which produces long-term capital gain, the gain flows through to the partners as long-term gain.<sup>99</sup>

The 1998 Amendments to the LLC Act enacted a material change to this rule. The per capita distribution rule has been abandoned. In its place has been substituted a rule providing that profits and losses shall be distributed on a per capital basis. The LLC Act now provides:

Except as otherwise provided in KRS § 275.310, distributions of cash or other assets of a limited liability company shall be allocated among the members and among classes of members in the manner provided in writing in an operating agreement. If the operating agreement does not so provide in writing, each member shall share in any distribution on the basis of the agreed value, as stated in the records of the limited liability company as required by KRS § 275.185, of the contributions made by each member to the extent they have

been received by the limited liability company and have not been returned. A member shall be entitled to receive distributions described in this section from a limited liability company to the extent and at the times or upon the happenings of the events specified in an operating agreement or at the times determined by the members or managers pursuant to KRS § 275.175.<sup>100</sup>

This section of the LLC Act also recognizes that an LLC may have differing classes of interests, and that differing classes of interests may have different allocations of distributions of cash and other assets. This flexibility with respect to the allocation and distribution of profits and losses is a significant advantage of the LLC over the S corporation. In the latter, only one class of stock is permitted (although this stock may be divided into voting and nonvoting classes), in effect requiring that each unit of ownership be treated equally for economic purposes. The LLC affords businesses the opportunity to customize the economic relationship of the various owners not possible in S corporations due to the limitation to a single class of stock while permitting the investor to be actively involved in day to day management (a difficult objective in a limited partnership) and retain limited liability (not possible in a general partnership as limited liability is not available under the partnership act).

#### **6.12      Distributions On an Event of Disassociation**

Under the LLC Act as adopted in 1994, and there following the partnership model (departing from the corporate model), a member could at any time and for any reason withdraw from the LLC and demand payment for the fair value of that member's interest. Such a voluntary withdrawal constituted an "event of disassociation." This unrestricted right of withdrawal could be limited by a written operating agreement. The valuation of that interest would be as of the date of disassociation.<sup>101</sup> Note that such a disassociation would encompass not only a voluntary decision to withdraw, but would also encompass a withdrawal occasioned by the death of a member. The fair value of the member's interest would be the member's pro-rata portion of the entire value of the LLC, and not merely the book value of the interest as shown in the ledger of accounts. Therefore, the distribution upon withdrawal should be based on an appraisal of the LLC operating on an ongoing basis, *i.e.*, a going concern value which should account for the appreciation and depreciation of LLC assets and the goodwill of the business. Also, as the valuation of the member's interest would be based upon a going concern value, no minority discount should be applied to the distribution.

The 1998 Amendments to the LLC Act, amending KRS § 275.280,<sup>102</sup> significantly narrowed the right to voluntarily withdraw from an LLC and to thereby compel a distribution of the fair value of an LLC interest.

Because of the complex questions which arise on the valuation of any business, and especially a going concern, the LLC operating agreement should address whether the valuation of the withdrawing members interest will incorporate profits (or losses) accrued between the date of withdrawal and the date the payment is made to the member. Similarly, the valuation guidelines should address whether interest will be paid on the amount due the member, how such interest will be calculated and from what day it will be paid. Perhaps most important, it should define a procedure for the selection of the appraiser as well as the valuation methodologies to be applied. In accord with the maximum degree of contractual flexibility afforded by the LLC structure, it should be possible to craft valuation procedures which would depart from the ongoing concern value model.

In addition, a withdrawing member is entitled to receive any distributions to which he or she was entitled prior to the disassociation.<sup>103</sup> The application of these provisions presupposed that the disassociation does not cause the dissolution of the LLC.<sup>104</sup>

There is also the flexibility to restrict the ability of a member to withdraw. Note that there is no requirement that such restrictions appear in a written operating agreement. Due to this ambiguity, the

result of a drafting oversight, it is important that this point be addressed in all written operating agreements.

#### **6.13      Distribution In Kind**

Unless a written operating agreement<sup>105</sup> provides otherwise, a member may not demand that any distribution be made other than in cash.<sup>106</sup> Furthermore, in kind distributions are restricted, and will not require a member to accept from the LLC a distribution in kind:

to the extent that the percentage of the asset distributed to the member exceeds the percentage that the member would have shared in a cash distribution equal to the value of the property at the time of distribution.<sup>107</sup>

In effect, this provision protects a member from receiving a non-cash distribution, the value of which is disproportionate to the non-cash distributions made to other members. This protection can be important to protect members from manipulative valuations by a majority of the members or the managers who may be at odds with the member being called upon to accept a non-cash distribution. However, it may not be advisable to prohibit any in kind distributions as such may force the sale of LLC assets in a disadvantageous market, thereby bringing a lower price for the assets and smaller distributions to the members.

#### **6.14      Restrictions on Distributions & Liability Upon Wrongful Distribution**

An LLC is prohibited from making distributions that would render the LLC insolvent or otherwise impair its capital.<sup>108</sup> A distribution is forbidden if, after it is made:

- the LLC would not be able to pay its debts as they became due in the ordinary course of business; or
- the total assets of the LLC would be exceeded by the sum of its total liabilities and the amount necessary to satisfy the dissolution rights of any interests which are superior to the dissolution rights of the member or members receiving the distribution.<sup>109</sup>

An LLC is permitted to determine that a distribution is not prohibited by reference to financial statements prepared under practices and principles reasonable under the circumstances or a fair valuation or other methods reasonable under the circumstances.<sup>110</sup> Therefore, it is not necessary that the LLC prepare its financial statements in accordance with generally accepted accounting principles ("GAAP") consistently applied. This flexibility in the preparation of financial statements will accommodate many small businesses that prepare their financial statements on a cash basis or otherwise do not follow GAAP.

The impact of a distribution upon the capital of an LLC is measured as of the date the distribution is authorized, provided payment is to occur within 120 days after the date of the authorization of the payment, or the actual date of distribution, if such occurs more than 120 days after the date of authorization.<sup>111</sup> A distribution may be made contingent upon the ability of the LLC to make such payments,<sup>112</sup> in which instance that contingent liability will not be used to assess the propriety of the distribution,<sup>113</sup> but the effect of the payment on that obligation is measured anew as of the date each payment is actually made.<sup>114</sup>

If a member votes for or assents to a distribution that violates these provisions, the member is liable to the LLC for the excess of the permissible distribution.<sup>115</sup> A member or manager liable to the LLC for the excess over a permissible distribution is entitled to contribution from:

- each other member or manager who could be found liable for violating KRS § 275.230(1); and
- each member who received the impermissible distribution.<sup>116</sup>

An action to hold a member or manager liable for an improper distribution, or to require contribution from those who approved or received the impermissible distribution, may not be brought except within the two years after the effect of the distribution is measured.<sup>117</sup>

The indebtedness of an LLC to a member arising out of the declaration of a distribution, save as subordinated by agreement, is equivalent to that of the LLC indebtedness to its general unsecured creditors.<sup>118</sup> The treatment of distribution indebtedness to members is equivalent to the treatment of dividends under the Corporation Act.<sup>119</sup>

#### **6.15      Ownership of LLC Property**

The property of an LLC, whether real or personal, is that of the entity, and is not the property of the individual members.<sup>120</sup> Therefore, holding an interest only in the membership interests, and not in the underlying property of the LLC, a member, absent a contrary provision in the operating agreement giving such a right, is unable to bring an action for partition of the LLC's property.<sup>121</sup> Neither can a member demand an in kind distribution of the property contributed by that member to the LLC. An LLC may acquire, hold in any estate and convey real property.<sup>122</sup>

#### **6.16      Transfer of LLC Property**

The 1998 Amendments significantly modified, and in the process simplified, the provisions of the LLC Act dealing with transfers of LLC property.

Where the management authority has been vested in managers, the title to LLC property may be transferred by an instrument executed in the name of the LLC by a properly authorized manager.<sup>123</sup> Correspondingly, no member, solely by reason of that status, has the authority to transfer the property of a manager-managed LLC.<sup>124</sup>

Where management authority has been retained by the members, any properly authorized member, in the name of the LLC, may execute an instrument of transfer on behalf of the LLC.<sup>125</sup>

The 1998 Amendments further amended this section of the LLC Act<sup>126</sup> to delete provisions dealing with transfers of property held by but not in the name of the LLC<sup>127</sup> and recovery of property by the LLC in the event of an improper transfer.<sup>128</sup>

#### **6.17      Admission of Members**

A person becoming a member by means of a contribution directly to the LLC, as contrasted with the acquisition from a member of an already issued interest, will become a member upon compliance with the provisions of a written operating agreement or, if the operating agreement does not otherwise provide in writing, upon the written consent of all members.<sup>129</sup> The admission of a member to an LLC is effective on the latter of the date of formation of the LLC or at such time as provided in the operating agreement.<sup>130</sup> If the operating agreement does not contain a provision relating to when a new member is admitted, the admission is effective when it is reflected in the records of the LLC.<sup>131</sup>

## 6.18 Assignment of LLC Interests

An interest in an LLC is personal property, and unless the operating agreement provides otherwise, an LLC interest, in whole or part, is assignable.<sup>132</sup> Furthermore, the interest may be evidenced by a certificate, which itself may provide for the assignment or transfer of the interest represented.<sup>133</sup>

However, while the interest is freely assignable, the rights of management incident to that interest are not freely transferable. Therefore, while a member may unilaterally transfer the prospective interest in the profits of the LLC (*i.e.*, the “economic rights”), a member may not unilaterally transfer the right to take part in the direction and management of the LLC (*i.e.*, the “management rights”).<sup>134</sup> The management rights include the right to:

- participate, either directly or by election, in management;
- inspect the records of the LLC;
- vote on the admission or replacement of additional members; and
- vote on the voluntary dissolution or continuation of the business after a dissolution event.

A member who has made an assignment of the economic rights of membership remains a member, exercising only the management rights of membership, until such time as the assignee becomes a member or the assignor member is removed.<sup>135</sup> An assignment of an LLC interest does not dissolve the LLC.<sup>136</sup>

An assignee who has not yet received a transfer of the management rights of membership has no liability as a member consequent to the assignment, and the assignment does not release the assignor of any liability they incurred while a member.<sup>137</sup>

Unless the operating agreement provides otherwise, a pledge, granting a security interest in, lien against or encumbrance of an LLC interest does not constitute an assignment, and does not terminate or impair the rights of the member.<sup>138</sup> Rather, such pledge entitles the assignee to receive, to the extent made, the distributions and other economic rights to which the assignor would be entitled.<sup>139</sup>

Permitting the bifurcation of the rights of membership between management rights and economic rights may lead to a situation in which the ownership of an LLC is divided into three camps: members with both economic rights and management rights; transferor members who retain only management rights but have no economic rights; and transferees who have economic rights but no management rights in the LLC.

It may be unwise for a statute or agreement to permit a member who completely assigns financial rights to retain management rights because the assignor might lack adequate incentives to exercise control for the benefit of the firm. But denying the assignor management rights would effectively separate ownership and control with respect to the assigned interest. If the assignor retains management rights, at least the assignor and assignee can contract or coordinate regarding exercise of these rights. Accordingly perhaps the assignor should retain management and information rights in the absence of contrary agreement. The nonassigning members could be protected from troublesome conflicts of interest that may result from the assignment by having the power, again subject to contrary agreement, to expel an assignor. (footnote omitted).<sup>140</sup>

One means of addressing this potential divergence of economic and management rights and their respective agendas is to provide in the operating agreement that, upon the members transfer of economic rights, the LLC shall have the right, for a nominal consideration, to purchase from the transferor member those management rights. As such, there would not arise a situation in which there exists

members with management rights but no economic stake in the LLC. It would then remain for the usual procedures in addressing the admission of a transferee to determine whether those management rights would subsequently be transferred from the LLC to that transferee.

#### **6.19      Right of Assignee to Become a Member**

A transfer of the management rights of membership, as contrasted with the merely economic rights, requires the consent of the other members, and it is only subsequent to such consent that a transferee succeeds to all of the rights of the transferor member. Prior to the adoption of the 1998 Amendments, the default provision for the consent to the transfer of the management rights to a transferee, which consent admitted that assignee as a full member of the LLC, was the unanimous consent of the non-assigning members.<sup>141</sup> The requirement of a unanimous vote to transfer the management right of membership to a transferee could be modified by a written operating agreement.

This rule was changed in the 1998 Amendments. The requirement of unanimity was deleted, and a rule requiring a consent of a majority-in-interest was substituted.<sup>142</sup>

The operating agreement may specify the manner in which the consent will be evidenced, the default provision being for a written instrument signed and dated by all members.<sup>143</sup>

Upon becoming a member, a transferee has the rights and powers of a member, and similarly is subject to the restrictions and liabilities of a member as determined pursuant to the articles of organization, any operating agreement and the LLC Act.<sup>144</sup> If the transferor was liable to make a contribution to the LLC, the transferee member succeeds to liability on that obligation, provided the assignee had knowledge of the liability at the time he became a member or such obligation could be ascertained from the articles of organization or a written operating agreement.<sup>145</sup> Regardless of whether the assignee becomes liable on the assignor's obligation to make a contribution to the LLC, the assignor member remains liable to the LLC for the contribution.<sup>146</sup> This rule may be amended by a written operating agreement.

The LLC Act is silent with respect to whether a transferee member, in addition to becoming liable for the transferor's liability to make a contribution to the LLC, is similarly liable to satisfy any obligation to return a prior distribution from the LLC. Permitting recovery of a distribution from a transferee member may serve as a significant impediment to the transfer of interests. In addition, unlike an obligation to make a contribution which will increase the capital of the LLC and presumably its ability to carry on business and earn profits, a transferor member enjoys no benefits from distributions made prior to the time he or she became a member.

Upon the elevation of the assignee to membership, the assignor of an LLC interest ceases to be a member.<sup>147</sup> This rule may be amended by a written operating agreement.

#### **6.20      Rights of Judgment Creditor**

A judgment creditor, upon application to the proper court, may charge a member's LLC interest with the payment of a judgment, with interest thereon.<sup>148</sup> A judgment creditor granted such a right against a member's LLC interest has only the rights of an assignee,<sup>149</sup> and therefore has no right to take part in the management of the business and affairs of the LLC. The LLC Act expressly recognizes the applicability of exemption laws to a member's LLC interest.<sup>150</sup>

#### **6.21      Rights of Estate of a Deceased or Representative of an Incompetent Member**

As adopted in 1994, the LLC Act provided that the estate of a deceased member or the representative of an incompetent member had all of the rights of an assignee of that member's interest, but did

not succeed to the member's right to take part in the business and affairs of the LLC.<sup>151</sup> The 1998 Amendments deleted KRS § 275.270.<sup>152</sup> Therefore, as the death or incapacity of a member no longer constitutes an event of disassociation, the executor/personal representative will succeed to all rights of the member.

## 6.22 Dissolution

The distinctions drawn in this section are based upon the rules of dissolution, winding up and termination applicable to partnerships in general.

For these purposes, a partnership is viewed as the aggregate of the identities of its partners, the partnership surviving for only so long as that aggregate identity is not disturbed. The "disassociation" of a partner alters that aggregate identity triggering the "dissolution" of the partnership.<sup>153</sup> At that point, the remaining partners may elect to "continue" the partnership, in which case it will be reconstituted with a new aggregate identity. Conversely, if there is no agreement to continue the partnership, it will enter the winding up phase. During the winding up phase, the assets of the partnership are collected and as necessary liquidated. Simultaneously, the liabilities of the partnership are ascertained and provision is made for their satisfaction. Assets not required to meet the claims of creditors, may then be distributed to the partners. Termination brings the existence of the partnership to a close, all assets having been distributed to the creditors and to the partners.

It should be noted that the addition of a new partner, which analytically alters the aggregate identity of the partnership to the same extent as does the disassociation of a partner, does not trigger dissolution and the need for a vote to continue the partnership.<sup>154</sup>

An individual disassociates and ceases to be a member of an LLC if he or she voluntarily withdraws, is removed, is confessed or adjudged bankrupt or insolvent or, unless otherwise provided in a written operating agreement, or upon assignment of all of his or her interest in the LLC with the written consent of a majority-in-interest of the members who have not assigned their interests.<sup>155</sup> These constitute "events of disassociation." The termination of a member's legal existence or recognition will likewise constitute an event of disassociation. Examples would be the dissolution of a corporation or the termination of a trust and the distribution of its assets which were not waived by a majority-in-interest of the remaining members.<sup>156</sup> A written operating agreement may provide that other events will cause the affected person to cease to be a member of the LLC or depart from the majority-in-interest default rule.<sup>157</sup>

The 1998 Amendments provided for a significant revision in the rule regarding the voluntary withdrawal of a member. Under the LLC Act as adopted in 1994, unless restricted by a written operating agreement, a member could withdraw from the LLC upon thirty days written notice.<sup>158</sup> This rule was revised in the 1998 Amendments. This provision of the LLC Act now provides:

Unless otherwise provided in a written operating agreement, a member has no right to withdraw from a limited liability company. If a written operating agreement does not specify a time a member may withdraw, a member shall not withdraw without the consent of all other members remaining at the time.<sup>159</sup>

This is a significant revision in a default rule, and should necessitate a review of all outstanding operating agreement for amendments now necessary to conform the operating agreement to the objectives of the members.<sup>160</sup>

## 6.23 Events of Disassociation

A person ceases to be a member of an LLC if he or she voluntarily withdraws,<sup>161</sup> is removed, is confessed or adjudged bankrupt or insolvent or, unless otherwise provided in a written operating agree-



ment, upon assignment of all of his or her interest in the LLC with the written consent. These constitute "events of disassociation." The termination of a member's legal existence or recognition will likewise constitute an event of disassociation. Examples would be the dissolution of a corporation or the termination of a trust and the distribution of its assets which were not waived by a majority-in-interest of the remaining members.<sup>162</sup> A written operating agreement may provide that other events will cause the affected person to cease to be a member of the LLC.<sup>163</sup>

#### **6.24      Dissolution and Winding Up**

An LLC is dissolved, and its affairs shall be wound up, upon the time or occurrence of events specified in the Articles of Organization or the operating agreement, the written consent of a majority-in-interest of the members, the entry of a decree of judicial dissolution or the filing of articles of dissolution.<sup>164</sup>

#### **6.25      Voluntary Dissolution**

An LLC dissolves automatically upon the written consent of a majority-in-interest members.<sup>165</sup> The operating agreement may provide a different threshold for voluntary dissolution.

#### **6.26      Judicial Dissolution**

Upon the petition of a member, a circuit court may grant a decree dissolving the LLC if "it is established that it is not reasonably practicable to carry on the business of the [LLC] in conformity with the operating agreement."<sup>166</sup> The appropriate court is that for the county in which the principal office of the LLC is located, or, if the LLC has no principal office, for the county of the registered office of the LLC.<sup>167</sup> Upon the entry of the decree of dissolution, the LLC will enter the winding up phase.<sup>168</sup> The decree dissolving the LLC is to specify the effective date of the dissolution, and shall be delivered by the county clerk to the Secretary of State for filing.<sup>169</sup>

#### **6.27      Administrative Dissolution**

The provisions dealing with administrative dissolution are modeled upon the provisions and procedures set forth in the corporation act.

The Secretary of State may commence a proceeding to dissolve an LLC if it does not:

- deliver its annual report within sixty days after the date such report is due;
- maintain a registered agent and registered office in Kentucky; or
- notify the Secretary of State of a change in its registered agent or registered office, the resignation of the registered agent or that its registered office has been discontinued.<sup>170</sup>

The LLC will be given notice of the grounds for administrative dissolution, and is granted sixty days to correct any ground for dissolution or demonstrate that there is no ground for dissolution.<sup>171</sup> Failing such a correction or demonstration, the Secretary of State will administratively dissolve the LLC.<sup>172</sup> An administratively dissolved LLC may petition for reinstatement by filing an application setting forth:

- its name and the effective date of its dissolution;

- a statement that the reason for the dissolution did not exist or has been remedied; and
- a statement that the name of the LLC satisfies the requirements of the LLC Act.

The application must be accompanied by a Revenue Cabinet certificate stating that all taxes have been paid, and by payment of all penalties and fees.<sup>173</sup> If the requirements for reinstatement are met, the Secretary of State will cancel the certificate of dissolution and issue a certificate of reinstatement.<sup>174</sup> Any reinstatement relates back to and takes effect from the date of the dissolution.<sup>175</sup> A denial by the Secretary of State to reinstate the LLC requires written notice to the LLC of the reason for the denial, which denial may be appealed to the circuit court.<sup>176</sup>

## 6.28 Winding Up

The winding up of the affairs of an LLC is carried out by the body with management authority, or, in certain cases of wrongful conduct, by the circuit court.<sup>177</sup> The circuit court is that for the county in which the LLC maintains its principal office or its registered office.<sup>178</sup> The LLC Act does not set forth a preference for which circuit court will oversee the winding up when the principal office and registered office are in different counties.

During the winding up phase, an LLC is limited to actions relating to collecting its assets, providing for the satisfaction of its liabilities and distributing to its members such assets as are not necessary to satisfy those liabilities.<sup>179</sup> A non-exhaustive list of the actions appropriate to the winding up of an LLC include:

- collecting its assets;
- disposing of assets that will not be distributed in kind to the members;
- discharging or making provision for discharging liabilities; and
- distributing its remaining property among its members according to their interests.<sup>180</sup>

The claims of creditors would include those of members for declared but unmade distributions.

The dissolution of an LLC does not:

- transfer title to its property;
- prevent the transfer of an interest;
- modify the standards of conduct typically applicable to members or managers;
- change provisions relating to the internal operation of the LLC;
- interfere with the commencement or continuation of a proceeding by or against the LLC;
- interfere with the authority of its registered agent; or
- affect the obligations of the LLC with respect to federal and state tax laws.<sup>181</sup>

Every member or manager must hold for the benefit of the LLC any gain derived from a transaction relating to the conduct or winding up of the affairs of the LLC.<sup>182</sup> A compromise of this rule must be approved by more than one-half of the disinterested managers or members.

**6.29      Agency Power of Managers or Members after Dissolution**

During the winding up phase, a member or manager of the LLC may bind the entity in the course of actions appropriate to the winding up of its affairs, and for such other purposes as are authorized by the members or managers.<sup>183</sup> With respect to third parties without knowledge of the dissolution, a manager or member may bind the LLC with respect to matters outside those appropriate to winding up.<sup>184</sup> The filing of articles of dissolution or a certificate of dissolution, or the entry of decree of dissolution, is presumptive notice of the dissolution of the LLC.<sup>185</sup>

**6.30      Distribution of Assets During Winding Up**

During the winding up phase, the assets of the LLC are distributed first for payments, or adequate provision therefor, to creditors, then to the satisfaction of pre-dissolution declared distributions to members and former members of the LLC.<sup>186</sup> Creditors will include members to whom the LLC is indebted other than for a declared but unpaid distribution or for the return of a contribution. Any remaining assets are then distributed to the members and former members as a return of contributions, and then in proportion to their rights to share in distributions of assets prior to dissolution.<sup>187</sup>

**6.31      Articles of Dissolution**

After dissolution, the LLC must file Articles of Dissolution setting forth:

- the name of the LLC;
- the statutory authority pursuant to which it was dissolved;
- the effective date of its dissolution; and
- whatever additional information the member(s) or manager(s) filing the articles of dissolution deem appropriate.<sup>188</sup>

**6.32      Known and Unknown Claims Against a Dissolved LLC**

The LLC Act provides a mechanism for giving creditors having known claims against the LLC notice of dissolution, and providing that the claims will be barred if those creditors do not make a claim against the LLC within the prescribed time and the publication of the notice of dissolution of the LLC in order to place on notice creditors having unknown claims, likewise providing that the claims will be barred if those creditors do not make a claim against the LLC within the prescribed time. For known claimants, the LLC must give written notice of the date of dissolution of the LLC and include:

- the information that must be supplied by the creditor to the LLC in order to make a claim;
- the mailing address to which the claim should be forwarded;

- a statement that the claim will be denied if not received by the deadline (not less than 120 days after the date of the notice);
- and state that the claim will be barred if not received by that deadline.<sup>189</sup>

A known claim will be barred against the LLC if notice of the claim is not received by the deadline or, if a claim is denied by the LLC, the claimant does not bring an action to enforce the claim within ninety days after the rejection notice.<sup>190</sup>

Notice to the unknown creditors of the LLC is accomplished by publication of the notice of dissolution. The newspaper notice must set forth the information which must be included by the creditor in the claim against the dissolved LLC, set forth the mailing address to which the claim should be forwarded and state that the claim will be barred unless filed within the applicable period.<sup>191</sup> Unknown claims against an LLC must generally be brought within two years after the dissolution.<sup>192</sup> An unknown claim against a professional LLC may be filed up to five years after the dissolution.<sup>193</sup> Regardless of whether the unknown claim is against a professional or a non-professional LLC, claims which are contingent or based upon events occurring after the date of dissolution may be banned.<sup>194</sup>

Unknown claims against an LLC are satisfied first against the LLC's undistributed assets, and then against the assets distributed to the members.<sup>195</sup> However, no member will be liable on a claim for an amount in excess of the amounts they have received in distribution from the LLC.<sup>196</sup>

#### **6.33 Parties to Actions By and Against an LLC**

An LLC may file suit in, and suits may be filed against the LLC, in its own name.<sup>197</sup> As such, the LLC is similar to a corporation, which has the right to sue and be sued in its own name.<sup>198</sup> Conversely, prior to the passage of S.B. 184, a general partnership could neither sue nor be sued in its common name. Section 107 of S.B. 184 authorized suits against partnerships in their common names. A member, by virtue of that status, is not a proper party to a proceeding by or against the LLC.<sup>199</sup> However, a member will be a proper party to a suit when the suit is brought by the LLC against the member to enforce an obligation to the LLC, or in a proceeding by the member against the LLC to enforce a right of the member against that LLC.<sup>200</sup>

#### **6.34 Authority to Sue on Behalf of an LLC**

Unless otherwise provided in a written operating agreement, suits may be filed on behalf of and in the name of an LLC by a member, provided that member has been authorized to do so by the vote of at least one-half of the members.<sup>201</sup> However, the vote of a member having an interest in the outcome of the suit adverse to the interest of the LLC shall be excluded from any such vote.<sup>202</sup> This authority of at least one-half of the members to bring a suit on behalf of the LLC exists regardless of whether management authority has been vested in managers. In addition, in manager managed LLCs, a manager, authorized by the approval of one-half of the managers, may bring suit on behalf of the LLC. Again, in any vote on whether to proceed with the suit, there will be excluded from the vote that of any manager who has an interest in the outcome of the suit adverse to the interest of the LLC.<sup>203</sup>

Note that an LLC is not permitted to appear *pro se*; rather, it must be represented by counsel.<sup>204</sup>

#### **6.35 Consequence of Lack of Authority to Bring Suit**

The lack of authority of a member or manager to file suit on behalf of an LLC may not be cited by a defendant as a defense to an action filed by the LLC. In addition, such lack of capacity may not be

cited by the LLC as a basis for the LLC to file a subsequent suit on the same cause of action.<sup>205</sup> As such, a lack of capacity to file the original lawsuit will not protect an LLC from the preclusive effects of *res judicata*, collateral estoppel and similar doctrines.<sup>206</sup>

## Endnotes to Chapter 6

- <sup>1</sup> See Chapter 4.
- <sup>2</sup> KRS § 275.015(12).
- <sup>3</sup> KRS §§ 275.015(12), (14).
- <sup>4</sup> This statement remains true even after the Small Business Job Protection Act of 1996, which substantially liberalized the rules regarding permissible shareholders of an S Corporation.
- <sup>5</sup> The tax classification of a single member LLC after January 1, 1997 is addressed in Chapter 4.
- <sup>6</sup> See § 6.03.
- <sup>7</sup> These new classification rules, referred to as "Check-the-Box," are reviewed in chapter 4.
- <sup>8</sup> H.B. 666, § 23, deleting KRS § 275.025(1)(d).
- <sup>9</sup> See Chapter 5, section 5.3.
- <sup>10</sup> See Chapter 5, section 5.3.
- <sup>11</sup> KRS §§ 275.135(1),(2).
- <sup>12</sup> KRS § 275.265(1).
- <sup>13</sup> KRS § 275.285(3)(a).
- <sup>14</sup> KRS § 275.205.
- <sup>15</sup> KRS § 275.210.
- <sup>16</sup> KRS § 275.135(1). *Accord*, UPA § 9(1); KRS § 362.190(1). See also *J. M. Equipment and Transportation, Inc. v. Gemstone, L.L.C.*, 1998 WL 573255 (Conn. Super. Aug. 25, 1998) (interpreting the parallel provision of the Connecticut LLC Act and holding the LLC liable for obligation incurred by LLC member in usual course of LLC's business).
- <sup>17</sup> See commentary to Prototype § 401. See also Miller, Sandra K., *What Remedies Should be Made Available to the Dissatisfied Participant in a Limited Liability Company?*, 44 AM. U.L. REV. 465 (December, 1994).
- <sup>18</sup> KRS § 275.135(2)(a).
- <sup>19</sup> KRS § 275.135(2)(a)-(b). As observed in the comments to § 301 of the Prototype:
- Unless the articles of organization provide for management by managers, this section would cause the act of any member to bind the company to the same extent as the act of a general partner in a general partnership. The agency extends to transactions which are carried on in the usual way of the business or affairs of the LLC in order to address those situations where it is unclear whether the activities of the limited liability company rise to the level of a "business". As under the UPA, acts which are outside the usual course of business may be actually authorized, and acts which otherwise would be apparently authorized are not binding to the extent that creditors know of a restriction on the member's authority. Because this section is based closely on the UPA, courts are likely to apply partnership precedents.
- If the articles of organization provide the management is vested in managers, this section would cause the act of any manager to bind the company, so long as the act is for carrying on the LLC's business or affairs in the usual way. Conversely, members would have no apparent authority as such to bind the firm. In this situation, the member's acts have no greater effect than those of a

corporate shareholder or limited partner, assuming the member is not acting in some other capacity. This puts a burden on creditors to know whether LLCs in the relevant jurisdiction are member- or manager-managed by checking the articles or organization and then to determine who the managers are.

20 KRS § 275.165(2)(a).

21 H.B. 666, § 27.

22 H.B. 666, § 21, creating new KRS § 275.015(11). Subsection (3) of section 29 of the 1998 Amendments is reviewed *infra* notes 120 through 124 and accompanying text.

23 KRS § 271B.8-050(5).

24 KRS § 275.165(2)(c).

25 KRS § 275.165(2)(b). As observed in the comments to § 301 of the Prototype:

This section is not intended to preclude an LLC from authorizing any person, including a member in a manager-managed LLC or a non-member in either kind of LLC, to act as an agent, just as a corporation can designate a shareholder or third party to serve in an agency capacity.

26 KRS § 275.165(2)(b). As observed in the comments to § 301 of the Prototype:

This section is not intended to preclude an LLC from authorizing any person, including a member in a manager-managed LLC or a non-member in either kind of LLC, to act as an agent, just as a corporation can designate a shareholder or third party to serve in an agency capacity.

27 KRS § 275.135(3).

28 KRS §§ 275.135(1), 275.135(4); 275.305(1)(b), 275.305(4). *See also*, KRS § 275.135(2)(b) (third party may rely on general authority of manager in manager-managed LLC; limit on agency binding only against third party with knowledge of restriction.)

29 RIBSTEIN AND KEATINGE ON LIMITED LIABILITY COMPANIES § 8.04 (1993) (footnotes omitted).

30 H.B. 666, § 25, creating KRS § 275.135(5).

31 KRS § 275.170(3).

32 *See* chapter 4.

33 *See* chapter 4.

34 KRS § 275.175(1) (prior to 1998 Amendments).

35 KRS § 275.175(2)(a)-(c) (prior to 1998 Amendments).

36 RIBSTEIN AND KEATINGE ON LIMITED LIABILITY COMPANIES § 8.03. *See also*, commentary to § 403 of the Prototype:

With the exception of Arizona § 29-681.D, all of the LLC statutes reviewed by the Committee that allocate voting rights among members provide that members vote according to their capital contributions, as in the case of limited partnerships, rather than per capita as in general partnerships. Although this capital-based voting system sensibly aligns members' voting rights with the investment, the Committee adopted a default per capita rule because of potential problems of determining capital contributions, particularly in the sort of informal firms that are likely to adopt the default rule. For instance, capital-based

voting would necessitate a determination of the parties' relative contributions each time a vote is to be taken. Moreover, it would not be clear whether a member's unperformed promise to contribute cash, property or, in particular, services, should be considered.

37 New KRS § 275.175(3), added by H.B. 666, § 29.

38 KRS § 275.175(1), amended by H.B. 666, § 29.

39 KRS § 275.175(1), amended by H.B. 666, § 29.

40 H.B. § 666, 29.

41 See KRS § 275.175(1).

42 KRS § 275.170(1).

43 KRS § 275.170(2)(b).

44 KRS § 275.180. *Accord*, KRS §§ 271B.8-500 through -580.

45 H.B. 666, § 30. The failure to require that such a limitation on elimination of liability be in a written operating agreement was a drafting oversight in the LLC Act as adopted in 1994.

46 KRS § 271B.8-300(1)(a)-(c).

47 KRS § 275.170(1) provides:

Unless otherwise provided in an operating agreement:

(1) A member or manager shall not be liable, responsible, or accountable in damages or otherwise to the limited liability company or the members of the limited liability company for action taken or failure to act on behalf of the limited liability company unless the act or omission constitutes wanton or reckless misconduct.

KRS § 271B.8-300(5)(b) provides:

(5) In addition to any other limitation on a director's liability for monetary damages contained in any provision of the corporation's articles of incorporation adopted in accordance with subsection (2)(d) of KRS § 271B.2-020, any action taken as a director, or any failure to take any action as a director, shall not be the basis for monetary damages or injunctive relief unless:

(b) In the case of an action for monetary damages, the breach or failure to perform constitutes willful misconduct or wanton or reckless disregard for the best interests of the corporation and its shareholders.

48 Compare, KRS §§ 271B.8-310 (directors); 271B.8-420 (officers).

49 For discussions of the fiduciary duties between members in an LLC, between the members and the managers and how these matters can be addressed in the operating agreement, *see, e.g.*, Booth, Richard A., *Fiduciary Duty, Contract, and Waiver in Partnerships and Limited Liability Companies*, 1 J. SMALL AND EMERGING BUS. LAW 55 (Spring 1997); Callison, J. William, *Blind Men and Elephants: Fiduciary Duties Under the Revised Uniform Partnership Act, Uniform Limited Liability Company Act, and Beyond*, 1 J. SMALL AND EMERGING BUS. LAW 109 (Spring 1997); Welborn, Caryl B., *Fiduciary Duties: How Far Can the Partnership or Operating Agreement Go?*, 1 LLC ADVISOR 4 (July 23, 1996); Hamill, Susan P. and Mitchel H. Boles, *Management and Fiduciary Duties in Limited Liability Companies*, Q243 - ALI/ABA - 77 (March 21, 1996); Dickerson, Claire M., *Equilibrium Destabilized: Fiduciary Duties Under the Uniform Limited Liability Company Act*, 256 STETSON L. REV. 417 (Winter, 1995); Demott, Deborah A., *Fiduciary Preludes: Likely Issues for LLCs*,



66 U. COLO. L. REV. 1043 (1995); Martel, John G., *Default Fiduciary Duty Rules Under Oregon's Limited Liability Company Act*, 73 OR. L. REV. 121 (Spring, 1994); Miller, Sandra K., *What Standards of Conduct Should Apply to Members and Managers of Limited Liability Companies?*, 68 ST. JOHN'S L. REV. 21 (1994).

<sup>50</sup> For discussions of the fiduciary duties between members in an LLC, between the members and the managers and how these matters can be addressed in the operating agreement, see, e.g., Booth, Richard A., *Fiduciary Duty, Contract, and Waiver in Partnerships and Limited Liability Companies*, 1 J. SMALL AND EMERGING BUS. LAW 55 (Spring 1997); Callison, J. William, *Blind Men and Elephants: Fiduciary Duties Under the Revised Uniform Partnership Act, Uniform Limited Liability Company Act, and Beyond*, 1 J. SMALL AND EMERGING BUS. LAW 109 (Spring 1997); Welborn, Caryl B., *Fiduciary Duties: How Far Can the Partnership or Operating Agreement Go?*, 1 LLC ADVISOR 4 (July 23, 1996); Hamill, Susan P. and Mitchel H. Boles, *Management and Fiduciary Duties in Limited Liability Companies*, Q243 - ALI/ABA - 77 (March 21, 1996); Dickerson, Claire M., *Equilibrium Destabilized: Fiduciary Duties Under the Uniform Limited Liability Company Act*, 256 STETSON L. REV. 417 (Winter 1995); DeMott, Deborah A., *Fiduciary Preludes: Likely Issues for LLCs*, 66 U. COLO. L. REV. 1043 (1995); Martel, John G., *Default Fiduciary Duty Rules Under Oregon's Limited Liability Company Act*, 73 OR. L. REV. 121 (Spring 1994); Miller, Sandra K., *What Standards of Conduct Should Apply to Members and Managers of Limited Liability Companies?*, 68 ST. JOHN'S L. REV. 21 (1994).

<sup>51</sup> Miller, Elizabeth, *The Advent of LLCs and LLPs in the Case Law: A Survey of Cases Dealing With Registered Limited Liability Partnerships and Limited Liability Companies*, PARTNERSHIPS AND LLCs - IMPORTANT CASE LAW DEVELOPMENTS 2000 (American Bar Association Annual Meeting, July 11, 2000).

<sup>52</sup> KRS § 275.185(1).

<sup>53</sup> KRS § 275.185(1)(a)-(d). *Accord*, KRS § 362.409.

<sup>54</sup> KRS § 275.185(e)(1)-(3).

<sup>55</sup> KRS § 275.185(4).

<sup>56</sup> KRS § 275.185(2).

<sup>57</sup> KRS § 275.185(3). *Accord*, UPA § 20; KRS § 362.245.

<sup>58</sup> *Compare*, KRS § 271B.16-020.

<sup>59</sup> KRS §§ 275.135(1), (2)(a).

<sup>60</sup> KRS § 275.145. *Accord*, UPA § 12.

<sup>61</sup> KRS § 275.190(2)(b).

<sup>62</sup> KRS § 275.145(2)(b).

<sup>63</sup> KRS § 275.150 was recodified in the 1998 Amendments to appear as KRS § 265.154(1). H.B. 666, § 26. The 1998 Amendments to KRS § 275.154(1) are as follows:

(1) Except as provided in subsection (2) of this section or as otherwise specifically set forth in other sections in this chapter, no member, manager, employee, or agent of a limited liability company, including a professional limited liability company, shall be personally liable by reason of being a member, manager, employee or agent of the limited liability company, under a judgment, decree, or order of a court, agency, or tribunal of any type, or in any other manner, in this or any other state, or on any other basis, for a debt, obligation, or liability of the limited liability company, whether arising in contract, tort, or otherwise. The status of a person as a member, manager, employee, or agent of a limited liability company, including professional limited liability company, shall not subject the person to personal liability for the acts or omissions, including any negligence, wrongful act, or actionable misconduct, of any other member, manager, agent or employee of the limited liability company.

<sup>64</sup> Accord KRS § 271B.6-220(2); KRS § 274.055(1). See *contra*, UPA §§ 15(a), (b); KRS § 362.220. The liability of a general partner in an LP is the same of a general partner in a general partnership — joint and several liability for the debts and obligations of the entity. KRS §§ 362.220; 362.447(2) While the impact of this liability may be mitigated through either indemnification from the company and/or insurance, third parties retain the right to move against the general partner regardless of the availability of such contractual protections or their sufficiency to meet the obligation in question. Of course, it is possible to use an entity affording limited liability, such as an LLC or a corporation, as the general partner. By so doing, there is actually no limitation upon the general partner's liability, but rather the entity serves to shield the individuals who make the decisions of the general partner from themselves suffering unlimited liability. Efforts to achieve limited liability for general partners have included the adoption in certain states, an example being Texas, of the Limited Liability Limited Partnership ("LLLP").

<sup>65</sup> Limited partners are shielded from general liability so long as they do not take part in the active management of the LP. The LP Act, KRS § 362.417(1), provides:

Except as provided in Subsection (4) of this section, a limited partner shall not be liable for the obligations of a limited partnership unless he is also a general partner or, in addition to the exercise of his rights and powers as a limited partnership, he participates in the control of the business. However, if the limited partner participates in the control of the business, he shall be liable only to persons who transact business with the limited partnership reasonably believing, based upon the limited partner's conduct, that the limited partner is a general partner.

By way of contrast, a limited partner, by being involved in the management of a limited partnership or holding himself/herself out as a general partner, can become personally liable on partnership obligations. The LP Act, KRS § 362.437(4), goes on to provide:

A limited partner who knowingly permits his name to be used in the name of a limited partnership, except under a circumstance permitted by KRS § 362.403(2), shall be liable to creditors who extend credit to the limited partnership without actual knowledge that the limited partner is not a general partner.

<sup>66</sup> H.B. 666, § 26. See also KRS § 271B.2-020(2)(b)(5) (permitting corporate articles of incorporation to set forth provisions regarding "the imposition of personal liability or shareholders for the debts of the corporation to a specified extent and upon specified conditions.")

<sup>67</sup> Johnson, *Limited Liability for Lawyers: General Partners Need Not Apply*, 51 BUSINESS LAWYER 85 at 91 (November, 1975) (footnote omitted).

<sup>68</sup> However, some of the rationales utilized in Kentucky to pierce the corporate veil appear inapplicable to LLCs. These provisions include the failure to follow organizational formalities. See, e.g., *White v. Winchester Land Dev. Corp.*, 584 S.W.2d 56, 62 (Ky. Ct. App. 1979) (holding that the "failure to observe the formalities of corporate existence" could constitute a factor in support of piercing the corporate veil). The LLC Act does not mandate organizational formalities such as appointment of officers and regular board and shareholders' meetings. Conversely, co-mingling of company and personal assets or the use of company assets for personal purposes any support an argument for piercing the veil.

Courts appear willing, even absent an express statutory incorporation of the law of piercing the corporate veil, to apply same to LLCs. See, e.g., *Ditty v. Checkrite, Ltd., Inc.*, 973 F.Supp. 1320 (D. Utah 1997) (veil of LLC not pierced); *In re Multimedia Communications Group Wireless Assoc. of Liberty County*; *Mills v. Webster*, 212 B.R. 1006 (Bankr. M.D. Fla. 1997) (veil of LLC not pierced); and *Northern Tankers (Cyprus) Ltd v. Backstrom*, 967 F. Supp. 1391 (D. Conn. 1997) (applying alter ego theory in the context of, among other points, intermingling of assets, common ownership, inadequate capitalization and failure to observe corporate formalities, veils of numerous entities, including LLCs, pierced). Reviews of the law of piercing the corporate veil as applied to LLCs include PRESSER, *PIERCING THE CORPORATE VEIL* § 4.01[2]; Cohen-Whelan, *Individual Responsibility in the Wake of Limited Liability*, 32 U.S.F.L. REV. 335 (1998); Thompson, *The Limits*

of Liability in the New Limited Liability Entities, 32 WAKE FOREST L. REV. 1 (Spring 1997); Bahls, *Application of Corporate Common Law Doctrines to Limited Liability Companies*, 55 MONT. L. REV. 43 (1994); and Fox, *Piercing the Veil of Limited Liability Companies*, 62 GEO. WASH. L. REV. 1143 (1994).

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KRS § 275.185(4).

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KRS § 275.095. *Accord*, KRS § 271B.2-040. The LLC Act does not contain an express provision recognizing that the LLC is liable for the acts of its members and managers when such occur in the carrying out of the ordinary business of the LLC. *Compare* ULLCA § 302, which provides:

A[n LLC] is liable for loss or injury caused to a person, or for a penalty incurred, as a result of a wrongful act or omission, or other actionable conduct, of a member or manager acting in the ordinary course of business of the company or with authority of the company.

However, general rules of principal and agent would dictate this result. There are cases which have held that, with adequate disclosure of the preformation status of an LLC, limited liability of those perspective members can be avoided. In *P.D.2000, L.L.C., v. First Financial Partners, Inc.*, 998 S.W.2d 108 (Mo. App. 1999), the court considered a situation in which the parties sought to avoid the enforcement of a contract entered into on behalf of a to be formed LLC on the basis that the LLC lacked the capacity to enter into the contract. The contract in question was signed by the organizer of the LLC as its president and the LLC, upon its formation, ratified the organizer's preformation activities. The contract itself acknowledged that the LLC was to be formed. Defendant sought to avoid liability under the contract by arguing that, as the LLC did not exist at the time the contract was signed, there was no party with which it entered into an agreement and that it was not bound by the subsequent ratification of pre-organizational activities. The court rejected both of these arguments, determining that the defendant, having entered into a contract with the LLC knowing it was to be formed, was thereby estopped for relying upon that "to be formed" status to avoid its obligations under the contract, and further determined the partial performance of the agreement by the LLC prevented the defendant from withdrawing.

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KRS § 275.160(1).

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KRS § 275.160(2).

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LLC's are certainly not the first business structure which have presented questions regarding the respect their attributes would be afforded outside their jurisdiction of formation. In *Bank of Augusta v. Earle*, 38 U.S. (13 Pet.) 519, 588-89 (1839), the Supreme Court wrote:

But it has been urged in the argument that, notwithstanding the powers thus conferred by the terms of the charter, a corporation, from the very nature of its being, can have no authority to contract out of the limits of the State: that the laws of a State can have no extra-territorial operations; and that as a corporation is the mere creature of a law of the State, it can have no existence beyond the limits in which the law operates; and that it must necessarily be incapable of making a contract in another place.

It is very true that a corporation can have no legal existence out of the boundaries of the sovereignty by which it is created. It exists only in contemplation of law, and by force of the law; and where that law ceases to operate, and is no longer obligatory, the corporation can have no existence. It must well in the place of its creation, and cannot migrate to another sovereignty. But although it must live and have its being in that State only, yet it does not by any means follow that existence there will not be recognized in other places; and its residence in one State creates no insurmountable objection to its power of contracting in another. It is, indeed, a mere artificial being, invisible and intangible; yet it is a person, for certain purposes in contemplation of law, and has been recognized as such by the decisions of this court.

<sup>74</sup> For an expanded discussion of the points raised in this section 6.8, see Rutledge, *To Boldly Go Where You Have Not Been Told You May Go: The Restatements' View of LLCs and LLPs in Interstate Commerce*, LLC ADVISOR (April, 1995), reprinted in STATE TAX REVIEW (May 1, 1995).

<sup>75</sup> The "Restatement".

<sup>76</sup> Titled "Shareholders' Liability."

<sup>77</sup> Titled "Treatment of Organization as Corporation."

<sup>78</sup> See also, *Hill-Davis Co. v. Atwell*, 10 P.2d 463 (Ca. 1932):

It is elementary law that, when the question arises in one state as to whether a particular association organized under the laws of a sister state is a corporation or merely an unincorporated association, the question will be determined by considering the nature of the association as indicated by the powers and faculties conferred on it by the state of its creation. If the powers and faculties conferred on it are such as to make it essentially a corporation, it will be held to be such, regardless of what or how the state of its creation calls or treats it.

<sup>79</sup> See Restatement §§ 174 ("Vicarious Liability")(tort claims); 295 ("Contractual Liability of Partnership, Partners and Third Person")(contract claims).

<sup>80</sup> See Restatement § 307.

<sup>81</sup> See, e.g., *Means v. Limpia Royalties*, 115 S.W.2d 468 at 475 (Tex. Ct. Civ. App. 1938) (refusing to recognize limited liability of shareholders of Oklahoma business trust); *Thompson v. Schmidt*, 274 S.W.2d 554 at 560 (Tex. 1925)(refusing to recognize limited liability of shareholders of Massachusetts business trust); *Ing v. Liberty Nat'l Bank*, 216 Ky. 467 (1926) (refusing to recognize, with respect to third parties, limited liability purportedly afforded by organizational documents to investors in unincorporated syndicate).

<sup>82</sup> See, e.g., *Abu-Nassar v. Elders Futures, Inc.*, No. 88-CIV-7906 (S.D.N.Y. March 28, 1991) (available on LEXIS) (in reviewing the question of personal liability of members in Lebanese limited liability company, the law of which provides for limited liability, the Court looked to Lebanese law); *Downey v. Swan*, 454 N.Y.s.2d 895 (N.Y. App. Div. 1982) (in reviewing the limited liability of a member of a dissolved New Jersey partnership association, the Court looked to New Jersey law).

<sup>83</sup> In *IHS Acquisition Services XV, Inc. v. Kings Harbor Care Center*, No. 98-CIV-7621, 1999 WL 223152 (S.D.N.Y. 1999), the plaintiff sued for payment on a professional services contract rendered by the defendant. While the plaintiff was the successor in interest to an LLC. Plaintiff was not organized as a professional LLC. On this basis, the defendant sought to avoid liability on the obligation, claiming it was not permitted to provide, or to contract to provide professional services in New York. In effect, this was a defense of illegality. After reviewing the law of illegality of contracts, the Court held that it would not, acting pursuant to a 12(b)(6) Motion to Dismiss for failure to state a claim, grant the requested relief. However, it did seem, at least, narrowly, to be open to such an argument on a Motion for Summary Judgment.

<sup>84</sup> KRS § 275.195.

<sup>85</sup> Ky. Const. § 193.

<sup>86</sup> Ky. Const. § 208.

<sup>87</sup> KRS § 446.010(8).

<sup>88</sup> KRS § 275.200(1)-(2). *Accord*, RULPA § 502(a),(b).

<sup>89</sup> KRS § 275.200(2).

<sup>90</sup> KRS § 275.200(2).

<sup>91</sup> KRS § 275.200(4)-(5). *Accord*, RULPA § 502 (b),(c).

<sup>92</sup> KRS § 275.205 (prior to 1988 Amendment). *Accord* ULLCA § 406(a); Prototype § 601.

<sup>93</sup> RULPA § 503.

<sup>94</sup> CALLISON, J. WILLIAM, PARTNERSHIP LAW AND PRACTICE § 4.14 (1992).

<sup>95</sup> This failure to require, by statute, that a departure from this default rule be pursuant to a written operating agreement was a drafting oversight. Section 503 of the Prototype, upon which KRS § 275.205 as adopted in 1994, was based, expressly required that a departure from the default rule be in a written operating agreement.

<sup>96</sup> H.B. 666, § 31, amending KRS § 275.205. Note that, subsequent to the 1998 Amendments, the rule continues that a departure from the default rule on allocations need not be set forth in a written operating agreement.

<sup>97</sup> KRS § 275.210 (prior to 1988 Amendments). The same per-capita default rule applied to voting as well. KRS § 275.175(1).

<sup>98</sup> KRS § 275.210 (prior to 1988 Amendments). Addressing the requirement that a departure from the default rule be in writing, the commentary to § 601 states in part:

Consistent with RULPA § 504, an overriding operating agreement provision must be in writing. Although this Act generally eliminates the requirement of a written operating agreement, any deviation from a per capita division arrangement should be in writing because of the detail and potential for litigation involved in such a provision.

<sup>99</sup> PARTNERSHIP LAW AND PRACTICE § 4.14.

<sup>100</sup> H.B. 666, § 32, amending KRS § 275.210.

<sup>101</sup> KRS § 275.215.

<sup>102</sup> Discussed below in § 6.22.

<sup>103</sup> KRS § 275.215.

<sup>104</sup> KRS § 275.215.

<sup>105</sup> The LLC Act, as adopted in 1994, did not require that a departure from this rule had to be set forth in a written operating agreement. This provision was amended in the 1998 Amendments to require that such departure be in a written operating agreement. H.B. 666, § 33.

<sup>106</sup> KRS § 275.220(1). *Accord* KRS § 362.469(1).

<sup>107</sup> KRS § 275.220(2). *Accord* KRS § 362.469(2).

<sup>108</sup> KRS § 275.225.

<sup>109</sup> KRS § 275.225(1)(a)-(b). *Accord*, KRS § 271B.6-400(3)(a)-(b).

<sup>110</sup> KRS § 275.225(2).

<sup>111</sup> KRS § 275.225(3)(a)-(b). *Accord*, KRS § 271B.6-400(5)(c).

<sup>112</sup> KRS § 275.225(5).

<sup>113</sup> KRS § 275.225(1).

<sup>114</sup> KRS § 275.225(6).

<sup>115</sup> KRS § 275.230(1).

<sup>116</sup> KRS § 275.230(2)(a)-(b). *Compare*, KRS § 271B.8-330(1)(b).

<sup>117</sup> KRS § 275.230(3).

<sup>118</sup> KRS § 275.225(4). *See also*, KRS § 275.235 (granting to each member the status of and remedies available to creditors of an LLC with respect to any right to receive a distribution.)

<sup>119</sup> *See* KRS § 271B.6-400(6); *Taylor v. Axton-Fisher Tobacco Co.*, 295 Ky. 226, 173 S.W.2d 377 (Ky. 1943).

<sup>120</sup> KRS § 275.240(1), (2). *Accord*, UPA § 8(1). As stated in the commentary to § 701 of the Prototype:

The first sentence of subsection (A) is from RUPA § 203. This section clarifies that, unlike a partnership under UPA, LLC property is owned by the firm itself rather than nominally or otherwise by the members. This ensures that the “tenancy in partnership” which has confused partnership law will not plague LLCs. It is implicit in this section that a member may use LLC property for LLC purposes provided the member is authorized to do so.

<sup>121</sup> In *Gattoni v. Zaccaro*, 1997 WL 139410 (Conn. Super., March 7, 1997), the court reviewed a situation in which the title owner to certain real property was an LLC. There was a falling out between the members of the LLC. In rejecting a claim for, *inter alia*, partition of the property, the Court cited the provisions parallel to KRS § 275.240 and held that the plaintiff had no interest in the real estate of the LLC which would entitle him to bring a partition action.

<sup>122</sup> In *Gattoni v. Zaccaro*, 1997 WL 139410 (Conn. Super., March 7, 1997), the court reviewed a situation in which the title owner to certain real property was an LLC. There was a falling out between the members of the LLC. In rejecting a claim for, *inter alia*, partition of the property, the Court cited the provisions parallel to KRS § 275.240 and held that the plaintiff had no interest in the real estate of the LLC which would entitle him to bring a partition action.

<sup>123</sup> KRS § 275.245(2)(a). The only revision to this provision by the 1998 Amendment is the addition of the language that the manager signing on behalf of the LLC must be “so authorized.” H.B. 666, § 34, amending KRS § 275.245(5), recodified at KRS § 275.245(2)(a).

<sup>124</sup> KRS § 275.245(2)(b). KRS § 275.245(5)(b) was recodified by H.B. 666, § 34 to appear as KRS § 275.245(2)(b).

<sup>125</sup> KRS § 275.245(1). The only revision to this provision by the 1998 Amendments was the addition of the language that the member signing on behalf of the LLC must be “so authorized.” H.B. 666, § 34.

<sup>126</sup> The provisions relating to the transfer of LLC property, as adopted in 1994, were themselves based upon § 302 of the Revised Uniform Limited Partnership Act with revisions made to accommodate LLCs directly managed by the members versus those managed by managers.

<sup>127</sup> As adopted in 1994, KRS § 275.245(2) provided that where property has been transferred to a member or manager in their capacity as such in the LLC, but without naming the LLC, an instrument of transfer could be executed by the member or manager in whose name that title was held. This provision was deleted by the 1998 Amendments. H.B. 666, § 34.

<sup>128</sup> The LLC Act, as adopted in 1994, provided that if property was transferred pursuant to KRS § 275.245(1) or § 275.245(2), it could be recovered by the LLC if it was able to prove that the instrument of transfer did not bind it, provided that property has not been subsequently transferred to a transferee who gave value without notice that the instrument of transfer had been executed without authority to bind the LLC. KRS § 275.245(3). However, if the property of an LLC is held in the name of a person other than the LLC, and the instrument transferring title does not indicate that it is transferred to them in their capacity as members or managers or does not reference the LLC, the property may be transferred free of any claims of the LLC or the members thereof. This provision is applicable only if the transferee gives value without notice that the property is properly that of the LLC. KRS § 275.245(4). Both KRS § 275.245(3) and KRS § 275.245(4) were deleted in the 1998 Amendments. H.B. 666, § 34.

<sup>129</sup> KRS § 275.275(1)(a). *Accord*, KRS § 362.433. This requirement of unanimity, set forth in the LLC Act as adopted in 1994, was not changed to a majority-in-interest standard by the 1998 Amendments.

<sup>130</sup> KRS § 275.275(2)(a)-(b).

- 131 KRS § 275.275(2)(b).  
 132 KRS § 275.255(1)(a). *Accord*, RULPA § 701.  
 133 KRS § 275.255(2).  
 134 KRS § 275.255(1)(b)-(c).  
 135 KRS § 275.255(1)(d).  
 136 KRS § 275.255(1)(c). *Accord*, UPA § 702; KRS § 362.280.  
 137 KRS § 275.255(1)(e)-(f).  
 138 KRS § 275.255(3).  
 139 KRS § 275.255(1)(b).  
 140 RIBSTEIN AND KEATINGE ON LIMITED LIABILITY COMPANIES § 7.07.  
 141 KRS § 275.265 (prior to the 1988 Amendments).  
 142 H.B. 666, § 36.  
 143 KRS § 275.265(1).  
 144 KRS § 275.265(2).  
 145 KRS § 275.265(2). *Compare*, RULPA § 704(b). The commentary to § 706 of the Prototype discusses the compromise reached on the assignee's succeeding to the assignor's liabilities to the LLC:

It is not clear as a policy matter that the assignor's obligations to the LLC should pass to the assignee, at least as long as the assignor remains obligated. Adding an obligor obviously benefits non-assigning members and creditors (which, in turn, may reduce the LLC's credit costs). At the same time, transfer of obligations reduces the marketability of LLC interests. This cost may exceed the benefit to the LLC because of the assignee's uncertainty about the extent of the assigned liabilities. Accordingly, perhaps the statute should provide that obligations are not assigned unless the parties so provide, or allow the members to contract around this consequence. At the least, as provided in this section, the statute should minimize the assignee's risk by eliminating liability for unknown contribution obligations not reflected in the LLC's official records.

- 146 KRS § 275.265(3).  
 147 KRS § 275.265(4).  
 148 KRS § 275.260. *Accord*, RULPA § 703; UPA § 28(1); KRS § 362.481.  
 149 KRS § 275.260.  
 150 KRS § 275.260. The commentary to § 705 of the Prototype, upon which KRS § 275.260 is based, states:

Just as LLC members cannot individually assign the firm's specific property, so they cannot individually make it available to their creditors to satisfy their individual debts. Members can, however, pledge their interests in the LLC as security on a debt.

This section provides that unsecured creditors can obtain from a court a "charging order," which is sort of attachment or garnishment, against the member's interest. Under this section, the charging order is available only to judgment creditors of members. It is therefore not available to others with rights against

members other than those of judgment creditors. It also cannot be used by judgment creditors of members' assignees.

A charging creditor has the rights of an assignee to the extent that the interest is charged. This implies that the creditor need not foreclose on the interest to acquire the full rights of an assignee. If assignees are given any other rights under the statute, such as the right to compel a judicial dissolution, legislatures should consider making the charging creditor's right to become an assignee contingent on judicial approval, in order to give a court an opportunity to consider the effect of the transfer on the non-debtor members.

While the section gives debtor members the benefit of any exemptions applicable under state law to LLC interests, the member cannot claim an exemption in specific LLC property, because the member lacks a direct ownership interest in specific LLC property.

For a discussion of charging orders, see Geu, Thomas, *A Brief Review Of Charging Orders UPA, RUPA, RULPA And Beyond*, XV Pubogram (Newsletter of the Committee on Partnerships and Unincorporated Business Organizations of the Section of Business Law of the American Bar Association) 6 (October, 1999).

<sup>151</sup> KRS § 275.270 (prior to 1998 Amendments). See also, KRS § 275.265(a).

<sup>152</sup> H.B. 666, § 59.

<sup>153</sup> See § UPA 29.

<sup>154</sup> See UPA § 30; RULPA § 801.

<sup>155</sup> KRS § 275.280(1)(a)-(b) (as amended by H.B. 666, § 37). Prior to the 1998 Amendments, the default rule was all members, rather than a majority-in-interest of the members.

<sup>156</sup> KRS § 275.280(1)(f)-(j) (as amended by H.B. 666, § 37). Prior to the 1998 Amendments, the default rule was all members, rather than a majority-in-interest of the members.

<sup>157</sup> KRS § 275.280(2).

<sup>158</sup> KRS § 275.280(3) (prior to 1988 Amendments). Compare KRS §§ 362.300, 362.463 (general partner in a general or limited partnership may withdraw at any time); KRS § 362.465 (prior to 1998 Amendments)(if not otherwise provided, limited partner may withdraw on six months notice.) See *infra* note 237 and accompanying text regarding the amendment of KRS § 362.465.

<sup>159</sup> KRS § 275.280(3), as amended by H.B. 666, § 37. A similar revision was made to the LP Act, providing that no limited partner, absent such a right set forth in a partnership agreement, may withdraw from a limited partnership prior to dissolution and winding up. H.B. 666, § 50, amending KRS § 362.465.

<sup>160</sup> KRS § 275.280(3). The 1998 Amendments also amended KRS § 275.280 by deleting the provisions addressing damages recoverable by the LLC in the case of an improper withdrawal. Those provisions provided that if the withdrawal constituted a breach of the operating agreement, or withdrawal was consequent to otherwise wrongful conduct by the withdrawing member, the LLC could recover from the withdrawing member damages resulting from the breach of the operating agreement or from the wrongful conduct. KRS § 275.280(3) (prior to 1988 Amendments). Those damages could include the reasonable costs of obtaining replacement of any services the withdrawing member was obligated to perform. Damages owed the LLC by the member as a consequence of his or her withdrawal could be offset against the amount distributable to the withdrawing member. Unless varied by the operating agreement, when the LLC has been organized for a definite term or for a particular undertaking, the withdrawal of a member before that expiration date constituted a breach of the operating agreement.

<sup>161</sup> See *supra* § 6.22 and accompanying notes regarding the 1998 Amendments and the newly adopted limitations on the right to voluntarily withdraw.



<sup>162</sup> A similar revision was made to the LP Act, providing that no limited partner, absent such a right set forth in a partnership agreement, may withdraw from a limited partnership prior to dissolution and winding up. H.B. 666, § 50, amending KRS § 362.465.

<sup>163</sup> KRS § 275.280(2).

<sup>164</sup> KRS § 275.285.

<sup>165</sup> KRS § 275.285(2). Prior to the 1998 Amendments, the default rule was a requirement of the consent of all members for a voluntary liquidation of the LLC. The 1998 Amendments changed this voting threshold to a majority-in-interest of the members. H.B. 666, § 38.

<sup>166</sup> KRS § 275.290(1). *Accord*, KRS § 362.489 (applying “not reasonably practicable” standard to judicial dissolution of a limited partnership). *Compare*, KRS § 271B.14-300, which provides that a corporation may be judicially dissolved where management is deadlocked, the shareholders are unable to break the deadlock and irreparable harm to the corporation is being suffered or threatened by the deadlock, or where the business or affairs of the corporation, because of the deadlock, cannot be conducted to the advantage of the shareholders generally, or where the directors or those in control of the corporation are acting in an illegal or fraudulent manner, or where the shareholders have been unable to resolve a deadlock relating to the election of directors.

<sup>167</sup> KRS § 275.290(1).

<sup>168</sup> KRS § 275.290(3).

<sup>169</sup> KRS § 275.290(2).

<sup>170</sup> KRS § 275.295(1)(a)-(c). *Accord*, KRS § 271B.14-200.

<sup>171</sup> KRS § 275.295(2)(a)-(b). *Accord*, KRS §§ 271B.14-210(1),(2).

<sup>172</sup> KRS § 275.295(2)(b). *Accord*, KRS § 271B.14-220(1).

<sup>173</sup> KRS § 275.295(3)(a)(i)-(v). *Accord*, KRS § 271B.14-220(1)(a)-(e).

<sup>174</sup> KRS § 275.295(3)(b). *Accord*, KRS § 271B.14-220(2).

<sup>175</sup> KRS § 275.295(3)(c). *Accord*, KRS § 271B.14-220(3).

<sup>176</sup> KRS § 275.295(4)(a)-(d). *Accord*, KRS § 271B.14-230.

<sup>177</sup> KRS § 295.300(1).

<sup>178</sup> KRS § 275.300(1)(b).

<sup>179</sup> KRS § 275.300(2).

<sup>180</sup> KRS § 275.300(2)(a)-(d). *Accord*, KRS § 271B.14-050.

<sup>181</sup> KRS § 275.300(3)(a)-(h).

<sup>182</sup> KRS § 275.170(2)(a).

<sup>183</sup> KRS §§ 275.305(1)(a); (3).

<sup>184</sup> KRS § 275.305(1)(b).

<sup>185</sup> KRS § 275.305(2).

<sup>186</sup> KRS § 275.310(1). Care should be followed in conforming to the specifics of the dissolution provisions of the LLC Act; failure to do so could expose the members to unnecessary liability. In *New Horizons Supply Cooperative v. Haack*, 1999 WL 33499 (Wis. App. Jan. 28, 1999), the court reviewed a situation in which the formalities of liquidation of an LLC were not satisfied, and on that basis imposed personal liability on a member for an obligation of the LLC. The court wrote:

The record is devoid, however, of any evidence showing that appropriate steps were taken upon the dissolution of the company to shield its members from liability for the entity's obligations. Although it appears that filing articles of dissolution is optional, the order for distributing the company's assets following dissolution is fixed by statute, and the company's creditors enjoy first priority. A dissolved limited liability company may "dispose of known claims against it" by filing articles of dissolution, and then providing written notice to its known creditors containing information regarding the filing of claims. The testimony at trial indicates that Haack knew of New Horizons' claim at the time Kickapoo Valley was dissolved. It is also clear from the record that articles of dissolution for Kickapoo Valley Freight LLC were not filed, nor was the cooperative formally notified of a claim filing procedure or deadline.

It appears from the record that certain of Kickapoo Valley's assets were sold, and that the proceeds from that sale were remitted to the bank which held a lien on the company's truck. There is nothing in the record, however, showing the disposition of other company assets, such as cash and accounts receivable. New Horizons' witness testified that, in October 1997, Haack had claimed to be attempting to collect the accounts of the dissolved company and hoped to pay the instant debt from those proceeds. We do not know the value of the accounts receivable in question, however, or the amounts of any other company debts to which the proceeds of the accounts may have been applied, because Haack presented no testimony on the issue.

In this regard, we agree with the trial court's comments regarding the lack of evidence in the record to show that Kickapoo Valley's affairs were properly wound up following its dissolution occasioned by Robert Koch's dissociation from the enterprise. Although Kickapoo Valley Freight LLC may have been properly formed and operated as an entity separate and distinct from its owners, Haack did not establish that she distributed the entity's assets in accordance with [ ] following Kickapoo's dissolution. Her failure to employ the procedures outlined in [ ], left her vulnerable to New Horizons' claim under [ ], absent proof that the value of any assets of the dissolved company she received were exceeded by the cooperative's claim.

- 187 KRS § 275.310(2).
- 188 KRS § 275.310(3).
- 189 KRS § 275.320(2). *Accord*, KRS § 271B.14-060.
- 190 KRS § 275.320(3).
- 191 KRS § 275.325(2)(b). *Accord*, KRS § 271B.14-070.
- 192 KRS § 275.325(2)(c).
- 193 KRS § 275.325(2)(c).
- 194 KRS § 275.325(3)(c).
- 195 KRS § 275.325(4)(a)-(b).
- 196 KRS § 275.325(4)(b).
- 197 KRS § 275.330.

<sup>198</sup> Compare, KRS § 271B.3-020(1)(a). Conversely, prior to the passage of S.B. 184, a general partnership could neither sue nor be sued in its common name. See *Telamarketing Comm. v. Liberty Partners*, 798 S.W.2d 462 (Ky. 1990). Section 107 of S.B. 184, codified at KRS § 362.605, authorized suits against partnerships in their common names.

<sup>199</sup> As stated in the commentary to § 305 of the Prototype:

Because members, in their status as such, are not liable for the debts of the LLC, they should not be proper parties in third-party actions against the LLC. This section is intended to affirm that the LLC is an entity separate and apart from its members for purposes of litigation by or against the LLC.

At least one court has taken the admonition that LLC members are not proper parties to heart, and imposed Rule 11 sanctions against counsel who named an individual member as a party in a suit against an LLC. In *Page v. Roscoe, LLC*, 497 S.E.2d 422 (N.C. Ct. App., 1998), the Court wrote:

The trial court also found that:

The actions of the Plaintiff and their Attorney of Record in naming the Defendant, Dale C. Bone, as an individual party defendant in this Complaint were contrary to North Carolina law in that N.C.G.S. § 57CD-3-30(b) prohibits the naming of a member of a limited liability company as a party to proceedings by or against a limited liability company. Moreover, the Complaint does not allege any acts on the part of Dale C. Bone individually, which are not related to his status as a member of a North Carolina limited liability company and would justify the naming of Bone as an individual party Defendant.

The court then concluded that the improper naming of Bone as an individual party defendant "violates Rule 11 of the North Carolina Rules of Civil Procedure in that the allegations are not well founded in fact or law and taken for the improper purpose of hindering, delaying and preventing the operation of a lawful business enterprise by Roscoe, L.L.C."

While we do not find that the allegations were not well-grounded in fact or were taken for an improper purpose, we do find that the allegations against Bone individually are not well-grounded in law.

N.C. Gen. Stat. § 57C-3-30 (1993) provides in pertinent part:

(a) A person who is a member or manager, or both, of a limited liability company is not liable for the obligations of a limited liability company solely by reason of being a member or manager or both, and does not become so by participating, in whatever capacity, in the management or control of the business. A member or manager may, however, become personally liable by reason of his own acts or conduct.

(b) A member of a limited liability company is not a proper party to proceedings by or against a limited liability company, except where the object of the proceeding is to enforce a member's right against or liability to the limited liability company.

The record sustains the trial court's conclusion that no acts by Bone, individually, were properly alleged. Therefore, under the above statute, it was improper to name an individual member of a limited liability company as a party defendant without any evidence to support it. As such, the naming of Bone as an individual defendant was not well-grounded in law and therefore a violation

of Rule 11. Even though defendant's counsel conceded at oral argument that the naming of Bone as an individual defendant did not require additional time and research beyond what was required to assert defenses and other legal arguments on behalf of Roscoe, it is for the trial judge to determine what sanctions, if any, are appropriate here. We remand for consideration by the trial court of an appropriate sanction based on the record or further evidence.

In *ING (U.S.) Securities, Futures & Options, Inc. v. Bingham Investment Fund, L.L.C.*, 934 F.Supp. 987 (N.D. Ill. 1996), the Court held that the members of a Michigan LLC were not subject to the personal jurisdiction of an Illinois court based upon their actions on behalf of that LLC, they being shielded by the fiduciary shield doctrine.

200 KRS § 275.155.

201 KRS § 275.335(1).

202 KRS § 275.335(1).

203 KRS § 275.335(2).

204 See, *Valentine L.L.C. v. Flexible Business Solutions, L.L.C.*, 2000 WL 960901 (Conn. Super. June 22, 2000) (holding that an LLC cannot appear *pro se*, seeing no reason to distinguish an LLC from a corporation or partnership, neither of which may appear *pro se*); *Banco Popular North America v. Austin Bagel Company, LLC*, No. 99 CIV. 11252 SAS, 2000 WL 669644 (S.D.N.Y. May 23, 2000) (default judgment entered against LLC which attempted to appear *pro se*); *International Association of Sheet Metal Workers Local 16 v. A.J. Mechanical*, No. CIV. 99-451-FR, 1999 WL 447459 (D. Or. June 16, 1999) (pleading of LLC which attempted to appear *pro se*); *Poore v. Fox Hollow Enterprises*, No. C.a. 93A-09-005, 1994 WL 150872 (Del. Su. Super Ct. March 29, 1994) (holding that a Delaware LLC, like a Delaware corporation, may not appear *pro se*).

205 KRS § 275.340.

206 In *Poore v. Fox Hollow Enterprises*, 1994 WL 150872 (Del. Super., March 29, 1994), the Delaware Court considered whether a Delaware LLC was permitted to represent itself *pro se*. The court determined that the LLC is an artificial entity, analogous to a corporation, which, under Delaware law, must in state court be represented by counsel. The similar result should be reached in Federal court. See also, *Rowland v. California Men's Colony*, 113 S.Ct. 716 (1993).

## 7.1 BASICS OF STATUTORY TRANSACTIONS

by

Thomas E. Rutledge

This chapter<sup>1</sup> will discuss certain fundamental and frequently occurring LLC transactions and examine their treatment under the LLC Act. These statutory transactions are conversion, merger and dissolution. Dissolution of an LLC is discussed *supra* at § 6.22 through § 6.33.

### 7.2 Benefits of Conversion and Merger Provisions

Several important benefits are realized by the inclusion in the LLC Act of detailed provisions authorizing LLC mergers and conversions. The provisions permit business combinations involving LLC's (and other designated business entities) to be effected by means of streamlined, statutory procedures. Absent such provisions, business combinations equivalent to conversions or mergers would be possible, but would require increased documentation. In this regard, statutory mergers and conversions, where appropriate, can replace the following transactions:

- a sale (or purchase) of assets by an LLC to or from another entity;
- a contribution of assets by (or to) an LLC in exchange for an ownership interest in that other entity, followed by a liquidation of the contributing entity;
- the acquisition by (or issuance from) an LLC of an ownership interest in another entity (or the LLC), followed by liquidation of the acquired entity; or
- a liquidation of an LLC (or other entity) followed by a sale or contribution of the assets by the former owners to another entity (or LLC).

Furthermore, statutory mergers or conversions may often circumvent costs or conditions not otherwise avoided in the case of transactions structured differently, including real estate transfer or recordation taxes, other transfer taxes, automatic novation of debts, third-party consents to assignment or assumption of contracts, leases, financing arrangements, etc.

The LLC Act makes clear that the merger provisions are not the exclusive means of accomplishing a merger or similar transactions.<sup>2</sup> When appropriate, such transactions may also be executed as described above or in any other manner as permitted by law.

### 7.3 Conversion of Partnership to LLC

The LLC Act permits a general or limited partnership to convert directly to a domestic LLC via a simple statutory conversion mechanism.<sup>3</sup> Kentucky's LLC Act is one of the few state LLC statutes currently providing a specific conversion mechanism for partnerships to become LLC's distinct from the merger procedure. Because LLC's generally retain partnership tax treatment yet offer their members limited liability, it is anticipated that many partnerships, both general and limited, will be interested in restructuring and continuing their operations as a LLC.

### 7.4 Parties to Conversion and Approval Matters

The LLC Act authorizes the conversion of both Kentucky and foreign general and limited partnerships into Kentucky LLC's.<sup>4</sup> In authorizing the conversion of both types of partnerships, foreign and domestic, Kentucky's LLC Act is broader than many current conversion statutes enacted by other states, certain of which statutes restrict the right of conversion only to domestic partnerships.

The conversion provisions set forth certain approval procedures required of the converting partnership.<sup>5</sup> These approval mechanisms differ for general and limited partnerships. For the former, the LLC Act establishes a default rule of unanimous consent of the partners, which rule may be changed by agreement, whereas, for the latter, unanimity is mandated and may not be altered. Therefore, in the case of a general partnership, the conversion must be approved by all partners, or by such lesser number or percentage as may be required in the partnership agreement to approve a conversion. Because few current partnership agreements are likely to specifically address "conversions", it is probable then that a unanimous vote of the partners will be required. Conversely, the conversion of a limited partnership always requires the affirmative vote of all partners, both limited and general, notwithstanding any contrary provision in the limited partnership agreement.<sup>6</sup>

## **7.5      Conversion Filing Requirements**

Once approved, the converting partnership files Articles of Organization with the Secretary of State.<sup>7</sup> These Articles of Organization must set forth the basic LLC information called for in Articles of Organization filed when forming a new LLC,<sup>8</sup> plus certain new information relating to the conversion. The additional information required in conversion Articles of Organization include:

- a statement that the partnership was converted to an LLC;
- the former name of the converted partnership; and
- a statement evidencing that the requisite number or percentage of votes necessary to approve the conversion was obtained.<sup>9</sup>

Any partnership operating under an assumed name must also file a certificate of cancellation of such assumed name and state in the Articles of Organization that such assumed name was canceled. A converting limited partnership must also file a Certificate of Cancellation of its Certificate of Limited Partnership.<sup>10</sup>

The conversion is effective at the later of the time of filing of the Articles of Organization, a subsequent effective date specified therein, or, in the case of a limited partnership, the filing of the limited partnership's Certificate of Cancellation.<sup>11</sup> In order to make certain that the desired effective date is attributed to a conversion of a limited partnership, practitioners should simultaneously file both the Articles of Organization and the Limited Partnership's Cancellation Certificate or, if simultaneous filing is not chosen, ensure that a Certificate of Cancellation is in fact filed on the selected subsequent effective date.

In addition to these statutory filings, converting partnerships will need to craft an operating agreement which, while likely largely based upon the pre-existing partnership or limited partnership agreement, will need to address the differing status and obligations of LLC members as contrasted with the status and obligations of either general or limited partners.

## **7.6      Effect of Conversion**

The LLC Act provides that an LLC formed pursuant to the conversion mechanism shall, for all purposes, be the same "entity" (*i.e.*, the partnership or the limited partnership) as existed before the conversion.<sup>12</sup> Conversion is not therefore deemed an event of dissolution or termination of the partnership for purposes of partnership law. This concept is related to RUPA's adoption of the "entity" theory of partnership in place of the UPA's previous "aggregate" theory. Similarly, of those state LLC statutes which have conversion provisions, most specifically provide that there is no dissolution of the "entity" upon conversion.

While it remains uncertain what effect courts will give to these provisions, the intent (as with RUPA's adoption of the "entity" theory) is to address previous ambiguities relating to the aggregate theory of partnership, particularly in the area of the conveyance by a partnership of title to real and personal property. Because it is intended that no new entity will be formed by the conversion process, no conveyance or transfer of title or assets in connection with the conversion of a partnership to an LLC will be deemed to have occurred. This construction should therefore preclude the need for deeds to convey title from the converting partnership to the LLC.

The LLC, as an entity, shall own all property previously owned as partnership property and be liable for all partnership liabilities or obligations, including pending actions and proceedings, of the converted entity without any further filing requirements.<sup>13</sup> The LLC Act specifically provides that title to all partnership property remains "vested" in the converted entity.<sup>14</sup> No further act or deed to vest title is required and title vests without reversion or impairment.

## 7.7 Personal Liability of Former Partners

The effect of a conversion on the individual personal liability of the former partners is explicitly addressed by the LLC Act.<sup>15</sup> Under the LLC Act, the treatment of pre-existing partnership recourse liability varies according to the former status of the partners as general or limited.

Former general partners remain fully liable for all obligations which were incurred by the partnership before the effective date of the conversion.<sup>16</sup> This serves to ensure that existing creditors who extended credit to a partnership or limited partnership in complete or partial reliance upon the personal credit of the general partners remain in the same reliance position following a conversion of such partnership to an LLC. Furthermore, third parties who transact business with the converted partnership unaware of the new status of the former partners as LLC members are protected for 90 days after the conversion. With respect to these transactions occurring during the 90 day period immediately following the conversion, former general partners may remain personally liable for LLC obligations if the other party to such transaction reasonably believed the member was entering into such transaction as a general partner of a partnership or a limited partnership.<sup>17</sup> A former general partner can avoid the 90 day exposure to liability by notifying those transacting business with the LLC of the conversion of the entity from a partnership and his new status as a member of the LLC.<sup>18</sup>

Former limited partners shall remain liable only as limited partners for all obligations of the converted partnership incurred prior to conversion, that is, only to the extent of their capital contributions to the former partnership.<sup>19</sup>

## 7.8 Inter-Entity Mergers

One of the most significant changes effected by the LLC Act (as well amendments to the Corporation Act and the LP Act) is the authorization of inter-entity or "cross-specie" mergers. The LLC Act, in conjunction with the Corporation Act and LP Act amendments, permits mergers of LLC's with domestic and foreign LLC's, limited partnerships and corporations.<sup>20</sup> This statutory authority to merge is, however, subject to (1) contrary written agreement in the operating agreement of the LLC, and (2) the statutes and regulations applicable to such other entities as may be involved in the transaction.<sup>21</sup>

Other states vary widely regarding what entities may participate in mergers involving LLC's, as well as in inter-entity mergers generally. With respect to mergers involving solely domestic entities, Kentucky's authorization of mergers among LLC's, limited partnerships and corporations is broader than that of many states which permit only single specie (*i.e.* corporation-corporation; LLC-LLC) mergers. However, in the case of mergers involving domestic LLC's where all other constituent entities are foreign, the LLC Act permits mergers with foreign entities other than LLC's, limited partnerships and corporations. In such instances, domestic LLC's are permitted to merge with foreign general partner-

ships, business trusts and sole proprietorships if authorized by the statutes applicable to the foreign business entity.<sup>22</sup>

As mentioned, corresponding inter-entity merger provisions have been added to Kentucky's Corporation Act and LP Act to enable domestic corporations and limited partnerships, respectively, to merge with foreign and domestic LLC's, limited partnerships or corporations.<sup>23</sup> Care has been taken to ensure that such provisions closely parallel the merger provisions in the LLC Act, particularly with respect to filing requirements, approval matters, effects provisions, etc. Because of this parallel construction, inter-entity mergers involving solely domestic entities are subject to a single set of conforming standards and requirements, regardless of the number and differing natures of the merging entities involved. Therefore only one filing of identical Articles and Plan of Merger will be required to effect LLC and inter-entity mergers in Kentucky.

Senate Bill 184's merger provisions, however, relate only to mergers involving at least one LLC or a limited partnership. Mergers involving solely corporations, whether foreign or domestic, will continue to be governed by the existing Corporation Act merger provisions of KRS ch. 271B, which track the Revised Model Business Corporation Act ("RMBCA"), and which provisions have not been altered. In this way, with respect to pure corporate-corporate mergers, the status of Kentucky as a RMBCA jurisdiction has been preserved.

It is also important to note that the authority for domestic limited partnerships to merge, whether with other limited partnerships, with LLC's or with corporations, is contained in the amendments to Kentucky's LP Act (KRS ch. 362). Therefore, the right to merge is available only to Kentucky limited partnerships which are governed by KRS ch. 362 and which have filed Certificates of Limited Partnership pursuant thereto. Any limited partnership formed under any prior Kentucky statute which has not previously elected to be governed by KRS ch. 362 (or which is not governed by KRS ch. 362 by operation of law) must first file an amended and restated Certificate of Limited Partnership under KRS ch. 362 in order to avail itself of Senate Bill 184's new merger provisions. This must be done whether such limited partnership is to be the disappearing or surviving entity in the merger. The filing of the amended and restated Certificate of Limited Partnership may be done simultaneously with the merger filings.

#### **7.9            Approving the Merger**

Absent a differing threshold set forth in a written operating agreement, a merger involving an LLC must be approved by a majority-in-interest of the members.<sup>24</sup>

With respect to the other business entities party to the transaction, a merger must be approved by such entities in accordance with their governing statutes and organizational documents.<sup>25</sup>

#### **7.10          Merger Filing and Documentation Requirements**

The LLC Act calls for the execution and filing of a Plan and Articles of Merger in connection with a merger, which instruments should be familiar to those required in current corporate mergers. This follows the ULLCA format, but differs from that of certain states, as well as from the Prototype, which do not require a written or filed plan of merger.

Under the LLC Act, the business entities party to the merger must enter into a written Plan of Merger setting forth:

- the name of each business entity which is a party to the merger and the name of the surviving entity;



- the terms and conditions of the proposed merger, including a statement setting forth whether limited liability is retained by the surviving business entity;
- the manner and basis of converting the interests of each business entity into interests of the surviving entity, cash or other property;
- any desired amendments to the Articles of Organization, articles of incorporation or certificate of limited partnership of the surviving entity; and
- other provisions deemed necessary or desirable.<sup>26</sup>

The purpose of setting forth in the merger documents whether limited liability is retained by the surviving entity is to protect LLC members from exposure to personal liability as a consequence of the merger without their clear and knowing consent.

Following approval of the plan by all business entities involved, the surviving business entity shall file Articles of Merger with the Secretary of State which set forth:

- the names and jurisdiction of each constituent business entity;
- the Plan of Merger;
- the name of the surviving business entity;
- a statement that the Plan of Merger was duly authorized and approved; and
- if the surviving entity is a foreign entity, statements agreeing to service of process in Kentucky and appointing the Secretary of State as agent for such service.<sup>27</sup>

It should be remarked that, unlike the articles of merger under KRS ch. 271B which need only to be signed by the surviving corporation, articles of merger in LLC transactions must be executed by all constituent entities party to the merger.<sup>28</sup> Unlike the conversion of a limited partnership, the filing of Articles of Merger will serve to act a cancellation of the Certificate of Limited Partnership of a domestic limited partnership. No further filing is necessary.

The LLC Act does not provide a procedure for amending the terms of, or abandoning, of a merger, although it does permit the parties to agree to such procedures.<sup>29</sup> It is not contemplated however that such procedures would allow the members or the entities to amend or cancel Articles of Merger which have been filed with the Secretary of State, even should such articles have a delayed effective date. This limitation is made more clear in the Senate Bill 184's conforming merger provisions amending the LP Act, where the amendment right is specifically limited to periods before the Articles of Merger are filed with the Secretary of State.<sup>30</sup>

Non-surviving domestic corporations and limited partnerships should also file Certificates of Cancellation of any assumed name used by such partnership.

#### **7.11      Effects of a Merger**

The LLC Act sets forth the effect of a merger on the constituent entities.<sup>31</sup> Every entity that is a party to the merger other than the surviving entity ceases to exist, and the surviving entity shall succeed to all the rights, property and powers, and all the restrictions, disabilities and duties, of each of the constituent entities. As with a conversion, all real property interests vested in any constituent entity shall vest in the surviving entity, without further act or deed and without reversion or impairment.<sup>32</sup>

Unlike the conversion provisions of the LLC Act, the merger section does not specifically address the effect of a merger upon the liabilities of individual holders of ownership interests in the constituent entities. The general merger provision indicates that the interests, shares and other property to be converted in a merger will be so converted, in accordance with the terms of the merger agreement.<sup>33</sup> Presumably then, upon consummation of the merger, holders of limited liability ownership interests in the surviving entity shall have only such limited exposure as customarily corresponds to such interests for obligations incurred subsequent to the merger.

The LLC Act also does not specifically address the recourse liability of former general partners for debts of a non-surviving partnership incurred prior to the merger. In particular, the merger section does not contain the language similar to the conversion provisions clearly preserving such liability. Nonetheless, it would be an odd and surely unintended consequence if it were possible for general partners to escape their recourse liability via a merger of a partnership into an LLC, while retaining such liability if the same transaction were structured as a conversion.<sup>34</sup> Despite the fact that the LLC Act does not speak directly to this issue, a careful reading of the merger provisions and the general law of partnerships indicates that this is an unlikely result.

The LLC Act merger provisions contain a section clearly stating that no rights of creditors, nor any related lien respecting the property of any constituent entity, is impaired by reason of a merger.<sup>35</sup> This language would appear to be broad enough to encompass the issue of recourse liability of former general partners, therefore preserving such liability for existing debts of a former partnership.

Furthermore, it is clear that the drafters of the Prototype sections upon which the LLC Act merger provisions are based did not intend that a merger would effect a general partner's liability for previously incurred debts.<sup>36</sup> These comments indicate the drafters' view that the issue is one more properly dealt with by reference to the underlying partnership law.

Partnership law, both statutory and case law, is quite clear that individual general partners remain personally liable for preexisting partnership debts, even if the partnership has been dissolved. Thus, under established tenants of partnership law, a discharge of recourse liability is accomplished only by an agreement among the parties involved, including the creditor and the remaining partners.<sup>37</sup> Therefore, because a merger serves to effect the dissolution of any constituent, non-surviving partnerships, application of these principles of partnership law regarding the status of individual recourse liabilities upon dissolution indicates that such liabilities would remain unaffected by a merger.

Finally, partnership law also serves to provide guidance concerning the scope of the personal liability of general partners of a partnership which is the surviving entity of a merger. The situation is analogous to that of the liability of an incoming partner in a general partnership under existing partnership law. In such cases, partnership law holds that a new partner has no personal liability to existing creditors of the partnership and only the new partner's investment is at risk for the satisfaction of existing partnership debts.<sup>38</sup> Similarly, a general partner of a surviving entity will be personally liable only for those obligations of the surviving entity (1) incurred after the merger, and (2) incurred before the merger, if he was a general partner of such entity at that time. He is liable only to the extent of his investment in the surviving entity for preexisting obligations of other constituent entities of which he was not a member or a general partner.

# Endnotes to Chapter 7

<sup>1</sup> This chapter is based on that written by John Fendig, Esq., which appeared in the 1994 version of this monograph.

<sup>2</sup> KRS § 275.360(c)

<sup>3</sup> KRS § 275.370.

<sup>4</sup> KRS § 275.370.

<sup>5</sup> KRS § 275.370(2).

<sup>6</sup> KRS § 275.370(2).

<sup>7</sup> KRS § 275.370(3).

<sup>8</sup> See KRS § 275.025, *supra* § 5.3.

<sup>9</sup> *Ibid.*

<sup>10</sup> KRS § 275.370(3)(d).

<sup>11</sup> KRS § 275.370(4).

<sup>12</sup> KRS § 275.375(1).

<sup>13</sup> KRS § 275.375(2).

<sup>14</sup> KRS § 275.375(2)(a).

<sup>15</sup> KRS § 275.370(5).

<sup>16</sup> KRS § 275.370(5).

<sup>17</sup> KRS § 275.370(5).

<sup>18</sup> It is interesting to note that this 90 day provision, though originally present in the 1992 ULLCA draft (and therefore in the LLC Act), was deleted in the subsequent 1993 ULLCA draft.

<sup>19</sup> KRS § 275.370(5)

<sup>20</sup> KRS § 275.345.

<sup>21</sup> KRS § 275.345.

<sup>22</sup> KRS § 275.345(1) and KRS § 275.015(2).

<sup>23</sup> KRS § 271B.11-080; KRS §§ 362.409 - 362.546.

<sup>24</sup> KRS § 275.350(1). The original default rule of unanimous consent by LLC members to effect a merger provided some protection from unfair mergers for owners of minority interests in LLC's, particularly in the absence of statutory dissenter's rights and appraisal actions for such owners. The new standard of majority-in-interest to approve a merger, as well as the fact that the original unanimity requirement could be lowered in an operating agreement, may lead to the conclusion that primary protection available to LLC members against unfair mergers will exist either in a retained voluntary withdrawal right (which must now be expressly provided in a written operating agreement) or specially crafted dissenters' rights provisions. However, with the abolition of the unanimity requirement, as well as the formally existing right to withdraw from the LLC absent the contrary provision in the operating agreement, minority LLC members are arguably now more subject to abusive merger transactions.

<sup>25</sup> KRS § 275.350(2).

26 KRS § 275.355.

27 KRS § 275.360.

28 KRS § 275.360.

29 KRS § 275.360.

30 KRS § 362.536(c).

31 KRS § 275.365.

32 KRS § 275.365.

33 KRS § 275.365(8)

34 KRS § 275.370(5).

35 KRS § 275.365(7).

36 See comments to Prototype Sections 1201, 1204.

37 KRS § 362.325; *First and Peoples Bank v. Fielder*, 323 S.W.2d 853 (Ky. 1959); (court considered status of personal liability on a partnership debt following dissolution of the partnership) *Robertson v. Southwood*, 447 N.W.2d 616 (Neb. 1989) (Partners joint liability for debts of partnership was unaffected by dissolution of the partnership, absent any agreement among partners and partnership creditors to the contrary.)

38 KRS § 362.230.

## 8.1 FEDERAL INCOME TAX ASPECTS OF OPERATION OF AN LLC

by

Charles Fassler and Charles J. Lavelle

To understand the current income tax treatment of LLCs, it is instructive to understand the historical evolution. Prior to the development of LLCs, if two or more persons wanted to form a business which had limited liability, they could not form a general partnership, but had to form either a corporation (C or S) or, to partially fulfill the goal, a limited partnership. If, in addition to limited liability, the owners wished pass through tax treatment, the permissible entities would be restricted to S corporations or limited partnerships. However, each of these entities have limitations. S corporations have restrictions on ownership, operations, distributions and allocations. Limited partnerships must have at least one general partner, thus the complete limitation from liability is not fully accomplished; further, limited partners cannot participate in the control of the limited partnership. Conversely, the managers of an LLC need not be members. In order to attain limited liability for all members and partnership treatment, as well as avoid the limitations of S corporations and limited partnerships, LLCs have developed. As discussed in chapter 4, the IRS initially determined that multi-member LLCs could not obtain partnership treatment; however, the IRS subsequently determined that multi-member LLCs would be treated as either corporations or partnerships depending upon whether they meet the tests of former Treas. Reg. § 301.7701-2. As noted in chapters 2 and 4, the IRS initially required that LLCs have more than one member to achieve pass-through treatment. Consistent with this, KRS § 275.025 initially required that there be at least two members of each LLC.

Much of the foregoing changed when the Treasury adopted the "check the box" regulations. As fully described in chapter 4, Treas. Reg. § 301.7701-3 provides that an LLC with multiple members will be taxed as a partnership unless it elects to be taxed as a corporation. An LLC with a single member will be disregarded, unless it elects to be treated as a corporation. Thus, if the sole owner of an LLC that does not elect corporate tax treatment is an individual, the LLC operations will be taxed as a sole proprietorship. If the sole owner is a corporation, the operations will be taxed as a division of that corporation (again assuming that the LLC does not elect to be treated as a corporation). Consistent with the IRS' favorable treatment of single member LLCs, Kentucky statutes now permit single member LLCs.

Accordingly, an LLC may be taxed as a tax nothing (sole proprietorship or corporate division), partnership or corporation, depending on the number and identity of its members and whether an election has been made. Because, in most situations, partnership treatment is sought for multi-member LLCs, this chapter assumes that the LLC is taxable as a partnership, unless otherwise indicated.

### 8.2 Comparison of Partnerships to LLCs

An LLC taxed as a partnership will have no Federal income tax liability at the LLC level and the income, gain, loss, deduction and credit will be passed through to the members as discussed for partnerships in chapter 3. See paragraphs 3.17 through 3.24. Stating that an LLC qualifies for partnership treatment does not completely dictate the tax treatment to either the LLC or its members. The tax treatment of general partners and limited partners sometimes differ. There is no uniform rule to apply to determine whether an LLC member will be treated as a general partner or a limited partner. Sometimes an LLC member is treated in the same manner as a general partner; sometimes it is treated in the same manner as a limited partner; often, there is not yet a clear answer how the member will be treated. The IRS has not issued guidance on a number of issues involving the taxation of LLC operations. It is imperative that the taxpayer determine if any of these unresolved issues are critical prior to the final selection of the entity.

The IRS apparently believes that LLCs and LLC members are unique and not treated exactly like either general or limited partnerships or general or limited partners. For instance, on the 1998 Form 1065 partnership return, the IRS asks the entity to identify itself as either a general partnership, a limited partnership, a limited liability company, or a limited liability partnership or other. Similarly on 1998

Form 1065 K-1, the IRS asks whether the partner is a general partner, limited partner or a member of a limited liability company.

In the following paragraphs we will first discuss the tax consequences of establishing and operating a new business as an LLC. Later in the chapter, we will discuss the tax consequences of converting an existing business operating in another entity to an LLC. Unless otherwise indicated, we will assume throughout the chapter, that the LLC has multiple members, desires to be taxed as a partnership and does not elect to be taxed as a corporation.

### **8.3            Contributions to an LLC**

As discussed in paragraph 3.18, there is generally no gain or loss upon the transfer of property from a member to the LLC; no gain or loss by the LLC; a carryover basis in the property by the LLC and a substituted basis by the member in the LLC interest (that is, the member's basis in the LLC will initially equal the basis the transferor had in the contributed assets).

### **8.4            Basis in an LLC**

As discussed in paragraphs 3.19 and 8.3, an LLC member will generally take an initial basis in his or her LLC interest equal to the basis in the assets contributed by that member. The basis will be increased by subsequent contributions, purchases of LLC interests and income passed through from the LLC; and reduced by distributions and losses passed through from the LLC; and adjusted for depletion. A member's basis will fluctuate as that member's share of liabilities increases and decreases; an increase in a member's share of the LLC's liabilities is treated as a contribution; a decrease in such share is treated as a distribution. Because no one is liable on the debts of the LLC unless someone affirmatively guarantees the LLC debt, the members will generally each have allocated to them a portion of the LLC debts. *See* paragraph 3.19. In a limited partnership, the limited partners generally do not share in any debts of the limited partnership, unless the debt is specifically nonrecourse to all partners.

### **8.5            Allocations of Income, Gain, Loss, Deduction and Credit in an LLC**

As set forth in paragraph 3.20, income, gain, loss, deduction and credit may generally be allocated among the members in any way that has substantial economic effect. Elaborate rules have been developed for such allocations, but generally each member of the LLC must have a capital account maintained for that member, and liquidating distributions must be in accordance with those capital accounts. The Treasury Regulations also require that the members be obligated to restore capital account deficits or that the operating agreement contain a qualified income offset provision. It is clear that LLC members will not want to be obligated to restore capital account deficits. A capital account deficit generally means that the member has received more distributions and been charged with more net losses than he or she has invested in the LLC. An obligation to make these up would require the members to continue to contribute money to the LLC to extinguish all their deficits. After all the initial contributions have been made, members anticipate that they will avoid all LLC liabilities, except for their own acts or omissions. A negative capital account make-up provision would eliminate the benefits of the LLC because it would require, in certain circumstances, that the members pay for any liabilities of the LLC.

### **8.6            Limits on the Ability of a Member to Deduct the Losses of an LLC**

If the LLC passes losses through to a member, the member's ability to utilize the losses is limited by the member's basis in the LLC, the at risk rules and the passive activity loss rules. *See* paragraph 3.21. Basis is discussed in paragraph 8.4. The at risk rules operate as they do for partnerships. *See* para-

graph 3.21. In general, in order to take a loss under the at risk rules, the member must be obligated to bear the economic brunt of it. Amounts borrowed which meet the requirement of a qualified nonrecourse financing will be treated as at risk. Neither the LLC member nor a partner would have an advantage over the other under the at risk rules. As paragraphs 3.14 and 3.21 state, the passive activity rules apply differently to general and limited partners: general partners (and S corporation shareholders) may materially participate by meeting one of seven tests set forth in Treas. Reg. § 1.469-5T (a)(1)-(7); limited partners may materially participate only if they meet one of three tests, the only one of which that depends on the current year activity requires 500 hours of participation. IRC § 469(h)(2) and Treas. Reg. § 1.469-5T(e)(2). Treas. Reg. § 1.469-5T(e)(3)(i)(B) provides that a partnership interest will be treated as a limited partnership interest for this purpose, if the interest holder's obligations for partnership debts is limited to a determinable fixed amount. There are no authorities that directly decide whether a member of an LLC is treated as a general partner or limited partner (or differently from both) for the passive activity loss rules. As a further aside, if a limited partner does participate in an activity for 500 hours, he or she may not be able to maintain limited liability because of excessive control; this would tend to favor use of an LLC over a limited partnership, even if the 500 hour rule applied to both.

### 8.7 Distributions from the LLC

An LLC taxed as a partnership will have its distributions taxed as set forth in more detail in paragraph 3.22. There is generally no tax on the distribution of property (and the property takes a carryover basis from the hands of the partnership or, if less, the basis of the member's partnership interest) except as it relates to unrealized receivables, inventory items and marketable securities in certain circumstances. See IRC §§ 731(a), 731(c) and 751(b). The tax treatment of payments to a withdrawing partner (member) is discussed below in paragraph 8.8.

### 8.8 Payments to Members Upon Withdrawal

The Revenue Reconciliation Act of 1993 substantially changed the tax treatment of payments to retiring or deceased partners. Such payments are generally not deductible to the partnership, if they represent partnership property, unless they are made to retiring or deceased general partners where the partnership did not have capital as a material income-producing factor, and then only if the payments represent unrealized receivables or goodwill (unless the agreement provides for the payment of goodwill). IRC § 736. Capital is generally viewed as not a material income-producing factor if the business is a service business (such as a doctor, dentist, lawyer, architect or accountant,) even if there is a substantial investment in plant or equipment, if it is merely incidental to the professional practice. H.R. Rep. No. 11, 103rd Cong., 1st Sess. 345. Thus, deductibility of payments to withdrawing partners represents an additional area where the characterization of a member of an LLC as a general partner, a limited partner or "other" may result in markedly different tax results.

If the member is treated as a general partner, then the partnership may deduct payments to a retiring partner for goodwill or unrealized receivables if capital is not a material income-producing factor. For this purpose, the narrow definition of unrealized receivables in IRC § 751 applies. If such payments are made to a member of an LLC, and the member is treated as a retiring limited partner or "other partners" for this purpose, then the payments are not deductible to the LLC. The House Committee Report also states, but does not explain, that the change was not to affect the deductibility of payments to retiring partners for past services. Nondeductible payments made to the retiring or deceased partner would generally represent capital gain or loss, subject, of course, to the fact that payments representing unrealized receivables (under the broad definition of IRC § 751) are ordinary income. The IRS has not issued any guidance on this issue and there is concern in the practitioner community that members of LLCs will not be treated as general partners for this purpose. This is one tax area where an LLP may be a superior tool to an LLC.

A self-employed individual must pay self-employment tax on his or her "net earnings from self-employment." IRC § 1401(a). With certain exceptions, a general partner's entire distributive share of income from a trade or business is "net earnings from self-employment." IRC § 1402(a) and Treas. Reg. § 1.1402(a)-2(d); *see, also* Rev. Rul. 75-525, 1975-2 C.B. 350. None of a limited partner's distributive share of income is "net earnings from self-employment," although guaranteed payments for services under IRC § 707(c) are included in "net earnings from self-employment." IRC § 1402(a)(13). The question which arises is whether an LLC member's distributive share is "net earnings from self-employment?" If so, the member would be subject to the self-employment tax (and, thus, ultimately eligible to receive social security benefits with respect to it.) Further, net earnings from self-employment is used in computing contributions for pension and profit sharing plans. *See, e.g.*, IRC § 401(c)(2)(A).

One possibility is to impose the self-employment tax if the member were active in the business. There is no direct analogy for this: there is no requirement that a general partner be active in the business to have the earnings subject to self-employment tax. *See Johnson v. Commissioner*, T.C. Memo 1990-461 (1990) and Rev. Rul. 54-613, 1954-2 C.B. 269. An S corporation shareholder/employee pays social security tax on salary, but not on his or her distributive share of income. This is similar to the limited partner paying on guaranteed payments for services. The IRS has ruled that an S corporation may not pay an unreasonably low salary in order to avoid the self-employment tax. This is an issue that will draw much attention in the future.

PLR 9432018 (5/16/94) ruled that the members of the LLC would each include their distributive share of income or loss for self-employment tax purposes. The ruling involves a professional firm which was manager managed, with each of the members being the managers. The PLR states that the members are taxed under the general rules that partner income is subject to self-employment tax and that IRC § 1402 (a)(13) does not except the members' income from self-employment tax. This conclusion, on these facts, is not surprising. When one makes a living in a full-time occupation, paying self-employment tax appears proper. Where, however, one is a passive investor, self-employment tax appears inappropriate.

Section 7414 of the proposed Health Security Act, the "Clinton Health Plan," would have altered this taxation scheme to provide that a 2 percent S corporation shareholder who materially participates in a service-related business, and any limited partner who materially participates, would be subject to the self-employment tax on their distributive share. This was never enacted.

The application of the self-employment tax to LLC members continues in a substantial state of flux. The IRS issued proposed Regulations dealing with the definition of the term "limited partner" for purposes of IRC § 1402(a)(13). *See* Prop. Treas. Reg. § 1.1402(a)-2(h). These proposed Regulations met with considerable adverse comment. As a result, the Tax Relief Act of 1997 imposed a moratorium until June 30, 1998 on any Regulation defining a "limited partner" for self-employment tax purposes. Although the moratorium has now ended, the IRS does not seem to be in any hurry to promulgate final Regulations in this area.

What can be said with some certainty is that in a manager-managed LLC, some or all of the manager's income from the LLC will be subject to self-employment tax, and that in a member-managed LLC, it is likely that all of the income will be subject to self-employment tax. While the proposed Regulations contain provisions which in some cases allow certain income not to be subject to self-employment tax, relying on those proposed Regulations before they are finalized is clearly a risky proposition. In mid-1999, the American Bar Association and American Society of Certified Public Accountants prepared legislative proposals to address these issues.

A member may deduct one-half of the self-employment taxes paid. IRC § 164(f).



### 8.11 TEFRA Audits and Tax Matters Partner

Partnerships are generally audited at the entity level, unless they have 10 or fewer partners, each of whom is an individual (other than a nonresident alien), a C corporation or an estate of a deceased partner; for this purpose, a husband and wife (and their estates) shall be treated as one partner. IRC §§ 6221-6233, generally, and § 6231(a)(1)(B) in particular. A partnership that is not obligated to be audited at the entity level may elect to be subject to the entity level audit procedures. IRC § 6231(a)(1)(B)(ii). The partnership may generally appoint a general partner to have authority to deal with the IRS; this person is called the tax matters partner ("TMP"). IRC § 6231(a)(7). If the partnership does not appoint a TMP, then the IRS generally appoints the general partner with the largest profits interest, or, if more than one, the first one of these alphabetically. If this is impractical, then the IRS can select a partner to be the TMP. Since members of an LLC are not general partners, the issue arises whether the LLC may appoint a TMP, or if the IRS could select one. It is clear that IRC § 6231 applies to LLCs if they are classified as partnerships. In Treas. Reg. § 301.6231(a)(7)-2, the IRS has taken the position that a member-manager of a manager-managed LLC will be treated in the same manner as a general partner, and that all members of a member-managed LLC will be treated as general partners for purposes of the tax matters partner rules. Therefore, the operating agreement should designate the tax matters partner (or the manner in which one is selected).

### 8.12 Taxable Year

LLCs must generally adopt the taxable year used by most of its members in interest. IRC § 706(b). The LLC may generally elect to use a taxable year ending one, two or three months before such year, if it pays an amount to reflect the benefit of the deferral received by using the earlier year end. IRC §§ 444(c)(1) and 7519. An LLC may adopt another year, if there is a business purpose.

### 8.13 Cash Method of Accounting

After the Tax Reform Act of 1986, C corporations and partnerships with C corporation partners are generally precluded from using the cash method of accounting. This provision does not apply to C corporations with 3 year average annual gross receipts of less than \$5,000,000 or which are qualified personal service corporations. Tax shelters are also precluded from using the cash method. Qualified personal service corporations are those that meet both a function test and an ownership test. To meet the function test, 95 percent or more of the corporation's activities must be in the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts or consulting. IRC § 448(d)(2) and Treas. Reg. § 1.448-1T(e)(4)(i). To meet the ownership test, 95 percent or more of the stock must be held by active employees, retired employees or estates or transferees as a result of the death within two years of death of an employee. IRC § 448(d)(2) and Treas. Reg. § 1.448-1T(e)(5). Thus, IRC § 448 operates to require certain entities to use the accrual method. Entities not named, such as individuals, partnerships and S corporations are, at the very least, not required to use the accrual method. While this could seem to imply that the cash method is acceptable for these entities, the IRS believes that other sections of the IRC may be used to place a taxpayer on the accrual method, even if IRC § 448 does not do so. Treas. Reg. § 1.448-1T(c).

An LLC treated as a partnership is not a C corporation, and, if the LLC does not have a non-PSC C corporation as a member, then IRC §§ 448(a)(1) and (2) would not be applicable. Thus deciding if an LLC must use the accrual method requires a determination of whether an LLC is a tax shelter within the meaning of IRC § 448(a)(3). Answering this question leads the reader on a serpentine odyssey through a surprising labyrinth of IRC and Treasury Regulations provisions. Because those who qualify for the cash method view it as a non-negotiable prerequisite to any selection of entity, it is necessary to fully analyze the definition of a tax shelter.

Tax shelters for purposes of IRC § 448(d)(3) are defined by IRC § 461(i)(3). IRC § 461(i)(3) states that a "tax shelter" is either (A) an enterprise (other than a C corporation) if at any time interests in such enterprise have been offered for sale in any offering required to be registered with any federal or state agency having the authority to regulate the offering of securities for sale; (B) any syndicate as defined in IRC § 1256(e)(3)(B); or (C) a tax shelter as defined in IRC § 6662(d)(2)(C)(ii), where the principal purpose of the LLC is the avoidance or evasion of federal income tax. Special rules apply for farming. IRC § 461(i)(4).

The first tax shelter test is whether interests in the entity have been offered for sale in an offering which was required to be registered under any state or federal securities or blue sky law. This test is met even if the offering was required to be registered, but was not registered in violation of the applicable registration requirement. The IRS believes this test is met if failure to file an exemption notice would result in a violation of state or federal securities law. Treas. Reg. § 1.448-1T(b)(2). The general definition of an investment contract is set forth in SEC v. W. J. Howey Co., 328 U.S. 293 (1946). In a state with strict blue sky laws, the registration requirement has the potential to pose a hurdle to the ability to use cash basis, particularly if the IRS is correct that a state or federal requirement of filing an exemption notice makes an entity a tax shelter. Here the LLC may operate at a relative disadvantage to other entities. S corporations are expressly excluded from the registration requirement of tax shelters, if they are required to file a notice of exemption from registration, if C corporations would have to file the same notice. IRC § 448(d)(3). General partnerships are generally believed not to be subject to securities and Blue Sky laws. Thus, only limited partnerships seem to be at a similar disadvantage as LLCs on this securities issue.

The second definition of a tax shelter is a syndicate as defined in IRC § 1256(e)(3)(B). A syndicate is a partnership or other entity (but not a C corporation) where more than 35 percent of the losses are allocable to limited partners or limited entrepreneurs (as defined in IRC § 464(e)(2)). A limited entrepreneur is a business owner (other than a limited partner) that does not actively participate in the management of the enterprise. Thus, an LLC has the potential to be treated as a tax shelter (and thus lose the ability to use the cash method) if more than 35 percent of its losses are allocated to those treated as limited partners or to those who do not actively participate in management. This is one of those areas where treatment of an LLC member as a limited partner could be of great significance. Although it would appear that this would be a rather nettlesome provision, the IRS National Office has issued a series of private rulings permitting law firms to convert to LLCs and use the cash method. *See, e.g.*, PLR 9321047 (2/25/93). This is true even though some of those involved executive committees that functioned like boards of directors. The National Office has, nonetheless, not treated the members as limited entrepreneurs, by finding that they have sufficient management rights. Further, based on these rulings, the National Office apparently does not view members to be limited partners for this purpose.

Most of these private rulings have concluded that the LLC member is not a limited entrepreneur because the member actively participates in management. PLR 9321047 (2/25/93) and 9328005 (12/21/92). The National Office has ruled that a member-managed law firm with both equity members and non-equity principal members is not a tax shelter. This is an extension of a number of other private letter rulings. At least one private ruling has held that a manager managed law firm LLC was not a tax shelter in years it does not in fact produce losses. PLR 9415005 (1/10/94). It has been suggested that LLCs may be able to avoid this provision by allocating more than 65 percent of losses to manager-members in a manager-managed LLC.

The third test for a tax shelter is a tax shelter as defined under IRC § 6662(d)(2)(C)(ii); *i.e.*, an entity whose principal purpose is the avoidance or evasion of federal income tax. This would not appear to be a concern for bona fide businesses.

It should be remembered that all of this authority is contained in private rulings. These rulings may not be cited as precedent and are only applicable to the taxpayers to whom they were issued. IRC § 6110(j)(3). The National Office has not yet issued any public guidance in this area. If the IRS determined that all LLC members are to be treated as limited partners for this purpose, then the LLC would be a syndicate and could not use the cash method, unless the LLC could be exempted from syndicate status because it did not have a loss.

#### **8.14      Additional Considerations in Using and LLC**

In addition to the tax consequences set forth above, there are several other items which may be significant to certain taxpayers.

A loan from a qualified pension and profit sharing plan to a 10 percent partner (and presumably LLC member) is a prohibited transaction under IRC § 4975(d).

Partners may only deduct 60% of their health insurance premiums in 1999, which will increase to 70% in 2002 and 100% in 2003.

The exclusion of premiums for up to \$50,000 of group term life insurance would not apply to members of an LLC. There is no authority, but commentators assume that members in an LLC are not eligible for either participation in cafeteria plans or the \$5,000 death benefit exclusion under IRC § 101(b)(3).

#### **8.15      Conversion of an Existing Business into an LLC**

In the preceding portion of this chapter, we have primarily discussed the consequences of establishing an LLC to operate a new business. In the immediately following sections, we will discuss the tax effects of converting an existing business, which is operated in a partnership or corporation form into an LLC.

#### **8.16      Conversion of Partnership into LLC**

A conversion of a partnership into an LLC should generally be tax-free to the partnership, the LLC and the partners/members and the partnership will not terminate under IRC § 708. PLR 9350013 (9/15/93). In concluding that a conversion by a partnership into an LLC is tax-free, the IRS has followed its ruling in Rev. Rul. 84-52, 1984-1 C.B. 157, where a general partnership was converted into a limited partnership tax-free. The conversion took place when the four equal partners amended their general partnership agreement into a limited partnership agreement, then two of the four partners effectively traded all their general partnership interests for limited partnership interests and the remaining two effectively traded a portion of their general partnership interests for limited partnership interests, and retained the remaining general partnership interests. The IRS ruled that, under IRC § 721, there was generally no gain or loss upon the exchange of the general partnership interests for the limited partnership interests.

The IRS also examined the application of IRC §§ 752 and 731 in computing gain or loss. Under IRC § 752(b), any decrease in the partner's share of liabilities will be treated as a distribution of money by the partnership to the partner. Under IRC § 731, if the partnership distributes money to a partner, the partner does not recognize any income unless the distributions exceed the partner's basis in the partner's partnership interest. Any distribution will decrease the partner's basis in the partnership, but any recognized gain will increase it. The partners had a single basis in the partnership (even if they held both general and limited partnership interests). *See also*, Rev. Rul. 84-53, 1984-1 C.B. 159. The IRS also determined that, under IRC § 1223(1), the partner had the same holding period in the limited partnership interests that they had previously had in the general partnership interests. The IRS also ruled that the partnership did not terminate upon the conversion: the business continued and, under Treas. Reg. § 1.708-1(b)(1)(ii), an IRC § 721 transaction is not a sale or exchange for purposes of IRC § 708.

The precise method of achieving the transformation appears unimportant. In PLR 9010027 (12/7/89), the partners of a limited partnership entered into an operating agreement under that state's (not Kentucky's) LLC Act; in PLR 9321047 (2/25/93), an Arizona law partnership contributed its assets to the LLC, which distributed LLC interests to the partnership which in turn were distributed to the part-

ners in liquidation of the partnership — there was apparently no adverse consequence of the transitory ownership of the LLC by the partnership, even though a one member LLC was not permitted under Arizona law; in PLR 9412030 (12/22/93), the partnership (an LLP) merged into the LLC; and in PLRs 9226035 (3/26/92), 9350013 (9/15/93) and 9407030 (11/24/93), the partners contributed their partnership interests to the LLC and the partnership liquidated or went out of existence by operation of law because it only had one owner.

Although there is no direct guidance, because a partner is generally not relieved of liabilities upon conversion of a partnership into an LLC and there is generally not a shift in the allocation of the liabilities upon conversion, the partner should generally not have a decrease in basis upon the conversion. Thus, there would not be income under IRC §§ 731 and 752(b).

#### **8.17      Conversion of C Corporation into LLC**

The merger of a C corporation into an LLC taxed as a partnership will generally result in tax at two levels: the C corporation level and the shareholder level. In PLR 9404021 (11/1/93), the merger was treated as the transfer by the C corporation of its assets to the LLC, followed by the distribution of the LLC interests to the shareholder in liquidation of the corporation. The transfer of the assets to the LLC is generally tax free to both the C corporation and the LLC under IRC § 721. Under the facts of this private ruling, there was no tax on the liquidation because the C corporation was a wholly-owned subsidiary. IRC § 332. However, outside the affiliated group context, there is a tax at the corporate level upon the distribution of the LLC interests in liquidation, equal to the difference between the value of the LLC interests and the corporation's basis in them. (There is at least one case that would measure the tax on the net value of the underlying assets rather than the value of the LLC interests, if the values differ. Pope & Talbot, Inc. v. Commissioner, 162 F. 3d 1236 (9th Cir. 1999) *aff'g* 104 T.C. 574; *see also*, related opinions at T.C. Memo 1997-116 and T.C. Memo 197-300.) There is a further tax at the shareholder level equal to the difference between the value of the property received and the shareholder's basis in the C corporation stock.

The merger of a C corporation into an LLC which elects to be treated as a corporation under the "check the box" regulations (*see* Chapter 4), is a tax-free reorganization under IRC § 368(a)(1)(F). The member's basis in the LLC interest is equal to that former shareholder's basis in the stock of the C corporation. The fiscal year and elections of the corporation will continue without interruption.

A professional firm, such as a law firm, which is a C corporation may have several assets which are appreciated and which would generate significant income upon the firm's conversion. Included among these will be goodwill and receivables (if the firm reported on the cash method). In many of the professions, there may be low basis assets that have some value such as law libraries, furniture, computers, etc. For these entities, the initial taxes which would be imposed upon conversion may prohibit the conversion into an LLC. It has been suggested that an LLC could be established that would operate the professional practice after its inception. The C corporation would continue to collect the receivables and would pay out its net income in compensation. Assuming that the C corporation could prevail on any challenge to the reasonableness of the compensation payments, this approach may avoid a double tax on the receivables. However, the operation of the LLC using the goodwill of the C corporation (as well as the furniture, library, etc.) would seem to require either a rental payment or would generate a constructive dividend.

#### **8.18      Conversion of S Corporation into LLC**

If an S corporation merges into an LLC taxable as a partnership, there will generally be taxation at a single level. As described above in connection with a C corporation conversion, an S corporation may be deemed to have transferred its assets to the LLC in exchange for interests in the LLC. If so, the S corporation will then be deemed to have distributed them in liquidation to the shareholders. Upon the

liquidating distribution, the S corporation must recognize income equal the difference between the value of the interests and their basis. *But see, Pope & Talbot, supra.* The income recognized at the corporate level will be passed through to the shareholders and reported by them. The income will increase the basis of the shareholders in their stock. The shareholders will also recognize gain equal to the difference between the value of the property received and their basis in the stock. Because of the increase in the basis in stock for the gain recognized on the distribution, there will often be no additional gain. Accordingly, there will generally be only one level of tax upon the conversion of an S corporation to an LLC.

If an S corporation merges into an LLC which elects to be taxed as a corporation, and further elects to be taxed as an S corporation, then this will be a tax-free reorganization under IRC § 368(a)(1)(F). The member's basis in the LLC interest is equal to that former shareholder's basis in the stock of the S corporation. The accumulated adjustments account, fiscal year and elections will continue without interruption.

#### **8.19      Conversion of LLP into LLC**

In PLR 9412030 (12/22/93), an LLP merged into an LLC. The National Office again used the analogy to Rev. Rul. 84-52 and ruled that there was no gain or loss to the LLP, the LLC or the partners/members under IRC § 721. Further, there was no termination of the LLP.

#### **8.20      Conversion of Partnership to LLP**

In PLR 9229016 (4/16/92), the IRS ruled that a partnership may be converted into an LLP without terminating the partnership. This transaction apparently did not constitute a sale or exchange. *See also*, PLRs 9420028 (2/18/94); 9423037 (3/16/94); 9423040 (3/18/94); 9424036 (3/21/94); and 9424038 (3/21/94).

#### **8.21      Conversion of a Single Member LLC to a Multi-Member LLC**

In Rev. Rule. 99-5, 1999 I.R.B.-5, 6, the IRS set forth its position with respect to the tax consequences of a single member LLC taxable as a disregarded entity having more than one member. The Ruling sets forth two factual situations.

In the first situation, B purchases a 50% interest in the LLC from A who was previously the sole member. In this situation, A is deemed to have sold an undivided 50% interest in each of the assets owned by the LLC to B and then A and B are each deemed to have contributed those assets to a newly formed partnership. A recognizes gain or loss on the deemed sale of the 50% interest of each of the assets. B's basis in the LLC is its cost of the 50% undivided interest in the assets, while A has a carryover basis for its interest in the partnership.

In the second situation, B contributes cash to the single member LLC in exchange for a 50% interest in the LLC. In this situation, A is deemed to have contributed the assets owned by the LLC to a newly formed partnership, while B is treated as having contributed cash to the newly formed partnership. Again, A has a carryover basis for its partnership interest, while B has a cost basis for its partnership interest. In both situations, IRC § 704(c) will be applicable with respect to A's deemed capital contribution to the newly formed partnership.

#### **8.22      Conversion of Multi-Member LLC to Single Member LLC**

In Rev. Rul. 99-6, 1999 I.R.B.-6, 6, the IRS set forth its position with respect to the tax consequences of a multi-member LLC taxable as a partnership becoming a single member LLC treated as a disregarded entity. The IRS again set forth two factual situations.

In the first situation, A and B are equal members of an LLC and A sells A's entire interest in the LLC to B. In the second situation, the two members of an LLC sell all of their interests to a third party. In each case, the IRS views the seller as having sold a partnership interest and the tax consequences to the seller are based on this analysis.

Notwithstanding that the seller is treated as having sold a partnership interest, based principally upon the case of McCauslen v. Commissioner, 45 T.C. 588 (1996), as to the purchaser, the transaction is treated as if the partnership liquidated, distributing its assets to its partners with the purchaser then purchasing the assets deemed distributed to the seller(s). The tax consequences of the transaction then flow from this characterization.

The IRS' position in Rev. Rul. 99-6 with respect to the purchaser has been roundly criticized by the tax professional community. Whether the IRS will prevail with respect to its position remains to be seen. If the tax consequences of the deemed liquidation and purchase of assets would adversely affect the purchaser, the purchaser should consider restructuring the transaction to avoid the result.

#### **8.23      Contrast of Transfer of a Corporate Interest vs. LLC Interest on Death**

The estate of a decedent-shareholder obtains a basis equal to the fair market value of the stock of the corporation on the date of death (or alternate valuation date). The corporation continues to have its same basis in its assets.

The estate of a decedent-partner/member obtains a basis equal to the fair market value of an interest in an LLC, LLP, limited partnership or general partnership on the date of death (or alternate valuation date); plus the decedent's share of the entity's liabilities; less items constituting income in respect of a decedent. Treas. Reg. § 1.742-1. If a decedent holds an interest in an LLC treated as a partnership, the LLC may make a section 754 election which will permit it to step up (to fair market value) the basis of its assets attributable to the decedent's interest. Thus, assume such an LLC's only assets are depreciable assets with a zero basis; further assume that decedent's 50% interest in such LLC had a fair market value of \$100. If the LLC made a section 754 election, then the LLC's basis attributable to the estate's share of such assets is \$100; and such basis in such assets may be depreciated. The depreciation will be allocated 100% to the estate. Furthermore, the depreciation claimed by the LLC prior to the date of death would not result in recapture of depreciation income if the LLC sold the assets. The same would apply if the decedent had an interest in an LLP, limited partnership or general partnership. The same applies to any transfer to any transferee (except for a redemption).

#### **8.24      Use of Life Insurance**

Life insurance proceeds paid to a C corporation are generally not taxable under IRC § 101. However, they are generally included in adjusted current earnings (ACE) for alternative minimum tax computations. Treas. Reg. § 1.56(g)-1(c)(5). Life insurance proceeds paid to an LLC treated as a partnership or LLP are generally not taxable for either regular tax purposes (IRC § 101) or for alternative minimum tax purposes (because ACE only applies to C corporations.) Life insurance proceeds lose some of their tax-free status if the policy has been transferred for value to an impermissible transferee. It will be taxable to the extent that the proceeds exceed the transfer price and subsequently paid premiums. Permissible transferees include partners of the insured, but not co-shareholders. Accordingly, using an LLC treated as a partnership permits more flexibility than using a corporation. Such an LLC permits an insurance policy which would fund a buy-sell agreement to be transferred to the members so that it can be used for a cross purchase arrangement.

## **8.25      Additional Considerations in Selecting an LLC**

LLCs, like most other business entities, permit the division of the ownership among various entities. This permits the ability to transfer a portion of the ownership to family members without multiple recordings of deeds, etc. Fractional ownership interests are subject to discounts in valuation upon transfer, either during the transferor's life or at death. Available discounts may include a minority interest discount, a discount for lack of marketability and a discount for lack of liquidity. In Rev. Rul. 93-12, 1993-1 C.B. 202, the IRS ruled that a minority discount was applicable to a family controlled enterprise.

Families that own interests in corporations and partnerships must be cognizant of valuation upon transfer. IRC § 2701 values interests that have liquidation, put, call, conversion or distribution rights. If all interests in an LLC are identical, then IRC § 2701 does not apply. IRC § 2701(a)(2).

IRC § 2704 discusses the treatment of certain lapsing rights and restrictions. IRC § 2704(a) addresses the lapse of voting or liquidation rights. Members of LLCs will not likely have the right to compel liquidation and IRC § 2704(a) can be avoided by not having such lapsing right, so this section need not apply. IRC § 2704(b) provides that if an interest in a corporation or partnership is transferred to a family member and the family controls the entity, and there is a restriction on the ability to liquidate which lapses or the family has the right to remove the restriction, then such restriction is disregarded in determining the value of the transferred interest. For this purpose, IRC § 2704(b)(3)(B) states that restrictions imposed by federal or state law are disregarded. Accordingly, in valuing an LLC, the normal state law rules will normally apply. KRS § 275.280 (3) provides that unless a written operating agreement provides otherwise, a member has no right to withdraw from the LLC. This provision supports the ability to claim a discount. KRS § 275.285(2), however, provides that unless the operating agreement provides otherwise, the LLC will dissolve upon the written consent of a majority-in-interest of the members. This provision raises issues with respect to the applicability of IRC § 2704(b).

## **8.26      Kentucky Income Tax Treatment of LLCs**

KRS § 141.208(2) provides that an LLC will be treated in the same manner for Kentucky income tax purposes as for Federal income tax purposes. Accordingly, if an LLC is treated as a partnership for Federal income tax purposes, it will be treated as a partnership for Kentucky income tax purposes. If it is treated as a corporation for Federal income tax purposes, it will be treated as a corporation for Kentucky income tax purposes. If it is disregarded for Federal income tax purposes, it will be disregarded for Kentucky income tax purposes.

## **8.27      Kentucky License Tax Treatment**

KRS § 136.070 imposes a corporate license tax on corporations of \$2.10 per \$1,000 of capital employed in Kentucky, subject to a reduction for corporations with less than \$500,000 in gross income. The Kentucky Revenue Cabinet has advised that LLCs are not subject to the Kentucky license tax. Kentucky Tax Alert (January 1997). As of the published date of this monograph, a tax bill has been introduced by the Governor's Office which would make all LLCs subject to the license tax.





## 9.1 SINGLE MEMBER LLCs

by  
Scott W. Dolson

The latest powerful weapon to enter the business planning arsenal is the single-member limited liability company ("SMLLC"). IRS regulations provide that a SMLLC is generally disregarded as an entity separate from its owner for federal tax purposes. A SMLLC held by an individual is treated as an extension of the individual's sole proprietorship. A SMLLC held by a corporation is treated as a division or branch of the corporation. This transparency for federal and generally state income tax purposes does not affect the liability shield afforded the SMLLC's owner against the debts and liabilities generated by the SMLLC's business activities.

The SMLLC's combination of liability protection and tax transparency opens the door for a number of useful planning opportunities:

- Creating a shield or firewalls against business liabilities.
- Avoiding real property transfer taxes and sales tax.
- Establishing liability shield protection in connection with real estate like-kind exchanges.
- Structuring a bankruptcy-remote or single-asset entity in connection with real estate financing transactions.
- Providing an alternative to the corporate subsidiary.
- Avoiding ancillary probate.

## 9.2 Liability Shield/Firewall Protection

The owner of a SMLLC is not personally liable for the debts and obligations of the SMLLC. Sole proprietors should consider placing business assets in a SMLLC in order to shield themselves from personal liability. Business owners can also use multiple SMLLCs to create liability firewalls between various assets and businesses. If one segment of the business generates a significant liability, the balance of the assets/businesses will be shielded through the multiple SMLLC structure. The SMLLC provides corporations with the flexibility of creating liability firewalls without dealing with the complexities of multiple subsidiaries and consolidated return issues.

A good example of the operation of a liability shield was the environmental superfund case of United States v. Bestfoods, 141 L. Ed. 2d 43 (1998), where the United States Supreme Court held that a parent corporation was not financially responsible for its subsidiary's CERCLA clean-up costs because the parent corporation's relationship with its subsidiary was consistent with an investor rather than the operator of its subsidiary's facilities. The same analysis and result should apply to a SMLLC.

The liability shield afforded by the SMLLC comes with a price. The SMLLC is a separate entity from its owner for state law purposes. This separateness means that owners cannot freely distribute funds from the SMLLC and freely treat those funds as though they belong to the owner. KRS § 275.225 puts limits on what can be distributed from a SMLLC. Basically, distributions cannot be made if the SMLLC would be unable to pay its debts or is insolvent from a balance sheet standpoint. KRS § 275.230 provides that a member or manager who violates these restrictions is personally liable for the illegal distributions. SMLLC owners whose entities are in a questionable financial position should take steps to identify any distributions that are compensation payments rather than member distributions. It helps if the SMLLC has an operating agreement in place prior to the onset of financial difficulties that sets forth the compensation payments due to the owner.

Another potential issue associated with the SMLLC's liability shield is that it may operate to convert debt with respect to which an individual is at-risk for purposes of IRC § 465 into debt for which the SMLLC owner is not at risk. Under IRC § 465(b), an individual is only at risk with respect to any activity to the extent that the individual has contributed money or property to the activity and the amounts borrowed with respect to the activity. IRC § 465(b)(2)(A) provides that an individual is considered at risk to the extent that he or she "is personally liable for repayment of amount" borrowed to finance the activity. There are exceptions to the debt rule for qualified nonrecourse financing incurred in real estate transactions. The general rule, however, will be that owners of the SMLLC will not be at-risk for the SMLLC's debt and, as a result, may not be able to take depreciation deductions otherwise permitted for debt under the basis rules. The possible application of the at-risk rules should be monitored as it is possible to structure debt so that an owner will be at-risk, although it will expose the owner to personal liability for the debt.

### **9.3        Avoiding Transfer Taxes**

In many states, including Kentucky, real estate can be contributed to SMLLCs without incurring real estate transfer taxes. Likewise, in many states, including Kentucky, the transfer of tangible personal property to a SMLLC is exempt from sales and use tax. Ownership of the real estate and tangible personal property can then be indirectly transferred without incurring real estate transfer or sales taxes by transferring the SMLLC's ownership interest.

In some cases, buyers may be reluctant to acquire a SMLLC interest rather than its assets because of the risk that the SMLLC has unknown liabilities. While this risk can be reduced by obtaining representations and indemnities, it cannot be eliminated. Buyers are shielded from a purchased SMLLC's liabilities, but the property held by the SMLLC will be subject to the claims of the SMLLC's creditors. Purchasing a SMLLC with potential unknown liabilities, however, may be better than purchasing directly real estate with unknown environmental problems. Purchasers of real estate should consider acquiring real estate directly into a newly-formed SMLLC. The SMLLC may shield the owner from direct contact with the real estate and the potential environmental cleanup obligations that accompany ownership.

### **9.4        Like-Kind Exchanges**

Participants in like-kind exchanges often are concerned about known or unknown liabilities associated with replacement property received in a like-kind exchange. The IRS has ruled in the past, however, that if replacement property is immediately contributed to an entity (e.g., a two-member limited liability company), then it does not qualify for like-kind exchange treatment. In order to qualify for like-kind exchange treatment, both the exchanged property and the replacement property must be held by the taxpayer for use in a trade or business or for investment purposes. Property immediately contributed to a separate entity or received into that entity is not "held" by the exchanging party.

Several recent private letter rulings have come to the rescue, however, by holding that SMLLCs can be used in connection with like-kind exchanges. Since the SMLLC is disregarded for income tax purposes, the IRS has reasoned that the property is actually "held" by the exchanging party if it is received into a SMLLC owned by the exchanging party. The IRS has also ruled that a two-member, bankruptcy-remote entity, with one member having no economic interests in the entity, would be disregarded and the acquisition by it of replacement property would be treated as a direct acquisition by its primary member for purposes of the like-kind exchange statute. See PLRs 199911033 and 199914006.

### **9.5        Bankruptcy-Remote SMLLCs**

Lenders often require that borrowers form "single-purpose, bankruptcy-remote" entities to borrow funds and hold property. Lenders generally require that the governing instruments of these

entities restrict their ability to engage in other activities that could give rise to liabilities endangering the assets held as collateral. As a result, a bankruptcy-remote, special-purpose entity is unlikely to become insolvent as a result of its own activities and is adequately insulated through the SMLLC from the consequences of its owner's insolvency. Bankruptcy-remote entities can be formed as SMLLCs, but in many cases, lenders desire to have a representative admitted to membership in the entity in order to be in a position to veto actions that might result in insolvency or bankruptcy.

A recent IRS private letter ruling has concluded that if the second member has no interest in the entity's profits, losses or capital, the entity would be treated as a disregarded SMLLC for tax purposes. PLRs 199911033 and 199914006. This result is consistent with the longstanding position of the IRS that a member must have a meaningful economic interest in a tax partnership to be treated as a second partner for tax purposes. This ruling opens the door for engaging in like-kind exchanges involving bankruptcy-remote, "two-member" SMLLCs.

#### **9.6 SMLLCs for Financing Flexibility with Single-Asset Entities**

Similar to "single-purpose, bankruptcy-remote" entities, lenders often require that borrowers seeking real estate financing be a single-asset entity (*e.g.* an entity owning one parcel of improved land or one parcel of unimproved, soon-to-be developed, land). If the single-asset entity borrower desires to exchange its asset in a like-kind exchange for multiple replacement properties, then a recent private letter ruling (PLR 9751012) concluded that the receipt of those replacement properties by multiple SMLLCs wholly-owned by the borrower, one property per SMLLC, would be treated as the receipt of the replacement property by the borrower for purposes of still qualifying the receipt of such property for nonrecognition of gain. In addition, when the transactions were completed, the SMLLCs were single-asset entities as required by the replacement indebtedness.

#### **9.7 SMLLCs as an Alternative to Corporate Subsidiaries**

Corporations desiring to avoid the potential complexities of organizing corporate subsidiaries and including those subsidiaries on a consolidated return can instead elect to form SMLLCs to hold various properties that either provide a liability risk to the parent corporation or need to be shielded from the parent corporation's liabilities. S corporations can also use SMLLCs in place of qualified S corporation subsidiaries. Many corporations will discover that reorganizing all or a portion of their subsidiary structure into SMLLCs will result, in the right circumstances, in a reduced overall state income tax liability.

#### **9.8 Avoiding Ancillary Probate**

If real estate held by an individual is located outside of the state of the individual's domicile, and the owner dies, there must generally be an ancillary probate. In contrast, the domicile of personal property, including a SMLLC interest, is the domicile of its owner. If the SMLLC is holding out-of-state real estate, then the death of the owner, so long as it does not trigger termination of the SMLLC under state law, will avoid ancillary probate and imposition of inheritance taxes in the state where the real estate is located.

#### **9.9 Formation; Use of Operating Agreements**

SMLLCs are formed by filing articles of organization with the Secretary of State. Kentucky, Indiana, Delaware and a number of other states permit the formation of SMLLCs. The SMLLC's owner should strongly consider entering into an operating agreement with the SMLLC in order to establish the

nature of the relationship between the owner and its wholly-owned SMLLC, although the formality of an operating agreement is not required. The existence of a written operating agreement may also provide support for the separate existence of the SMLLC in the event it is attacked by a plaintiff's attorney attempting to "pierce the entity veil" as a way of getting into the pocket of its owner.

#### **9.10      Preserving the SMLLC Liability Shield**

The principal benefit of the SMLLC form is the liability shield that it affords its owner. This liability shield is the same liability shield provided to corporate shareholders and members of multiple-member limited liability companies. Just as attempts are made to "pierce the corporate veil", attempts will be made to pierce the SMLLC liability shield to get at the assets of its owner.

SMLLCs are, by their nature, entities that will lack formalities beyond articles of organization and a written operating agreement, due to the simple fact that they have a single owner. As a result, many of the factors that courts look at when considering whether to respect the separate existence of a corporation will not apply generally to the SMLLC. This places a greater emphasis on the issue of whether the SMLLC is adequately capitalized. There are no objective standards to satisfy in the area, but the courts often consider whether there was an attempt to adequately capitalize the entity, or whether its owner(s) used the separate entity as a way of avoiding the financial responsibilities of the business. The courts consider insufficient capital as compared with the entity's business and the risks associated with that business as grounds for denying the separate entity privilege. Certainly SMLLC owners should maintain separate checking accounts for the SMLLC, guard against co-mingling funds, execute SMLLC documents in the appropriate capacity (*e.g.* as a member, manager, etc.) and observe as many "formalities" as possible (*e.g.* adopting limited liability company resolutions for significant SMLLC activities), especially all operating formalities contained in the SMLLC's operating agreement.

SMLLC owners should also keep in mind that there are restrictions under state law on distributions to SMLLC owners where the distribution would render the SMLLC incapable of paying its liabilities or where the SMLLC is already insolvent. These restrictions are the price paid for the liability shield afforded by the SMLLC. In some cases, it might make sense to structure the contribution of funds to a SMLLC as loans rather than as capital contributions.

#### **9.11      Conversion of SMLLCs to Multiple Member LLCs — Rev. Rul. 99-5**

Revenue Ruling 99-5, 1999-5 I.R.B. 6, addresses two situations in which an SMLLC that is disregarded as an entity separate from its owner becomes an entity with more than one owner, resulting in its classification as a partnership.

In the first fact scenario, B purchases a 50% LLC interest from A, who previously had held 100% of the membership interests. The IRS treated this transaction as though A held the assets of the SMLLC directly and then sold a 50% undivided interest in the assets to B, with A and B then contributing the assets to a newly-formed partnership. Gain or loss is recognized by A on the deemed sale of the interest in each asset. B takes a cost basis in the new LLC interest equal to the amount paid to purchase the assets. A has a carryover basis.

In the second fact scenario, B contributes cash to the SMLLC in exchange for a 50% membership interest. The transaction is not treated as a purchase of assets but instead as an IRC § 721 contribution of assets by A and cash by B. A will have a carryover basis in its LLC interest and will deal with IRC § 704(c) issues if the assets are appreciated. B will have a cost basis for its interest. B should negotiate for an IRC § 754 election to be afforded the ability to write off its share of the assets based on its capital contribution.

### 9.12 Conversion of Multiple Member LLCs to SMLLCs — Rev. Rul. 99-6

In Revenue Ruling 99-6, 1999-6, I.R.B. 6, the IRS considered the tax consequences of a sale of an LLC interest from one member to the other in a two-person LLC. The IRS treated the selling member as selling his interest under IRC § 741. Despite treating the transaction from the viewpoint of the selling member as a sale of an LLC interest, the IRS concluded that the buying member would be treated as buying assets as if they had been distributed to the selling member and then sold. The IRS relied upon McCauslen v. Commissioner, 45 T.C. 588 (1966) for this inconsistent treatment.

The significance of the IRS' position that the buying member is acquiring an undivided interest in assets rather than an LLC interest is that the buying member must treat those assets as newly placed in service and subject to new depreciable lives. In some instances, Rev. Rul. 99-6 may create a better result than would be obtained under the normal IRC § 708 rules, as those rules in some instances would result in a technical termination and new depreciation lives for 100% of the LLC's assets.

There are a number of other code provisions that are potentially implicated by Rev. Rul. 99-6. IRC § 1239 is potentially applicable and could convert capital gain into depreciation recapture ordinary income. Furthermore, if the LLC owns IRC § 197 nonamortizable intangibles, the IRS' characterization of the transaction could be read to provide that the selling member has received an undivided interest in all of the LLC's assets, which would cause the anti-churning rule to apply to all of the LLC's assets.

There are a number of ways to structure around the application of Rev. Rul. 99-6 and/or avoid termination of the LLC's tax partnership. The tax partnership may be kept alive through the acquisition of the selling member's interest by a related party. Other methods involve bootstrap acquisitions (partial capital contribution/partial purchase) or dilution and sale transactions. The important things to keep in mind are the IRS' treatment of the straight interest buyout transaction set forth in Rev. Rul. 99-6, its impact on the proposed transaction, and the tax goals of the continuing owner.

### 9.13 Parting Thoughts

The SMLLC's two principal features—being disregarded for tax purposes and providing an effective shield for liability purposes—open the door for the use of the SMLLC in a variety of creative ways in the real estate and business planning fields.



## 10.1 TAX-EXEMPT ORGANIZATIONS AND LLCs

by  
James C. Seiffert

### 10.2 Introduction

In an effort to expand and diversify their exempt activities, exempt organizations<sup>1</sup> have discarded traditional approaches and actively pursued nontraditional, more sophisticated business opportunities, either on their own or by pooling their resources in partnership with proprietary partners.<sup>2</sup> Because of the potential for abuse, the Internal Revenue Service ("IRS") has historically scrutinized an exempt organization's commercial endeavors, particularly in the areas of healthcare and low income housing, to determine whether the methods it uses to pursue and achieve its goals conflict with its legal obligations imposed by the Code.<sup>3</sup> Against this background, exempt organizations find themselves examining the attributes of limited liability companies ("LLC(s)") and whether LLCs will better protect an organization's exempt status when it is engaged in raising capital or developing new commercial relationships. By all indications, the IRS intends to closely police the non-traditional activities by tax-exempt organizations through the use of LLCs as joint venture vehicles and as the entity of choice for a newly created exempt organization.<sup>4</sup>

### 10.3 LLCs as Joint-Venture Vehicles

In the past, the limited partnership was the vehicle of choice of tax-exempt organizations when forming ventures with for-profit enterprises or investors. Typically the tax-exempt organization served as a general partner while the individuals or taxable entities participated as limited partners. Now, with the presence of LLCs, tax-exempt organizations are looking to the LLC as a possible alternative to limited partnerships. The LLC, as an unincorporated association, from a business perspective offers the best of all worlds by providing its members with the limited liability of a corporation and the beneficial tax treatment and structural flexibility of a partnership.<sup>5</sup> Nonetheless, although the LLC possesses attributes common to both corporate and partnership law, its use by tax-exempt organizations is viewed with some apprehension by the business community, in general, and by the IRS in particular.<sup>6</sup>

Until recently, tax-exempt organizations have been apprehensive about utilizing LLCs and understandably so since the IRS had provided no real guidance prior to the issuance of Rev. Rul. 98-15.<sup>7</sup> The only indication of the IRS's position, prior to Rev. Rul. 98-15, came in the form of Ltr. Rul. 9517029 where it stated that a tax-exempt organization, when involved as a member of an LLC, must be able to demonstrate that it is in control of the operations and that the assets are not being "siphoned off" in a manner that would constitute use for non-exempt purposes.<sup>8</sup> The concepts applied by the IRS were very similar to those it had applied in the limited partnership setting. Moreover, the fundamental concepts of "control" and duty to further the organization's exempt purpose became the basis for Rev. Rul. 98-15.<sup>9</sup>

### 10.4 Prior History - The Limited Partnership Model

Prior to the creation of LLCs, the IRS gained considerable experience in analyzing exempt organizations' involvement in investment limited partnerships, particularly in the areas of healthcare and low-income housing.<sup>10</sup>

Traditionally, the IRS's focus has been on the exempt organization's role as the general partner.<sup>11</sup> While the limited partnership has served tax-exempt organizations well in procuring capital, it has forced the organizations to offer investors limited risk, a return on their capital investment, and substantial tax benefits at the expense of greater personal liability. As the general partner, the exempt

organization's statutory and contractual obligations and duties to the limited partners, as viewed by the IRS, conflict with its duty to operate exclusively for charitable purposes, which can preclude exemption.<sup>12</sup> The same situations could arise with an LLC. A tax-exempt organization may participate as either a member in a member-managed LLC or as a manager in a manager-managed LLC. In both situations, the tax-exempt organization could find itself confronted with many of the same problems and tensions it would face as a general partner.

The IRS, having discarded its "per se" prohibition against a general partner,<sup>13</sup> employs a two-step approach in examining an organization's role as a general partner.<sup>14</sup> This approach examines the partnership relationship and the terms of the partnership agreement to determine whether: (i) the partnership is operated exclusively for exempt purposes, and (ii) the partnership structure, as represented in the partnership agreement, imposes certain duties and obligations on the tax-exempt organization that advance private interests at the expense of its charitable interests.

The IRS also has made clear that there is nothing per se objectionable with an exempt organization entering into a limited partnership where it either lacks the necessary funds or does not wish to expend all of its funds to acquire property.<sup>15</sup> This is a facts and circumstances analysis that places significance on the venture's charitable goals and the means by which it intends to achieve them.

## 10.5 Charitability

The IRS began by examining the purpose or objective of the limited partnership. The issue of "charitability" is one that is fundamental to an exempt organization's involvement in any commercial venture regardless of the type of entity. The participation of the exempt organization must contribute importantly to its exempt purposes. This analysis involves an examination of the objectives of the parties rather than the type of vehicle used by the parties to achieve their objectives. In GCM 39862, 11/22/91, the IRS concluded that there is inherent tension between furthering charitable purposes and the obligations of a general partner to pursue the financial interests of the investors. While private interests can be advanced, they must be only "incidental" both qualitatively and quantitatively, *i.e.*, the objectives pursued by the activity can only be accomplished by benefiting certain individuals, and the private benefit must not be substantial in comparison with the public benefit conferred by the activity.<sup>16</sup>

In GCM 39862,<sup>17</sup> for example, the IRS reexamined three letter rulings issued in the late 1980s involving joint ventures and concluded that tax-exempt hospitals did little to further their exempt purpose by serving as general partners in limited partnerships formed to share either gross or net revenue streams of income with participating medical staff physicians. Under each arrangement, the IRS found that the sale of the revenue stream of a medical department to a joint venture promoted the private interests of the physicians (as insiders) in both a direct and substantial manner and was advanced at the expense of the exempt organization. It concluded that the business venture did not provide a new healthcare provider or service or resource to the community, but simply enhanced and protected the hospital's market share by retaining and rewarding physicians for referrals and admissions while preempting physicians from creating a competitive provider. Conversely, in GCM 39005, 6/28/83, the IRS concluded that the partnership in which a tax-exempt organization served as a general partner was serving the organization's exempt purpose since the participation in the building and management of a government-financed housing project for limited-income handicapped and elderly persons served to further those charitable purposes set forth in its articles of incorporation and recognized by the IRS.<sup>18</sup>

## 10.6 Structure

Once "Charitability" is found to exist, the IRS examined the structure of the limited partnership to determine if it inhibits the tax-exempt organization's exempt purpose. In its attempts to regulate a tax-exempt organization's involvement as a general partner, the IRS had required both adequate con-



trol of the venture to insure furtherance of exempt purpose and proper safeguards that serve to preserve and protect the organization's resources.<sup>19</sup>

To the extent that the investors were found to enjoy all the upside benefits and suffer none of the downside risks, the organization's exemption was in jeopardy. However, where the partnership had been structured to insulate the exempt organization from potential conflicts that would serve to advance the investors' private interests, the IRS would acquiesce.

An example of this approach can be seen in PLR 9736039 (June 9, 1997), where the IRS issued a favorable ruling that an organization's participation as a general partner in a low-income tax credit limited partnership did not jeopardize its IRC §501(c)(3) tax-exempt status. The ruling described a number of specific changes that the IRS required in the partnership agreement as a condition of issuing the ruling. The importance of this ruling lies, in part, in that its content provided much of the conceptual basis to the IRS in its issuance of Rev. Rul. 98-15.

### 10.7 The LLC and Rev. Rul 98-15—In General

With the corporate attributes of limited liability and participation in management along with the partnership characteristic of "freedom of contract," the LLC technically offers a tax-exempt organization greater control over the joint venture and greater protection for its assets than does a limited partnership.

First and foremost, the LLC offers all its members limited liability. Similar to the protection a corporation offers its shareholders, an LLC insulates both its members and managers from the debts, liabilities, and obligations it incurs.<sup>20</sup> In the past, the IRS has voiced strong objections where the tax-exempt organization, as the general partner, has unlimited personal exposure for the partnership's obligations.<sup>21</sup> By using an LLC, a tax-exempt organization can participate in a joint venture with for-profit investors and maintain control without having to expose its assets to the venture's liabilities. With an LLC there is no need to involve others in the management of the venture in an effort to spread the risk. Moreover, there is no statutory obligation which obligates a tax-exempt organization as the member or manager of the LLC to (i) contribute or loan additional capital to satisfy operating or capital deficits; (ii) personally return to an investor his capital contribution from its own assets; or (iii) provide indemnification to or create loss reserves for the investors.

From a statutory perspective, a tax-exempt organization can isolate itself entirely from losses related to the LLC's activities.<sup>22</sup> Equally important, the LLC will provide the exempt organization with limited liability without sacrificing an active role in the management of the venture. Unlike a limited partner, both members and managers can retain their limited liability status even though they participate actively in day-to-day management. By providing the tax-exempt organization with the ability to control the business venture through management without exposing its assets to substantial risk, the use of LLCs should remove a principal objection raised by the IRS in the limited partnership context.

### 10.8 Fiduciary Duties

The element of "control" required by the IRS imposes certain fiduciary duties on the tax-exempt organization to the LLC and its members that may interfere with the pursuit of the organization's exempt purposes. The duty of loyalty and the duty of care are often statutorily imposed on general partners in limited partnerships. The duty of loyalty imposes on the general partner the obligation to refrain from self-dealing, usurping business opportunities, and competing with the partnership, while the duty of care requires the general partner to refrain from engaging in grossly negligent, reckless conduct, intentional misconduct, or knowing violation of the law.<sup>23</sup>

State LLC statutes may or may not specify the fiduciary duties of members or managers. Consequently, depending on the particular state, management may have broad discretion in defining their fiduciary standards.<sup>24</sup> For example, the Kentucky Limited Liability Act does not define the fiduciary duties of the members or managers as it relates to the LLC. By using an LLC, tax-exempt organizations will have the flexibility to draft the standards of conduct for its fiduciaries in a manner that preserves its exempt status. While these duties may be varied by contract as well as by the particular management structure selected, the element of control required of the exempt organization by the IRS will most likely result, at a minimum, in the imposition by the courts of the customary duties of loyalty and care to the LLC's members.<sup>25</sup> These duties should not create an obstacle to the furtherance of a tax-exempt organization's exempt purposes subject to the following caveat.

It is the implicit duty of management to maximize an investor's return that has drawn the IRS's attention.<sup>26</sup> It has been suggested by the IRS that there is a duty on the part of the organization to maximize profits.<sup>27</sup> While a duty may exist to provide investors with a return on their capital, this duty must be balanced with the duty to achieve the objectives of the entity, itself. More important, the IRS has conceded that while this duty may create a conflict, with the tax-exempt organization's exempt purposes, that conflict can be overcome by a well-drafted agreement between the parties.<sup>28</sup>

#### 10.9 Rev. Rul. 98-15

In March 1998, the IRS issued Rev. Rul. 98-15,<sup>29</sup> the long-awaited pronouncement dealing with a joint venture in which a tax-exempt organization and a for-profit corporation formed a LLC. In this particular case, an exempt acute care hospital, in the hopes of attracting additional funding, contributed all its operating assets, including the hospital to the LLC, while the for-profit corporation contributed certain assets. In return, both entities received ownership interests in the LLC proportional and equal in value to their respective contributions. The Ruling examined two alternative situations and arrived at different conclusions.

#### 10.10 Situation 1

The LLC's articles of organization and operating agreement in this situation provided the following:

- (1) The LLC was to be managed by a governing board consisting of three individuals chosen by the exempt organization and two chosen by the for-profit corporation. The exempt organization intended to appoint community leaders who had experience in hospital matters but were not on the hospital staff and did not otherwise engage in business with the hospital.
- (2) The governing documents could be amended only with the approval of both members.
- (3) A majority of three board members must approve certain major decisions, including those regarding the LLC's annual budgets, distributions of its earnings, selection of key executives, acquisition or disposition of health care facilities, contracts exceeding a certain dollar amount per year, changes to the types of services offered by the hospital, and renewal or termination of management agreements.
- (4) The LLC must operate any hospital that it owns in a manner that furthers the tax-exempt member's charitable purposes. It explicitly provided that it was the duty of the members of the governing board to operate the LLC in such a manner and that this duty overrides any

duty they may have in operating the LLC for the financial benefit of its for-profit member.

- (5) All returns of capital and earnings to the members must be proportional to their ownership interests. The exempt member intended to use any distributions that it received from the LLC to further its charitable purposes.
- (6) The LLC enters into a management agreement with a management company unrelated to either member. The agreement is for five years, renewable for additional five-year periods by mutual consent. The LLC may terminate the agreement for cause. The management company will be paid a fee for its services based on the LLC's gross revenues. The other terms and conditions of the agreement must be reasonable and comparable to what other management companies receive for similar services at similarly situated hospitals.

The IRS concluded under this fact pattern that the tax-exempt corporation would be operated exclusively for a charitable purpose and that the LLC structure would provide only incidental benefit to the private interests of the for-profit corporation. Consequently, the tax-exempt corporation would retain its tax-exempt status.

#### 10.11 Situation 2

In this scenario, the IRS modified the set of facts, with the following results:

- (1) The governing board consists of three individuals appointed by the tax-exempt organization and three appointed by the for-profit corporation.
- (2) The major decisions requiring majority board approval include only the LLC's annual budgets, distributions over a required minimum level, unusually large contracts, and selection of key executives.
- (3) The LLC's only purpose is to construct, develop, own, manage, operate, and take other action in connection with operating its health care facilities.
- (4) There is no override of the board members' fiduciary duty to operate the LLC for the financial benefit of its owners.
- (5) The management company is a wholly owned subsidiary of the for-profit corporation member.
- (6) The management contract is renewable at the management company's discretion.
- (7) The tax-exempt organization agrees to approve the selection of two individuals to serve as the LLC's CEO and CFO, both of whom have previously worked for the for-profit corporation in hospital management. They will receive compensation commensurate with that received by executives at similarly situated hospitals.

Under this set of facts, the IRS determined that the circumstances could not support a favorable determination that the tax-exempt corporation would be operated exclusively for a charitable purpose. It was found that the benefit to the for-profit corporation resulting from the LLC's activities would be more than incidental. The operational test was not met and the tax-exempt organization would lose its exempt status.

In analyzing the Rev. Rul 98-15, the IRS has focused on whether the tax-exempt organization can meet the operational test under IRC §501(c)(3) by participating as a member of a joint venture LLC where it contributes all or substantially all of its assets to conduct activity to further its exempt purpose. In Situation 1, the IRS created a safe harbor for a structure which provides for the organizational, financial and management decisions to be determined by the tax-exempt entity. In Situation 2, the IRS invoked a new set of rules to ensure that the LLC satisfies the operational test of IRC §501(c)(3). From these two situations, the following guidelines can be drawn: first, the IRS applies the "aggregate approach" used in partnership taxation by attributing the activities of the LLC to the tax-exempt member when evaluating whether it is operating exclusively as an IRC §501(c)(3) organization; and second: there are a number of specific requirements that will be the focus of the IRS' attention when making the determination.

With the structural flexibility the LLC offers its members (and with some reliance on prior guidance advanced by the IRS in the limited partnership setting),<sup>30</sup> the governing documents (*i.e.*, articles of organization and operating agreement) can be drafted to satisfy the requirements of Rev. Rul. 98-15.

1. **A specific exempt business purpose should be established with a prohibition against altering it.** Whether it is charitable, educational, or scientific, the furtherance of an exempt purpose must be the principal objective of the venture. The LLC must be operated in a manner to further its exempt purpose. The documents must include language which reveals that the for-profit motive of the for-profit partners is subordinate to the tax-exempts' exempt purpose. The governing documents should include a provision that prevents the altering of the business purpose if to do so would be inconsistent with the exempt organization's exempt status or with the tax exemption of the income generated from the business venture. Moreover, the tax exempt member must be able to initiate new LLC action to accomplish its needs.
2. **For-profit should lack influence over the exempt organization.** The non-profit members must be in control of the LLC's management without regard to its percentage ownership in the LLC. Strategic and day-to-day operational control must be vested in the tax-exempt. For-profit members should not have any strong or common interest in the exempt organization. Individuals of the for-profit should not be in the exempt organization control group, which would include officers, directors, employees, or representatives. It is clear that executives of the LLC should not be insiders of the for-profit. If such individuals are included for purposes of assuring compliance with the exempt purpose or minimizing disputes, they should not, in the aggregate, control the LLC's management. Where this occurs, it may prove helpful to create an independent committee to monitor the role of the exempt organization to insure that any conflicts with the charitable purpose are minimized.
3. **Fiduciary Duty of the LLC Members/Managers.** The duties of the members of the governing body of the LLC must operate the LLC to override any duty they may have in operating the LLC for the financial benefits of all its owners. The fiduciary duty requires the members to operate the LLC in a manner that furthers its charitable purpose and that this duty overrides the duty to operate the LLC for the financial benefits of its owners. All of those employed by the LLC should sign a conflict of interest disclosure statement and acknowledge their fiduciary duty to serve the LLC.

4. **Capital contributions should determine each member's capital interest and any additional capital contributions should be pro rata.** The exempt organization and the for-profit members should receive capital interests in the venture commensurate with their respective capital contributions. In the past, the IRS has focused on the exempt organization's nominal capital contributions as a way to minimize the conflict between its obligations to the venture and its exempt purpose.<sup>31</sup> Any additional capital required for the venture should be funded, in the form of equity or debt, by all members ratably, based on their capital interests.
5. **Profits, losses, and cash should be allocated and distributed pro rata.** Items of income, losses, deductions, and credits should be allocated strictly by the members' percentage interests in capital. The use of special allocations should be limited to special circumstances.<sup>32</sup>
6. **The rate of return on an investor's capital should be "reasonable" and most likely "capped" at a fixed rate.** The LLC should provide for a reasonable return on an investor's capital, which should take into account tax benefits, cash flow from operations, and sales proceeds. It is suggested that the return be "capped" at a fixed amount or percentage to ensure that the pecuniary interests of the investors will not be achieved at the expense of the charitable purpose.<sup>33</sup> It appears that the priority return of an investor's capital is permissible.<sup>34</sup>
7. **The exempt organization should have the first right to acquire the LLC's assets and property.** To protect the charitable purpose, the exempt organization should be entitled to purchase the LLC's property before any sale to a third party.<sup>35</sup> The purchase price of the property should, most likely, be tied to the lesser of fair market value or a maximum return on the investor's capital.
8. **Management contracts.** An LLC may enter into a management contract with an independent third party. All contracts should be negotiated or bid at arm's length in order to establish that the arrangement is not for the benefit of the private interest of a third party.<sup>36</sup> The duration, including renewals, should be reasonable. The contract should consider performance standards that allow the tax-exempt to terminate the agreement early if necessary. Contracts or agreements that contain "incentive" provisions create a profit motive but do not bar exemption as long as the end result is reasonable and as long as appropriate checks and balances are present.<sup>37</sup>

Although the guidelines will most likely benefit the organization in its role as a member of an LLC, they may not go far enough in addressing critical situations commonly present in today's joint ventures. Conspicuously absent from this analysis are such issues as:

- Guarantees of investment returns or return on capital by exempt organizations.
- The consequences of the exempt organization's failure to fund a required additional capital contribution.
- The removal of the exempt organization from control, either as a general partner or a managing member.

What should be the result, for example, if the exempt organization as the managing member is simply not fulfilling its duties under the operating documents? This could occur where it fails to satisfy a future capital call or where it is unable to satisfy a performance guarantee in one form or another. Is it permissible to simply remove the exempt organization from management or buy out its interests? These remain open issues and undoubtedly will have to be dealt with by the LLC members in the operating documents.

The manner in which these issues are handled in the LLC's operating documents will more than likely have a profound effect on a tax-exempt organization's exempt status. A standard of "reasonableness" should be applied in these situations, keeping in mind that the promotion of private interests to an extent greater than otherwise would be justifiable on the basis of reasonable financial solvency would create a conflict of interest that is legally incompatible with the exempt organization's charitable purposes.

#### **10.12      LLCs as Tax-Exempt Corporations**

Traditionally, only nonstock, non-profit corporations, charitable trusts and unincorporated associations are eligible for tax exemption.<sup>38</sup> Conspicuously absent from this list are partnerships and LLCs. Based in part on its fundamental profit motive and in part on its pass-through character (so that the assets and income are allocated and ultimately distributed by the partners rather than by the entity itself), the partnership has been precluded from qualifying as an exempt organization.<sup>39</sup>

The question now being asked is whether the LLC, otherwise recognized as a legitimate form of doing business under state law, will be accepted by the IRS as an organization exempt from tax under IRC § 501(c)(3). It is possible that an exempt organization and its members may find it advantageous to organize as an LLC. Alternatively, two or more tax-exempt organizations might select the LLC over the traditional nonprofit corporation as their joint venture vehicle. The IRS has yet to issue a definitive statement that addresses the qualifications under IRC § 501(c)(3) of an organization formed as a limited liability company under any specific state statute. Moreover, history indicates that the IRS tends to react cautiously in examining different types of organizations outside the traditional structures. With respect to the LLC, therefore, the IRS most likely will move slowly, since unlike the other organization structures, the LLC lacks a historical background.<sup>40</sup>

#### **10.13      State Law Questions**

Initially, whether an LLC can qualify for tax exemption will most likely depend on whether a nonprofit LLC will be recognized under a particular state's LLC statute. The IRS contends that fundamental to the tax-exemption is a requirement that a state have the oversight authority to ensure that use of assets will be dedicated to charitable purposes. Whether a nonprofit LLC can be formed may depend on implications drawn from the specific language of a particular state's statute. For example, both Delaware and Virginia apparently do not preclude nonprofit LLCs.<sup>41</sup> New York and Georgia, on the other hand, would seem to prohibit their use, based on a "for profit" requirement as a result of incorporating the reference to any "lawful business activity" in their respective statutes.<sup>42</sup> California neither expressly accepts nor rejects the formation of a nonprofit LLC,<sup>43</sup> but it appears unlikely that the state will recognize such an organization absent clear treatment in the California LLC Act itself or in the Internal Revenue Code.<sup>44</sup> Finally, Kentucky does not have a specific statute, unlike the corporate provisions of KRS Chapter 273, nor does the LLC Act itself, specifically authorize the organization of a non-profit LLC. Since the LLC is a "creature of statute," requiring substantial compliance with state law, it is likely that the IRS will consider the tax-exempt issue only after it is convinced that state law permits the formation of nonprofit LLCs. Assuming that nonprofit LLCs can be formed under state law, what will, or what should be, the IRS's response when a request for exemption is submitted?

## 10.14 Qualifying an LLC for Exemption

Initially it appears that an applicant for a tax-exempt LLC will have to convince the IRS that there is a valid business purpose to be served or benefits to be achieved or greater powers to be gained by using the LLC organization structure instead of the nonprofit corporation.<sup>45</sup> In a business context, LLCs are selected over the traditional forms because of the statutory restrictions or formalities associated with those forms. A similar argument can be made on behalf of the nonprofit LLC.

For example, the Revised Model Nonprofit Corporation Act specifically prohibits the organization from making any distributions of income or profit to its members.<sup>46</sup> Consequently, if nonprofit organizations incorporate in a state that has adopted the Model Act, with the intent to pursue a charitable objective, they would be precluded by statute from making any kind of distribution out of the nonprofit corporation to themselves. In many situations, this defeats the purpose of organizing in the first place. The formation of a nonprofit LLC could easily cure this problem. With the structural flexibility available in an LLC, the exempt organizations, by contract, can devise a procedure whereby distributions can be made without violating the law. Similarly, the LLC can be used where other statutory obligations imposed on nonprofit corporations, such as fiduciary duties, standards of conduct, indemnification, and corporate formalities, prove too restrictive.

Will the IRS be more inclined to rule favorably on an application submitted by a corporate-styled LLC rather than one organized with partnership attributes? Does the mere fact that a nonprofit LLC has been structured in a manner that would result in it being classified as a "corporation" under the check-the-box classification rules give the IRS a greater degree of comfort than a partnership-styled LLC? The IRS has indicated that this indeed may be the case. It has stated informally that a nonprofit LLC may have a better chance of receiving exempt status where it is classified as a corporation for federal tax purposes and inserts within its operating agreement the appropriate restrictive IRC § 501(c)(3) language with respect to distributions, control, and the dedication of assets on dissolution.<sup>47</sup> A partnership styled LLC, on the other hand, presumably will not be acceptable for the simple reason that a partnership due to its pass-through nature, is not a taxable entity, and so cannot be tax-exempt.<sup>48</sup> As a result of its unique attributes and the fact that it is a relatively new and untested entity, the issue of whether an LLC can qualify as a tax-exempt organization in its own right remains at this time an open issue with the IRS.

In conclusion, an LLC that elects to be classified as an association for federal tax purposes will be required to demonstrate that its stated purposes are exclusively charitable, that its assets would upon dissolution be dedicated to exclusively charitable purposes, and that no part of its net earnings would inure to private shareholders or individuals. Provisions in either an LLC's operating documents or by operation of state law that permit assets to be used for non-exempt purposes or distributed to private persons will be considered to violate these requirements. The law of Kentucky is controlling in construing the terms of its articles, and where an organization contends that such terms have under Kentucky law a meaning different from their generally accepted meaning then clear and convincing reference to relevant court decisions, opinions of the Kentucky attorney-general, or other evidence of applicable Kentucky law is required.

A limited liability company that elects to be classified as a disregarded entity for federal tax purposes will also be required to satisfy the above-referenced requirements to qualify as an IRC § 501(c)(3) organization.

## 10.15 Conclusion

Tax-exempt organizations undoubtedly will continue to aggressively pursue their exempt purposes by engaging in commercial joint ventures with for-profit and other nonprofit partners. Accordingly, the emergence of the LLC should be of considerable interest to tax-exempt organizations. By offering the tax-exempt organization limited liability, the right to control the direction of the venture

without interference from others, and the "freedom of contract" to structure the specific terms and conditions of the operating agreement, the LLC should go a long way in allocating risk and reward among all members in ways that will serve to further the organization's charitable purposes. For these reasons alone, the LLC may, indeed, replace the traditional forms of doing business as an exempt organization's vehicle of choice when engaged in business transactions with for-profit investors. Moreover, in certain situations, the LLC, in and of itself, may prove to be a better vehicle for tax-exemption than the traditional nonprofit corporation or trust. At this time, there appear to be more questions than answers with respect to the LLC in general and its utility to tax-exempt organizations in particular. What is clear is that any involvement by tax-exempt organizations in LLCs should be done with care in order to insure that "concern for the bottom line is subrogated to the concern of the mission."<sup>49</sup>



## Endnotes to Chapter 10

- <sup>1</sup> For purposes of this, "exempt organization" refers only to those organizations qualifying under IRC § 501(c)(3).
- <sup>2</sup> See, for example, Mills, "Whole Hospital Joint Ventures Raise Questions About Exemption" and "Exempt Financing and Exempt Status Can Cloud Hospital Joint Ventures," 7 J. Tax'n of Exempt Orgs. 204 and 252 (March/April and May/June 1996).
- <sup>3</sup> An organization may satisfy the requirements of IRC § 501(c)(3) even though it operates a trade or business as a substantial part of its activities if the operation is in furtherance of its exempt purpose and if the organization is not organized or operated for the primary purpose of carrying on an unrelated business; Treasury Regulation 1.501(c)(3)-1(e). See also IRC § 513.
- <sup>4</sup> See "Tax-Exempts Should Participate in Limited Liability Companies With Care," 14 Tax Mgmt. Weekly Rep. 774 (5/29/95).
- <sup>5</sup> The LLC was referred to as the "greatest single discovery of modern times" at the ABA Tax Section's Exempt Organizations Committee meeting in Washington, D.C., on 5/19/95 (panel III, "Federal Tax Treatment of Investments in Limited Liability Companies by Exempt Organizations").
- <sup>6</sup> See note 4, *supra* (IRS warned exempt organizations that intend to participate as members in an LLC to be very careful that both their status in and returns from the LLC can be justified in terms of their exempt purpose).
- <sup>7</sup> *Id.*
- <sup>8</sup> *Id.*
- <sup>9</sup> Rev. Rul. 98-15, 1998-2.
- <sup>10</sup> See, e.g., GCMs 36293, 5/30/75, and 39005, 6/28/83 (low-income housing); GCM 39862, 11/22/91 (healthcare). In the healthcare area, the IRS has issued hospital audit guidelines that deal, in part, with joint ventures. See IRM 7(10) 69-38, section 333.4(3); Ann. 92-83, 1992-22 IRB 59.
- <sup>11</sup> See GCM 39444, 11/13/85, for a discussion of the IRS's focus on tax-exempt organizations' involvement as corporate general partners. The IRS has not concerned itself with a tax-exempt's interest as a *limited* partner in a limited partnership, even where the organization's exempt purpose is not advanced. Such arrangement may result in the assessment of tax on unrelated business taxable income under IRC § 512. Presumably, the same result would occur where an exempt organization participated as a member in a manager-managed LLC, where the organization has delegated exclusive authority and control of the business to the manager.
- <sup>12</sup> See GMC 39005, 6/28/93.
- <sup>13</sup> Plumstead Theatre Society, 675 F.2d 244 (CA-9, 1982).
- <sup>14</sup> See note 11, *supra*.
- <sup>15</sup> See GCM 39732, 5/19/88. The IRS also explained that it does not use a "but for" test in analyzing the exempt organization's participation in the limited partnership. There is no requirement that the taxpayer show that the purpose of the venture could not have been achieved but for participation in limited partnership.
- <sup>16</sup> To be qualitatively incidental, the benefit to the public cannot be achieved without necessarily benefiting private individuals. To be quantitatively incidental, the benefit must be insubstantial when viewed in relationship to the public benefit conferred by the activity. See also Housing Pioneers, Inc., 58 F.2d 401 (CA-9, 1995), where the court held that the entire plan was to lend the organization's exempt

status in order to achieve a property tax reduction. The organization's participation, as a co-general partner, violated the operational test in that the operation of the partnership caused substantial federal and state tax benefits to flow to the nonexempt partners.

<sup>17</sup> See also GCM 36293, 5/30/75, where the IRS concluded that the exempt organization failed to demonstrate a charitable purpose for its involvement in the limited partnership, since housing units were made available to both low-income and moderate-income tenants and the project was located in an affluent neighborhood.

<sup>18</sup> In GCM 39005, 6/28/83, 100% of the housing units were held open to the elderly and handicapped with limited incomes. In addition, the organization conducted numerous programs to meet physical, social, and recreational needs of the tenants. The organization's engaging in these activities was viewed by the IRS as its being operated exclusively for charitable purposes. See, e.g., Rev. Rul. 79-18, 1979-1 CB 194.

<sup>19</sup> See GMC 39005.

<sup>20</sup> Ltr. Rul. 9517029. While there is no statutory obligation on the part of the exempt organization as a member-manager, business considerations may require the organization to become contractually liable for certain aspects of the LLCs operations. The contractual liabilities should be analyzed in the same manner as the statutory obligations of a general partner.

<sup>21</sup> See GCM 39546, 8/15/86, and Ltr. Rul. 8338127. See also Revised Uniform Limited Partnership Act (RULPA), section 306, under which a general partner is jointly liable for all contractual obligations and jointly and severally liable for tort liabilities of a partnership.

<sup>22</sup> Contrast GCM 39546 8/15/86 (an exempt organization as general partner cannot fully insulate itself from all liabilities simply because of the state law requirements imposed on a general partner).

<sup>23</sup> Revised Uniform Partnership Act (1976) with 1985 Amendments (RUPA), section 403(a); a general partner's duties to the limited partnership are the same duties that bind partners in a general partnership. See RULPA section 404.

<sup>24</sup> For example, the California LLC statute aligns the fiduciary duties of a manager to what a partner owes a partnership and its partners; Calif. Corp. Code § 17153 (West 1995). Contrast that with Delaware, which allows members broad discretion in drafting their fiduciary standards of conduct; accordingly, members of an LLC can contract among themselves as to the standard of conduct owed to the LLC and its members. See Del. Code Ann. Tit. 6, §§ 18-107 and 108.

<sup>25</sup> See Ribstein and Keatinge on Limited Liability Companies (Clark Boradman Callaghan), § 9.01.

<sup>26</sup> See note 22, *supra*; GCM 39546, 8/15/86.

<sup>27</sup> See the edited transcript of the ABA Tax Section's Exempt Organizations Committee meeting in Chicago on 8/5/95 (panel on "Exempt Organizations Investing LLCs With For-Profit Investors").

<sup>28</sup> *Id.*

<sup>29</sup> See note 9, *supra*.

<sup>30</sup> See note 28, *supra*. See also Internal Revenue Service, *Exempt Organizations Continuing Professional Education Technical Instruction Program of 1986* (1/86), page 136, where IRS identifies certain factors, both favorable and unfavorable, to be considered when evaluating whether a partnership arrangement is consistent with an IRC § 501(c)(3) exemption.

<sup>31</sup> See GCM 39005; Ltr. Ruls. 8338127 and 8541108.

<sup>32</sup> GCMs 39732, 39005, and 39444.

- 33        *See also* Ltr. Rul. 8541108, GCM 39005 (where profits were limited by federal restrictions), and Ltr. Rul. 8338127.
- 34        *See also* GCM 39732.
- 35        *See also* GCMs 39005 and 39444; Ltr. Rul. 8338127.
- 36        *See also* Ltr. Rul. 9438030; Housing Pioneers, Inc., *supra* note 15.
- 37        GCMs 39005, 39862.
- 38        *See* Rev. Proc. 82-2, 1982-1 CB 367.
- 39        *IRS Exempt Organizations Handbook* (IRM 7751), section 315.1. *See* Emerson Institute, 356 F.2d 824 CA-D.C., 1966), *cert. den.*
- 40        *See* note 4, *supra*. The IRS has recognized forms other than corporations and trusts as exempt from tax (*e.g.*, a hospital organized and operated on a cooperative basis was held exempt under IRC § 501(e)(2)).
- 41        *See* Del. Code Ann. Tit. 6, §18-106(b); Va. Code Ann §13.1-1008.
- 42        *See* N.Y.L.L.C. Law §201; Ga. Code Ann. §14-11-201(b)
- 43        *See* Cal. Corp. Code §17002.
- 44        *See* Short, *Overview of Beverly-Killea Limited Liability Company Act* (Publication #1L, Beverly Hills Bar Association, 1994), page.3.
- 45        *See* note 10, *supra*.
- 46        *See* Model Nonprofit Corporation Act, Section 13.01, Prohibited Distributions, Official Text with Official Comments, adopted by the ABA Business Law Section's Subcommittee on the Model Nonprofit Corporation Act, Suite 1987.
- 47        *See* note 11, *supra*. *See also* PS-43-95, 5/9/96, and Slider, "Check-the-Box Proposed Regulations Make LLCs Even More Appealing." 3 JLLC51(Fall 1996).
- 48        *Id.*
- 49        GCM 39862.



## **11.1 WEALTH TRANSFER PLANNING USING FAMILY PARTNERSHIPS AND FAMILY LIMITED LIABILITY COMPANIES**

**by  
Scott W. Dolson**

Many readers of this chapter will remember the glory days of the limited partnership when it served as the vehicle for structuring tax shelter transactions. The 1986 Tax Act put an end to that era and temporarily relegated the partnership to the backwaters of entity planning. Two events have resulted in the return of the partnership to the planning forefront. In 1993, the IRS conceded in a published ruling that minority interest discounts were available even in situations where a family held all of the interests in a family partnership. Revenue Ruling 93-12 literally opened the family limited partnership floodgates. The second event was the introduction of the limited liability company ("LLC"). The LLC era began in earnest after a 1988 IRS ruling confirmed that the LLC would be classified as a partnership (rather than corporation) for tax purposes. The rapid acceptance of the LLC as the entity of choice for closely-held businesses can be directly attributed to an unbeatable combination of entity characteristics—LLCs are eligible for flow-through partnership tax treatment, while at the same time possessing the corporate characteristic of liability protection for its owners.

This chapter focuses on the use of partnerships and LLCs as a vehicle for transferring wealth between generations. The wealth being transferred may be a family business, but might also include investment assets (*e.g.*, stocks, securities, other personal property and real estate). This chapter describes why the use of family limited partnerships (FLPs) and family LLCs (FLLCs) have become one of the most popular estate planning tools for the 1990's. Finally, no chapter on family wealth transfer planning would be complete without a discussion of the latest IRS efforts to undermine the planning device.

### **11.2 Importance of Integrating FLP and FLLC Planning into Overall Estate and/or Business Succession Planning Process**

The decision to engage in wealth transfers through FLPs and FLLCs should not be made in isolation, but rather as part of an overall estate planning and/or business succession planning program.

### **11.3 Why are FLPs and FLLCs a Hot Planning Technique?**

There are several reasons why FLPs and FLLCs are among the most popular family wealth transfer planning techniques in use today:

- **Flexibility as a Family Business Succession Planning Tool**— FLPs and FLLCs are well suited for family business succession planning because of the structural flexibility they bring to the table. These entities allow the senior generation to shift a substantial block of ownership interests while at the same time retaining management control. Alternatively, both equity ownership and management control can be partially or entirely shifted to the next generation, with the timing of the transfer at the discretion of the parent. FLP and FLLCs also allow for flexible planning in the area of allocation of taxable income, deductions, losses and most importantly, cash distributions. These items of income and cash can be allocated disproportionately, and in the case of distributable cash, retained in part for reinvestment in the business or investment enterprise. These characteristics are important when there are some children who work in the business and others who do not. Planning flexibility increases the odds that ownership will be retained in a family as equity ownership shifts between generations;

- **Facilitates the Making of Lifetime Gifts**—FLPs and FLLCs facilitate the making of gifts because they permit gifting of interests in an entity rather than co-ownership interests in the underlying assets. Gifting fractional interests in assets is often inconvenient from a management, transfer tax and ownership standpoint. Ownership interests in FLPs and FLLCs, on the other hand, can be naturally fractionalized into units of equity ownership, making the shift of ownership convenient and efficient. Lifetime gifts are a fundamental estate and succession planning tool and any vehicle that makes it easier to accomplish the gifting of assets is valuable for that reason alone. The pooling of family assets in an entity, followed by gifting of equity interests in the entity, may also reduce the risk associated with one or more children holding a single business or investment asset;
- **Facilitates the Obtaining of Substantial Valuation Discounts**—Making gifts of FLP or FLLC interests creates the opportunity for obtaining valuation discounts, often resulting in substantially reduced transfer taxes. Because transfer tax rates are extremely high, successfully obtaining valuation discounts is a lynchpin of aggressive wealth transfer planning. Although this chapter focuses primarily on gifting as a planning technique, the availability of the valuation discounts also creates an attractive opportunity to sell assets to children at a discount;
- **Allows the Senior Generation to Maintain Control**—If maintaining control over a family business or investment assets is a goal of the senior generation, then the FLP or FLLC provide a flexible vehicle for accomplishing that goal, even after a majority of the equity is passed to the next generation. Although there are tax ramifications that must be taken into consideration, it is also possible for parents to maintain a substantial degree of control over the timing and amounts of cash distributions to the entity's owners;
- **Facilitates Effective Asset Protection Planning**—The FLLC, and to a lesser degree the FLP, provides two-way asset protection planning—FLLC owners and FLP limited partners are not liable for the entity's liabilities and obligations, and in turn, the entity's assets are shielded from the claims of the owners' creditors; and
- **Facilitates Structuring Freeze Transactions Through Use of Preferred Interests**—the FLP and FLLC can be structured to create "preferred interests" that have a preferred right to income and a fixed share of the entity's assets upon liquidation or redemption. Bifurcating the value of the FLP or FLLC through the creation of preferred interests provides a vehicle for structuring gifting or charitable giving programs that satisfy the differing goals of donors, including, making charitable contributions or gifting assets out of the estate while retaining the right to receive a future income stream.

#### 11.4 Nuts and Bolts of FLPs and FLLCs

The family partnership is a limited partnership formed under state law. The family LLC is a limited liability company formed under state law. Both FLPs and FLLCs are classified as partnerships for federal income tax purposes, unless an election is made to treat the entity as an association taxable as a corporation (highly unlikely in the family entity context). In structuring wealth transfers through family entities, the following areas of law, among others applicable to the assets held by the entity, should be considered: (i) federal income and transfer tax laws; (ii) state income and transfer tax laws; (iii) state limited partnership and LLC laws; and (iv) state fraudulent conveyance laws.

#### **11.4.1      State of Formation**

Each state has enacted its own limited partnership and LLC laws. These laws have many similarities but each state will have statutes that differ on crucial issues. With the 1998 amendments to the Kentucky LLC Act and the Kentucky LP Act, it is no longer necessary for Kentucky families to forum shop for favorable state laws from a wealth transfer standpoint. The 1998 amendments revised Kentucky's laws to prohibit partners and members from withdrawing or forcing the dissolution of the entity. Prohibiting withdraw should open the door for obtaining the maximum available valuation discounts. In addition, the term of a Kentucky LLC is now generally perpetual, rather than terminable upon the occurrence of a variety of events. These changes put Kentucky on the cutting edge for valuation discount planning. Some attorneys may nevertheless prefer to use Delaware or another state's entity for various business, tax or personal reasons, which should not present a problem from a wealth transfer planning standpoint, so long as those states also have favorable provisions restricting withdrawal from and dissolution of the entity. The significance from a valuation standpoint of restricting withdrawal and dissolution is discussed below in this chapter.

#### **11.4.2      Federal and State Tax Classification**

The 1997 "check-the-box" partnership classification regulations (Treas. Reg. §§ 301.77012-1 through 3) insure that both family partnerships and LLCs will be taxed as partnerships for federal income tax purposes. The check-the-box regulations eliminate the multi-step classification tests. Partnership tax treatment is the default tax treatment for both partnerships and LLCs, so the check-the-box form (Form 8832) does not need to be filed with the IRS in order to treat partnerships and LLCs as tax partnerships. There appears to be little reason why a family partnership or LLC being used as a vehicle for wealth transfers would "check-the-box" to be treated as a corporation for federal tax purposes. If the corporate form for tax purposes is desired, then an entity formed under state corporation laws should be utilized.

The tax laws of the states in which the limited partnership or LLC generates income should be examined in order to determine how those states will treat the entity for tax purposes. Some states impose an entity level tax on LLCs, which suggests that the limited partnership may be the better choice of entity in that state.

#### **11.4.3      The Formation Process**

The first step in the organization of a family limited partnership is the filing of a certificate of organization with the secretary of state. The first step in the organization of a family LLC is the filing of articles of organization with the secretary of state. This instrument requires only very basic information (*e.g.*, name, registered agent, duration of existence) about the entity. Delaware refers to organizational documents of various entities by slightly different names (*e.g.*, certificates of organization; limited liability company agreements).

Once the organizational instrument is filed, then the partners/members should enter into a partnership or operating agreement. This is the agreement among the owners of the entity and governs the operation of the entity and the relationship among its owners. In a family wealth transfer transaction, this agreement is generally not a negotiated agreement among business partners, but instead, is an agreement designed to maximize the benefits available through using the entity (*e.g.*, valuation discounts, retention of management control, asset protection planning) and is agreed to only by the donor/parent prior to the gifting of interests to children. The limited partnership or LLC agreement deals with issues such as the initial capital contributions, additional capital contributions or loans, allocation of taxable income and losses, distributions of cash flow, management of the entity, buy-sell arrangements, and liquidation procedures. In most cases, these provisions supersede the application of the

organizational state's default statutes that deal with the same issues. If the owners of a FLP or FLLC fail to enter into an agreement governing the operation of the entity, then the state law default provisions will apply. When a limited partnership or LLC is being used for family wealth transfers, however, there are a number of specialized provisions that will need to be in the governing instrument in order to maximize the potential for valuation discounts and minimize possible IRS attacks. Reliance should never be placed on the default provisions of state law to serve as the entity's governing instrument.

The typical family wealth transfer arrangement includes the initial contribution of assets by the parent/donor in exchange for units of membership interest in the entity. The contribution of assets to the FLP or FLLC will generally be tax-free under IRC § 721. After a period of time ranging from a couple of months to years passes, the parent/donor then gifts units of membership interest to children/donees. The transaction is usually structured so that the donee/children are not required to make any capital contributions or loans to the entity and the parent/donor has the right to acquire additional units of membership interest in exchange for the contribution of additional assets.

If at all possible, there should be a separation in time between the transfer of assets by the parent/donor to the family entity and the gifting of interests in the family entity to children/donees. Furthermore, the children should not be brought in as partners/members at the time of the entity's formation, but only later when they are gifted interests. There are two reasons for this focus on timing. First, the separation in time of formation and gifting reduces the potential applicability of IRS arguments that the transaction is a sham or the entity should be ignored under IRC § 2703. Second, this separation in time helps to distinguish the transaction from the facts of a troubling Tax Court case where the IRS argued successfully that the transfer of assets to a family corporation (where the children also held stock) by parents was itself a gift to the children, on the theory that the interests received by the parents in return for their assets were worth less than the property contributed (thereby benefitting the other existing shareholders). Trenchard v. Commissioner, T.C. Memo 1995-121.

Where there is only a single parent contributing assets to an FLP/FLLC, the natural inclination might be to initially form a single member LLC and subsequently gift units to children. This structure would successfully plan around the timing issues discussed in the preceding paragraph and might neatly fit the needs of a parent who wants to form the entity but is not quite ready to make gifts. Unfortunately, the use of a single member LLC might be risky. In Revenue Ruling 99-5, 1996-6 I.R.B. 8, the IRS concluded that the conversion of a single member LLC into a multiple member LLC (taxed as a partnership) through the sale of membership interests to a second member should be treated for tax purposes as a purchase by the second member of an undivided interest in the LLC's assets followed by a contribution by both members of the assets to a newly formed tax partnership. While this treatment may not create many problems in the business LLC context, in the FLLC context it could be deadly. The IRS could argue that a parent who initially forms a single member LLC and then later gifts a substantial interest in the FLLC to children is actually gifting an undivided interest in the underlying assets. If the gift was of the underlying assets, then the valuation discounts associated with the gifting of the FLLC interests might be lost. A way to avoid this problem is to bring a child in from the beginning of the FLLC's formation for a minimal (*i.e.*, 1%) interest, thereby creating the tax partnership from the outset and taking the transaction outside of the potential scope of Rev. Rul. 99-5. The formation by the parent of the FLLC and the gifting of a 1% interest may raise the Rev. Rul. 99-5 issue but to a much lesser extent than the gifting of a substantial interest in connection with the creation of the tax partnership.

Although this chapter focuses primarily on the gifting of FLP/FLLC interests, the availability of valuation discounts also creates an opportunity for parents to sell assets to their children at a discount. Parents who desire to realize cash out of the transfer of the family business or wealth to the next generation can structure the transaction as a sale at the discounted value after the assets are contributed to the FLP/FLLC. The transaction can take advantage of installment sale treatment in order to allow the children to have the opportunity to pay for the assets out of earnings. Sale transactions avoid transfer tax problems and parents can elect in the future to forgive installment notes if they want to introduce a gift element into the transaction.



Perhaps the most important part of structuring the FLP or FLLC plan is the drafting of the partnership or operating agreement. First and foremost, the agreement must successfully maneuver through all of the tax provisions that affect family partnerships and LLCs with particular attention paid to the various avenues of attack then in use by the IRS. Secondly, the agreement must be structured to facilitate family wealth transfer planning from a practical standpoint—addressing issues such as management, acquisition of additional interests, control over distributions, and restrictions on transfer.

The parent or an entity controlled by the parent will generally be the FLP general partner or FLLC manager, and will have substantial control over the entity's operations. The partnership or operating agreement will provide for the distribution of all cash flow, with the definition of "cash flow" giving the manager/general partner the discretion to retain revenues within the FLLC/FLP to fund the payment of expenses and otherwise engage in the entity's business activities (e.g., reinvestment and capital improvements). The parent/donor will generally have the right to freely transfer his or her units of membership interests. The children/donees will have the right to transfer the economic rights to their membership interests subject to a right of first refusal in favor of the entity to repurchase the interests.

The agreement of all partners/members will generally be required to dissolve the entity, in order to limit the ability of the donees to cause a dissolution of the entity. This provision places a greater restriction on dissolution than the default provision in the Kentucky LLC Act which calls for dissolution upon the vote of a majority in interest of the members. As a result, the provision constitutes an "applicable restriction" under IRC § 2704(b) and would be ignored for valuation purposes (i.e., reverting back for valuation purposes to the majority-in-interest statutory default). The fact that dissolution by a majority-in-interest will govern for valuation purposes should be kept in mind, and the FLLC ownership should be structured so that no member holds or controls more than a 49% interest, thereby preserving all of the available valuation discounts.

#### 11.4.4 The Importance of Appraisals

Obtaining an appraisal of the value of the membership interests being gifted is crucial if any valuation discounts are being taken. The value of the assets held by the family partnership or LLC must also be appraised if that value is not readily provable. There are a number of accounting firms and valuation companies with personnel qualified to appraise ownership interests in FLPs and FLLCs. When selecting an appraiser, careful attention should be paid to past experience in the area of appraising FLP and FLLC interests and the quality of the appraisal report (i.e., review a past effort). An assessment should also be made of the credibility and support that the appraiser would bring to the table if the IRS challenged the valuation discounts. Taking valuation discounts without obtaining an appraisal is like riding a motorcycle without a helmet, you save a few dollars up front but the expenses down the road can be a killer.

Obtaining a competent appraisal has become even more of a necessity in light of the IRS' additional disclosure requirements for gift tax returns. See the section New Gift Tax Return; Proposed Regulations *infra*.

#### 11.4.5 Types of Assets held by Family Entities

FLPs and FLLCS have been used to hold a wide variety of investment and business assets, including publicly traded and closely held stocks, interests in partnerships and LLCs, various financial instruments, including bonds, real property and interests in real estate ventures, life insurance, and interests in, or the assets of, closely-held operating businesses.

There is a substantial degree of concern that the IRS will be successful in attacking FLPs and FLLCs that hold only publicly-traded securities. The IRS' argument that holding investment securities

is not a proper business purpose flies in the face of various statutes and regulations that expressly contemplate partnerships holding nothing but investment securities. At this point, the IRS has not been successful in obtaining authority that would cause a prudent planner to cease structuring family entities that hold nothing other than publicly-traded investment securities. There may come a day when legislation puts an end to FLPs and FLLCs holding investment securities, or even investment assets generally (as contrasted with operating businesses), but until that time, prudent planners should focus on emphasizing the non-tax business purposes for structuring the holding of investment securities in a family entity (e.g., asset protection and management control).

FLPs and FLLCs should not hold voting stock of closely-held corporations if the general partner/manager of the family entity is using the entity as a gifting vehicle. If voting stock is used, the IRS might be able to argue that the donor retains control of the stock through his indirect voting power and under IRC § 2036(b), the donor has retained control over the assets and they should, therefore, be included in his estate. The use of nonvoting stock will solve this problem.

#### **11.4.6      Use of Family Entities to Hold Real Estate**

Limited liability companies and limited partnerships have traditionally been popular entities for holding real estate because their features are well suited to the holding of real estate. In the family wealth transfer planning context, family entities are equally popular and useful. Family entities, especially FLLCs, shield the owners from liabilities arising out of the ownership and operation of the real estate. Once real estate is transferred to the family entity, interests in the FLP or FLLC can be transferred without incurring real estate transfer taxes. Finally, the use of the family entity avoids the necessity of gifting fractional interests in real estate, which in many cases is not an efficient ownership structure. There is nothing more cumbersome from a legal standpoint or potentially divisive for a family, than having multiple family members jointly owning real estate.

#### **11.4.7      Use of Family Entities as a Business Succession Planning Vehicle**

Family entities are an effective planning vehicle for business succession planning where the goal of the succession plan is to transfer (through gifting or sale) ownership of the business to one or more members of the junior generation. Most if not all of the benefits of the family entity generally are also applicable to the use of the family entity as a business succession planning vehicle.

The family entity allows the senior generation to transfer ownership of a family business for transfer and income tax purposes without prematurely giving up control of the business. The availability of valuation discounts allows for transfer of the business at reduced transfer tax costs. The asset protection features of the FLLC are also attractive. FLLCs protect the owners from liabilities arising out of the operating business owned by the family entity, and also protect the value of the family business from its owner's financial problems. The FLLC operating agreement or FLP partnership agreement will generally include buy-sell provisions that give family members remaining with a business the right of first refusal to acquire the interests of a family member who ceases to work for the business, or who merely wants to cash out his or her equity position in the business.

Interposing the family entity between the equity owners and the business allows the senior generation to divide control and management of the business from equity ownership in the business. This ability to separate ownership from control is important where a parent wants a child to own an equity interest but not interfere with the day-to-day operation of the business.

#### 11.4.8 Use of Family Entities to Hold Life Insurance

Family entities are attractive alternatives to trusts as a planning vehicle for the ownership of life insurance. Life insurance is often a fundamental part of a comprehensive estate plan. Life insurance provides tax-free proceeds to support family members upon the death of a breadwinner. Life insurance proceeds are also often used as a tool for paying estate taxes, either directly by the estate (but subjecting the proceeds to estate taxes) or indirectly through the purchase by family members of assets from the estate using those proceeds (thereby keeping the insurance proceeds out of the estate).

Trusts have traditionally been the planning vehicle of choice as they ensure that the life insurance proceeds are managed competently for the benefit of the beneficiaries and because they effectively remove the proceeds from an insured's gross estate. Trusts have certain disadvantages, however, including the fact that (i) the arrangement is irrevocable, (ii) planning with trusts is inflexible and must take into consideration the complicated tax and legal consequences of the trust form, and (iii) the insured cannot be the trustee of the trust.

The typical family entity holding life insurance is structured with the insured parent acting as the manager or general partner of the family entity. Under IRC § 2033, so long as the life insurance proceeds are payable to the family entity and not used for the benefit of the insured, the only portion of the proceeds includable in the insured's gross estate will be the insured's share of the proceeds based on his or her interest in the family entity. Treasury Regulation § 20.2031-2(f) provides in part that, in valuing a corporate interest, consideration must be given to nonoperating assets, including proceeds of life insurance policies payable to or for the benefit of the company. IRC § 2042 should not apply to bring the entire insurance proceeds into the decedent's gross estate, even if the insured is the manager or controlling partner. See Estate of Knipp v. Commissioner, 25 T.C. 153 (1955) and Rev. Rul. 83-147, 1983-2 C.B. 158. The threat of IRC § 2042 makes it imperative, however, that the family entity's agreement be drafted to negate the implication of any power of the insured to exercise an incident of ownership with respect to the entity's life insurance policies.

From a practical standpoint, the family entity provides a great deal more flexibility and control for the insured parent than the trust. Once a trust is established and a trustee appointed, flexibility to react to changing circumstances is greatly reduced or lost. With the parent as the controlling manager or general partner of the family entity, and the family members as a group being able to liquidate the family entity or amend the entity's agreement, more flexibility is retained by the insured directly and through the family indirectly if insurance planning is undertaken through the family entity.

Another potential benefit of the family entity over the trust as a planning vehicle for life insurance is the fact that family entity ownership of insurance and making gifts of family entity interests may offer greater advantages over trusts in qualifying for the IRC § 2503(b) annual exclusion. Since 1968 there has existed authority that a presently exercisable power of withdrawal may be used to qualify contributions to a trust for the gift tax annual exclusion. See Crummey v. Commissioner, 397 F.2d 82 (9th Cir. 1968). The continued use of "Crummey powers" or "Crummey withdrawal rights" is regularly threatened by case law and proposed legislation, however, making the continued use of this technique problematic. Effective annual gifts can be made to the family entity, however, without relying on Crummey withdrawal rights. Parents contribute money to the family entity and receive additional Units of Participation in the family entity in exchange. The contribution of the money to the family entity is not a gift, so long as the contributor is issued sufficient Units of Participation. The family entity can then use the contributed capital to pay life insurance premiums or fund other operating expenses or capital needs of the family entity. The parents can then turn around and gift the additional Units of Participation to the children, with the gift of those Units qualifying under IRC § 2503(b) for the annual exclusion.

#### 11.4.9 Preferred FLP and FLLC Interests

FLPs and FLLCs can be structured with multiple classes of equity, with one class being a “preferred” class, with preferential rights to distributions of net cash flow and a fixed amount of liquidation proceeds. The preferred class does not participate in the appreciation of the entity’s assets because its share of liquidation proceeds is limited to the stated dollar amount of its preferential liquidation rights. This division of economic rights is similar to the typical structure of a corporation having both common and preferred stock.

Preferred FLP or FLLC interests can be used in several ways. The classic structure is for the senior generation to retain the preferred interests and make gifts of the nonpreferred interests. The senior generation often desires to retain an income stream, which is facilitated by the retention of the preferred interests. The preferred interest’s preferential right to liquidation proceeds reduces the value of the remaining “common” interests for gift tax purposes, at a cost of not removing the value of the liquidation preference from the donor’s estate. The gifting of the common interests maximizes the removal of future appreciation from the donor’s estate. The gifted common interests are eligible for various valuation discounts (*e.g.*, minority interests; lack of marketability), in addition to the suppression of their attributable to the existence of the preferred interests.

If a donor is charitably inclined, then he can make charitable contributions of preferred interests and achieve several desirable results. First, the value of the preferred interest is a charitable contribution. Second, the income stream to the charity is not taxable to the donor. Third, the donor retains the right to the future appreciation of the assets through ownership of the common interests.

FLPs and FLLC’s with preferred interests must satisfy the requirements of IRC § 2701, which is designed to deal specifically with “freeze” transactions using preferred FLP or FLLC interests. IRC § 2701 requires that the preferred interest’s right to net cash flow be cumulative. Any noncumulative net cash flow preference feature will be considered a transfer, and thus a gift to the holders of the nonpreferred interests. The provision also requires that preferred interest values must be sustained on the basis of solid economic fundamentals comparable to those that support the values of publicly traded nonconvertible preferred stock, such as yield and the safety of the dividend and liquidation preferences. The value of the nonpreferred interests must equal at least 10% of all of the entity’s interests, plus the total indebtedness owned by the entity to its owners. This 10% minimum value rule is designed to assign at least some significant value to the right of the nonpreferred interests. Various rights (*e.g.*, puts, calls, conversion rights) that support the values of preferred interest’s dissolution preference will be ignored.

#### 11.4.10 Combining FLPs/FLLCs with GRATs

Grantor retained annuity trusts (GRATs) are irrevocable trusts to which the grantor transfers appreciating or income producing assets in exchange for the right to receive a fixed amount annuity for a fixed number of years. When the trust term expires, any remaining assets held by the GRAT are transferred tax-free to the remainder beneficiaries. The value of the gift upon the formation of the GRAT depends both on whether any valuation discounts are available because of the nature of the assets being gifted (*i.e.*, valuation discounts for FLP/FLLC interests) and the terms of the annuity stream to be paid back to the grantor. The bottom line is that if the assets held by the GRAT appreciate faster than the baseline rate of return dictated by the IRS at the time of the GRAT formation, then there will be assets left over in the GRAT at the end of its term, with those assets going tax-free to the beneficiaries. GRATs are useful tools to employ in situations where maximum use has been made of the unified credit and a taxpayer is looking for a further way to transfer assets (or at least potentially do so) without incurring any substantial additional transfer taxes.

#### 11.4.11 Charitable FLPs/FLLCs

An aggressive planning strategy that has recently been in vogue is the charitable FLP/FLLC. Charitable FLPs/FLLCs are usually formed in connection with the sale of substantially appreciated business assets, and especially business assets held in a C corporation that will be subject to double taxation (*i.e.*, corporate and shareholder levels) if the assets are sold. Instead of selling the business assets directly to a third party, the business assets are instead contributed to an FLP/FLLC. The business owner becomes the FLP/FLLC general partner/manager. FLP/FLLC interests representing the bulk of the economic interests in the entity are then gifted to a charity and a charitable deduction is taken. The business is then sold by the FLP/FLLC and the pass-through of gain on the sale to the charity is shielded from tax.

The economic benefit to the owner forming the FLP/FLLC is the ability to "run" the FLP/FLLC and take advantage of the sales proceeds now held by the FLP/FLLC through the payment of management fees, etc. during the remaining (often extended) term of the FLP/FLLC. After the term is over, the remaining funds in the FLP/FLLC go to the charity. The goals of this strategy are similar to the upfront goals of a charitable remainder trust (avoiding tax on the sale of the business; charitable intent), with the added presumed benefit of a continuing income stream through control of the FLP/FLLC after the business is sold. Some versions of the strategy involved the sale of the business out of the FLP/FLLC to the original owners at a discount. Charities often have the right to put the business back to the donor at a fraction of value, which nevertheless may be the only available market for the charity, as the FLP/FLLC interest truly lacks marketability due to the various ownership restrictions. Some charities are willing to participate in this planning strategy because they end up with something at the end of the day, which is better than nothing unless you are concerned about the sanctity of the tax system.

The charitable FLP/FLLC was discussed in detail in the July 13, 1999 edition of The Wall Street Journal. The article reported that the IRS was investigating the strategy and could take steps to direct audits of taxpayers and charities involved with the technique and/or issue a regulation denying tax benefits. The IRS is stating publicly that for taxpayers now setting up new charitable FLPs/FLLCs, the risk is considerable.

#### 11.4.12 Conversion of Family Corporations into FLLCs

There is a perception and in many instances the reality that valuation discounts available in connection with the gifting of FLLC interests are somewhat greater than those available when gifting voting or nonvoting stock. The introduction of the check-the-box classification regulations has created the potential for the conversion of a C or S corporation into an LLC that elects to be taxed as a corporation. The conversion is usually accomplished through the formation of an LLC that elects to be taxed as a corporation, followed by the merger of the newly-formed LLC in a tax-free IRC § 368(a)(1)(F) reorganization (mere change of identity) with the existing corporation. For income tax purposes, this transaction is the merger of two corporations. The LLC is the surviving entity in the merger, but the tax life of the corporation continues unabated in the LLC shell.

One obvious planning idea that this conversion technique suggests is converting a family corporation into an FLLC in order to increase the potential valuation discounts available in connection with the subsequent gifting of FLLC interests. This technique should work although it may have unintended negative tax consequences if the children already hold stock of the family corporation at the time of conversion.

Private Letter Ruling 199947034 addresses the potential application of IRC § 2701 in the context of the conversion of a family corporation into an FLLC. IRC § 2701 determines the extent of a gift in situations where, for example, parents hold a preferred equity interest and make a gift of common equity interests. The IRS takes the position that a reorganization or other change in the capital structure of a corporation is treated as a transfer of an interest which could result in a gift from the parents to the

children if the reorganization results in a recapitalization fitting within the scope of IRC § 2701. PLR 199947034 concluded that a conversion transaction where the family members' equity is identical before and after the conversion does not trigger a deemed gift to the children under IRC § 2701. Any material change in the relative rights and preferences of the equity held by the parents and children in the conversion could, however, result in a deemed gift. IRC § 2701 is not an issue in this context if the conversion occurs prior to the gifting of equity interests in the business to the children. The gifting of FLLC units must still run the general gauntlet of IRC § 2701 if there are multiple classes of equity, but the conversion itself would not create an issue.

#### **11.4.13      Comparing FLPs and FLLCs**

In the past, the FLP has reigned supreme as the vehicle for structuring family entities. As a practical matter, the choice between the FLP and FLLC was often governed by the past experiences of the professionals involved in the planning process. Professionals who have used FLPs for years may be reluctant to use FLLCs if the differences between the entities are not compelling. The FLLC, however, does offer certain technical advantages over the limited partnership as the vehicle for family wealth transfer planning.

A significant advantage of the FLLC over the FLP is that the FLLC does not have a general partner. General partners are jointly and severally liable for all of the debts and liabilities of the FLP. In many instances, family members will desire to be individual general partners in order to exercise management control, thereby unnecessarily exposing them to the entity's liabilities and obligations. No member of an FLLC is personally liable for the entity's obligations or liabilities. FLLCs also permit, if desired, participation in management by the non-manager members, in contrast to the FLP, where limited partners must remain passive or risk the loss of their liability protection.

Depending on which state's law applies, the FLP may also have certain theoretical problems from a discount planning standpoint. There is some concern that the provision relied upon to prevent limited partners from withdrawing and obtaining the fair value for their interests—the provision that provides that the FLP is for a term—should not be interpreted to prevent limited partners from withdrawing and obtaining the fair value for their interests, or that the limitation may constitute an applicable restriction under IRC § 2704(b). In fact, the IRS has made arguments along these lines in several 1998 Technical Advice Memorandums. Kentucky responded during the 1998 legislative session to this concern by amending its limited partnership laws to provide that limited partners cannot withdraw unless withdrawal is contemplated by the partnership agreement.

Another problem with the FLP is the fact that partnerships dissolve if a disassociation event occurs with respect to the FLP's general partners (*e.g.*, death). The bottom line is that there are substantial disadvantages associated with the use of a sole individual general partner in the FLP context. The optimal structure would require the use of multiple general partners, with at least one of the general partners being a corporation or trust. If this structure is employed, then the death of the grantor will not trigger a dissolution of the FLP. This structure presents certain practical problems, however, where a parent desires to be the general partner but does not desire to go through the effort of creating multiple general partners. The use of the FLLC solves this problem as the death of a manager or member does not trigger the dissolution of the FLLC.

One of the 1998 amendments to Kentucky's LLC act creates a potential problem for obtaining valuation discounts. The 1998 amendments modified KRS § 275.285 to provide that an LLC can be dissolved upon the written consent of a majority-in-interest of its members. "Majority-in-interest" is based on the members' relative capital contributions. To the extent that interests in the LLC are gifted, then the capital contributions associated with those gifted interests would be deemed to be held by the donee for purposes of determining voting and economic rights under Kentucky's LLC act. The significance of the ability of a majority-in-interest to dissolve an LLC is that if an LLC member holds such a majority-in-interest, then he can trigger a dissolution of the LLC and force a distribution of LLC assets.

The valuation discounts that are available with respect to an interest that carries with it the potential right to cause a dissolution of the family entity are severely restricted, as the interest cannot be appraised on a going concern valuation (*e.g.*, minority interest and lack of marketability). Any additional restrictions placed on dissolution in an operating agreement (*e.g.*, unanimous consent required) might be deemed to constitute an applicable restriction under IRC § 2704(b) and therefore be ignored for valuation purposes.

There are a couple of ways to deal with KRS § 275.285. If an FLLC is being used as the family entity, then the valuation problem can be avoided by not gifting units of membership interest constituting a majority-in-interest, and, if the donor intends to hold a substantial interest in the FLLC, planning to avoid having the donor hold a majority-in-interest of the FLLC until death (*i.e.*, reducing the ability to obtain valuation discounts for the estate tax value). Another way of avoiding the problem is to use an FLP rather than an FLLC. KRS § 362.487 provides that dissolution occurs upon the written consent of all partners. Of course, KRS § 362.487 also provides for the dissolution of the FLP upon an event of withdrawal of the general partner, which requires the use of multiple general partners and entities with perpetual existence as one of the general partners to avoid its potential application in the valuation discount context, especially when interests are to be held by the senior generation until death.

### 11.5 Estate Planning Fundamentals; The Importance of Lifetime Gifts

FLPs and FLLCs are primarily used as vehicles for making lifetime gifts of family wealth. Family wealth may be in the form of a family business or investment assets, or a combination of both. In order to understand the importance of FLPs and FLLCs as an estate and business succession planning tool, it is important to understand why lifetime gifts are a powerful wealth transfer planning tool.

Lifetime gifts remove assets from the donor's taxable estate. Assets that are not in a donor's estate will not be taxed when that donor dies. In fact, when a gift is made, both future appreciation and the income generated by the gifted asset are removed from the donor's estate. The math of lifetime gifts is simple. If a family business is appreciating and/or generating income, then overall transfer taxes will be reduced or eliminated if the business is transferred before too much income or appreciation is generated. Of course, there are non-tax business and personal issues that weigh against transferring an interest in the family business, but how many of those issues are worth losing a large chunk of a family's wealth to the IRS? The use of a family entity may allow a family to reduce crippling transfer taxes while still addressing the concerns of the senior generation with respect to issues such as cash flow and management.

Subject to several important exceptions, all transfers of assets between parents and children, whether lifetime gifts or testamentary transfers, are subject to taxation under a unified transfer tax system. Planning to reduce or eliminate those transfer taxes is a fundamental goal of estate and business succession planning.

Every individual has a unified credit against gift and estate taxes for the first \$650,000 of assets (for 1999) transferred through a combination of lifetime gifts and testamentary transfers. The unified credit will increase, from \$650,000 in 1999 to \$1,000,000 in 2006. Transfers of interests in family partnership and LLCs are often structured to take advantage of this unified credit. The 1997 Tax Act also introduced an exclusion from the estate tax for qualified family-owned business interests that allows in combination with the unified credit amount, if all of the requirements are satisfied, an aggregate exclusion from transfer taxes of up to \$1,300,000.

Every individual also has the right to make annual gifts of \$10,000 each to any number of beneficiaries free from any transfer taxes or credit against an individual's unified credit. A married couple may make \$20,000 in annual gifts to any number of individuals. The annual gift exclusion, in combination with the unified credit, permits the transfer over time of substantial assets free from transfer taxes. Many FLPs and FLLCs are designed to facilitate the making of annual gifts to one or more beneficiaries.

Spouses are able to make unlimited inter-spouse transfers of assets free from any transfer or income taxes. As there is no transfer tax liability associated with an inter-spouse asset transfer, there is no need to structure an inter-spouse asset transfer through FLPs and FLLCs, as valuation discount planning is unnecessary, but even in that case there may be non-tax reasons for using FLPs and FLLCs (e.g., management control or asset protection planning).

The existence of the inter-spouse transfer tax deduction encourages a basic tax planning mistake that often results in the IRS ending up with an additional \$211,300 (based on the 1999 unified credit equivalent of \$650,000) in transfer taxes upon the death of the second spouse. Here is how it happens. If a couple has \$1,300,000 million in assets and they have not undertaken any basic estate planning, then upon the death of the first spouse, all of that spouse's assets will be transferred tax-free to the second spouse. Upon the death of the second spouse, however, estate taxes of \$211,300 will be paid on \$650,000 (with the other \$650,000 shielded by the second spouse's \$650,000 unified credit). Contrast that result with one where basic estate planning is undertaken. If the first spouse to die had made lifetime gifts of \$650,000 worth of assets to his children, then the IRS would have been entitled to nothing upon the death of the second spouse (assuming that the second spouse held \$650,000 in assets). In the second example, both spouses make use of their unified credit, rather than just the second spouse. Making lifetime gifts is only one way to use a spouse's unified credit, but one way or the other, basic estate planning that takes advantage of the unified credit is necessary in order to avoid making the IRS the estate's principal heir. The numbers in this paragraph will become even more compelling as the unified credit increases in the coming years to \$1 million in 2006.

The math of our transfer tax system weighs in favor of lifetime gifts over testamentary transfers. Although lifetime gifts and testamentary transfers are taxed in a "unified" transfer tax system, with lifetime and testamentary transfers aggregated for purposes of the various transfer tax brackets, they are not treated equally for tax purposes, as the gift tax is "exclusive" while the estate tax is tax "inclusive." The following example is illustrative.

Hillary, who is in the 50% transfer tax bracket, wants to make substantial gifts in 1999. Hillary has exhausted her unified credit and she has \$2,000,000 of assets available for transfer to Chelsea, her daughter. Hillary can make a gift of \$1,333,000 and use the remaining \$666,000 to pay the gift tax. The gift tax is imposed only on what is transferred to Chelsea, and is exclusive of the tax cost itself. Alternatively, if Hillary retains the property in her estate, the full \$2,000,000 would be subject to estate tax. With the inclusive tax, Hillary's estate would owe \$1,000,000, leaving only \$1,000,000 for Chelsea. If the assets are not gifted but instead remain in Hillary's estate until her death, she will pay an additional \$333,000 in transfer taxes to the IRS, which is money that would otherwise be Chelsea's if Hillary had made lifetime gifts.

The use of FLPs and FLLCs should be integrated into a comprehensive estate plan and when interests in a closely-held business are involved, a comprehensive business succession plan.

## 11.6 Discount Planning

FLPs and FLLCs are wildly popular estate planning tools because of the phenomenon of valuation discounts. If a valuation discount applies, then the value of the asset being transferred and the corresponding transfer taxes are reduced. The transfer tax on a \$1 million gift is \$345,800. The marginal transfer tax rate for gifts in excess of \$3 million dollars is 55%. The stakes (plus a phase out of graduated rates) are high.

On a basic level, valuation discounts reflect the difference in value of the assets held by a FLP or FLLC and the value of the corresponding interest in the FLP or FLLC. When you determine the value of a gift of an interest in a FLP or FLLC, you value the ownership interest being transferred, not the assets held by FLP or FLLC. The value of those assets is one factor in determining the value of the ownership interest, but the other attributes of the interest must also be taken into consideration. For example, while the stock held by an FLLC might be able to be sold immediately on a national securities market, the interest in the FLLC itself may be unmarketable. If the assets held by an FLLC are valued at \$10 million,



then without a discount, the value of a 10% interest in the FLLC would be worth \$1 million. If a 50% valuation discount applies, then the value of a 10% interest in the FLLC would be only \$500,000. Obviously, if a valuation discount applies to a gift of an interest in a FLP or FLLC, then transfer taxes are substantially reduced.

Valuation discounts apply when marketable assets (*e.g.*, stocks or real estate) are held by a FLP or FLLC, which renders them illiquid and therefore less valuable to a third party. Valuation discounts reflect the reality that minority interests in closely-held investment entities such as FLPs and FLLCs, especially those for which there is no established market, will trade at a substantial discount to the value of the entity's underlying assets.

There are several features of the FLP and FLLC that provide a solid basis for obtaining valuation discounts. The underlying concept is that these features tend to make an interest in the entity undesirable to a third party purchaser, the standard used for valuation purposes. The most important factor is that there is no way for a holder of an interest in a FLP or FLLC to force a cashing out of that holder's interest. An interest in a family entity is the ultimate illiquid investment. What is the value of a million dollars if you own it through an entity where you have no ability to spend the money? The governing agreement for the entity generally provides that parents control the entity. The children as equity holders have little or no say in management, whether or not they own a majority of the entity's equity. The governing agreement also generally provides that mandatory cash distributions to unit holders are limited to the minimum distributions necessary to cover taxes, with additional distributions at the discretion of the manager (subject to fiduciary duty obligations). This mix of features results in the transfer of an equity interest that has little appeal to a third party investor, and forms that basis for the availability of substantial discounts. These discounts are generally referred to in the valuation industry as discounts for minority interest and lack of marketability.

The fact that a single family controls 100% of a FLPs' or FLLCs' units (thereby giving them the ability to lift all of the restrictions on marketability on the underlying assets) does not affect this analysis. See Rev. Rul. 93-12, 1993-1 C.B. 202, where the IRS concluded, in connection with the transfer of equity in a family entity, that "a minority interest discount will not be disallowed solely because a transferred interest, when aggregated with the interest held by family members, would be part of a controlling interest." The IRS' concession in Rev. Rul. 93-12 is based on the constitutional principle that the gift tax is a transfer tax rather than a property tax, with the tax based on the value of the asset being transferred. The fact that the transferor or other family members hold other interests in the FLP or FLLC, which together with the interest gifted could vote to sell the entity's assets and distribute them to the owners, is not taken into consideration in valuing the interest being gifted.

The two principal valuation discounts that are available through the use of FLPs and FLLCs are (1) the minority interest discount, and (2) the discount for lack of marketability. Chapter 9 of the IRS Valuation Guide addresses valuation discounts. Chapter 9 confirms that an IRS Appeals Officer will have as its guide a manual which acknowledges that courts have awarded discounts ranging between 10 and 65 percent for the minority interests and lack of marketability.

- (1) **Minority Interest Discount**—A minority discount is appropriate when valuing the transfer of less than a controlling interest in an entity because the holder of the interest is not able to control the distribution of cash and other property, the hiring and firing of employees, and other matters relating to obtaining financial benefits from the enterprise. "The critical factor is lack of control, be it as a minority partner or as a minority shareholder." Moore v. Commissioner, 62 T.C.M. 1128 (1991).
- (2) **Lack of Marketability Discount**—A lack of marketability discount is appropriate when valuing an interest in a closely held business to account for the difficulty a seller would have in finding a willing buyer and the expenses of selling the interest, including syndication, accounting, and legal fees.

## **11.7      Asset Protection**

The asset protection characteristics of the FLP and FLLC are a significant feature that should not be lost in the shuffle of discount planning. These asset protection features often provide a valid business purpose for forming a FLP or FLLC that is unrelated to the valuation discount features of the entity. Having this non-tax business purpose could blunt any IRS argument that the FLP or FLLC structure was a sham transaction.

### **11.7.1      Liability Shield Provided by the Family Entity**

The limited partnership entity shields limited partners from personal liability for the liabilities and obligations of the entity, so long as the limited partner does not participate in the management and operation of the entity beyond the extent permissible for limited partners under state law. A general partner of a limited partnership is personally liable, however, for the entity's liabilities and obligations, which means that if liability is an issue, the general partner should be an entity that itself shields its owners from liability (e.g., a corporation or LLC), rather than an individual. An example where the liability shield might be important is where a parent desires to transfer real estate to his or her children, but there is a concern about environmental or other tort liability. Structuring the transfer as a contribution of the property to a FLLC, followed by a gift of FLLC membership units to the children would shield the children from the potential environmental and tort liabilities.

### **11.7.2      Asset Protection Planning**

Wealth transfers through family entities facilitate the most basic method of protecting assets against the claims of creditors of the donor—the assets are no longer owned by the donor. Gifting assets to other persons, including one's spouse, is a way of removing those assets from the reach of creditors, subject to the application of the fraudulent conveyance rules discussed below.

Contributing assets to a FLP and FLLC often results in it being more difficult for creditors to attach those assets. After formation of the FLP or FLLC, the only asset held by the debtor and available for attachment by the creditor is the ownership interest in the entity. A creditor's recourse against a debtor holding an interest in a FLP or FLLC is to seek a "charging order" from a court giving the creditor the right to debtor's economic interest in the membership interest. This economic interest is not a direct interest in the underlying assets of the FLP or FLLC, but instead represents a legal right to the income stream and other economic benefits derived from the membership interest. For example, if a debtor contributes rental real estate to a FLLC, then a subsequent creditor should only be able to step into the shoes of the debtor and be entitled to whatever distributions of rental income the debtor would otherwise be entitled to receive. If the debtor gifts interests in the FLP or FLLC before a creditor enters the picture, then the creditor should have no rights with respect to those gifted membership interests. The interposing of the family entity between the creditor and a debtor's assets has the effect of increasing a creditor's difficulties in any attempt to engineer a forced sale or split up of the property held by the FLP or FLLC.

The FLP and FLLC also shield the family entity's assets from the claims of the creditors of the donees/children. The creditor is once again limited to seeking a charging order. The bottom line is that where a family member is experiencing financial difficulties, the family's assets are much more likely to end up partitioned or sold if they are held in a co-ownership or jointly than if those assets were held by a FLP or FLLC. Under Revenue Ruling 77-137, a creditor with a charging order is treated as a substitute limited partner for federal tax purposes. This means that the judgment creditor must report as income the distributive share of income attributable to the debtor's interest. Because of the potential tax liability, creditors are often reluctant to risk applying for a charging order.

### 11.7.3 Fraudulent Conveyance Issues

An important issue that should be kept in mind whenever family wealth transfers are undertaken, and especially when asset protection planning is a goal, is the question of whether an asset transfer (e.g., formation of the FLP or FLLC or gifting of membership interests) constitutes a fraudulent conveyance.

A transfer by a debtor is fraudulent as to an existing creditor when the transfer was made without receiving reasonably equivalent value in exchange and the debtor was insolvent at the time or became insolvent as a result of the transfer. Gifts are by definition transfers that are not for reasonably equivalent value. Transfers of assets to a family entity in exchange for interests in the entity are arguably for reasonably equivalent value, but creditors may have an argument that the membership interests received in exchange are not as valuable as the assets transferred to the entity. Also, a transfer made with the actual intent to hinder, delay or defraud is fraudulent regardless of whether the transferor was solvent at the time of transfer. The existence of a claim against an individual, regardless of whether that claim has been reduced to a judgment, may result in any asset protection planning taking place during the pendency of that claim falling into the category of a fraudulent conveyance. Kentucky cases provide that the transfer of assets when there is a foreseeable lawsuit may constitute a fraudulent conveyance. See James v. Stokes, 261 S.W. 868 (1924) and McDonough v. McGowan, 177 S.W. 277 (1915). Kentucky also has several statutes dealing with fraudulent conveyances. See KRS § 378.010.

The best and most effective asset protection planning takes place before the occurrence of an event that gives rise to a claim, and certainly before a debtor incurs the debts that cause his or her balance sheet to go into the red, if the FLP or FLLC formation causes assets to be removed from the balance sheet.

There are legal and ethical issues associated with an attorney's or accountant's assisting in structuring a family wealth transfer plan that may be a fraudulent conveyance as against the client's creditors. Rule 1.2 of the Kentucky Rules of Professional Conduct provides that it is an express ethics violation to assist a client in engaging in a fraudulent conveyance. In Pearce v. Stone, 720 P.2d 542 (Arizona 1986) an attorney who drafted a trust instrument and otherwise assisted in transferring assets in an asset protection planning scheme lost a summary judgment motion to dismiss a damage claim charging conspiracy. In United States v. Kraig, 99 F.3d 1361 (6th Cir. 1997), an attorney was convicted of conspiracy in assisting to conceal assets of a client from the IRS and sentenced to 30 months in prison. Advisors participating in wealth transfer planning would be prudent to explore why his or her clients want to transfer wealth, and regardless of the client's intent, whether the transfers might trigger a fraudulent conveyance claim based on their effect on the client's balance sheet.

## 11.8 FLP and FLLC Tax Issues

### 11.8.1 Importance of Appraisals

If valuation discount planning is being undertaken, then the parties should obtain an appraisal of the assets held by the FLP or FLLC and of the FLP or FLLC interests being gifted. The failure to have this backup support for the valuation discounts could prove to be fatal if the IRS contests the amount of the discounts. The worst thing that a taxpayer can do is take a discount based on what he or she thinks is a standard discount rate based on his or her review of court decisions and general scuttlebutt on the street.

Estate of Berg v. Commissioner, 61 T.C.M. 2949 (1991) is a useful guide for what the Tax Court looks for when considering valuation discounts. The Tax Court in that case concluded that "[T]he valuation of the appropriate discounts must take into account all relevant facts and circumstances. . . This and other courts have decided many cases involving discounts. The fact that petitioner found several

cases which approve discounts approximately equal to those claimed in the instant case is irrelevant. . . [The Tax Court]. . . does not consider the amount of discount applied in other cases cited by petitioner as persuasive." The IRS gift tax form now requires that taxpayers indicate whether a valuation discount has been taken. The IRS will most likely go after the easiest prey, which in the valuation discount field means taxpayers who do not have independent appraisals backing up their discounts or are otherwise over-aggressive in their planning.

The appraisal of a FLP or FLLC interest involves reviewing the partnership or LLC agreement to ascertain the rights of the partner/member. The key element to this review is determining whether a partner/member has the right to withdraw, and if the partner/member has that right, what the partner/member is entitled to receive upon withdrawal. Valuation discounts are predicated on the assumption that the interest is valued on a going concern rather than liquidation basis—that the partner/member holding the interest will not have the ability to force a redemption of his or her interest on a pro rata basis or force the liquidation of the FLP or FLLC. Lack of marketability is irrelevant if the holder can cash out the interest at will. Owner agreements for FLPs and FLLCs almost always prohibit withdrawal, or if withdrawal is permitted, then limit the amount received by the withdrawing partner/member to something substantially less than the fair market value of the interest being redeemed.

The appraiser will focus on the terms of the FLP's or FLLC's agreement to determine the rights of the interest holders. The appraiser assumes that the terms of the agreement will govern. The appraiser leaves it to the tax attorney to make sure that the state's partnership or LLC laws do not preempt the agreement and allow an owner to force a liquidation of the entity or the owner's interest at fair market value. The appraiser also assumes that the terms of the FLP agreement or FLLC operating agreement will be ignored or affected by applicable tax laws and regulations. Once again it is up to the tax attorney to determine whether the valuation discounts will hold up under IRS attack.

#### **11.8.2      The Application of IRC § 2704(b)**

The principal weapon in the IRS arsenal for attacking valuation discounts is IRC § 2704(b). Under IRC § 2704(b), any provision in a partnership agreement or LLC operating agreement which limits the ability of a partner/member to cause a liquidation of such owner's interest or the entity as a whole is ignored for valuation purposes if it not also a default term under the applicable state law. For example, a provision in a Kentucky LLC operating agreement stating that members cannot withdraw from the entity would be ignored by the IRS if Kentucky's LLC law provided that members could withdraw and receive fair value for their interest, unless the members restricted withdrawal in the operating agreement. The end result of ignoring a restriction on withdrawal would be the elimination of valuation discounts. If a member can withdrawal at will and receive fair value for his or her interest, the facts that an interest is a minority interest and lacks marketability are irrelevant.

State law varies significantly on the issue of whether a partner or member can force a liquidation of a partnership or LLC. Many states follow the Revised Uniform Limited Partnership Act (RULPA), under which a general partner may withdraw from the partnership at any time, upon notice to the other partners. The RULPA also states that a limited partner may withdraw upon giving at least six months' notice to the partnership, if the agreement does not specify in writing the time or the events upon the happening of which a limited partner may withdraw or a definite time for the dissolution and winding up of the limited partnership. RULPA appears to be seriously flawed as any provision in the partnership agreement restricting withdrawal would appear to constitute an applicable restriction. Under Kentucky's version of RULPA, a limited partner's right to withdraw was limited by the requirement that the partnership's Certificate of Organization provide for an outside dissolution date. Limited partners were prohibited from withdrawing prior to that date. This combination of a required dissolution date in the Certificate of Organization and a limited partner's right to withdraw upon 60 days notice in the absence of such a date has led some commentators to speculate that this version of RULPA was susceptible to attack via IRC § 2704(b). Recently enacted amendments to Kentucky's version of RULPA

however, eliminate the right of limited partners to withdraw, which should insulate Kentucky FLPs from the potential application of IRC § 2704(b).

Recently enacted amendments to the Kentucky LLC Act eliminate the right of LLC members to withdraw, which should insulate Kentucky LLCs from one potential application of IRC § 2704(b). Under Kentucky's LLC act in effect prior to July 1998, LLC members could withdraw upon the giving of advance notice and obtain the fair value for their interests. This withdrawal right made Kentucky FLLCs a poor choice for discount planning and required planners to look to Georgia or other states with LLC acts restricting withdrawal rights. The term of a Kentucky FLLC is now perpetual, except as provided in Articles of Organization.

The 1998 amendments to Kentucky's LLC Act modified KRS § 275.285 to provide that an LLC can be dissolved upon the written consent of a majority-in-interest of its members. "Majority-in-interest" is based on the members' relative capital contributions. To the extent that interests in the LLC are gifted, then the capital contributions associated with those gifted interests would be deemed to be held by the donee for purposes of determining voting and economic rights under Kentucky's LLC Act. The significance of the ability of a majority-in-interest to dissolve an LLC is that if a donee holds such a majority-in-interest, then he can trigger a dissolution of the LLC and force a distribution of LLC assets. The valuation discounts that are available with respect to the gift of an interest that carries with it the potential right to cause a dissolution of the family entity are severely restricted, therefore, as the interest cannot be appraised on a going concern valuation (*e.g.*, minority interest and lack of marketability). In addition, if an interest in an LLC that constitutes a majority-in-interest under KRS § 275.285 is held until death, the workings of KRS § 275.285 will likely reduce any valuation discounts on the value of the interests held by the estate. Any additional restrictions placed on dissolution in an operating agreement (*e.g.*, unanimous consent required) might be deemed to constitute an applicable restriction under IRC § 2704(b) and therefore be ignored for valuation purposes.

There are a couple of ways to deal with KRS § 275.285. If a FLLC is being used as the family entity, then the valuation problem can be avoided by not making gifting at one time to any one donee aggregate units of membership interest constituting a majority-in-interest. Obviously, efforts should also be made to avoid having a majority-in-interest in the FLLC retained by the donor at the time of death. Another way of avoiding the problem is to use an FLP rather than an FLLC. KRS § 362.487 provides that dissolution occurs upon the written consent of all partners. Of course, KRS § 362.487 also provides for the dissolution of the FLP upon an event of withdrawal of the general partner, which requires the use of multiple general partners and entities with perpetual existence as one of the general partners to avoid its potential application in the valuation discount context, especially when interests are to be held by the senior generation until death.

### 11.8.3 The IRS' Latest Weapon and Greatest? Weapon—IRC § 2703.

IRC § 2703 requires that any buy-sell terms that are at less than fair market value be ignored for purposes of valuing an interest. For example, if an operating agreement provides that an interest will be redeemed by a family LLC for \$100 upon the death of a member, and the fair market value of the interest is actually \$200, then the buy-sell terms will be ignored. IRC § 2703 provides that the value of an interest will be determined without regard to any right or restriction relating to the property. During 1997, the IRS launched a new career for IRC § 2703 as its principal family wealth transfer entity buster, by arguing that the reference in IRC § 2703 to "rights and restrictions on property" could be stretched to include not only family entity interests themselves, but also the underlying property held by the entity—in effect taking the position that the entity could be ignored as being merely a restriction on the property held by the entity. This extreme position is discussed in the section entitled The IRS Turns up the Heat on FLPs and FLLCs *infra*.

#### 11.8.4 IRC §§ 2036 and 2038

If a FLP or FLLC is not structured to avoid the application of IRC §§ 2036 and 2038, then the transfer will not successfully remove assets from the donor's estate. IRC § 2036(a)(2) requires inclusion in the gross estate of property transferred by the decedent if the decedent retained the right to control the possession or enjoyment of the property or the income therefrom. The IRS has ruled that the value of transferred interests in a limited partnership is not includable in the decedent's gross estate under IRC § 2036(a) where the decedent was the sole general partner because the decedent occupied a fiduciary position with respect to the other partners and could not distribute or withhold distributions, or otherwise manage the partnership for purposes unrelated to the conduct of the partnership business. *See* PLR 9415007 and TAM 9131006. The IRS cited United States v. Byrum, 408 U.S. 125 (1972) for the proposition that, because the general partner had a fiduciary duty to the other partners, the general partner did not retain control within the meaning of IRC § 2036(a). The same reasoning should apply to FLLCs, as long as the operating agreement explicitly provides that the manager has a fiduciary duty towards the members and the FLLC.

Estate of Dorothy Schauerhamer, T.C. Memo 1997-242, is an example of tripping over IRC § 2036 when structuring a FLP. The Tax Court concluded that an implied agreement existed among the partners which tacitly allowed the decedent to treat the income of the partnership as her own. The Tax Court concluded that this disregard for the partnership structure amounted to the retention of an interest by the decedent and that the property was includable in the decedent's estate under IRC § 2036.

If the donor of FLP/FLLC interests is also the general partner/manager of the family entity, then the FLP/FLLC should not hold voting stock of a closely-held corporation. The IRS could argue that under IRC § 2036(b), the donor has retained control of the stock through his indirect voting rights. Nonvoting stock should be used in these circumstances.

IRC § 2038 requires the inclusion in the gross estate of property transferred by the decedent if the decedent retained the right to alter, amend, revoke or terminate the transfer. The IRS has ruled in the limited partnership context that this provision was not applicable because the sole general partner retained no power to alter the beneficial interests of the other partners. *See* PLR 9415007 and TAM 9131006. The same reasoning should apply to FLLCs. In the case of both FLPs and FLLCs, the agreement should not provide for a special allocation of income to the senior generation or give the senior generation the right to alter the distribution of income. If the senior generation wants a disproportionate share of the income, then the payment should be structured as a management fee.

Technical Advice Memorandum 9736004 (June 6, 1997) is an example of what can go wrong in the IRC § 2038 context. In this TAM, a son used a power of attorney from his mother that did not expressly authorize the power holder to make gifts to form two FLLCs and then gift FLLC interests. The IRS concluded that since the son did not have authority to make gifts of the decedent's property, the decedent had a right up to the date of her death to make a claim for recovery of the amounts transferred by the son, which amounted to the right under IRC § 2038 to revoke the transfer, the result being the property transferred to the LLCs ended up in the mother's estate.

#### 11.8.5 The IRC § 704(e) Family Partnership Rules

The family partnership rules under IRC § 704(e) are designed to ensure that the income of a partnership (or an LLC taxed as a partnership) is taxed to the person who earns it through his or her own labor and skill or the use of his or her capital. If the IRC § 704(e) rules are not satisfied, then the IRS may reallocate some or all of the entity's income to the member controlling the entity (which is not always a bad thing from a planning standpoint). A partnership or LLC interest acquired by gift is recognized for income tax purposes if capital is a material income producing factor in the entity's business and if the donee is the real owner of the interest in the entity's capital. These requirements are designed to prevent the reallocation of income earned by parents to children through a partnership arrangement.

The requirement that capital be a material income-producing factor in the entity's business is not usually difficult for most family entities to satisfy. The income of most family entities is generated by the business or assets held by the entity, not by the services of the parent on behalf of the entity. Obviously, a parent will be prevented from making his or her children partners in his or her personal service business, but gifting interests in a FLP or FLLC holding investment assets or a non-personal service family business should work.

Even where capital is a material income producing factor, the allocation may not be respected if the holder is not deemed to be the "real owner" of the interest acquired by gift or purchase. First, a gift must be a gift of a property interest, rather than a mere interest in profits. Second, a gift of a partnership interest is legally effective if it vests complete dominion over the interest in the donee. If the donee is a minor and cannot hold title personally, then title must be held in a custodianship created under the Uniform Transfers to Minors Act or in a trust. Finally, a holder is not the real owner of an interest if the parent/donor retains excessive controls over the transferred interest. Retained controls include: (i) limitation on the right to liquidate or transfer an interest; (ii) retention of management powers inconsistent with normal relations among partners; (iii) retention of control of the distribution of income; or (iv) retention of control over essential assets. With respect to limited partners, the IRC § 704(e) regulations focus on the partner's ability to liquidate or transfer the interest and other rights consistent with being a limited partner. These concepts would also seem applicable to a manager-managed LLC.

The best approach in drafting a partnership agreement or LLC operating agreement with IRC § 704(e) in mind is to require distributions of income and to allow for the transfer of interests subject to a right of first refusal. A parent/donor should also be paid reasonable compensation to the extent that he or she performs services for the FLP or FLLC.

#### 11.8.6 The Gift Tax Annual Exclusion

IRC § 2503(b) provides that the first \$10,000 of gifts made to any person during a calendar year shall not be included in the total amount of gifts made during such year, if the gift is of a present interest in property. Treasury Regulation § 25.2503-3(b) provides that a present interest in property is an unrestricted right to the immediate use, possession or enjoyment of the property (such as a life estate or a term certain).

In TAM 9751003 (December 19, 1997), the IRS concluded that the income component of a gift of a partnership interest was not a present interest because the partnership agreement provided that income was to be distributed to the limited partners in the complete discretion of the general partner. In the same TAM, the IRS also concluded that the property component of the gift of the partnership interest was not a present interest because the partnership agreement prohibited transfer of the interests. Given the requirements of TAM 9751003, a partnership agreement or LLC operating agreement should be structured to provide that the members have the right to receive income (at least amounting to their tax liability arising out of their ownership interest) and to transfer the economic rights to their interest (but not assign the right to be a member), subject to a right of first refusal.

#### 11.8.7 IRC § 2704(a)

Under IRC § 2704(a), a lapse of a voting or liquidation right is treated as a transfer for transfer tax purposes. If a parent/donor has the right to cause a liquidation of a FLP or FLLC, then the lapse of that right upon the transfer of the parent's interest by gift or upon the parent's death might trigger the application of IRC § 2704(a), resulting in additional transfer tax liability. In order to avoid the potential application of IRC § 2704(a), a partnership agreement or LLC operating agreement should not give the parent managing the entity any ability to alter the economic interests of the other owners. The partnership should be structured using a corporation or trust as one of the general partners, in order to ensure that the death of the parent does not result in the liquidation of the entity or that the IRS could argue

that the parent could withdraw and force a liquidation of the entity. Under Kentucky's revised LLC laws, the death of a member does not trigger the dissolution of the LLC and an LLC member is not entitled to withdraw absent anything to the contrary in the LLC's operating agreement, thereby inoculating Kentucky family LLCs from the application of IRC § 2704(a). If the FLLC is formed in another state, however, the laws of that state should be examined to determine whether IRC § 2704(a) might have potential application.

#### **11.8.8      IRC § 2701**

The impact of IRC § 2701 on the use of preferred interests and freeze transactions is discussed in the section Preferred FLP and FLLC Interests above.

#### **11.8.9      Business Purposes for FLPs and FLLCs**

As outlined above, FLPs and FLLCs have a number of purposes beyond obtaining valuation discounts and reducing gift and estate taxes. For example, FLPs and FLLCs have favorable asset protection features and provide a useful vehicle for structuring the ownership and management of operating businesses and assets. Because of the increased IRS focus on the use of FLPs and FLLCs as a discount planning vehicle, many planners take steps to emphasize (for the IRS' benefit) the non-transfer tax aspects and benefits of their use. This emphasis sometimes takes the form of separate "business purpose" letters to the parties forming the FLPs and FLLCs and in other cases a recital of non-tax business purposes is embodied in the FLPs' or FLLCs' organizational documents. How to handle the highlighting of these business purposes without appearing self-serving is a judgement call that each planner must make on his or her own. An emphasis on non-tax business purposes may provide some protection in the course of an initial review by the IRS of a gifting program, but will only be useful in the long run if there are in fact real non-tax business purposes. Fortunately, in most cases there will be one or more compelling non-tax reasons for structuring a gifting program from an FLP or FLLC.

Item 19 of the IRS pre-audit questionnaire discussed below and attached to this chapter as Exhibit A focuses on business purpose and requires a statement "indicating the identity of the parties recommending the use of the partnership, when the recommendations were made, and the reasons set forth in support of the partnership." This question suggests that practitioners and their clients should focus attention on the significant non-tax benefits of the FLPs/FLLCs and create contemporaneous documentation of such focus. This documentation could be in the form of language in the operating agreement, correspondence between practitioner and client, and/or practitioner client oriented materials highlighting the non-tax benefits of FLPs/FLLCs.

#### **11.8.10      Potential Roadblock to Tax-Free Contribution of Appreciated Assets to FLP or FLLC—The Partnership Investment Company Rules**

The contribution of appreciated assets by owners to FLPs or FLLCs, whether they are in the form of real estate, operating company assets or investment assets, is generally tax-free under IRC § 721(a). Under IRC § 721(b), the general nonrecognition rule of IRC § 721(a) does not apply to gain realized upon a contribution of property to a tax partnership "investment company" if the contribution results in the diversification of the transferor's assets. IRC § 721(b) is intended primarily to prevent tax-free diversification of securities portfolios.

IRC § 721(b) does not apply in situations where each owner contributes the same mix of assets — there is no diversification of the investment. IRC § 721(b) does not apply where a husband and wife trade securities prior to the formation of the FLP so that they then are each contributing the same mix of securities to the FLP. PLR 9012024 (December 19, 1989). In order to be on the safe side, spouses should even the assets to be contributed prior to contribution in order to fall within the scope of PLR 9012024. Alternatively, one



spouse can form a single member FLLC and then gift FLLC units to the other spouse for use by that spouse in making unified credit gifts. IRC § 721(b) is not applicable to the gifting of FLP or FLLC units. The donee who had no interest prior to the receipt of the gift is achieving no diversification of an investment he or she did not previously hold. Likewise, the gifting achieves no diversification for the donor. The subsequent sale of an appreciated asset by an FLP or FLLC does not trigger any investment company issues under IRC § 721(b), even when the sale was prearranged. Rev. Rul. 88-32, 1988-1 C.B. 113. Nor does the post-contribution borrowing by the FLP or FLLC followed by purchase of additional securities constitute diversification. PLR 9607005 (November 7, 1995).

There are several ways to avoid the application of the partnership investment company rules. If 20% or more of the FLP's or FLLC's assets are real estate or operating company assets, then IRC § 721(b) is applicable. If each owner contributes a diversified portfolio of assets (no one asset constituting 25% and five or fewer not constituting 50%), then IRC § 721(b) is inapplicable. In the FLP or FLLC context, the principal way that you could stumble into the application of IRC § 721(b) is where a holder of units (e.g., the original donor) makes an additional contribution of appreciated property at some point after the initial formation and inadvertently achieves diversification as a result of such action. This problem can be avoided by contributing sufficient assets upon the formation of the FLP or FLLC so that the founding donor has sufficient units to make gifts down the road without the necessity of acquiring additional units from the FLP or FLLC through the contribution of additional appreciated assets. Of course, many FLP or FLLCs will fall outside of the definition of an investment company by nature of their asset mix. Finally, if it is not possible to avoid the application of IRC § 721(b) in the case of later contribution of additional appreciated assets, then the best strategy may be to form a second FLP or FLLC and undertake the intended gifting program through that vehicle instead of the original FLP or FLLC.

#### **11.8.11 Louisville and Jefferson County Occupational Fees**

An issue that has arisen in the past year or two is whether an FLP or FLLC holding investment securities is subject to the Louisville/Jefferson County occupational fees on the income generated from those investments.

Louisville and Jefferson County impose occupational fees (*i.e.*, combined 2.2% on residents and 1.45% on nonresidents) on individuals, partnerships and LLCs engaging in business activities in Louisville and Jefferson County. The introduction to the Regulations of the Louisville/Jefferson County Revenue Commission (the "Regulations") state that the "City/County license fees are imposed only on earned income. Thus, for example, the interest earned on an individual's personal bank savings account is not subject to the license fee. For persons other than individuals, however, most income is deemed to be earned income and except as expressly provided in the City and County Ordinances and herein, 'passive' income of corporations and partnerships is subject to the license fee." Although information and perhaps enforcement is spotty on this issue, it appears that the Revenue Commission has, in fact, taken the position with certain FLP/FLLC taxpayers that interest, dividends, and gains from investment assets are subject to occupational license fees.

The Revenue Commission's introduction to its Regulations (the "Introduction") suggests that its ordinances create a distinction between individuals and partnerships with respect to the taxation of passive income. The Introduction further suggests that its ordinances should be read to suggest that the passive income of partnerships is subject to occupational license fees. Neither one of these conclusions is supported by the language of the Regulations.

Section 112.02 of the Regulations imposes a fee on every natural person, . . . and partnership "engaged in any business, profession, occupation, or other activity in the city" on "the net profit of all businesses, professions, or occupations from activities conducted in the city." There appears to be no dispute that an individual investor is not engaged in business, profession or occupation if he or she invests in stocks and bonds, receives interest and dividend payments, and sells the equities for a profit.

All of these are items of "passive income." The Introduction confirms that individuals are not subject to the license fee with respect to items of passive income. Strangely though, the language of Section 112.02, which is the operative provision imposing the license fee, uses identical language for individuals and partnerships, which raises the question of where the statutory support exists for the distinction between individuals and partnerships.

The Revenue Commission apparently relies on the definition of "net profit" for support. This definition provides that for partnerships, net profits means "the licensee's gross receipts or sales from its trade, business, profession, or occupation including but not limited to interest, dividends, rents, royalties, ordinary and capital gains or losses, and other income as defined for federal income tax purposes." The listing of interest, dividends and capital gains appears on an initial read to support the application of the license fee to a partnership's passive income, but the definition should be read carefully. The "Net profit" of partnerships is defined to mean the licensee's gross receipts or sales from its trade, business, profession or occupation. The balance of the sentence (*i.e.*, the including but not limited to phrase) merely suggests categories of gross receipts that fall within the scope of "net profit." Before you can work your way to those categories of gross receipts, however, you must satisfy the definition's requirement that the gross receipts arise out of the taxpayer's trade, business, profession or occupation. If the partnership's gross receipts do not arise out of those active trade or business activities, then they would not qualify as "net profits" regardless of whether they are listed as categories of gross receipts in the balance of the definition.

An example of how this definition would work in another context would be to define living room furniture as follows: "Living room furniture" means all furniture located in the living room, including without limitation, rugs, couches, chairs, tables, etc. You can conclude from this sentence that all rugs located in the living room fall within the definition of "living room furniture", but not that all rugs are living room furniture. Rugs that are not located in the living room are not living room furniture. Interest, dividends and gains from investments in stock and bonds by a partnership that is not engaged in the trade or business that makes such items of income active income are not "net profit" for purposes of the license tax.

As the Introduction suggests, the concept of "trade, business, profession or occupation" goes to the issue of active versus passive income. Holding stock and bonds purely as an investment has never fallen within the scope of a trade or business — you must go beyond investor status and become a trader or investment professional before the ownership of stock and bonds signifies that a taxpayer is engaged in a trade, business, profession or occupation. Investing in stock and bonds is not an active trade or business, whether you are holding those assets individually or through a FLP/FLLC.

There is a logical reason why the Regulations would include interest, dividends and capital gains in the partnership's laundry list of gross receipts categories even if partnerships are not taxed on passive income. A business can engage in a trade or business that encompasses receiving gross receipts in the form of interest, dividends and capital gains. The receipt of interest payments can be an integral part of any business. A business can receive dividends from stock held in connection with the trade or business of stock trading, or brokerage or investment banking activities. Wall Street brokerages and investment banking firms receive dividend payments from various stock held in their portfolios as market makers or otherwise, but there is no question that those firms are receiving the dividends in connection with a trade or business. Finally, IRC § 1231 affords taxpayers capital gains treatment on the sale of property used in a trade or business.

"Net profits" for a sole proprietor is defined as "the licensee's gross receipts or sales from his trade, business, profession, or occupation, including, but not limited to . . ." The list of categories of gross receipts does not specifically mention interest, dividends and capital gains, but so what? The phrase "including but not limited to" means exactly that — an individual could also have gross receipts from interest, dividends and capital gains. Since the definition of "net profits" for both individuals and partnerships refers to gross receipts or sales from a trade, business, profession or occupation, there is no logical way to distinguish between the individuals and partnerships with respect to the application of the license fee to passive income. If a partnership is subject to a license fee on passive income, then so

are individuals. Of course, the Regulations support the conclusion that neither partnerships nor individuals are subject to the license fee for merely reaping the financial rewards of passive investing.

### **11.9      The IRS Turns up the Heat on FLPs and FLLCs**

Undoubtedly because of the high stakes involved and the aggressive activities of tax planners in the field, beginning in 1997 the IRS began to focus on the availability of valuation discounts in connection with family wealth transfers.

#### **11.9.1      New Gift Tax Return; Proposed Regulations**

The IRS adopted a gift tax return (Form 709) which specifically asks if a valuation discount is being claimed on the return. If the answer is "yes", then the instructions require the disclosure of whether a discount is taken for any of the following: (i) lack of marketability; (ii) minority interest; (iii) fractional interests in real estate; (iv) blockage; (v) market absorption; or (vi) any other reason. If a discount is taken, an explanation must be attached to the return, giving the factual basis for the claimed discount and the amount of the discount taken. The short form return (Form 709-A) cannot be used if any value reported reflects a valuation discount.

For gifts made in 1997 and thereafter, if a gift is made and the value is required to be shown on a gift tax return (without regard to the annual exclusion) and is not shown on a return, no statute of limitations applies unless the item is disclosed in a return in a manner adequate to apprise the IRS of the nature of the item. IRC § 6501(c)(9). Proposed regulations were issued December 21, 1998 regarding adequate disclosure for gift tax returns. *See* Prop. Reg. § 301.6501(c)-1(f). These regulations require the providing of detailed information regarding the gift, the parties involved, and the method used to determine the fair market value of the property transferred. In addition, the regulations include the requirement that there be included with the return a statement in essence listing of all factual information that could result in an audit issue, or instead, to actually list the audit issues. Requiring that the taxpayer theorize for the IRS' benefit all of the possible problems with the gift and/or valuation thereof in order to trigger the running of the statute of limitations is an unreasonable requirement that seems to reach beyond the requirements of IRC § 6501(c)(9).

#### **11.9.2      Pre-Audit Questionnaire**

During 1999, the IRS developed a comprehensive pre-audit questionnaire that provides practitioners with useful insights into the IRS' focus when looking at wealth transfer planning transactions. A copy of the questionnaire is attached to this chapter as Exhibit A. Some practitioners believe that the IRS and the Tax Court will place increasing focus on item 19 addressing the business purposes for the FLP or FLLC transaction.

#### **11.9.3      IRS National Office Directive**

During 1997, the IRS National Office issued a directive to District Offices that requests that all districts send FLP (also applicable to FLLCs) cases for technical advice where the following three criteria are met:

- (1) The partnership consists either entirely or predominately of liquid assets;
- (2) Transfers were made to the limited partnership shortly before the transferor's death; and

- (3) Transfers were made pursuant to a durable power of attorney.

• **11.9.4 Treasury Department Business Plan**

A 1997 Treasury Department Business Plan specifically identified FLPs and LLCs as a priority area for guidance—a sign that the use of these entities would be coming under increasing scrutiny.

**11.9.5 Death Bed Gifting Under Attack**

During 1997, the IRS issued several new Technical Advice Memoranda (TAMs 9719006, 9723009, 9725002, and 9730004) and a private letter ruling (PLR 9735003) attacking FLPs.

- In TAM 9719006 (January 14, 1997), the decedent's partnership documents were executed by her two children acting as trustees of her trust, who established the limited partnership, transferred real estate and securities to the partnership, and then effected a sale of a portion of the partnership interest to themselves in exchange for long-term promissory notes. Life support was removed around the time the transfers took place and death occurred two days later. The decedent's children were the sole beneficiaries of the estate both before and after the partnership transaction. The decedent's remaining partnership interest was substantially discounted on the estate tax return.
- In TAM 9723009 (February 24, 1997), the decedent was 90 years old and the documents creating the partnership and corporation, which acted as general partner, were executed by her son under a power of attorney. The decedent transferred (also done under power of attorney) her two residences and all of her cash, securities, and personal property into the partnership. The decedent did not transfer any of her partnership interests, but the interests were substantially discounted on the estate tax return. The decedent's son was the sole estate beneficiary.
- In TAM 9725002 (March 3, 1997), the decedent's revocable trust, the decedent's two children, and five separate trusts for the benefit of the decedent's five grandchildren were the partners of the partnership. The partnership agreement was signed by decedent's two children, both individually and as trustee, for the various trusts. The partnership was funded with cash and marketable securities valued at \$2,050,000. Two months later, the decedent died and the estate tax return valued the trust's interest in the partnership at \$1,260,250.
- In TAM 9730004 (April 3, 1997), the decedent's only child was an attorney. Shortly after being diagnosed with terminal cancer, the decedent wrote a letter to his son directing him to form a FLP, and setting out six non-tax objectives for creation of the partnership. The stated objectives were the same as set forth in an article written by the son. One of the recommendations made by the decedent's son in his FLP article was to set out the non-tax business reasons for the FLP in a letter. Pursuant to the decedent's direction in the letter, the decedent's son prepared and filed articles of incorporation. The decedent established a corporation to serve as general partner. He contributed cash to the corporation in which he was the sole shareholder. He then gifted 50% of the shares to his son, and 1% of the shares to a family friend. The corporation contributed cash in exchange for its general partnership interest and the decedent contributed farmland in exchange for a limited partnership interest. The decedent died less than two months after formation of the partnership, and the estate substantially discounted the value of both the corporate stock and the partnership owned by the decedent.

What is important to note about these 1997 TAMs is that they have striking factual similarities. They are all variations of "death bed" transactions. They appear to represent an attempt by the IRS to target the most abusive uses of the FLP and FLLC. Why would the IRS target these extreme examples? Apparently, the IRS believes that attacking taxpayers with the weakest positions will create the best environment for the creation of favorable precedent. Because these TAMs represent extreme situations, however, they provide little clear guidance with respect to how far the IRS will go in its attack. It is extremely useful, however, to closely examine the legal arguments made to the IRS to determine whether it is possible to learn from other taxpayer's mistakes.

#### 11.9.6 The IRS Sham Argument

In each of the four TAMs discussed above, the IRS concluded that the formation of the partnership and the subsequent transfer, by gift or sale, should be treated as a single testamentary transaction. What this means is that if the IRS position is correct, then the transfer was not effective in removing the assets from the donor's estate. For the most part, the TAMs repeat the same IRS arguments. The IRS' principal argument is that the transactions are a "sham."

Basically, the IRS argument presents as follows: The "death bed" transactions were entered into solely for the purpose of suppressing the value of the assets being indirectly transferred through FLPs or FLLCs. The same beneficiaries would have received the property if the family entities had not been created. Referring to these transactions as a single testamentary transaction is another way of saying that there was no valid business purpose other than the reduction in estate taxes. The IRS cites several authorities for the proposition that transactions will be disregarded if they have no purpose other than to reduce taxes. For example, Estate of Murphy v. Commissioner, T.C. Memo 1990-472.

The death bed sham argument would not seem to carry the same weight if the transactions were instead garden variety lifetime gifting plans. In many instances, there will be other valid business purposes for gifting through family entities. Examples of valid business purposes include asset protection planning, the desire to retain a degree of management control and the avoidance of fractionalization of assets. The IRS' sham argument certainly illustrates the importance, however, of focusing on the many valid business purposes for using FLPs and FLLCs, rather than merely concentrating on their discounting potential.

#### 11.9.7 The IRC § 2703 Argument

This is the argument in the TAMs that has received the most attention because it has the most far reaching potential consequences. In fact, if the IRS is successful with this argument, then possibly no discounts would be available. If applicable and applied literally, IRC § 2703 would require that all FLP and FLLC interests be valued as if the entity's property is held directly by the entity members and any restrictions on transfer in the partnership or LLC operating agreement or in state partnership or LLC law would be ignored. In this scenario, the value of the interest transferred would be the corresponding value of the property held by the entity.

The IRS' position is that IRC § 2703, which requires that the value of property be determined without regard to any restriction on the right to sell or use property, should be interpreted to require the ignoring of the existence of the partnership or LLC itself, not just restrictions in the partnership or LLC agreement. The IRS cites Treasury Regulation § 25.2703-1(a)(3), which provides that a right or restriction may be in the agreement or implicit in the capital structure of the entity.

The IRS also makes an alternative argument that is perhaps more troubling. The IRS argues that even if the entity itself is respected and you only look at the restrictions on the right to "sell or use" the entity's interests, this would still mean that you would ignore restrictions on transfer and more importantly, restrictions on the ability to withdraw or terminate the entity, even if those limitations were

“implicit in the capital structure of the entity,” meaning that the restrictions were imposed by state law on the entity and its partners/members. If the IRS is successful with this argument, then it would not require a sham type transaction for discounts to be a thing of the past.

#### 11.9.8 Rebuttal to the IRS’ IRC § 2703 Argument

The IRS’ IRC § 2703 argument as expressed in the 1997 TAMs has a number of flaws and is a highly questionable interpretation and application of that Code section. If Congress intended to eliminate the vast majority of discounts for closely held businesses, it seems unlikely that Congress would do this in a Code section which is clearly intended to police buy-sell and option agreements.

When a FLP or FLLC is formed and interests are gifted, the property being transferred is the interest in the partnership or LLC, not the underlying property held by the FLP or FLLC. By its nature, IRC § 2703 is a statute that deals with buy-sell restrictions and options relating to the property being gifted. When a gift of a partnership interest is made, there is no gift of the partnership’s property. The partnership’s ownership of its property is not affected by the transfer of the partnership’s equity interests. The IRS’ argument that there is a restriction implicit in the capital structure of the partnership should be irrelevant because it is not a restriction on the property being transferred, which is the FLP interest. The only way that the IRS’ argument makes any sense is if you ignore the separate existence of the FLP or FLLC. If the FLP or FLLC is not a sham, then on what basis does the IRS ignore the existence of an entity validly formed under applicable state laws?

The IRS’ expansive interpretation of IRC § 2703 would eliminate the need for more directly applicable provisions such as IRC § 2704(b), an illogical and unlikely result. Furthermore, how can you explain a provision like IRC § 2704(b), which explicitly respects any restriction on withdrawal imposed by state law, when you are arguing that when applying IRC § 2703(a)(2) you are free to ignore the same state law?

The IRS has ignored the fact that IRC § 2703’s legislative history strongly suggests that the statute was designed to deal with buy-sell provisions, not provisions dealing with such matters as withdrawal and dissolution of FLP and FLLCs. There is a good argument that the inability to withdraw or terminate an entity is not a restriction on the ability to sell or use an entity’s interest, unless you take the extreme position that anything that potentially impacts the value of an interest is something that restricts the ability to sell or use the interest. An example of taking the IRS’ argument to its logical extreme would be the fact that an FLLC has a manager (and that the FLLC interests being transferred don’t carry with them the right to be the manager) could be considered as being something that would reduce the value of the FLLC interest and therefore would constitute an indirect restriction on the ability to sell or use the interest.

Careful attention should be paid to whether the exceptions in IRC § 2703(b) might apply in non-death bed situations. IRC § 2703(b) excludes from the application of IRC § 2703 restrictions (1) that are bona-fide business arrangements, (2) that are not devices to transfer property to members of a decedent’s family for less than full and adequate consideration in money or money’s worth, and (3) whose terms are comparable to similar arrangements entered into by persons in arms’ length transactions.

Stacy Eastland of Baker & Botts, L.L.P., reported in March, 1998 seminar materials that he has handled three Tax Court cases where the IRS initially made the IRC § 2703(a) argument (Estate of White v. Commissioner, Docket No. 14412-97, Estate of Brown v. Commissioner, Docket Nos. 7495-95 and 14899-96; and Morris v. Commissioner, Docket No. 19620-97. In White, Eastland reported that in response to the taxpayer’s informal discovery request that the government identify the restrictions on the right to sell or use the taxpayer’s partnership interests that would be subject to IRC § 2703(a), the government replied “every conceivable restriction found in the partnership agreement, most notably the restrictions on transfer, withdrawal, and dissolution.” In each case, however, the IRS abandoned the IRC § 2703(a) argument when it appeared that Eastland would be successful in bringing the issue squarely before the Tax Court. Even though in two of the cases 70% and 80% of the assets consisted of marketable

securities, bonds and cash, the Taxpayer was allowed a substantial discount. The government is apparently waiting to pick a fight on another day with a less well prepared taxpayer and attorney before it will chance a test case.

#### **11.9.9      The Road Ahead for FLPs and FLLCs**

The IRS has substantially increased its focus on valuation discounts over the past couple of years. The IRS is currently experimenting with several legal arguments in Technical Advice Memoranda. So far, the focus has been on extreme cases involving death bed transfers. The IRS' legal arguments even in those extreme fact situations has been less than compelling. The IRS' success or failure in attacking valuation discounts in the courts should be carefully monitored over the coming months and years to see whether the courts buy into any of the arguments currently being sent up as trial balloons in the TAMs. The likely end result will be that family wealth transfer transactions that are not carefully planned or are undertaken at the last minute will be unsuccessful, while those transactions that have valid business purposes other than reducing transfer taxes and are not undertaken in haste will continue to provide significant tax and non-tax benefits to the parties involved.

During each of 1998 and 1999, President Clinton proposed that legislation be enacted restricting the ability of the FLP or FLLC to be used as a vehicle for obtaining valuation discounts where investment assets/marketable securities are held by the family entity. Clinton's proposals highlight the fact that valuation discounts may not always be available. The only thing that practitioners can do at this point is to monitor all of the current developments. The IRS attacks and the possibility of damaging legislation have merely encouraged some estate planners to accelerate plans for gifting assets through family entities, on the theory that their clients should take advantage of the benefits of valuation discounts through family entities before the door slams shut.





**EXHIBIT A: INTERNAL REVENUE SERVICE QUESTIONNAIRE  
FAMILY LIMITED PARTNERSHIPS**

1. All documents relating to the creation of the partnership (including bills) from an attorney, accountant, or firm involved in recommending the creation of the partnership or in drafting the partnership agreement. If a claim is made that any of these documents are privileged, identify each privileged document by date, source, audience, and reason for the privilege.
2. Original partnership agreement and all amendments thereto.
3. Articles of incorporation of the general partner, if the general partner is a corporation.
4. All documents that were prepared to meet state law requirements on the formation and operation of the partnership (*i.e.*, certificate of limited partnership which has the filing date stamp on it and all amendments thereto; stamped copies of annual reports; supplemental affidavits on capital contributions, etc.)
5. All partnership financial statements and tax returns prepared and/or filed since inception.
6. All of the partnership's bank and other records (*i.e.*, general ledger, cash receipts and disbursements journals, check registers, etc.) which reflect the amount and nature of all deposits and distributions, including distributions to partners, for the period since the partnership was formed to the date of the death/current date.
7. Minutes of all partnership meetings; if none, indicate the dates of all meetings and the business discussed.
8. Evidence showing how the value of each partnership asset was arrived at as of the date:
  - a. it was contributed to the partnership;
  - b. of each gift of a partnership interest; and,
  - c. of the death of the donor; provide all appraisals and supporting workpapers obtained of the partnership's assets, including partnership interests and any discounts.
9. Evidence to substantiate all initial and subsequent capital contributions and the source of all contributions by partners other than the donor/decedent.
10. For any partnership asset that has been sold or offered for sale since the formation of the partnership, provide evidence which documents the sale or attempted sale (*i.e.*, sale agreement, listing agreement, escrow statement, etc.).
11. For each partnership asset, explain/provide:
  - a. evidence that the partnership owns the asset (*i.e.*, deeds, bills of sale, other title changes, and account statements);
  - b. when the donor/decedent acquired the asset;
  - c. how the asset was used by the donor/decedent since its acquisition and how the partnership has used the asset since (*i.e.*, held for rent; personal residence, investment, etc); and
  - d. who managed the asset prior to and after its contribution; explain in detail what the management consisted of and how it changed after the partnership was formed.
12. Brokerage statements reflecting the ownership and activity of the securities and mutual funds contributed to the partnership for the period beginning one year prior to the formation of the partnership and continuing through the current date, and copies of any other tax returns and financial statements which reflect the activity of the partnership assets, if different from the foregoing.
13. For each gift or transfer of a partnership interest, provide:

- a. evidence that the partnership interest was legally transferred under state law and under the partnership agreement;
  - b. any assignment of partnership interest prepared;
  - c. the terms of the assignment, if not indicated in a written statement;
  - d. the amount and source of any consideration paid;
  - e. an explanation of how the amount of the consideration was arrived at.
14. Provide the following with respect to the donor/decedent, all other original partners and any recipients of gifts or transfers of partnership interests;
- a. date of birth;
  - b. education and occupation;
  - c. experience and expertise in dealing with partnerships, real estate, financial affairs and investments; provide tangible evidence thereof;
  - d. extent of the donor's/decedent's investments as of the date of the formation of the partnership, including a summary of assets that were not contributed to the partnership; provide tangible evidence thereof; and
  - e. any personal financial statements and credit applications which were prepared in connection with loan applications after the partnership was created.
15. Indicate whether the partnership is currently in existence; and, if so, provide the current ownership interests.
16. Provide a summary of any other transfers of partnership interests not reflected in the gift tax returns filed.
17. A statement describing the donor's/decedent's state of health at the time of the formation of the partnership and for the six month period prior thereto, including a description of any serious illness. Please also provide the names, addresses and telephone numbers of all doctors who would have knowledge of the donor's/decedent's state of health during this period to the present date and provide these doctors with authorization to respond to the Service's future requests for information, including a copy of the medical records, if necessary.
18. The donor's/decedent's will, revocable trust, and any executed power of attorney, if not submitted with the return.
19. A statement indicating the identity of the parties recommending the use of the partnership, when the recommendations were made, and the reasons set forth in support of the partnership.
20. Names, addresses, and current telephone numbers of the representatives of the donor/estate, all donees/beneficiaries, all partners, accountants/bookkeepers, and brokers/investment advisors.

**12.1 SECURITIES LAW ISSUES  
FOR LIMITED LIABILITY COMPANIES**  
by  
**Alan K. MacDonald and C. Bradford Harris**

Federal and state regulators, as well as commentators, have advanced several theories as to whether LLC interests are securities. Generally, most agree that LLC interests are not securities per se, but LLC interests that possess certain characteristics will be considered securities. If LLC interests are securities, it could subject the LLC to, among other things, securities registration requirements and disclosure obligations, broker-dealer registration requirements and potential securities fraud liability. This chapter reviews the treatment of LLC interests under federal and state securities laws.

**12.2      Federal Securities Laws**

In determining whether an LLC interest is subject to the federal securities laws, one must determine whether the LLC interest meets the definition of a "security" in the Securities Act of 1933. Section 2(1) of the Securities Act defines "security" as any note, stock, bond, debenture, ..., [or] investment contract ... . If an instrument is not specifically listed in the definition, one must analyze whether the transaction involves an "investment contract," a term in the statutory definition that was defined in SEC v. W.J. Howey Co., 328 U.S. 293 (1946). In Howey, the U.S. Supreme Court held that the sale of a portion of an orange grove coupled with a mandatory management contract was an "investment contract" and therefore a security within the meaning of Section 2(1) of the Securities Act. The Howey Court determined that an investment contract is any arrangement requiring a person to invest money in a common enterprise with the expectation of deriving a profit solely through the efforts of others.

LLC interests typically satisfy the first three prongs of the Howey test because the purchase of LLC interests generally involves (i) an investment of money, (ii) in a common enterprise, and (iii) with an expectation of profits. However, the fourth prong, whether the profits are expected solely or principally from the efforts of others, depends on the participation of the investor in the management of the LLC. If the investor participates actively in the management of the LLC, his interest will likely not be a security. If the investor leaves the management of the LLC to others, his interest will likely be a security. Further, the larger the number of investors in an LLC, the less likely it becomes that the investors can participate meaningfully in the management of the LLC.

**12.3      Member-Managed Versus Manager-Managed LLCs**

One of the most important factors in whether LLC members participate actively in management is the management structure of the LLC.

There are two methods of management of an LLC—manager-managed, where the members delegate management authority to a manager, and member-managed, where the members retain management power, including the power to bind the LLC. A manager-managed LLC will almost always be deemed to be a security due to the strong presumption that members do not actively participate in the management of the LLC since they have formally agreed to delegate management power to a manager. This presumption may be overcome in some special situations where the members maintain management power of the LLC by requiring a member vote on all major LLC decisions and the members can quickly and easily remove a manager. However, these types of provisions are relatively unusual. Therefore, as a general rule, one can expect LLC interests in manager-managed LLCs to be securities.

If the LLC is member-managed, one must analyze the management structure as one would analyze a general partnership. Generally, courts have found that general partnership interests are not securities except in certain circumstances. In Williamson v. Tucker, 645 F.2d. 404 (5<sup>th</sup> Cir. 1981), the Fifth Circuit recognized that even if the general partners had the legal right to participate in the management

of the partnership, their interest could be a security if the general partners have no realistic opportunity to exercise their authority to participate in a meaningful way. Management authority may not be meaningful if the number of partners is so large that it prevents each partner from having a meaningful role in management. As noted in Williamson, "[a]t some point there would be so many partners that a partnership vote would be more a corporate vote, each partner's role having been diluted to the level of a single shareholder in a corporation." Likewise, a general partner may be prevented from having a meaningful role in management if (i) the agreement among the partners leaves little power in the hands of the general partners, (ii) the business requires a special expertise that one or more partners does not possess or (iii) one or more of the partners is so inexperienced in business affairs that they are incapable of participating in management in a meaningful way. See SEC v. Professional Assocs., 731 F.2d. 349 (6<sup>th</sup> Cir. 1984). Therefore, as with certain general partnership interests, member-managed LLC interests can be securities if the investors cannot participate meaningfully in managing the enterprise, even if they have the technical authority to do so.

#### 12.4 State Securities Laws

In addition to the federal securities laws, an LLC interest may be a security under the Blue Sky laws of each state. Many states have taken the position that LLC interests that possess certain characteristics will be considered securities. Some of these states have applied tests similar to the Howey test, evaluating whether the investor maintains control over his investment in the LLC. Other states have adopted black letter rules. These rules usually take one or a combination of the following approaches: (i) adding LLC interests to the definition of a "security," with an exception for LLCs in which all members directly participate in management, (ii) presuming that LLC interests are securities if the LLC has more than a designated number of members, and/or (iii) presuming that LLC interests are securities if the LLC is manager-managed. Kentucky's approach includes (ii) and (iii) above.

In 1998, the Kentucky Department of Financial Institutions promulgated 808 KAR 10:360, which provides a safe harbor for LLC interests to avoid being securities. Under the Regulation, a LLC interest will not be considered a security if (i) the articles of organization of the LLC do not vest management of the LLC in one or more managers; and (ii) the aggregate members of the LLC does not exceed 15. The Regulation also creates a rebuttable presumption that an LLC interest will not be considered a security if (i) the articles of organization of the LLC do not vest the managerial responsibilities of the LLC in one or more managers who are not members; and (ii) the aggregate number of members does not exceed 35. Alternatively, there is a rebuttable presumption that an LLC interest is a security if (i) the articles of organization vest the managerial responsibilities in one or more managers who are not members or (ii) the aggregate number of members of the LLC exceeds 35.

The KDFI's Division of Securities has expressed some dissatisfaction with the Regulation in practice, which may lead to changes in 2000.

#### 12.5 Consequences of Issuing a Security

If an LLC interest is a security, the transaction must satisfy federal and state disclosure requirements. The federal and state securities laws require that any transaction involving a security be registered unless the transaction qualifies for an exemption from registration. Failure to comply with the registration requirements or the conditions for an exemption could result in the LLC's promoters being personally liable to the purchaser for rescission or damages.

#### 12.6 Exemptions from Registration

The statutory exemptions available under the Securities Act to an LLC offering newly issued securities fall into two general categories: limited public offerings and private placements. The Securi-

ties and Exchange Commission has promulgated rules setting forth the conditions for each of these exemptions. Transactions must also comply with the independent requirements of state securities laws. The following is a summary of some of the most commonly used exemptions from registration.

In a limited public offering, there are no limitations on the number of persons to whom the LLC may offer its securities. There are also fewer restrictions on the manner in which the LLC can offer its securities to the public, including general solicitation. If the LLC relies on one of the limited public offering exemptions at the federal level, it must also qualify for a separate exemption at the state level.

The intrastate exemption is a limited public offering exemption that permits an issuer domiciled in, organized under the laws of, and doing business within a single state to offer and sell securities without federal registration solely to persons resident within that state. Under this exemption, federal law leaves disclosure requirements to the state involved.

The federal Rule 504 exemption exempts public offerings up to \$1 million. Rule 504 leaves disclosure requirements to the applicable state exemption, although the federal securities antifraud provisions continue to apply. Resales of securities issued in reliance on Rule 504 are restricted for a period of two years.

Regulation A is a third limited public offering exemption, which allows an LLC to sell up to \$5 million of its securities in any 12 month period. There are no limitations on the nature and number of offerees or purchasers. Regulation A requires an issuer to prepare an offering circular in accordance with SEC guidelines, which must be submitted before the offering for review and clearance by the SEC staff.

In a private placement offering, the general solicitation of potential investors is prohibited. In addition, a private placement is subject to more restrictions on the number and the financial and sophistication qualifications of potential investors than a public offering.

The most commonly used federal private placement exemptions are Rules 505 and 506, which permit LLCs to raise more than \$1 million of capital. Technically, there is no limit on the number of persons to whom the LLC can offer its securities, as long as the LLC does not use any form of general solicitation or advertising. Both Rule 505 and 506 limit the number of purchasers to 35 non-accredited investors plus an unlimited number of accredited investors. Accredited investors include, among others, institutional investors and natural persons with a net worth of \$1 million or \$200,000 in income in each of the past two years. Rule 505 limits the aggregate offering price to \$5 million, whereas Rule 506 has no limitation on the aggregate offering price. In both instances, the LLC must give prospective investors access to information about the offering, the LLC, and its business. If the LLC expects to sell interests to nonaccredited investors, the LLC must provide written offering materials containing the same information that would have to be provided in a registered public offering to raise the same dollar amount. Rule 506 has an additional requirement that the issuer must have a reasonable basis to believe that any non-accredited investor, or its purchaser representative, has sufficient knowledge and experience in financial and business matters to be able to evaluate the merits and risks of a prospective investment. As with Rule 504 offerings, there are restrictions on the resale of securities issued in reliance on Rules 505 and 506.



## 13.1 THE USE OF LLCs IN VENTURE CAPITAL TRANSACTIONS

by  
William G. Strench

### 13.2 Reasons for Using LLCs for Venture Capital Transactions

### 13.3 Description of Venture Capital Transactions

In this outline, the term "venture capital transaction" is used not only to describe traditional venture capital investments but also more broadly to include any transaction in which a business entity has two classes of ownership—active management which may make a minimal or no capital contribution to the business entity and passive (at least in the day-to-day sense) investors who will supply most, if not all, of the entity's equity capital. The structure of such transactions generally provides for the investors to receive a preferential return on their investment upon liquidation or dissolution, a fixed dividend (which usually accrues and is not currently payable), the right to convert their preferred equity position into a common equity position, board representation and the right to participate in some management decisions through consent requirements or veto rights with respect to certain business transactions. The investment terms would also generally include some form of "exit strategy" such as the ability to force the entity to repurchase the investors' shares after a certain period of time.

Until recently, the only suitable entity for venture capital transactions was the corporate form of entity. The corporation would issue preferred stock to the investors with the stock typically having a fixed dividend rate, liquidation preference, optional redemption rights, a conversion feature allowing it to be converted into common stock of the company and voting rights on an "as converted" basis. As described below, the corporate form in most instances is an inferior vehicle for structuring venture capital by type transactions for a variety of reasons. However, despite the disadvantages of the corporate structure and the fact that limited liability companies have now become the "vehicle of choice" with respect to most new entity formations, most venture capital transactions continue to be structured as corporate transactions. This is likely explained by the complexity of using this form of business structure as well as the much greater familiarity of all participants with the corporate structure. Nonetheless, it may be expected that in the future an increasing percentage of such transactions will be conducted through limited liability companies.

### 13.4 Advantages of LLCs

Limited liability companies have a number of advantages over C corporations, the traditional form of entity used for venture capital investments.

#### 13.4.1 Pass Through Taxation

Limited liability companies are not subject to any entity level tax. Like partnerships and S corporations, only the owners (members) of LLCs are subject to taxation on the entity's income. In contrast, C corporations are subject to double taxation. The corporation is taxed on its earnings and profits and its shareholders are subject to tax upon receipt of dividends. A related tax advantage of LLCs is that they may pass through their losses to their owners. These losses may offset other taxable income earned by the members. Shareholders in a C corporation are not entitled to deduct losses at the corporate level.

#### 13.4.2 Special Tax Allocations

Within certain parameters, a limited liability company has the ability to make special allocations of its income, deductions, gains and losses to its members. Accordingly, it may be possible to allocate all the losses to the investors who may be better able to derive full benefit from them.

### **13.4.3      Distribution of Appreciated Property**

Generally, there are no adverse tax consequences to an LLC or its members when the LLC distributes appreciated property to its members. Thus, if an LLC wishes to separate out a portion of its business or properties and transfer it to its members or to a separate entity owned by them, this can likely be accomplished on a tax-free basis. Conversely, under most circumstances, it is not possible to distribute appreciated property out of a C corporation without double taxation. Rather, the corporation recognizes gain on the appreciation and the shareholders will recognize dividend income up to the extent of the corporation's current or accumulated earnings and profits.

### **13.4.4      State Tax Issue**

Under the tax laws of most states, including Kentucky, it is also preferable to operate in the LLC form as opposed to the corporate form. As is true at the federal level, C corporations are subject to double taxation under Kentucky law. In addition, all Kentucky corporations (both S corporations and C corporations) are subject to the Kentucky license tax which is due annually. The amount of the tax is calculated on the basis of the amount of capital contributed to the corporation. No comparable tax exists for LLCs.

### **13.4.5      Structural Flexibility**

State corporate laws contain numerous mandatory provisions relating to the operation and management of corporations. Management of corporations is expressly delegated to the board of directors and not to shareholders. Although officers of a corporation can be granted broad managerial authority, certain duties of the board can never be delegated. State corporate law statutes contain specific procedures regarding the calling and holding of shareholder and board meetings and minimum vote requirements. Shareholders are provided with statutory rights relating to the inspection of corporate records including shareholder lists. Minimum vote requirements are necessary for the merger of the corporation, the sale of substantially all of its assets and dissolution. In contrast, there are almost no limits on the manner in which the management and operations of an LLC can be structured. As discussed below, this allows management and investor owners of LLCs to structure the economic, managerial and operational aspects in a manner that is consistent with their mutual objectives.

### **13.5        Disadvantages**

An LLC may not be suitable for all venture capital transactions. The following is a summary of some of the disadvantages associated with LLCs.

#### **13.5.1      Self-Employment Taxes**

Unlike C and S corporations, management of LLCs may be subject to self-employment taxes on their distributive shares of income. Under certain circumstances, the tax may apply to income earned by management members on amounts they have contributed as equity to the company. Moreover, Congress and the IRS have not clarified to any significant degree the treatment of the self-employment tax in the LLC context. Therefore, it may not be possible to structure any LLC transaction to avoid this tax with any degree of certainty.

#### **13.5.2      Tax-Free Mergers**

Corporations may merge and, in some instances, engage in asset sales, in a manner that is tax-free to its shareholders under IRC § 368. There are no comparable provisions for a merger or asset sale involving a limited liability company. Thus, if the owners of an LLC anticipate that the company will be eventually sold to a public corporation in a transaction in which they will receive stock, it may be advantageous to form the entity as an S corporation or a C corporation. Although such a conversion from corporate to LLC form can be made later, the conversion may be ignored for tax purposes if it takes place shortly before the merger.



### 13.5.3 Unavailability of Stock Options and Other Employee Benefits

S corporations and C corporations are permitted to grant their employees incentive stock options under IRC § 422. An LLC is only permitted to issue nonqualified options. Unlike incentive stock options, a recipient of nonqualified options recognizes compensation income upon exercise of the option. Certain other fringe benefits are only available to employees of a corporation, such as medical expense reimbursement plans and deductions for premiums for group life insurance.

### 13.5.4 Unrelated Business Taxable Income

Certain types of investment vehicles such as IRAs will be taxed on the “unrelated business taxable income” they earn on investments in a pass-through entity. As such, these entities will be subject to current tax on investments in LLCs whereas they would not be required to pay such taxes on C corporation investments.

### 13.6 Comparison to S Corporations

An S corporation has some of the same advantages over C corporations that LLCs possess such as the pass-through character of income earned by the entity. However, there are significant disadvantages to using S corporations in venture capital transactions. S corporations cannot be owned by partnerships, corporations or LLCs (unless they are wholly-owned subsidiaries) and must be owned by individuals or certain limited types of trusts. This precludes organized venture capital business entities from investing in S corporations. In addition, S corporations are only permitted to have a single class of stock and thus the preferred stock form of investment favored for venture capital investments is not permissible. For these reasons, S corporations are generally not a suitable investment vehicle for venture capital type transactions.

### 13.7 Adapting the Corporate Structure to LLCs

### 13.8 Capital Structure

The preferred stock structure favored for venture capital investments in C corporations can be readily adapted for investments in LLCs. With the flexibility afforded LLCs, the structure can be refined to more closely achieve the relative goals of the parties since, for the most part, there are no statutory constraints. Generally, the interests in the LLC can be designated as preferred units (or shares) and common units. The relative rights of holders of common units and preferred units are set forth in the operating agreement for the company. The following is a description of how the corporate preferred stock features can be adapted to the LLC form.

#### 13.8.1 Dividends

As with preferred stock in a corporation, the preferred units can have a fixed dividend right that is either currently payable or that accrues until it is declared by the board of directors.

#### 13.8.2 Conversion Rights

It is possible to structure the preferred units to make them convertible into common units at a specified conversion rate. However, in the LLC format there is really no need to ever effect a conversion to common units. In a corporate structure, a preferred holder will want to retain all the advantages that preferred holders have over common holders. Therefore, a preferred holder will likely never convert except in connection with a public offering. A conversion is necessary in that instance since public shareholders generally prefer investing in companies with a single class of stock. As a practical matter, an LLC will need to convert to a corporate form in the event that it goes public. Therefore, there is no need to provide for conversion of the preferred units to common units.

### **13.8.3      Liquidation Preference**

Generally, it is possible to provide for the same form of liquidation preference for preferred units in an LLC structure as can be achieved in the corporate setting. Care needs to be taken in drafting these provisions, however, since one of the safe harbor requirements for recognition of the tax allocation provisions in the LLC agreement is that any liquidating distributions must be made in accordance with positive account balances. To accomplish this, the ongoing allocations of taxable income and losses should be structured so that at liquidation, the preferred units will have capital account balances equal to their liquidation preference.

### **13.8.4      Voting Rights**

Voting rights can be established for preferred units in the same manner as are provided for in corporate venture capital transactions. Typically, preferred shares in a venture capital transaction are entitled to the number of votes that the holder would have if the shares were converted to common shares. Therefore, if one share of preferred stock is convertible to 100 shares of common stock in a corporation, the preferred would have 100 votes per preferred share. With the flexibility of the LLC structure, it is possible to modify general voting rights to achieve particular goals. For example, preferred shares can be given a greater number of votes with respect to certain types of actions requiring approval.

### **13.8.5      Put Rights**

As is true in a corporate setting, preferred units of an LLC can be made redeemable at the option of the shareholder after a specified number of years. This provides the investor with the ability to dispose of its investment if the company has not gone public or been sold within a specified number of years. The only constraint on these put rights under Kentucky law are certain solvency requirements similar to those under the corporate statute.

### **13.8.6      Tax Treatment**

For C corporations and S corporations, the Code specifies exactly how the corporation and/or its owners are taxed with respect to the earnings of the corporation. This allocation of tax responsibility cannot be altered by contract. Conversely, in an LLC structure, the owners have significant flexibility in allocating taxable income and loss. In a venture transaction, income and losses would generally be allocated to provide the investors with all losses with income (after loss recoveries) allocated according to relative ownership percentages.

### **13.9          Adapting Corporate Management Structure to the LLC Form**

#### **13.10      Board of Directors**

A limited liability company may have a board of directors (sometimes described as the Board of Managers) that governs the affairs of the LLC just as a board would govern a corporation. Since the responsibilities, duties and obligations of board members, the manner of their election, appointment and removal are not addressed in the Kentucky LLC Act, these must be described in the operating agreement. Since there are no specific statutory provisions, the board of directors of an LLC can have attributes that are substantially dissimilar to those of a board of directors. For example, board members can have different voting rights with some members having two votes and the others having one vote. In addition, if authorized in the operating agreement, the directors can act by written consent of less than all of the directors (the Kentucky LLC Act requires that the board act by written consent only if there is unanimous consent.)

### 13.11 Officers

As is the case for the board of directors, an LLC can also have officers with the same types of titles that officers of a corporation have. Again since there are no relevant statutory provisions, the responsibilities and duties of officers need to be specified in the operating agreement. In many instances, a shorthand method of describing such duties and responsibilities would be to state that the officers of the LLC shall have the same responsibilities and duties that officers of a Kentucky corporation with the same titles would have. Of course, the same flexibility exists with respect to officers as it does with directors. For example, the operating agreement can provide that officers may only be removed with the approval of the members or that approval of certain LLC actions require the consent of both the Board of Directors and the President of the company.

### 13.12 Manager or Member-Managed Designation

One of the few mandatory requirements of the Kentucky LLC Act and other state limited liability company acts is the requirement that LLCs identify whether they will be member-managed or manager-managed. In the corporate type structure, it is generally preferable to provide that the LLC will be manager-managed. Any member of a member-managed LLC would have the statutory authority to bind the LLC, a generally undesirable result. If the LLC is to be manager-managed, the issue arises as to what individuals or groups of individuals should constitute managers. There are several alternatives in this regard. First each member of the board of directors could be designated a manager. The disadvantage of this approach is that each board member would have the authority to bind the LLC when the intent is to require the board to act in a collective fashion. Some operating agreements provide that the board of directors as a whole constitutes the manager of the LLC. While desirable in some respects, this structure does have certain practical limitations. For example, if action by the managers is required to authorize a particular agreement, a majority (or possibly all) of the directors would be required to execute the agreement. Generally, the best approach may be to identify the chief executive officer of the LLC as the manager. The terms of the operating agreement can provide that the CEO is subject to the control of the board of directors. Although there is some risk that the CEO could bind the LLC without board approval because of his or her status as a manager, this is similar to the risk that exists with a corporation where the CEO may have apparent authority to bind the corporation.

### 13.13 Fiduciary Duties

Under the corporation acts of all states, boards have certain fiduciary duties to the owners of the business which cannot be contracted away in the articles of incorporation or bylaws. No comparable provisions exist in the Kentucky LLC Act. Therefore, it may be possible to limit or eliminate altogether all fiduciary duties that board members and officers owe to the LLC's members. In addition, an operating agreement provision stating that one or more directors appointed by a particular group of members have no fiduciary duty to any other members is likely enforceable. This is a very useful provision in transactions in which the directors appointed by the investors have different interests than the management appointed directors. For example, if the investors believe it is an optimal time to sell the company for the purpose of satisfying their liquidity needs, the directors appointed by them could vote for such a sale even though the sale may not be optimal for owners of the company generally.

### 13.14 Other Modification to Corporate Rules

### 13.15 Access to Company Records

The Kentucky Business Corporation Act (the "KBCA") and other state corporate laws contain very detailed provisions regarding a shareholder's ability to obtain access to corporate records, including shareholder lists. In the LLC context, it is arguably possible to completely eliminate such rights. If the rights are to be preserved in any form, the procedure should be addressed in the operating agreement.

### **13.16            Shareholder Meetings**

Shareholders of Kentucky corporations have the ability to call shareholders meetings under certain circumstances. This right can be eliminated in the LLC context.

### **13.17            Indemnification and Limitation of Liability**

The KBCA provides specific limitations on the ability to indemnify officers and directors and to eliminate their personal liability for actions taken in their corporate capacity. Although, for equitable reasons, it may be impossible to provide for mandatory indemnification in all instances and for the complete elimination of liability of officers and directors of an LLC, it is likely that rights of officers and directors in this regard can be significantly expanded beyond what it is available to corporate officers and directors.

### **13.18            Related Party Transactions**

The KBCA has specific provisions dealing with related party transactions between the corporation and its officers, directors and shareholders. Because there are no such limitations under the Kentucky LLC Act, in theory, it might be possible to authorize all such transactions in the operating agreement. However, it is more likely a provision this broad would be held unenforceable as implicitly authorizing management to commit fraud with respect to the LLC's members. Accordingly, it is best to set up a specific procedure by which related party transactions can be approved and, in some cases, to authorize blanket approval of certain categories of transactions (*e.g.*, sales of certain products using formula-derived pricing). If the approval procedure for such transactions is reasonable, it is likely to be held enforceable given the contractual nature of an operating agreement. Such procedures may include an independent third party appraisal or approval by disinterested directors.

### **13.19            Miscellaneous Issues**

### **13.20            Conversion to C Corporation**

There are a number of reasons an LLC may eventually wish to convert to a C corporation. Very few public corporations exist in any form other than the C corporation form. As indicated above, if the business eventually wishes to merge with a corporation on a tax free transaction, it will need to be in corporate form to achieve this objective. There are three methods to convert an LLC into a corporation:

1.        Transfer all of the LLC's assets to a corporation followed by a distribution of the corporate stock to the members;
2.        The transfer of the LLC interests by the members to the corporation in return for stock resulting in termination of the LLC and a distribution of its assets to the corporation; and
3.        A liquidation by the members of the LLC followed by a transfer by the members of the distributed assets to the corporation in return for stock.

The three methods of incorporation of an LLC may produce different tax consequences with regard to holding periods, share basis considerations, gain recognition and characterization and other tax issues, although generally most LLC's will be able to be converted into corporations without recognizing taxable income.

### **13.21            Pre-IPO Distributions**

One unique advantage available to LLCs that is not available to C corporations is the ability to make a cash distribution to their owners prior to an initial public offering on a tax free basis. Generally, it may be possible for the LLC to distribute an amount equal to the LLC's aggregate capital contribu-

tions plus accumulated net earnings, less prior distributions, immediately prior to the IPO. This is often funded through a short term loan that will be paid from the IPO proceeds. Although such distributions prior to IPO are somewhat unusual, they may often be acceptable to the IPO underwriters because the pricing of such offerings is typically based on a multiple of earnings rather than on the company's net book value.

**13.22                    Securities Laws Holding Period**

Under existing Securities and Exchange Commission interpretations of Rule 144, the rule that governs the ability of shareholders to sell shares acquired in a private transaction, conversion from a limited liability company to a corporation starts a new holding period. The effect of this interpretation is to impose a minimum one year limitation on the sale of shares following an IPO. An exception to this Rule exists if the conversion is mandatory at the election of the manager. Therefore, if there is any prospect of an LLC eventually going public, such a provision should be included in the operating agreement.



## **14.1 NEW STRATEGIES FOR STRUCTURING SUCCESSFUL BUSINESS JOINT VENTURES AND STRATEGIC ALLIANCES**

by  
**Scott W. Dolson**

Business joint ventures have traditionally been structured using general partnerships or corporations. This chapter explains why these traditional choices should be discarded in favor of limited liability companies ("LLCs"). This chapter also identifies key issues in structuring joint venture relationships and explores various strategies for successfully dealing with those issues.

Reconsidering the issues surrounding the structuring of joint venture relationships is timely today because businesses are increasingly turning to joint ventures and other strategic alliances as a growth strategy. Strategic alliances have historically played an important role in the international business scene. Domestic companies often discovered that the joint venture relationship was the only way to effectively penetrate otherwise closed foreign markets. In recent years, however, there has been an upsurge in the use of domestic joint ventures. Coincidentally, the recent introduction of the LLC entity has provided these domestic businesses with a state of the art entity through which to structure their joint venture relationship.

### **14.2      Business Joint Ventures — Background**

Business joint ventures involve the pooling of resources and the sharing of profits and losses by two or more businesses. The joint venture relationship provides a business with the opportunity to acquire the use of new technologies, service capabilities, customer bases, financial resources and market presence without incurring potentially backbreaking startup costs or battling head-on with a competitor who may have a crucial competitive advantage. The bottom line is that if a business owns valuable resources but lacks other crucial resources required to accomplish a growth strategy, then it may be more efficient for the business to identify a partner that owns those crucial ingredients and propose a mutually beneficial strategic alliance, rather than attempt to purchase or internally develop those resources.

Joint ventures have other uses besides the pooling of resources. In some cases, the joint venture relationship is used by the venture capitalist as a means of acquiring an equity interest in a business. Of course, venture capitalists bring financial resources to the joint venture table. Joint ventures are also used as tax-favored acquisition vehicles. Favorable tax treatment is often obtained in situations where the acquirer and target companies (often competitors) pool their resources in a joint venture and afterwards share the profits generated by the combined businesses. There is often an exit strategy built in for taking out the acquisition target business partner. The use of the joint venture in this situation rather than an outright acquisition may defer or eliminate the tax consequences associated with the purchase transaction.

### **14.3      Comparing Entity Choices**

Joint ventures are formed when two or more businesses contribute cash, tangible and intangible property and services to an entity that becomes the vehicle through which the joint venture is operated. Partnerships and corporations have historically been the two choices available for the business joint venture. Business persons throughout the United States, however, decided that both of those entity choices had problems and sought to develop an entity combining the best and avoiding the worst features of the corporation and partnership. That effort gave birth to the LLC, which is now destined to become the entity of choice for the business joint venture — a use for which it is perfectly suited. Legislation recognizing LLCs has now been enacted by all 50 states and the "limited liability" form of noncorporate entity is familiar in many foreign jurisdictions.

The LLC's favorable features in the business joint venture context include:

- (i) pass-through tax treatment (income is taxed at only the equity owner level rather than at both the entity and owner levels);
- (ii) liability protection for the LLC's owners (LLC owners are not individually responsible for the liabilities and obligations of the business);
- (iii) unfettered flexibility with respect to structuring the sharing of the LLC's income and tax items;
- (iv) tax-free contribution of assets to and distribution from, the LLC (true in most cases);
- (v) tax-free formation and liquidation of the LLC (true in most cases); and
- (vi) the ability to issue LLC interests in exchange for services without triggering adverse tax consequences.

Prior to the enactment of LLC legislation, the partnership was the entity of choice for business joint ventures. Like the LLC, the partnership is a pass-through entity from a tax standpoint — only the LLC's owners are taxed on the profits of the business and losses are passed through and are used at the owner level. This is the most favorable feature of the partnership entity. An unfavorable feature of the partnership is the fact that partners are liable for the debts and other liabilities and obligations of the joint venture. In contrast, members of an LLC or corporate shareholders are shielded from the liabilities, debts and other obligations of the joint venture.

In contrast to the pass-through tax treatment of the LLC and partnership, a corporation's income is taxed at the entity level and then again at the owner level if the income is distributed in the form of dividends. Corporate shareholders are entitled to a dividends received deduction that reduces this double taxation burden, but the dividends received deduction is only 80% for a 20% to 99% owned corporation, leaving a portion of the dividends subject to double taxation. Double taxation could be avoided by paying out all of the joint venture's income in the form of compensation to the shareholders, but this technique does not permit the retention of earnings to grow the business and could be subject to IRS attack if compensation payments are excessive, or will not work if one of the venture partners is not contributing services. The threat of double taxation poses a serious stumbling block for the successful use of the corporation as a joint venture vehicle.

In addition to double taxation, corporations have several other potentially serious tax problems. Start-up and operating losses cannot be passed through to the owners of a joint venture operated in corporate form unless the owner is a corporation and holds an 80% interest in the joint venture (an unlikely scenario). Joint ventures operated in LLC form pass through all losses to the LLC's owners. The issuance of an LLC interest in future profits is generally tax-free until income is distributed to the owner providing the services. In contrast, the issuance of stock to a shareholder in exchange for future services is often taxable at the time of receipt.

The initial contribution of appreciated assets to a corporate joint venture is generally tax-free if the corporation is newly-formed, but subsequent contributions of appreciated assets by additional joint venture partners will usually be treated as taxable sales — an unappealing result. Likewise, distributions of appreciated assets from the corporate joint venture or the liquidation of the joint venture will be treated as a taxable sale of the distributed assets, including goodwill if the corporation is liquidated. In contrast, appreciated assets may generally be contributed to or distributed from an LLC joint venture on a tax-free basis. Both the formation and liquidation of an LLC may usually be accomplished on a tax-free basis.

In spite of the tax problems associated with the corporate form, one situation where the corporation was selected as the joint venture entity of choice was where the intention was to raise money



through an offering of the joint venture's equity. Today's best strategy, however, may be to start operations as an LLC (taking full advantage of the pass-through of any start up write-offs) and later convert to the corporate form prior to the equity offering. The conversion of an LLC joint venture to a corporation will be tax-free.

#### 14.4 Negotiating and Drafting the Joint Venture Agreement

Once the entity choice is made, there are a variety of issues that should be considered when structuring and negotiating the joint venture relationship: (1) the nature and scope of the joint venture's business activities; (2) the initial cash and/or property contributions to the joint venture; (3) the owners' obligations to make subsequent capital contributions and/or loans; (4) the capital account credits awarded to the owners for their contributions; (5) the sharing of operating profits and losses and sale or liquidation proceeds; (6) management of the joint venture; (7) rules for admission of additional owners; (8) exit strategies, including IPOs; (9) buy-sell, withdrawal, and put-call rights and restrictions; (10) confidentiality and noncompetition covenants; (11) the joint venture's right to owner generated business opportunities; and (12) the services to be performed by the owners for and on behalf of the joint venture (either for compensation or in exchange for joint venture interests).

One approach that should be considered when the LLC entity is being used is the adopting of a "corporate" style of management structure, complete with officers, directors and shareholders. Equity interests may be denominated as shares, with two or more classes having differing rights and preferences, much in the same way corporations have common and preferred stock. By adopting a corporate-style joint venture, the owners will be able to take advantage of the LLCs' favorable tax features without being forced to deviate from the familiar corporate style management and ownership structure. An alternative to the corporate style of management structure is the general partnership management format, where the LLC is managed by its members, with each member having a percentage voting interest and decisions being made by a majority or super-majority vote of those members. The LLC allows for unfettered flexibility in fashioning the joint venture's management and equity structure. The price for this flexibility is the need to carefully craft the provisions of the joint venture operating agreement to reflect the owner's agreement on these issues.

Another valuable strategy to consider when structuring the joint venture relationship is building into the management and operational structure of the joint venture the concept of a business plan and budget. The discipline of formulating and then agreeing upon both an initial (often multi-year) business plan and budget, along with annual updates, forces the owners to consider the difficult economic issues associated with undertaking a joint venture relationship. The business plan and budget concept also is a useful mechanism for keeping a degree of control over the joint venture's managers. Minority owners exercise a greater degree of control if the joint venture's managers are forced to seek approval for budget overruns or actions that fall outside of the scope of the business plan. Majority owners, on the other hand, might want to think twice before agreeing to restrict their management authority through the business plan and budget concept.

The role of the business owners in structuring a joint venture is usually to plan for success by addressing issues such as the scope and nature of the joint venture's business activities, the sharing of profits, and the raising of additional equity for expansion. The role of the attorney is to ensure that the joint venture agreement reflects the owners' agreement on these key economic and business issues. Attorneys also must make sure that the agreement deals with issues that arise when the joint venture is not successful. Key issues that need to be addressed include the limits placed on an owner's obligation to make additional capital contributions or to otherwise guarantee the joint venture's debts and obligations, and owner exit strategies (*e.g.*, withdrawal, sale and put rights, and venture liquidation). Dealing with these issues up-front may not make business failure more palatable, but it at least may reduce the chance for misunderstandings to arise among unhappy joint venturers.

Finally, an important strategy for successfully negotiating a joint venture agreement is to focus on not only the obvious business and economic issues, but also "technical" issues such as whether owners will be permitted to compete with the joint venture, who has rights to use the intellectual property created by the venture, the protection of the trade secrets of the owners and the joint venture, and whether owners will be required to bring similar business opportunities they develop to the venture or whether they may develop those opportunities outside of the venture. Any one of these issues could become significant once the venture is underway. These issues should be addressed during the formation process, before they become real life issues (and a possible breeding ground for disputes) during the joint venture's operation.

The negotiation of a joint venture relationship is a unique situation. If an owner has a strong opinion on an issue relating to the structuring of the joint venture, it will be important to that owner that the final agreement reflect its position. On the other hand, that same owner would often not be well served if the other owners are unable to live with that position or the position cripples the viability of the joint venture. There needs to be a balancing act when negotiating and structuring a joint venture between the wants and needs of the individual owners and what is good for the venture as a whole. A joint venture is more akin to a marriage than a hostile takeover or acquisition. It is possible to win battles at the negotiation table but lose the war if the bigger picture of what will make the joint venture successful is ignored or forgotten.

#### **14.5      Accounting Treatment for Joint Ventures**

The financial accounting for a joint venture is often a significant issue for one or more of the joint venture owners. Because of this, it is important to go into the negotiation of a joint venture relationship having a clear understanding of how the venture will be accounted for by each of the venture owners. Under current GAAP rules, consolidated financial statements are required where a parent directly or indirectly controls the majority voting interest of a subsidiary. For purposes of the GAAP rules, a subsidiary may include a joint venture relationship. If an owner "controls" the joint venture, then the venturer includes on its consolidated return all of the income and expenses of the joint venture, with a deduction shown for the net income attributable to the minority interest in the joint venture held by other venturers. On the other hand, a combined financial statement is used by venturers who do not control the joint venture. On the combined return, the income expenses attributable to the interest held by the venturer is shown on the statement. The Financial Accounting Standards Board is currently studying the concept of "control" for purposes of accounting for joint venture interests.

#### **14.6      Antitrust Filing Requirements**

Businesses forming joint ventures may be required to comply with the antitrust reporting requirement of the Hart-Scott-Rodino Act ("HSR Act"). The HSR Act requires the filing of a pre-merger notice with the Federal Trade Commission ("FTC"), which includes a \$45,000 filing fee. Except for exempt transactions, compliance with the HSR Act is required if (i) one joint venture owner has annual net sales or total assets of at least \$100 million, any other owner has annual net sales or total assets of at least \$10 million, and the joint venture itself will have total assets of at least \$10 million; or at least two of the joint venture owners have annual net sales or total assets of at least \$10 million (size of the person test), and (ii) one joint venture participant owns at least 15% of the "voting securities" or an aggregate or an aggregate of at least \$15 million worth of assets and voting securities of the joint venture (size of the transaction test).

Previously, the FTC had interpreted the HSR Act to exclude from the pre-merger filing requirements LLCs whose membership interests were more like partnership interests than voting securities. Recently, the FTC changed its interpretation of the HSR Act in recognition of the fact that the LLC has become a commonly used vehicle for the combination of competing businesses. The FTC now treats as

reportable the formation of an LLC if (1) the size of the person and size of the transaction tests are satisfied, (2) two or more pre-existing, separately controlled businesses will be contributed, and (3) at least one of the members will control the LLC (*i.e.*, at least one member will have an interest entitling it to 50 percent (50%) of the profits of the LLC or 50 percent (50%) of the assets of the LLC upon dissolution). The formation of all other LLCs will be treated like the formation of a partnership which, under the FTC's traditional position on partnership formations, will not be reportable.



## 15.1 PLLCs AND THE PLLC LIABILITY SHIELD

by  
Scott W. Dolson<sup>1</sup>

This chapter addresses issues relating to the use of LLCs by professionals. The substantial portion of this chapter focuses on the liability shield provided by the professional LLC ("PLLC"). The discussion focused on the liability shield applies for the most part to both PLLCs and non-professional LLCs.

### 15.2 Use of the PLLC

The decision was made by the drafters of the LLC Act to explicitly authorize the practice in Kentucky of certain professions through PLLCs. KRS § 275.005 provides that the purpose for which a PLLC may be organized includes "the provision of one (1) or more professional services." KRS § 275.015(19) defines professional services to be "personal services rendered by physicians, osteopaths, optometrists, podiatrists, chiropractors, dentists, nurses, pharmacists, psychologists, occupational therapists, veterinarians, engineers, architects, landscape architects, certified public accountants, public accountants, physical therapists and attorneys."

Professions not listed in KRS § 275.015(19) should be able to practice their profession in an LLC, but will not be subject to the limited requirements (discussed elsewhere in this chapter) imposed on those activities falling within the scope of professional services. If the activities of the proposed entity do not include any of the professional services within KRS § 275.015(19), then it follows that the entity should be organized as an LLC rather than a PLLC. If the proposed activities include one or more of the professional services within KRS § 275.015(19), along with other professional or nonprofessional activities, then there is nothing in the LLC Act itself that prevents the use of a PLLC for these activities. Before a PLLC is utilized, however, or for that matter before professionals embark on conducting both one professional service and other professional or nonprofessional activities in the same entity, the statutes, regulations and regulatory board rulings that govern each of the professions should be reviewed to determine whether there are limitations on the activities that can be conducted in an entity that includes the performance of the professional service.

KRS § 275.010 provides that the LLC Act will not restrict, limit or expand in any manner the authority and duty of any regulating board to regulate persons providing professional services, including the establishment of regulations concerning "[t]he provision of one (1) or more professional services through a professional limited liability company." This provision might be read to suggest that a regulatory board has the authority to prohibit the practice of a profession within a PLLC. This conclusion would seem to be consistent with the general powers and duties of the various regulatory boards established by KRS Chapters 310 through 335. Although the specific language of the statutes empowering the regulatory boards differs from profession to profession, in each case, the regulatory boards have the general authority to regulate professional conduct, including issues relating to professional licensure. This authority would seem to extend to the issue of what type of entity a professional was permitted to practice in or through.

The alternative (and better) interpretation of the above-quoted provision of KRS § 275.010, however, is that regulatory boards are delegated general authority to regulate the provision of professional services through the PLLC, but that this right does not extend to the basic decision of whether the profession may practice in a PLLC. This argument goes that decision was made for the regulatory boards by the General Assembly through the enactment of the LLC Act (*i.e.*, KRS § 265.015(19)). Following this line of reasoning, the above-quoted provision is merely a catch-all provision confirming the regulatory board's right to regulate professions under their jurisdiction.

KRS § 275.010(2) provides that regulatory boards have the authority and duty to regulate the practice of professional services, including the establishment of regulations, "even though the persons are members, managers, employees, or agents of a professional limited liability company, or provide professional services through a professional limited liability company." Read as a whole, the logical conclusion is that KRS § 275.010 assumes that the regulatory board is dealing with the regulation of professionals operating through LLCs, which by definition means that such regulation does not extend to denying those professionals the basic right to practice in LLC form. This interpretation of KRS § 275.010 is supported by OAG 63-14 (January 8, 1963). In that ruling, the Attorney General was asked to consider the continued effectiveness after the enactment of KRS Chapter 274 (providing for professional service corporations [PSCs]) of a Kentucky regulation which provided that accountants were not permitted to practice through corporations. OAG 63-14 provided that:

"It is our opinion that the Legislature in the enactment of the Professional Service Corporation Act has made it clear that professional services may be rendered through a corporation and that any provision to the contrary found in any professional code of ethics is unenforceable and void as to any corporation formed under and complying with the requirements of KRS Chapter 274. It follows that SBA-E-10 is now a nullity as to a corporation formed under KRS Chapter 274 since the law permits public accountants, under specified conditions, to be officers, directors, stockholders, representatives or agents of a corporation engaging in the practice of public accountancy. The other rules of ethics and the powers of the Board to regulate the practice of the profession were not affected and remain in force."

The statutes and regulations of each of the professions differ as to whether the practice of the profession in or through an entity is mentioned. Several of the professions which have previously addressed the issue of entity practice may require amendment of their statutes or regulations in the aftermath of the enactment of the LLC Act.

KRS § 325.300 contemplates the practice of accounting through sole proprietorships, partnerships, PSCs or any other form of business organization. The accountants clearly desired to allow for the practice of accounting through PLLCs and registered limited liability partnerships, in addition to any other entities which might become available in the future.

In the past, legal counsel for the Kentucky Board of Medical Licensure and the Kentucky Medical Association have informally concluded that it is unnecessary to undertake an amendment of that profession's statutes or regulations in the aftermath of the enactment of the LLC Act. The Board has previously stated in a 1994 letter that physicians can practice through PLLCs. The only reference to the practice of medicine through entities is in KRS § 311.595(18), which encompasses partnerships, associations and PSCs, and addresses the issue of the sharing of fees rather than the question of the entities available to physicians. As long as the Board of Medical Licensure interprets "associations" to encompass PLLCs, then there should be no issue of whether the sharing of fees among the members of a PLLC constitutes prohibited fee splitting.

Among the remaining professions, dentists should consider amending KRS § 313.240 which effectively restricts the practice of dentistry or dental surgery through a company, association or corporation to PSCs established under KRS Chapter 274. The Board of Dentistry concluded in a 1998 letter that KRS § 313.240 does not permit dentists to practice through PLLCs. KRS § 313.240 should be amended to include PLLCs.

### 15.3 Use of the PLLC by Lawyers

The Kentucky Supreme Court, in a historic move, recently adopted practice rules expressly permitting lawyers to practice law in limited liability entities.<sup>2</sup> In a surprising turnabout, the Supreme

Court justices acknowledged for the first time that lawyers practicing together, regardless of their number, can eliminate professional vicarious liability (*i.e.* liability without fault) for the malpractice of their partners simply by operating in a PLLC, registered limited liability partnership (RLLP) or PSC. With the adoption of amended SCR 3.022 "Forms of Practice of Law" and new SCR 3.024 "Requirements of Practicing Law in Limited Liability Entities," lawyers in Kentucky can now be assured that they will no longer be held personally liable merely because of their status as business owners for something they did not do. These rules, however, are qualified in two important respects: First, subject to judicial or prosecutorial immunity, all lawyers remain personally liable and accountable to their clients, regardless of their practice structure, for their own acts, errors and omissions, as well as the acts and omissions of others under their direct supervision. Second, in order for lawyers to avail themselves of the protection from vicarious liability, the limited liability entity, itself, must maintain at all times adequate professional liability insurance or an acceptable form of financial protection covering the acts and omissions of its owners.

Section 116 of the Kentucky Constitution empowers the Kentucky Supreme Court to govern the admission to the Bar and the discipline of members of the Bar. The Kentucky Supreme Court has interpreted this provision quite broadly to give it the right to regulate the practice of law in Kentucky even in the face of legislation to the contrary.<sup>3</sup> While a few individuals and even some law firms had been practicing law in PSCs since the enactment of KRS Chapter 274 in 1962, the issue of eliminating vicarious liability by practicing in limited liability entities did not surface until the summer of 1994 when the Kentucky Supreme Court was presented for the first time with proposed SCR 3.130, (5.7).<sup>4</sup> The introduction of this rule was triggered by the enactment of the Kentucky Limited Liability Act which authorized the practice of law in a PLLC.<sup>5</sup> Consequently, in 1994, Kentucky offered its lawyers the opportunity to organize and operate their practice in either a PLLC, RLLP, or PSC; all of which remained subject to the Kentucky Supreme Court's oversight. At the same time, Kentucky was one of only ten states which imposed vicarious liability on its lawyers.<sup>6</sup>

There were compelling reasons supporting the elimination of vicarious liability. First, the notion of vicarious liability among lawyers appeared to be more of a myth than reality. Clients expect and demand nothing more from their lawyers and law firms than to stand behind their professional services. Few, if any, clients contemplate the financial strength of the individual lawyers in a firm when selecting legal representation or expect compensation from those lawyers not at fault. Second, vicarious liability punishes disproportionately the lawyer who has no knowledge of, involvement with, or responsibility for other lawyers' malpractice; moreover, lawyers remain personally liable as a result of vicarious liability for the firm's non-legal business claims. Third, the elimination of vicarious liability is not inconsistent with or in violation of state or national rules of professional conduct. While compelling as the reasons may have been, the Kentucky Supreme Court rejected this proposal, in short form, by stating that...[T]he members of the Supreme Court of Kentucky do not agree that lawyers can so limit their liability.<sup>7</sup> As a result, the practice of law remained the only major profession in Kentucky that could not eliminate vicarious liability by practicing in a PLLC, RLLP or PSC form.

Some three years later, the Kentucky Bar Association presented SCR 3.022 and SCR 3.024 to the Kentucky Supreme Court. Unlike the prior proposal, the KBA, in an effort to protect the public's rights, introduced the concept of requiring the limited liability entity to maintain malpractice insurance in order to gain the protection from vicarious liability. The Kentucky Supreme Court, in a nondecisional response, once again, summarily rejected these rules.

In February 1999, in a third and final attempt, proposed practice rules, SCR 3.022 and SCR 3.024 were once again submitted by the Kentucky Bar Association to the Kentucky Supreme Court. At that time, more than 250 law firms had organized and were operating as PSCs, PLLCs or RLLPs in the Commonwealth.<sup>8</sup> Much to the surprise of the Bar, the Supreme Court Justices during December 1999 ruled that Kentucky lawyers are entitled to protection against vicarious liability through the use of PLLCs, RLLPs or PSCs.

SCR 3.022 "Forms of Practice of Law," as amended, allows lawyers to practice law in Kentucky as . . . employees of or as partners, shareholders, members or co-owners of a registered limited liability

partnership, professional service corporation or limited liability company or any other limited liability entity organized pursuant to an applicable statute.

By endorsing the practice of law in limited liability entities, the Kentucky Supreme Court made it clear that a lawyer will not be held personally responsible for negligent legal acts and/or omissions so long as that lawyer was not involved with or responsible for the malpractice itself. Equally clear under the rule is that a lawyer who is guilty of malpractice or who supervises another lawyer committing malpractice remains personally liable and the limited liability entity in which the lawyer(s) practiced to the extent of its assets remains liable. As one can see, these rules will provide no practical relief from legal liability to the sole practitioner.

The Supreme Court justices imposed a malpractice insurance coverage requirement on those lawyers who intend to utilize limited liability entities. SCR 3.024 "Requirements of Practicing Law in Limited Liability Entities" requires lawyers and the limited liability entities themselves to secure adequate professional liability insurance or secure an acceptable form of adequate financial coverage to cover any damages arising out of or resulting from legal malpractice claims.

Adequate insurance is described as one or more professional liability policy or policies which insures both the entity and its individual owners with insurance coverage equal to \$50,000 per claim (multiplied by each attorney) with an aggregate maximum limit of liability per policy year for all claims equal to \$500,000 (multiplied times each attorney). However, a limited liability entity is required to maintain at all times minimum coverage of no less than \$250,000 per claim and \$500,000 for all claims during the policy year. In response to the financial burden this would impose on large law firms, the justices concluded that no firm will be required to carry malpractice insurance in excess of \$5 million per claim and \$10 million for all claims during the policy year.

Lawyers are afforded the option of establishing an acceptable form of adequate financial coverage other than professional malpractice insurance. Forms of adequate financial coverage include (i) deposits in trusts, escrowed cash, certificates of deposits, or United States Treasury obligations, (ii) a bank letter of credit, or (iii) a surety bond. These forms of financial coverage, while remaining within the firm's control, must be designated and segregated from the firm's other assets; must satisfy the dollar requirements placed on the professional malpractice insurance and must be available for payment to any person presenting a valid final judgment in a Kentucky court for acts, errors and omissions arising out of the performance of legal services by the firm. To the extent there is a coverage shortfall (or presumably a deductible) lawyers, as co-owners, will remain jointly and severally liable.

Under SCR 3.024, there is no affirmative duty at the present time on the part of the entity to register with the Kentucky Supreme Court or any other regulating agency in order to take advantage of the benefits of limited liability.<sup>9</sup> Law firms, which currently practice in a limited liability entity form or intend to practice in such form in the future, must have or must acquire the necessary financial coverage or reorganize as a general partnership. Failure to satisfy the financial coverage requirements will most likely lead to a ruling that the limited liability entity will be ignored, and the lawyers will be treated as partners of a general partnership with joint and several liability for legal malpractice claims.

A Kentucky law firm operating as a general partnership may convert into a PLLC by filing articles of organization with the Kentucky Secretary of State.<sup>10</sup> The articles of organization must include a statement that the conversion was approved by the necessary percentage of partners. Unanimous approval is required unless the partnership agreement provides for a lesser percentage for approval of a conversion.<sup>11</sup> In addition the articles of organization must designate that "law" is the professional service to be practiced through the PLLC.<sup>12</sup> Once the conversion is effective, the successor PLLC is for all purposes the same entity that existed before the conversion. This is an "operation of law" transaction, which means that there is no need to transfer assets, assign contracts, or assume specific liability in connection with the conversion.<sup>13</sup>

In conjunction with the conversion, law firms should review their contracts (especially leases and loan documents) to determine if any consents or notifications are required. The firm has an affirma-



tive duty to notify its clients of its new status and all signs, advertisements, stationery and business cards should be changed to reflect the addition of "PLLC" to the law firm name.<sup>14</sup> A PLLC can file an assumed name and drop the "PLLC" from the name.<sup>15</sup>

PLLCs with law offices in other states generally must qualify to do business in those states, and special attention should be given to the requirements imposed. For example, PLLCs with an office in Tennessee should consider operating in that state through a disregarded single member LLC (with the Kentucky PLLC as the sole member), as the filing fee for a multiple-member PLLC can quickly reach \$3,000.<sup>16</sup>

Most law firms operating as general partnerships will have a written partnership agreement. A review of this agreement is mandatory as it may contain contractual provisions that are designed to address liability sharing among general partners and contribution obligations. Under the partnership statute general partners are jointly and severally liable for a partner's wrongful acts and breach of trust, and jointly liable for the partnership's debts and obligations.<sup>17</sup> In contrast, PLLC members are not personally liable for the PLLC's liabilities by reason of being a member, employee or agent.<sup>18</sup> Many general partnership agreements include provisions requiring contribution by partners for partnership liabilities paid by one partner on behalf of the partnership and other partners. The right to contribution and similar provisions should be modified or deleted as they create a contractual obligation to pay PLLC debts and obligations, and potentially create third-party beneficiary rights, in a statutory framework where there is otherwise an effective liability shield.

An important aspect of the conversion is that general partners remain personally liable for pre-conversion liabilities.<sup>19</sup> Drafters of a PLLC operating agreement should consider either incorporating the provisions of the existing partnership agreement which deals with a partner's rights and obligations for partnership liabilities or including a provision creating an obligation for post-conversion members to contribute towards the payment of pre-conversion liabilities if any pre-conversion member is held personally liable. Converted partnerships should also request from their insurance carrier "fall" coverage for pre-conversion liabilities. Consideration should also be given to the elimination of any provisions suggesting that members have agreed to make additional capital contributions to cover the PLLC's debts or liabilities or less than unanimous approval is required to approve additional capital contributions. Contribution or other liability sharing provisions could create a third-party beneficiary right or otherwise result in members effectively losing their liability shield if less than a unanimous vote is necessary to require additional contributions.

PLLCs do not shield members from personal liability for their own wrongful acts. As a result, drafters of a PLLC operating agreement should consider including a provision expressly requiring the PLLC to indemnify any member held personally liable for malpractice or other liability, perhaps subject to exceptions for bad faith or breach of fiduciary duty.<sup>20</sup>

Neither the LLC Act nor the common law of LLCs includes a fleshed out requirement of fiduciary duty of members. Drafters of a PLLC operating agreement should consider including an express fiduciary duty obligation of full disclosure, good faith and fair dealing.

The LLC Act provides that profits, losses and cash will be allocated and distributed among members on the basis of the agreed value of the members' contributions if there is no written operating agreement or the agreement is silent on the issue.<sup>21</sup> For this and a variety of other reasons, law firms converting to PLLCs should have a written operating agreement addressing economic, management and ownership issues in a comprehensive fashion.

PLLCs may be member or manager managed.<sup>22</sup> Because of the flexibility granted to the drafters of the PLLC's operating agreement to fashion a desired management structure, the fundamental distinction between member or manager managed PLLCs goes not to who "manages" the PLLC, but instead to whom has agency authority to act on behalf of and bind the PLLC.<sup>23</sup> If members desire each member to have agency authority to bind the PLLC, then the member-managed structure should be adopted. If only certain designated individuals should have agency authority, then the manager-man-

aged structure should be adopted. In either case, the PLLC's operating agreement should set forth the management structure. In most cases PLLCs will be member-managed and will be managed by a management committee or manager, with the members voting on management and other important issues such as admission of members and dissolution.

In Revenue Ruling 95-37, 1995-1 C.B. 130 the IRS concluded that the conversion of a general partnership into an LLC would be treated as a partnership to partnership conversion.<sup>24</sup> Accordingly, most conversions will be tax-free. In addition, the LLC will retain the tax year of the partnership and the resulting PLLC will continue to utilize the partnership's taxpayer identification number. Not all conversions of general partnerships into LLCs are completely tax-free, but gain is generally triggered by either a reduction in the sharing of liabilities or at-risk amount recapture,<sup>25</sup> neither of which would generally occur in a law firm PLLC where debt and depreciation and amortization of assets plays an insignificant role. The IRS has confirmed in private letter rulings that partnerships converting into PLLCs may continue to use the cash method of accounting.<sup>26</sup>

The retirement and fringe benefits available to general partners and PLLC members are substantially the same. The IRS has ruled that members of a PLLC, like general partners, must include in net earnings from self-employment his or her distributive share of PLLC income or loss.<sup>27</sup>

The physical conversion of a law firm general partnership into a PLLC is relatively painless from a paperwork and tax standpoint. The conversion does require careful consideration of the operation of the PLLC liability shield and other features of the PLLC form in structuring the contractual relationship among the PLLC's members. Drafting a written operating agreement that takes into account the differences between the general partnership and PLLC form is the key to a successful conversion.

#### 15.4 Multiple Services

KRS § 275.015(18) defines a professional limited liability company as a company organized under KRS Chapter 275 "for purposes that include, but are not limited to, the providing of one (1) or more professional services." The LLC Act allows for the possibility that more than one profession may be conducted through a single LLC or that professional and non-professional activities may be conducted in a single LLC.

KRS § 275.010, which acknowledges the authority of regulatory boards over persons providing professional services, is broad enough to contemplate that a regulatory board will have authority to restrict a professional LLC to the practice of a single profession or limit an LLC's activities to the providing of professional services.

The laws governing the practice of public accounting are clear that an accounting firm can practice in PLLCs, but cannot engage in activities other than public accounting. KRS § 325.220(6) provides that "Firm" means a PSC or other form of business organization engaged solely in the practice of public accountancy. KRS § 325.301(1)(a) provides that the sole purpose and business of a firm engaged in the practice of public accountancy must be that activity. A common practice in Kentucky is for members of an accounting firm to engage in their accounting practice through a PLLC or PSC whose sole business is accounting, and to engage in other business activities through separate entities, some of whose members might be individuals who are not accountants.

Rule 5.4(b) of the Rules of Professional Conduct for lawyers provides that "a lawyer shall not form a partnership with a nonlawyer if any of the activities of the partnership consist of the practice of law." In addition, Rule 5.4(d) of the Rules of Professional Conduct for lawyers provides that a lawyer may not "practice with or in the form of a professional corporation or association authorized to practice law for a profit if (1) a nonlawyer owns any interest therein. . . , or (2) a nonlawyer has the right to direct or control the professional judgment of a lawyer." These provisions should effectively prevent a nonlawyer from owning an equity interest in an entity with an attorney.

The Kentucky Rules of Professional Conduct do not include Rule 5.7 of the ABA's Model Rules of Professional Conduct. Rule 5.7 relates to the provision of ancillary services by a law firm. The commentary to the Rule indicates that a law firm is not restricted in engaging in business activities which are not ancillary (functionally connected) to the practice of law. Examples which are given include law firms owning restaurants, shops or taxi services. As matters now stand, a Kentucky law firm may engage in ancillary or unrelated business activities as long as the law firm does not have non-lawyer owners or is not otherwise controlled by a nonlawyer. Lawyers engaging in ancillary business activities should keep in mind the ethical concerns behind Rule 5.7 of the Model Rules.

The statutes, regulations and rules governing the profession or professions in question should be carefully reviewed before engaging in any activities (either professional or nonprofessional) other than the profession through a PLLC or other business form.

### 15.5 Governing Boards

KRS § 275.010 confirms that the right of professionals to practice in a PLLC does not generally alter the relationship of the professional and the board regulating the profession. This general rule is qualified in Section 2 by a provision which states that KRS Chapter 275 does not restrict, limit or expand in any manner the authority and duty of any regulating board to regulate a profession "[e]xcept for those provisions concerning the personal liability of members, managers, employees, and agents of a limited liability company." The drafters of the LLC Act made a conscious effort to eliminate the ability of regulatory boards to alter or amend the limitations on vicarious liability embodied in KRS § 275.150. Of course, this provision probably does not apply to the Supreme Court's regulation of the legal profession, as that authority is based on Section 116 of the Kentucky Constitution (*see* paragraph 15.3).

### 15.6 Name; Articles

KRS § 275.150 provides that the name of a PLLC "shall contain the words 'professional limited liability company' or 'professional limited company' or the abbreviations 'PLLC' or 'PLC'." KRS § 275.025(2) provides that the articles of organization of a PLLC must designate the professional services to be practiced through the PLLC. In other respects, the articles of organization of a PLLC do not differ from those of other LLCs.

### 15.7 Tax Issues

Most of the tax issues relating to the PLLC are the same as those of any LLC. Unless the owners check the box to be taxed as a corporation, a single member PLLC will be disregarded for tax purposes (with the owner being taxed through his Schedule C as a sole proprietor) and a multiple member PLLC will be treated as a partnership for federal tax purposes. There are several tax issues, however, which are of particular concern to professional LLCs.

Most professional practices use the cash basis of accounting. IRC §446 generally allows taxpayers to use the cash method, but IRC §448(a) prohibits "tax shelters" from using the cash method. The term "tax shelter" includes a "syndicate," which means "any partnership where more than 35% of the losses are allocable to limited partners or limited entrepreneurs." PLLC members who actively participate in the management of the business are not treated as "limited partners" or "limited entrepreneurs." IRC §1256(e)(3)(C); Treas. Reg. §1.448-1T(b)(3). The question, however, is whether PLLC members who do not actively participate in management will be treated as "limited partners" or "limited entrepreneurs."

The IRS has issued several favorable private letter rulings on the issue of accounting treatment. Private Letter Ruling (PLR) 9321047 (law PLLC) allowed for the cash method of accounting where rep-

representations were made that all of the LLC's members would participate in management. PLR 9407030 (law PLLC) went a step further by providing that a 55-partner Delaware law firm could convert into an LLC and retain the cash method, based on representations that the members all would actively participate in management, notwithstanding the delegation of many of the responsibilities of management to the firm's executive committee. Finally, in PLR 9415005 (law PLLC), the firm received a favorable ruling on the use of the cash method of accounting based on representations regarding the absence of losses. Since the term "tax shelter" is defined in the context of the allocation of losses, the absence of losses takes the LLC outside of the "tax shelter" definition, as long as the LLC continues to avoid incurring losses. While the trend is consistently favorable on the issue of accounting treatment of PLLCs, the IRS Rulings should be carefully scrutinized prior to converting to a PLLC and in connection with drafting the PLLC's operating agreement. Professionals may decide to seek a private letter ruling on the classification issue because the determination of whether there is sufficient participation in management will depend on the organization and operation of a particular practice.

Another issue facing the organizers of a professional LLC is whether the member's allocable share of the PLLC's income from the professional business will be treated as net earnings from self-employment under IRC §1402(a)(13). If the members are treated as "limited partners," then their net earnings from self-employment will only include guaranteed payments for services under IRC §707(c). A ruling request is currently before the IRS on this issue and any ruling should be carefully scrutinized in connection with the retirement planning for PLLC members. If the income is not characterized as income from self-employment, then there are no earnings on which to base a retirement contribution. The most likely result is that members' interest in a PLLC will be treated as a general partner's interest for purposes of characterizing the income as net earning from self-employment.

#### 15.8 Formation of PLLCs; Practice Conversions

Professionals practicing alone should consider a single member PLLC if they believe that liabilities or obligations that do not have their source in the professional's acts (including professional malpractice) may arise. The single member PLLC will shield the professional from those liabilities, unless the professional has contractually obligated himself (*e.g.*, guaranteed a lease or PLLC debt). Professionals forming a practice should consider the PLLC as an attractive alternative to the sole proprietorship, general partnership, RLLP or PSC.

Sole proprietorships can convert into single member PLLCs by contributing all of the practice assets and liabilities to the PLLC in exchange for the PLLC's equity. A review of the practice's contracts should be undertaken to determine if any consents or notifications are required in connection with the assignment of contracts to a separate legal entity for state law purposes.

Most professionals practicing in general partnerships should consider converting to a PLLC by taking advantage of the LLC Act's simple procedure for converting into a LLC. KRS § 275.370 allows for a conversion to LLC form without any adverse impact on the existing contracts and relationships of the practice, unless there is specific language in a contract which is triggered by a conversion. Conversions to LLC form are discussed in detail in chapter 7. The conversion of a general partnership into a PLLC can also be accomplished through a merger transaction, but this seems a poor choice given the availability of the statutory conversion. KRS § 275.345 governs mergers and is also discussed in detail in chapter 7. Professionals operating in a C or S corporation will usually incur a tax liability for converting the corporation into a PLLC, arising out of the fact that the conversion is treated as a taxable liquidation of the corporation. In many cases, the tax cost of the conversion will make the conversion unattractive, even if there is no value placed on the practice's professional goodwill.

Issues relating to the conversion of a law firm to a PLLC are discussed in paragraph 15.3. Many of these same issues would apply to the conversion of other professional practices.

## 15.9 PLLCs and the Liability Shield

We live in an era when professionals are justifiably concerned about personal liability arising out of the performance of their professional services. The negative impact of malpractice claims on the cost of health care has been widely reported. National law and accounting firms have become favored target of lawsuits by regulators and investors in the aftermath of the savings and loan collapse. In the wake of the disintegration of several large law firms in Boston, Washington, D.C. and New York, attorneys have learned what it really means to be a partner with joint and several personal liability for their firm's debts and obligations. In this increasingly hostile environment, the PLLC's ability to shield professionals from personal liability is one of its most appealing features.

The issue of personal liability was a principal focus of the drafters of KRS Chapter 275. This focus is reflected in the language of the LLC Act. Because of the justifiable importance professionals attach to shielding themselves from personal liability, the interpretation and application of the provisions dealing with liability in the LLC Act is central to the understanding and use of the LLC entity.

### 15.10 Liability Shield Statutory Framework

KRS § 275.150 provides that:

Except as otherwise specifically set forth in this chapter, no member, manager, employee, or agent of a limited liability company, including a professional limited liability company, shall be personally liable by reason of being a member, manager, employee, or agent of the limited liability company, under a judgment, decree, or order of a court, agency, or tribunal of any type, or in any other manner, in this or any other state, or on any other basis, for a debt, obligation, or liability of the limited liability company, whether arising in contract, tort, or otherwise. The status of a person as a member, manager, employee or agent of a limited liability company, including a professional limited liability company, shall not subject the person to personal liability for the acts or omissions, including any negligence, wrongful act, or actionable misconduct, of any other member, manager, agent, or employee of the limited liability company.

KRS § 275.150 states and then restates for good measure that there is no vicarious liability as a result of being a member, manager, employee or agent of an LLC. KRS § 275.150 also provides that an LLC member, manager, employee or agent is not responsible for the debts or other obligations of the LLC merely as a result of such person's status as a member, manager, employee or agent.

KRS § 275.150 of the LLC Act recognizes that a person may become obligated for the debts or obligations of an LLC, or even vicariously liable for the wrongful act or omission of a principal or employee of the LLC by a separate act of such person. For example, a member of an LLC may personally join in as a party to a lease, or agree in an operating agreement to make a capital contribution to an LLC to cover such person's share of the LLC's liabilities.

KRS § 275.155 provides that:

A member of a limited liability company shall not be a proper party to a proceeding by or against a limited liability company, solely by reason of being a member of a limited liability company, except if the object of the proceeding is to enforce a member's right against or liability to the limited liability company or as otherwise provided in an operating agreement.

KRS § 275.155 in some respects states what should be obvious. If a member of an LLC is not liable under KRS § 275.150 for the liabilities and obligations of the LLC, then there should be no reason to join the

member into an action against the LLC, unless the member is liable for some reason other than by virtue of such member's status of being a member. Nevertheless, this provision reinforces the liability limitations in KRS § 275.150 and should reduce the chance that an LLC's members are unnecessarily brought into an action against the LLC.

KRS § 275.160 provides that:

The personal liability of members, managers, employees, and agents of a limited liability company to any person or in any action or proceeding for the debts, obligations, or liabilities of a limited liability company or for the acts of (sic) [or] omissions of other members, managers, employees, or agents of a limited [liability] company shall be governed solely and exclusively by this chapter and the laws of this Commonwealth. When a conflict arises between the law of this state and laws of any other state with regard to the liability of the members of the limited liability company for the debts, obligations, and liabilities of the limited liability company, or of the acts or omissions of other members, managers, employees, or agents of the limited liability company, this Commonwealth's law shall be deemed to govern in determining the liability.

KRS § 275.160 represents an attempt by the drafters of the LLC Act to place members of a Kentucky LLC in the best position possible to argue that KRS § 275.150 and the LLC Act generally should apply in determining the personal liability of members of a Kentucky LLC who are engaging in activities in another state. The ultimate resolution of this question will involve the statutes and common law of the jurisdictions involved and the facts of the particular matter giving rise to the issue.

KRS § 275.010 provides generally that the use of the LLC form by professionals will not affect the authority of a regulating board to regulate the profession. An exception to this general rule are "provisions concerning the personal liability of members, managers, employees, and agents of a limited liability company." As discussed in paragraph 15.5, the drafters of the LLC Act desired to limit the ability of regulatory boards to alter the application of KRS § 275.150 and other related provisions of the LLC Act.

KRS §§ 275.225 and 275.230 may create personal liability under certain circumstances for an LLC member or manager who votes for a distribution from an LLC when the LLC's assets are less than the sum of its liabilities. Those members may seek and obtain contribution from other members receiving the "illegal" distributions. The personal liability of members is limited to the amount of the distributions in excess of the LLC's assets. This provision could create some problems relating to making distributions from the LLC while an action or dispute between the LLC and a third party is pending.

#### **15.11      Professional Liability Generally**

Liability in a professional practice will generally fall into one of several categories. Liability may result from the contract obligations of the practice. For example, the practice may default on a lease or in connection with an employment relationship. Another category of liability is liability for the wrongful acts and omissions of practice's professionals and its employees. Yet another category of liability is liability under various statutes, including various employment and securities laws. In each case, the initial question will be whether there is liability. If liability exists, then the next issue is to identify the persons responsible for such liability and to determine whether the entity is responsible for such liability under an agency theory. Finally, if the entity is determined to be liable, then the question is whether the owners of the entity are personally responsible for the liability.

Professionals have personal liability for their own acts or omissions, regardless of the type of entity in which they practice. A partnership agreement, corporation's organizational documents or an LLC operating agreement may provide for indemnification of the professional against liabilities arising

out of the professional's practice on behalf of the entity, but this is merely a contract obligation between the professional and the entity and does not affect the right of the injured party to seek damages against the professional committing the act which gave rise to the damages. See Smith v. Isaacs, 777 S.W.2d 912 (Ky. 1989).

A professional may be found to be responsible not only for personal acts and omissions, but also for the acts and omissions of employees and other professionals under the professional's supervision and control. This is not vicarious liability but rather is an extension of the scope of individual liability. KRS § 275.150 and comparable provisions in the Kentucky Business Corporation Act and the PSC statutes will not protect a professional if a plaintiff is successful in arguing that the professional breached a duty of supervision.

This issue was addressed when the Kentucky Supreme Court considered the interpretation and application of KRS § 274.055(1), the PSC liability statute, in Boyd v. Badenhausen, 556 S.W.2d 896 (Ky. 1977). Although Boyd involved a PSC rather than an LLC, the liability issue is applicable to LLCs if Boyd is viewed as a case involving the expansion and interpretation of the concept of a professional's liability for his or her own acts, rather than as a vicarious liability case.

Boyd involved a patient's claim against an orthopedic surgeon for damages resulting from pain and suffering caused by an unreasonable delay in operating. The patient first obtained an appointment with Dr. Badenhausen. She was actually seen by Dr. Lang, one of the employee's of Dr. Badenhausen's PSC. She was then referred by Dr. Lang to a third party for tests and was told that those results would be reported to Dr. Badenhausen. The test results were misfiled by the PSC's clerical staff. Dr. Badenhausen's defense included the argument that he should not be held personally liable for the acts of other PSC employees. Dr. Badenhausen could cite as support for his position the literal language of KRS § 274.055(1), which does not impose liability on a professional for the acts of those under his supervision. The Supreme Court posed the question raised by Dr. Badenhausen's defense:

The question is whether the veil of a professional service corporation protects its members from personal responsibility for the negligence of its corporate employees in doing or failing to do those things that are embraced in the duties owed by a physician to his patient. The answer is 'No.'

The Supreme Court included within the scope of the relationship between a professional and his client or patient, the activities of

... persons employed by a corporation to carry out for him the clerical details that are necessary to the successful performance of his duty to render skillful care and attention to whomever he accepts as a patient. . . Placing a layer of other people, by whomsoever they may be employed, between a physician and his patient does not alter the situation, because the physician's professional duties are not susceptible of being delegated or diffused.

Boyd expands the scope of a professional's liability under KRS § 274.055(1) beyond the literal reach of its language. The rule established by the Supreme Court in Boyd is that the professional who has a relationship with and/or duty to a patient/client is personally responsible and liable for damages resulting from the acts of other PSC employees, if the damage relates to or falls within the scope of the professional's duty/services to the client/patient. The Supreme Court referred to this scope as being "things that are embraced in the duties owed by the professional." Boyd left undisturbed the protection provided to a professional by KRS § 274.055(1) against personal liability for (i) the PSC's debts and obligations, and (ii) the acts of the PSC's other professionals whose acts do not fall within the scope of the professional's duties (to supervise, etc.). The problem is determining what acts fall within the scope of a professional's "duty" to his patients/clients.

The scope of a professional's liability established by Boyd would logically include support staff directly supervised by the professional (e.g., paralegals and nurses) and the LLC's other support staff

(e.g., record keeping personnel). It is difficult to imagine a scenario where an act by a non-professional PSC employee which relates to the professional services being provided to the patient/client would not fall within the scope of the professional's duties under Boyd. Almost by definition, if an act is significant enough to result in damages to the client/patient, and the act relates to the professional services being provided to the patient/client, then the act must also fall within the scope of the professional's duty.

Under Boyd, the professional providing services to a client/patient should not be personally liable for the acts of a PSC's or LLC's employees if those acts fall outside of the scope of the professional services being provided to the patient/client. For example, the professionals should not be held personally liable for a failed business transaction between the patient/client and the LLC or other LLC personnel. A physician might not be personally liable under Boyd for the acts of a nurse unless that nurse is under the physician's direct supervision. The physician may be successful in arguing that the nurse is also a professional responsible for his own acts. The problem with this argument is that in most cases the services provided by a nurse will be ancillary to those provided by the physician who has the primary relationship with and "duty" to the patient.

The liability of the professional who has the primary relationship with a patient/client might also extend to the acts of other professionals under the supervision of that professional. The theory behind this extension of liability is that in the patient/client's eyes, that professional is or should be acting in a supervisory role and has assumed responsibility for assuring the quality of the work performed by the PSC's other professionals. If more than one professional is performing services for the patient/client, then the professionals who are not acting in a supervisory capacity should be liable only for their own acts.

A professional with a significant relationship with a client/patient might be found to have personal liability for the acts of other professionals who perform work for the same client/patient, regardless of whether there was any reasonable expectation of a supervisory relationship among the professionals. The theory behind this further extension of liability would again be based on the nature of the relationship between the professional and the client/patient. The issue would be whether the client/patient could reasonably assume that the professional with whom he had a substantial relationship should be held responsible for or stands behind the work product of the LLC's other professionals. The finding of liability in this situation would depend heavily on the particular facts surrounding the nature of the professional relationship and the representations made to the patient/client. The finding of liability under these circumstances would be stretching the "duty" concept enunciated in Boyd somewhat beyond its logical scope.

Finally, if a patient/client regularly deals with various professionals within an LLC and relies on each of them separately and independently for a specific or specialized work product, then each professional working with the client/patient should not be exposed to liability for the acts of other professionals. Without this limitation on a professional's personal liability, there would be nothing left of the shield against personal liability for the acts of other personnel. This would have the effect of eliminating any protection against vicarious liability by expanding the scope of a professional's individual liability to the point where all of the acts of other personnel of the entity were within the scope of each professional's duty. This expansion would be unreasonable given the clear intention of the General Assembly to limit vicarious liability.

Vicarious liability of owners for the liabilities of their business depends on the nature of the entity. KRS Chapter 362 provides that general partners are jointly and severally liable for the wrongful acts and omissions of the partnership and jointly liable for the debts and obligations of the partnership. KRS Chapters 271B (corporations), 274 (PSCs), and 275 (LLCs) limit an owner's personal liability for the liabilities of business. In each case, a professional is not vicariously liable for the acts and omissions of the entity's other professionals and employees.



## Endnotes to Chapter 15

- <sup>1</sup> Paragraph 15.3 of this chapter is derived from an article written by James C. Seiffert, Scott W. Dolson and Thomas E. Rutledge for the Kentucky Bench and Bar Magazine.
- <sup>2</sup> SCR 3.022 and SCR 3.024 became effective during December 1999.
- <sup>3</sup> See e.g., Auditor of Public Accounts, Ky., 609 S.W.2d 682 (1980)(holding that Section 116 superseded any legislative authority to regulate the legal profession and therefore the State Auditor did not have the authority to audit the Kentucky Bar Association.
- <sup>4</sup> SCR 3.130 (5.7) entitled "Form of Practice" stated, "A lawyer may practice . . . in the form of . . . a registered limited liability partnership, a professional service corporation or a limited liability company. (See, Lawyers' Mutual Insurance Company of Kentucky, Vol. 6, Issue 4, p. 1 (Fall 1995).
- <sup>5</sup> See KRS § 275.005. "Purpose of Limited Liability Company" states ". . . a limited liability company may be organized under this chapter for any lawful purpose, including the provision of one or more professional services conducted in or outside the Commonwealth. In conjunction with the enactment of KRS Chapter 275, KRS Chapter 362 was amended to provide for registered limited liability partnerships.
- <sup>6</sup> Oregon, South Dakota and Wisconsin, by statute, and Illinois, Colorado, Delaware, Georgia, Hawaii, Indiana, Nebraska and Ohio by Supreme Court rules.
- <sup>7</sup> See In re Order Amending Rules of Civil Procedure (CR): Rules of Criminal Procedure (RCr): Rules of Supreme Court (SCR) 95-1 (September 22, 1995), p. 15.
- <sup>8</sup> The 1998 Kentucky Legal Directory listed some 250 law firms operating in limited liability entities, 30 RLLPs, 171 PSCs and 52 PLLCs.
- <sup>9</sup> See Indiana Rule of Professional Conduct 27(I). Indiana requires lawyers to apply for permission to organize in a limited liability entity with the Indiana Board of Law Examiners. Along with the application, lawyers will be required to submit certain documents for review along with a filing fee of \$200 plus \$10 for each lawyer licensed to practice in Indiana.
- <sup>10</sup> KRS § 275.370 (3)
- <sup>11</sup> KRS § 275.370 (2)
- <sup>12</sup> KRS § 275.025 (3)
- <sup>13</sup> KRS § 275.375
- <sup>14</sup> See ABA Formal Op. 303 (1961); K-y Scr. 3.130 (8.3), See also Committee on Ethics - Advisory Services, Kansas Bar Association Opinion 94-03,5 (1994)
- <sup>15</sup> KRS § 365.105 (2) (a). Some lawyers find this to be risky because a plaintiff's lawyer may argue that the injured party was operating under a reasonable assumption that the firm was a general partnership.
- <sup>16</sup> Tenn. Code Ann. §48-247-103(d)
- <sup>17</sup> KRS § 362.220
- <sup>18</sup> KRS § 275.150
- <sup>19</sup> KRS § 275.370 (5). The statute goes on to state that for a 90 day period after the conversion if a third party to a transaction with the PLLC reasonably believes when entering into the transaction that the member of the PLLC undertaking the transaction is a partner in partnership, then the member will be personally liable for an obligation incurred by the PLLC.

- <sup>20</sup> See KRS § 275.180 (2) which allows operating agreements to provide for indemnification of its members and managers.
- <sup>21</sup> KRS §§ 275.205 and 275.210
- <sup>22</sup> KRS § 275.165
- <sup>23</sup> KRS § 275.135
- <sup>24</sup> Rev. Rul. 95-37, 1995-1 C.B. 130
- <sup>25</sup> See IRC § 752 and Treasury Regulation § 1.1402(a)-2
- <sup>26</sup> See PLRs 9415005 and 9412030.
- <sup>27</sup> See Proposed Treasury Regulation § 1.1402(a)-2

## **16.1 COMMERCIAL LAW ISSUES: LOANS TO LLCs**

by

**Charles R. Keeton and John S. Egan**

This chapter focuses upon lending to LLCs and matters of particular concern to lenders and counsel to lenders. It analyzes typical lending issues and procedures as they apply to LLCs and discusses the ways that LLCs may differ from other forms of business entities.

### **16.2      Loan Structuring and Documentation**

The specific attributes of LLCs require some changes in or special attention to the structure and/or documentation of loans to LLCs.

### **16.3      Guarantees from LLC Members**

Documentation for loans to LLCs, like documentation for loans to closely-held corporations, will typically include a personal guaranty from the LLC members. This is necessary because members are shielded from personal liability for debts and obligations of the LLC absent a written contract imposing such liability upon them. *See* KRS §§ 275.150 and 155.

### **16.4      Distribution of Earnings**

Documentation for loans to LLCs will also typically include provisions prohibiting distributions of earnings to members. However, because most LLCs will be structured to be taxed as partnerships, and the individual members will be responsible for income tax on their share of LLC taxable income, the LLC will probably want to make distributions to the members to enable them to pay their taxes. Loan documentation may therefore need to allow distributions of LLC earnings to the extent that are necessary to reimburse LLC members for tax liabilities growing out of the LLC income attributed to them. Loan documentation typically prohibits other distributions.

### **16.5      Representations and Warranties**

Documentation for loans to LLCs should also include the warranties, affirmative covenants and negative covenants typically required in loan transactions involving corporations or partnerships. These would include affirmative covenants as to existence, authorization, maintenance of property, no additional borrowings, no additional liens, no sale of material assets, etc. The covenant regarding maintenance of existence is particularly important. Failure of the LLC to meet annual statutory requirements (such as filing of an annual report setting forth certain information) may result in administrative dissolution of the LLC by the Secretary of State. *See* KRS § 275.295.

In the case of an LLC that is to be taxed as a partnership, the loan documentation should include a covenant whereby the LLC agrees to refrain from taking any action in violation or contravention of the LLC Act or which would render the LLC taxable as a corporation. Taxation as a corporation could have an adverse impact upon the LLC by adding expenses, further burdening the revenues of the LLC.

### **16.6      Granting of Security Interests in Personal Property and Real Property**

Under KRS § 275.240, an LLC has the power to acquire, hold and convey property in the name of the LLC. Based on this (although not explicitly stated anywhere in the LLC Act), an LLC should have

the authority and power to grant security interests in its personal property and to enter into mortgages with respect to its real property. In the typical LLC loan transaction, the lender will probably require the manager (in the case of manager-managed LLCs) or the member to whom authority has been delegated by the authorizing resolution (in the case of member-managed LLCs) to execute the security agreement and financing statements (in the case of personal property) and the mortgage (in the case of real property) in favor of the lender. Counsel will need to verify that the person executing the security instruments in fact has the power to do so under the authorizing resolution.

#### **16.7      Perfection of Security Interests in Personal Property and Real Property**

With respect to financing statements (when Kentucky is the proper state in which to file), counsel should look to the Kentucky version of Article 9 of the U.C.C., KRS § 355.9-101 *et seq.* KRS § 355.9-401(1)(c) sets forth the property location for filing a financing statement for collateral other than farm products, consumer goods, timber, minerals or fixtures:

In all other cases, if the debtor is a resident of this state, in the office of the county clerk in the county of the debtor's residence or, if the debtor is a non-resident of this state, then in the office of the Secretary of State of the Commonwealth of Kentucky.

KRS § 355.9-401 enumerates various "safe harbors" for purposes of determining the proper county of residence for certain entities. In 1998, KRS § 355.9-401(5) was revised to provide that a "limited liability company organized under KRS Chapter 275 shall be deemed a resident of the county in which its registered office is located, as set forth in its most recent filing with the Secretary of State which officially designates its registered office." *See* KRS § 355.9-401(5)(e) (1998). Similarly, an LLC organized under the laws of a state other than Kentucky is deemed to be a resident of the county in which its registered office is located, as identified in a filing with the Secretary of State's office. *See* KRS § 355.9-401(5)(f) (1998). These changes are a significant departure from the pre-1998 statute, which had caused creditors to file UCC financing statements based upon an LLC's principal place of business. *See* KRS § 355.9-401(5)(k) (1994). The registered office test eliminates the complexity and subjectivity of filing, particularly where an LLC has a registered agent and operations are in more than one county.

Mortgages for real property should be filed in the same manner and filing offices as is customary for mortgages executed and delivered by any other borrower (*e.g.*, in each county in which the real property is located).

#### **16.8      Pledges of Ownership Interest in the LLC**

Under KRS § 275.250, a member's interest in an LLC is personal property. A member may pledge that interest in the same way that a shareholder may pledge stock in a corporation or a partner may pledge his partnership interest. A lender making a loan to an LLC member will likely want the member to execute a pledge agreement. Alternatively, a lender making a loan to an LLC could have each individual member of the LLC execute a collateral assignment of such member's LLC interest, which collateral assignment includes a grant of security interest.

In structuring a pledge of an LLC interest, lender's counsel will have to consider whether the LLC interest is a "security" or whether it is something else, such as a "general intangible." KRS § 355.8-103 states:

An interest in a partnership or limited liability company is not a security unless it is dealt in or traded on securities exchanges or in securities markets, its terms expressly provide that it is a security governed by this article, or it is an

investment company security. However, an interest in a partnership or limited liability company is a financial asset if it is held in a securities account.

In the rare instance where an LLC interest is publicly traded or is carried in a securities account with a broker dealer, such interest will be viewed as a "security" and "investment property" under KRS § 355.9-115 and perfection will be governed by the "control" concepts set forth in that section. In most instances, however, an LLC interest will not be publicly traded or carried in a securities account and will therefore have to fit within one of the other categories of personal property identified in Article 9. Because an LLC interest is not "goods, accounts, chattel paper, documents, instruments, investment property or money" it is probably therefore a "general intangible" under Article 9. ("General intangibles" means any personal property, including things in action, other than goods, accounts, chattel paper, documents, instruments, investment property and money. KRS § 355.9-106 (1998)). Perfection of a security interest in a general intangible may only be achieved by filing a financing statement with the appropriate filing office. KRS § 355.9-302. The lender will therefore want to cause a UCC-1 to be filed in such filing office and conduct a UCC search to make sure that no other lenders have a prior security interest in the general intangibles of the pledgor.

To foreclose a security interest in an LLC interest, the lender should follow the procedures set forth in KRS § 355.9-501 *et seq.*

#### 16.9 Effect of Pledge of Ownership Interests

Assignments of ownership interest in LLCs are limited under the LLC Act. Generally, to the extent permitted by the operating agreement, an assignment will only allow the assignee to receive, to the extent assigned, distributions to which the assignor would be entitled. *See* KRS § 275.255. An assignment, for instance, generally does not allow the assignee to participate in the management or affairs of the LLC or to become or exercise any rights of a member other than the rights to receive distributions. An assignee of an LLC interest can acquire these rights *only* by becoming a member, which requires the consent of the other members. *See* KRS § 275.255(1)(d) and .265(1). Consent must be unanimous unless the operating agreement provides for a lower percentage. *See* KRS § 275.265(a). This limitation on the ability of assignees to participate in the management or affairs of the LLC means that the pledgee or assignee of the LLC interest can *not* obtain a proxy to vote the interest, which is a dramatic variance from the rights that a pledgee of a share of corporate stock can obtain. Virtually all pledge agreements for pledges of shares of corporate stock include an outright or conditional proxy; many lenders take the pledge of the shares in a closely held corporation in large measure to obtain the proxy, so as to be able to control the voting rights in certain circumstances (especially after default). But the limitations of KRS §§ 275.255 and .265 deny those rights to the pledgee or assignee of an LLC interest.

Furthermore, the LLC Act permits an LLC to flatly prohibit assignment of LLC interests by agreement (*e.g.* in its operating agreement). *See* KRS § 275.255 ("Unless otherwise provided in writing in an operating agreement..."). Lenders will therefore want to review the operating agreement to make sure that no such prohibitions bar an LLC member from assigning his interest to the lender. While provisions of Article 9 might make such prohibitions ineffective against a lender (*See* KRS § 355.9-318), few lenders would wish to proceed in the face of such a prohibition.

#### 16.10 Waiver of the LLC's Right of Offset Against Distributions to Members

General and limited partnerships sometimes structure their agreements to provide that partners will receive distributions net of any monies owed back to the partnership (*i.e.*, net distributions). Lenders have typically dealt with this problem by including a covenant in the loan agreement or the agreement pledging the interest (also signed by the partnership) causing the partnership to waive its right to offset monies owing to the partnership against distributions to partners and that any distribu-

tion to which the lender, as assignee of a member's interest, may be entitled shall be the gross distribution to which the member would be entitled. Counsel for lenders will want to consider inclusion of a similar provision in the LLC loan agreement or agreement pledging the LLC interest (also signed by the LLC) because the lender, as assignee, is only entitled to receive distributions that would go to the assignor. See KRS § 275.255(1)(c).

#### **16.11      Due Diligence – General**

At the beginning of any loan transaction, lender's counsel (and borrower's counsel if an opinion is required by the lender) typically go through a process of gathering certain basic information about the borrower. This process, known as "due diligence," serves several purposes. First, the information informs the lender as to whether it is entering into a transaction with an entity that is validly existing under the laws of the state in which the entity is located. Second, the information gathered informs the lender as to whether the entity may lawfully enter into such a lending transaction. Third, the information informs the lender as to whether the entity has done whatever is required by its internal governing strictures – its bylaws, partnership agreement or other operating document – to approve the borrowing of money and, if required by the transaction, the grant of a security interest in or mortgage on assets of the entity. Fourth, the information informs the lender as to who may be authorized to execute and deliver documents on behalf of the entity. Finally, the information gathered provides the factual underpinnings for an opinion of counsel, to the extent that the lender has required either borrower's counsel or its counsel to deliver an opinion on some or all of these matters.

The due diligence process is standard operating procedure when lending to corporations, partnerships and limited partnerships. It should also be used when lending to LLCs. Due diligence, reviewed in paragraphs 16.12 through 16.17 below, is discussed from the point of view of lender's counsel, but the discussion may apply equally to borrower's counsel in certain loan transactions.

#### **16.12      Articles of Organization**

Like a corporation or limited partnership (and unlike a general partnership), an LLC is required to make an initial informational filing with the Kentucky Secretary of State. This filing document is referred to as "articles of organization." As a preliminary matter, counsel involved in an LLC loan transaction should obtain the articles of organization of the LLC and ensure that the articles comply with the requirements of the LLC Act.

The statutory requirements for the articles of organization are similar to the statutory requirements for articles of incorporation contained in KRS Chapter 271B or for certificates of limited partnership contained in KRS Chapter 362. The articles of organization must set forth the following: (i) the name of the LLC in proper form (the name must contain the words "limited liability company," "limited company," "LLC" or "LC"); (ii) the street address of the LLC's initial registered office and the name of the initial registered agent at the office; (iii) the mailing address of the initial principal office; and (iv) a statement that the LLC is to be managed by one or more managers or that the LLC is to be managed by its members. KRS § 275.025.

The informational requirement referenced in clause (ii) is relevant to counsel's inquiry into the location of the registered office for purposes of determining where to make UCC-1 filings, as discussed above.

The informational requirement referenced in clause (iv) is relevant to counsel's inquiry into matters of due authorization of the loan transaction by the LLC. As discussed in chapter 1 of this monograph, flexibility of style of management is a distinguishing characteristic of the LLC. An LLC may be managed by its members or by one or more managers. The drafters of the LLC Act thought the designation of manager governance or member governance to be sufficiently important to require such design-

nation to be a matter of public record; e.g., to be set forth in the articles of organization (notwithstanding that KRS § 275.165 provides that unless the articles of organization vest management of an LLC in a manager or managers, management of the LLC is vested in the members). The determination of which style of management has been adopted by an LLC is obviously critical to a lender's determination of whether the LLC has done that which is required to approve the borrowing of money, the grant of security interest, etc. Counsel can make this determination by reviewing the articles of organization as filed with the Secretary of State.

#### 16.13 Operating Agreement

After the articles of organization, no document is more integral to a due diligence review than the LLC's operating agreement. The operating agreement is analogous to the bylaws of a corporation, or the partnership agreement of a general or limited partnership. While the articles of organization, like articles of incorporation, will contain the bare statutory minimum of information, the operating agreement, like the bylaws of a corporation or agreement of a general or limited partnership, sets forth the rules for operating the LLC, including the rights of members to participate in the management of the LLC and to share in profits and losses of the LLC and the admission of new members to the LLC. *See* KRS § 275.165, 275.180.

The operating agreement may also provide information as to whether the LLC will be treated as a partnership for federal income tax purposes. Based upon the members' intended use of the LLC, they may choose for the LLC to be taxed as a partnership or as a corporation at both the federal and state levels. *See* 26 U.S.C. § 761 (1998); Treas. Reg. § 301.7701-3. KRS § 141.203. provides that any limited liability company which is treated as a partnership for federal income tax purposes will be treated as a partnership for Kentucky income tax purposes and any limited liability company which is treated as a corporation for federal income tax purposes will be treated as a corporation for Kentucky income tax purposes. The Treasury's new "check-the-box" rule provides that the LLC will be taxed as a partnership unless it affirmatively "checks-the-box" to be taxed as a corporation. *See* Treas. Reg. § 301.7701-3. This "check the box" test simplifies counsel's due diligence by eliminating the need for a review of the operating agreement against the four "corporate" characteristics ((i) limited liability; (ii) centralized management; (iii) continuity of life; and (iv) free transferability of membership interest) which used to be determinative of how a business entity was taxed. Now, an LLC may have all of the corporate characteristics and still reap the benefits of partnership taxation, so long as it has not "checked-the-box" and elected to become taxed as a corporation. This is one of the biggest advantages of the LLC, only realized after the check-the-box regulations revised the Internal Revenue Code in late 1996.

The LLC Act does not require operating agreements to be in writing. KRS § 275.015 defines "Operating Agreement" to include "any agreement, written or oral, among all of the members, as to the conduct of the business and affairs of a limited liability company." This raises some potential concerns for lenders and for counsel involved in LLC lending transactions. Borrower's counsel should generally obtain (and lender's counsel should require) a representation from the LLC (either in a certificate or a loan agreement) that the written operating agreement provided to the lender is the complete expression of the LLC's operating agreement.

#### 16.14 Certificate of Existence

The LLC Act provides that any person may apply to the Secretary of State to furnish a certificate of existence for an LLC or certificate of authorization for a foreign LLC. *See* KRS § 275.085. The certificate of existence must set forth the following information: (i) the LLC's name; (ii) that the LLC is duly organized under the laws of Kentucky and the date of organization or that the LLC is a foreign LLC authorized to do business in Kentucky; (iii) that all fees and penalties owed to the Secretary of State have been paid, if payment is reflected in the record of the Secretary of State and nonpayment affects the

existence or authorization of the LLC; (iv) that articles of dissolution have not been filed; and (v) that the most recent annual report required by KRS § 275.190 has been delivered to the Secretary of State. Typically a certificate of existence would be one of the documents obtained in the exercise of due diligence.

#### **16.15      Authorization by Licensing Boards**

The due diligence review should include some consideration of the extent to which the LLC is subject to any statutory or regulatory licensing requirements that could affect the entity's ability to use the LLC structure. This will come into play mainly when professionals seek to organize themselves as LLCs (or LLPs). For instance, accountants now have statutory authority to use "any other form of business organization engaged solely in the practice of public accountancy that is not otherwise prohibited from operating by the laws of this Commonwealth." KRS § 325.220. This language is understood by the accounting profession to include LLCs. Medical professionals and other professionals licensed to practice in Kentucky must determine their eligibility to use the LLC structure.

#### **16.16      Authorization to Do Business as an LLC in Other States**

The due diligence review should also include an inquiry of the LLC as to whether it is doing business in states other than Kentucky. Today, all 50 states authorize the use of the LLC form with local variations, and most states' LLC Acts prohibit a foreign LLC from transacting business without first qualifying by obtaining a Certificate of Authority (e.g., KRS 275.385). What constitutes "transacting business" is always open to debate, but an LLC with an office or payroll in a state or one that has income "sourced" in a state (requiring the filing of an income tax return) is often found to be transacting business in that state.

#### **16.17      Resolutions**

The determination of whether a business entity has duly authorized loan documents is a cornerstone of the opinion typically required of borrower's counsel in a loan transaction. Borrower's counsel should review the resolution authorizing the LLC to enter into the loan transaction for purposes of opinion giving and lender's counsel should review the resolution for purposes of due diligence. Who should adopt that resolution to approve the transaction will depend upon whether the LLC is governed by managers or by members. In either case, the resolution should be approved by all of the persons entitled to vote thereon (whether managers or members) through a vote at a meeting duly called or through a unanimous written consent, unless the articles of organization expressly allow approval by less than all of such persons, with a majority being the bare minimum required for approval.

The articles of organization will provide counsel with guidance on who will be entitled to approve a transaction such as a borrowing by the LLC. KRS § 275.135(2)(a) provides that if articles of organization provide for a manager, the power to act for the LLC resides exclusively in the manager and not in the members (solely by virtue of member status). However, KRS § 275.135(1) provides that if management authority is not delegated to managers, every member of the LLC can act for the LLC. Notwithstanding the fact that the action of a manager is effective under the LLC Act to bind the LLC in the case of a manager-managed LLC and that the act of a member is sufficient to bind the LLC in the case of a member-managed LLC, it is probably prudent lending practice to require a resolution to be adopted by the unanimous consent of members in the case of member-managed LLCs and by the unanimous consent of the manager or managers (or board of managers) in the case of a manager-managed LLC.

The resolution should also be drafted to designate a member to execute and deliver loan documents in the case of a member-managed LLC and should designate the manager or managers to execute and deliver the loan documents in the case of a manager-managed LLC.



### 16.18 Charging a Member's Interest

The LLC Act provides that a judgment creditor shall, on application to a court of competent jurisdiction, charge the member's LLC interest with payment of the unsatisfied amount of judgment with interest thereon. KRS § 275.260. The concept of "charging" an interest has long been a part of Kentucky's general partnership and limited partnership laws. *See* KRS §§ 362.285 and .481. To the extent that a lender to an LLC has already taken a security interest in the member's interest as collateral security, the lender's security interest would rank ahead of a judgment creditor's charge. Lenders' counsel may therefore give consideration to assignment of members' interests as security for loans to LLCs.

### 16.19 Events of Dissolution

Several events can trigger dissolution of an LLC. First, the articles of organization or operating agreement may provide that the LLC will dissolve upon the occurrence of certain happenings (*e.g.*, the occurrence of some date certain). *See* KRS § 275.285. Second, the members may agree to dissolve the LLC. *Id.* Third, entry of a judicial decree of dissolution or filing of a certificate of dissolution by the Secretary of State will dissolve the LLC. *Id.* In the past, the disassociation of a member would trigger the dissolution of the LLC; however, that provision was removed from the Act in 1998. An "event of disassociation" is defined in KRS § 275.280 as the withdrawal of a member under a variety of circumstances, including death, voluntary withdrawal, upon written assignment of all of a member's interest with written consent of the other members, and various events of insolvency, including the member's filing of a petition in bankruptcy. KRS § 275.280. Now, however, the death or bankruptcy of a member of an LLC does not affect the continuity of life of the LLC, unless specified in the operating agreement.

Notwithstanding this, there are still potential paths to the dissolution that lenders will want to protect themselves against. KRS § 275.295 provides that an LLC may be administratively dissolved for not complying with filing and registration requirements. Lenders' counsel will want to include in loan documents a provision that the dissolution of the LLC without reinstatement is an event of default.

### 16.20 Merger and Conversion

Loan documentation should make provision for the events of merger and conversion. The concept of merger is similar to that applicable to corporations. *See* KRS §§ 275.350 and .355. However, the concept of "conversion" is unique to LLCs. KRS § 275.370 provides that a partnership or limited partnership may convert to an LLC simply by filing articles of organization as an LLC with the Secretary of State. Such conversions must be approved by all partners (or a lesser number if the partnership agreement so provides) in the case of a general partnership and by all partners in the case of a limited partnership. Partners of former general partnerships and general partners of former limited partnerships remain liable for obligations of the general or limited partnership entered into before the conversion. *See* KRS § 275.370(5). However, former general partners will no longer be statutorily liable for obligations of the LLC that are incurred after conversion.

Prudent lenders will want to inquire as to whether a partnership has converted into an LLC before lending to a partnership. A lender who mistakenly loans to an LLC that has converted from a partnership believing the member is a partner or general partner may hold the partner liable to the extent that the loan occurs within 90 days of the conversion.

The LLC Act provisions on merger, KRS §§ 275.345 .365, until recently did not include language similar to that found in KRS § 275.370(5) for conversions. This disparate statutory treatment of mergers and conversions created ambiguity surrounding the treatment of partnerships merged with LLCs. Now, KRS § 275.365(9) clarifies partner treatment in event of a merger with an LLC by providing that a general partner will remain liable for obligations incurred before the merger by the partnership as a general partner. A limited partner will be liable as a limited partner for pre-merger obligations incurred by the

partnership. *Id.* Any partner will be liable as a member for obligations incurred by the LLC after the merger has taken effect. *Id.*

Lenders' counsel should consider incorporating covenants into loan documentation to prohibit a general or limited partnership from converting into an LLC without the lender's prior written consent. Counsel may also want to advise lenders to inquire of general partners seeking extensions of existing loans as to whether the general or limited partnership has converted to an LLC.

#### 16.21 Opinions of Counsel

The lender should require the LLC to deliver an opinion of counsel containing the usual matters found in borrower's counsel opinions in commercial transactions. From the lender's perspective, the form of opinion should encompass such matters as (i) the organization and existence of the LLC under the laws of the state of its formation; (ii) the qualification of the LLC to do business in foreign jurisdictions; (iii) requisite power and authority of the LLC to conduct its businesses; (iv) actions taken to authorize and deliver the loan documents; (v) execution and delivery of the loan documents does not violate the LLC's certificate of existence, operating agreement or material contracts, etc.; (vi) the loan documents constitute valid and binding obligations of the LLC, enforceable in accordance with their terms; (vii) the consents, waivers, etc. are necessary in connection with the LLC's execution, delivery and performance of the loan documents; (viii) the creation and perfection of security interests; and (ix) any other matters particular to the transaction. From the borrower counsel's perspective, due diligence regarding matters discussed above will be necessary in order to deliver an opinion encompassing the foregoing.

#### 16.22 Use of the LLC as a Bankruptcy-Remote Entity

A bankruptcy-remote entity ("BRE") is a "single-purpose entity which, because of its purpose and operating restrictions, is unlikely to become insolvent and whose governing body must vote unanimously to approve certain actions, including the decision to seek bankruptcy relief."<sup>1</sup> Money-center lenders have been requiring borrowers to use BREs in commercial loans, particularly in commercial real estate financing or in other areas where the borrower is highly leveraged and the possibility of a bankruptcy filing is higher than usual. The idea is to make certain actions, including filing of a voluntary bankruptcy petition, beyond the borrower's authority without the consent of someone controlled by or at least influenced by the lender. This is typically done by requiring the BRE to have formation documents that require unanimous consent of all directors, partners or members, as applicable and by having the lender appoint a director, partner or member.

An LLC may be used as a BRE, instead of a corporation or partnership. Because an LLC allows more flexibility in operation than a corporation, there may be some advantage to using the LLC structure instead of a corporation. At the same time, the LLC affords more limitation from liability than a limited partnership or general partnership. The use of any BRE, however, introduces the risk that the lender, through its possible control of the borrower, may incur liability – whether through lender liability or equitable subordination – for the borrower's actions. A discussion of such risks and the possible applications of a BRE is beyond the scope of this article.<sup>2</sup>

Endnotes to Chapter 16

<sup>1</sup> Gregory A. Tselikis, "Bankruptcy-Proofing" Your Commercial Transaction: Reality or Myth?, 13 ME. B.J. 234, 234 (1998).

<sup>2</sup> See The Committee on Bankruptcy and Corporate Reorganization of The Association of the Bar of the City of New York, *Structured Financing Techniques*, 50 BUS. LAW. 527, 532 (1995); Sheryl A. Gussett, *Bankruptcy Remote Entities in Structured Financings*, AM. BANKR. J. March 15, 1996 at 14, 14; Frederick Z. Lodge, Robert E. Michael and Christopher Dewees, *Bankruptcy Remote Structures in Mortgage Loans*, 10 PROB. & PROP. 49, 49 (1996).



## 17.1 RETIREMENT AND FRINGE BENEFIT PLANNING

by  
Debbie F. Reiss  
Glenn D. Gunnels\*

Advisors to LLCs should be familiar with the availability and features of (i) tax-qualified retirement plans, (ii) nonqualified plans, and (iii) welfare (fringe) benefit plans, as they relate to entities taxed as a partnership for federal income tax purposes.

### 17.2 Qualified Retirement Plans

The LLC's principals should strongly consider the advantages of using a qualified retirement plan as a tax shelter and retirement planning vehicle. Qualified retirement plans receive highly favorable tax treatment under the Internal Revenue Code. The LLC's contributions are deductible when made, yet owner/employees are not taxed until they receive a distribution from the plan. IRC §§ 402 and 404. The investment earnings on plan assets (held in a trust) are permitted to accumulate tax-free until distributed to the employees or their beneficiaries. This combination of the deductibility of contributions by the LLC, tax-free investment of plan assets, and deferral of income by the employee represents one of the most favorable packages of tax benefits available under the Internal Revenue Code.

Qualified retirement plans must comply, however, with a complex set of rules under both the Internal Revenue Code and the Employee Retirement Income Security Act of 1974 ("ERISA"). These requirements are designed to protect the participants' rights, to ensure that the plan does not discriminate in favor of highly compensated employees, and to limit tax-favored benefits available to participants.

A qualified retirement plan is a plan that meets the numerous requirements of IRC § 401(a). A plan that does not meet these requirements may lose the favorable tax benefits accorded qualified plans. Satisfying on an ongoing basis all of the requirements of IRC § 401(a) is a complex science; the consequences of failing to satisfy those requirements at any time during the life of the plan may be significant. The favorable tax benefits almost always, however, outweigh the cost and effort required to maintain a qualified plan. Partnerships and S corporations are for the most part governed by the same rules<sup>1</sup> regarding qualified plans as C corporations, although plans maintained by these types of entities are often called Keogh or HR 10 plans (named for the bill that gave partnership and S corporation plans substantial parity with those of C corporations).

There are two basic types of qualified plans, "defined benefit plans" and "defined contribution plans."

### 17.3 Defined Benefit Plans

A defined benefit plan is a plan in which the LLC promises employees a specific dollar benefit and the LLC is responsible for funding the plan to make sure its assets are sufficient to meet the promised benefits. With this type of plan, investment gains or losses benefit (or burden) the LLC as they, in addition to the LLC's contributions, are used to meet the LLC's obligation to provide a fixed retirement income. Conversely, investment risks in a defined contribution plan are borne by the participants.

The defined benefit is usually expressed as a formula based on age, compensation and/or service that computes the employee's benefit in terms of monthly payments for life beginning at a retire-

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ment age. The most common type of defined benefit plan bases each participant's benefit on his average annual salary over his last three to five years of employment. The benefit formula usually provides that participants will receive a monthly benefit for life at normal retirement age of a specified percentage of that annual salary, such as 1.5 percent of average annual salary for each year of service. Under this type of formula, a participant's benefit will increase each year as his years of service and salary increase. There are many variations of the above type of formula, but all defined benefit plans have a formula which definitely determines the participant's benefit.

A participant's benefits are funded by the LLC's contributions to a trust qualified under IRC § 401(a). The Employee Retirement Income Security Act ("ERISA") and the Internal Revenue Code contain complex funding requirements for defined benefit plans that require the LLC to employ an actuary to determine funding obligations. For this reason, a defined benefit plan is generally more expensive to maintain than a defined contribution plan. For a group of employees who did not begin saving for retirement at an early age, a defined benefit plan may be the best design choice because it often allows for higher contributions each year than a defined contribution plan.

#### **17.4      Defined Contribution Plans**

Under a defined contribution plan, employees are only entitled to the amount allocated each year to their individual accounts under the plan, participant contributions (if allowed), and investment returns. IRC § 414(j). The defined contribution plans discussed in paragraphs 17.5 through 17.9 below will be commonly used by LLCs.

#### **17.5      Profit Sharing Plans**

Profit sharing plans are plans in which the amount of the LLC's contributions are discretionary. The LLC determines each year the amount it will contribute to the plan. The amount a LLC may contribute to the plan each year is not limited by the amount of the LLC's profits. IRC § 401(a)(27)(A). Profit sharing plans are the simplest and most flexible of all qualified plans to maintain and therefore are among the most popular types of plans. One disadvantage of a profit sharing plan is the deduction limit imposed by IRC § 404, which provides that only 15 percent of aggregate participants' payroll may be deducted for contributions to a profit sharing plan. In an entity taxed as a partnership (or LLC), this limit is calculated based on "net earnings subject to self employment tax, less one half of the self employment tax, a figure that is determined after the contribution is deducted, IRC § 401(c)(2); therefore the deduction is closer to 12 percent to 13 percent of gross earnings, versus the full 15 percent that would be allowed with respect to the wages of a C corporation owner/employee.

A profit sharing plan alone will allow the maximum contribution of \$30,000 to be made each year for all employees only if each employee in the LLC has earned income of more than \$170,000 (as of January 1, 2000; indexed each year by the IRS); otherwise the 15 percent of payroll limitation will prevent some of the LLC's employees from receiving the maximum contribution. For this reason, profit sharing plans are often adopted along with a money purchase pension plan (*see* paragraph 17.6 below).

#### **17.6      Money Purchase Plans**

Money purchase plans are plans under which a LLC is required, under the terms of the plan, to contribute a specified amount or percentage of employees' pay each year. The LLC may contribute and deduct up to 25 percent of a participant's payroll<sup>2</sup> in this type of plan (subject to individual contribution limits). Money purchase plans are often used in combination with profit sharing plans to ensure that all of the LLC's higher-earning employees are able to make the maximum \$30,000 annual contribution to qualified retirement plans.

**17.7      401(k) Plans**

IRC § 401(k) plans are plans under which an employee may elect to defer part of his salary and have the deferral contributed to the plan by the LLC. These contributions to a qualified plan are on a pre-income tax basis. An employee, therefore, does not pay income taxes on the amount of pay he contributes to the plan until those contributions are distributed to him. The Internal Revenue Code places limits on the amount an employee may electively contribute to qualified plans each year (\$10,500 in 2000; indexed each year by the IRS). The amount highly compensated employees may contribute is further limited by discrimination tests designed to ensure that the plan does not discriminate in favor of highly compensated employees.

A common feature of a 401(k) plan is employer matching of employee contributions. An employer will typically match a specified percentage of employee contributions, such as 50 percent of the amount each employee contributes up to three percent of each employee's pay. Prior to January 1, 1998, the IRS treated matching contributions by an LLC taxed as a partnership as elective contributions of the self employed person to whom they were allocated, thus counting against the annual elective contribution maximum limit of that individual. As such, matching contributions were not advisable for an LLC. However, the law has subsequently been changed and matching contributions are no longer treated as elective contributions unless the LLC elects to have them treated as such to satisfy certain discrimination tests. IRC § 402(g)(9).

Including a 401(k) feature in the LLC's defined contribution plan will significantly increase the cost of administration because of the additional discrimination tests. In addition, because the amount that highly compensated employees may contribute is limited by a function of the average amount other employees contribute (including clerical staff), a 401(k) plan often is not attractive for the LLC's highly paid employees.

**17.8      Target Benefit Plans**

A target benefit plan is a plan which contains the same type of formula a defined benefit plan would contain, but rather than promising that the employee will receive the amount computed under the formula, the LLC merely promises to fund the amount necessary to pay that benefit in the future, with certain interest and mortality assumptions, and no guarantee is made that the amount contributed will be sufficient to pay the target benefit.

**17.9      Thrift and Tax Savings Plans**

Profit sharing plans which allow employees to make pre- or after-tax contributions are commonly called thrift or savings plans. Although employees are subject to income tax on after-tax employee contributions on a current basis (unlike contributions to a 401(k) plan), earnings on those contributions will accumulate tax-free until distributed. Employers also may make discretionary contributions to these plans, and may match employee contributions. Plans that permit after-tax employee contributions are losing popularity because this type of contribution is now subject to discrimination tests similar to those for 401(k) plans. IRC § 401(m).

**17.10     Qualification and Administration of Plans**

LLCs establishing a retirement plan must satisfy a variety of requirements set forth in the Internal Revenue Code and ERISA in order for those plans to be qualified plans. The most significant requirement is the prohibition on plans discriminating in favor of highly compensated employees regarding benefits and contributions. IRC §§ 401(a)(4) and (5). There are specific requirements as to when

employees must be allowed to participate, a requirement that a minimum number participate, and vesting schedules that cannot be exceeded. LLCs establishing qualified plans must satisfy certain ERISA reporting and disclosure obligations. LLCs considering adopting qualified plans should make sure that they have qualified advisors to guide them through the compliance mine field created by the Internal Revenue Code and ERISA.

#### **17.11      Nonqualified Plans**

Nonqualified retirement or deferred compensation plans are normally designed to defer the recognition of income by employees. The LLC owners are not allowed a deduction until the income is recognizable by the employee. IRC § 404(a)(5). Because the income of an LLC is passed through to its owners, a nonqualified plan is generally not an appropriate vehicle for another LLC owner, as it would only serve to temporarily shift income from one owner to the others (assuming substantial economic effect of the allocation).

Under IRC § 736, payments to a retired partner are not distributed to the active partners but are treated as the retired partner's distributive share, basically allowing the active partners a deduction, and causing the income to be included by the retiree, except to the extent of payments that are deemed to be for the retiree's interest in the partnership's "property." Under the 1993 Tax Act, goodwill and unrealized receivables (*i.e.* work in progress in a service business) must be considered interests in property (therefore not deductible, even though a distribution of property in excess of the retired partner's basis will mean he has to pay taxes).

The Tax Act's rules *do not* apply to a typical service business partnership, but the exception is not so broad to clearly apply to an LLC. While providing any deferred compensation in an entity with pass-through taxation is problematic, this complicates things even more if the entity is an LLC.

#### **17.12      Retirement Plans: Advantages of the Corporate Form and Unanswered LLC Questions**

The principal benefit of the corporate form in the area of qualified plan benefits used to be that the ceiling on contributions of a self employed individual was substantially lower than that of an employee participating in a corporate plan. Substantial (but not complete) parity was granted in 1982.

However, because of the prior, better treatment of corporations, some service industries developed the technique for using partnerships of corporations. This structure permits the incorporated partners to take advantage of the substantial benefits of a qualified plan, while at the same time bypassing the practical problems associated with attempting to incorporate a large firm. Multiple entities often had multiple qualified plans designed to meet the differing needs of the owner/employees. Most of the tax advantages of these multiple entities were reduced over the years, however, and the Tax Reform Act of 1986 ("1986 Tax Act") essentially eliminated the opportunity to form multiple plans to cover employees of several corporations working in partnerships or other related groups. Entities with individuals working together, regardless of the nature of the corporate or partnership umbrella used for ownership, must with few exceptions have the same qualified retirement plan, or no plan at all.

The Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA") made changes in the Internal Revenue Code that greatly reduced the corporation's significance from a tax standpoint. TEFRA adopted a series of amendments to the Internal Revenue Code that produced substantial parity between the qualified plan benefits that may be enjoyed by corporate employees and self employed individuals. TEFRA reduced maximum contribution limits for corporate plans and increased the limits for plans of unincorporated entities (*i.e.*, HR 10 or Keogh plans).



Although TEFRA and the successive tax acts since 1982 have sought to achieve parity between the qualified plan benefits that may be enjoyed by employees versus self employed individuals, differences remain which favor slightly the corporate employees. They are discussed below.

Corporations may adopt a defined benefit pension plan which requires a plan contribution on behalf of a professional employee which is greater than the employee's direct compensation. A self employed person cannot deduct an amount contributed to a defined benefit pension plan which is more than the person's "earned income." IRC §§ 401(c)(2) and 404(a)(8)(C).

IRC § 4975(f)(6) and ERISA § 408(d) treat qualified plan loans to self employed "owner-employees," (IRC § 401(c)(3)), and "shareholder-employees," (IRC § 1379(d)) as "prohibited transactions" under ERISA, and such a loan will disqualify the plan. IRC § 401(a)(13). A more than 5 percent S corporation shareholder or a more than 10 percent partner are treated as shareholder-employees and owner-employees, respectively, therefore subjecting both to the prohibition on loans. While you may want to be cautious and assume that these prohibitions apply to an LLC owner, the strictly-read definitions in ERISA and the IRC apply only to someone who, "in the case of a partnership, is a partner who owns more than 10%...."

Incorporated business owners can terminate employment and obtain lump sum distribution tax treatment (income averaging), while a partner or self employed individual must attain age 59-1/2 to qualify for this treatment. IRC § 402(e)(4)(D).

Contributions to a qualified retirement plan made on behalf of a self employed individual cannot be used to create or increase a net operating loss. IRC § 172(d)(4)(D) and Treas. Reg. § 1.172-3(a)(3)(iv).

A general partner's distributive share of income, gains and losses from the partnership (reflected on the K-1) is subject to self employment tax under IRC § 1402, but a *limited partner's* distributive share is not, unless it is a "guaranteed" payment. IRC § 1402(a)(13). This raises the question of whether an LLC owner (who by definition has limited liability) will be treated as a limited or a general partner for purposes of the net income from self employment needed to support any deduction for qualified retirement plan contributions. See paragraph 17.5 above regarding the normal deduction limits. The IRS has considered this question in several Private Letter Rulings. PLRs 9432018, 9452024, and 9525058. Generally, the IRS does not find the limitation of liability for an LLC under state law dispositive and instead appears to consider the level of the person's involvement with the business. However, this issue remains relatively unclear.

A self employed person does not get a basis to the extent of the P.S. 58 cost included in his income for life insurance purchased with qualified plan assets. IRC § 72(m)(2); Treas. Reg. § 1.72-16(b).

### **17.13      Welfare (Fringe Benefit) Plans**

The LLC's principals must be familiar with the tax treatment of fringe benefits plans in order to structure the benefit package for their employee-owners and their other employees, who often outnumber the LLC's owners and often account for a substantial share of the LLC's expenses. Paragraphs 17.14 through 17.18 below discuss the fringe benefit plans which are most commonly used.

### **17.14      Health and Accident Insurance**

Corporations may deduct payments of health and accident insurance premiums under IRC § 162(a), subject to the limitation that such payments must constitute reasonable compensation. This favorable treatment contrasts with the plight of the self employed individual who is limited to deducting in a tax year the amount by which his unreimbursed medical payments exceed 7.5 percent of his adjusted gross income for the year. IRC § 213. The 1986 Tax Act added IRC § 162(l) (which section's effectiveness was extended by the 1993 Tax Act), which allowed a self employed individual to deduct 25

percent of his health and accident insurance premiums in certain circumstances. Subsequent legislation has increased the percentage to 60 percent for the years 1999 through 2001, 70 percent for 2002, and 100 percent for 2003 onward.

Under IRC § 1372, two percent shareholders of S corporations are treated as partners with respect to employee fringe benefits. This means that the deductibility of health and accident insurance premiums for two percent S corporation shareholders is limited to the IRC § 213 deduction (and the IRC § 162(l) deduction) available to individuals.

IRC § 106 provides that an employee's gross income does not include the value of coverage under an employer's accident and health plan. Payments from an employer's accident and health plan to health care providers or to an employee to reimburse him for expenses incurred for medical care (as defined in IRC § 213) for the employee, his spouse and dependents are not included in the employee's gross income. IRC § 105(b).

Payments made to certain employees from self-insured health and medical reimbursement plans are taxable to employees, unless the plan satisfies the nondiscrimination tests set forth at IRC § 105(h), which are designed to ensure that the plan does not discriminate in favor of highly compensated individuals as to eligibility to participate or benefits received. The Internal Revenue Code does not allow a self employed person, partner or two percent or more S corporation shareholder to receive reimbursement of health costs directly from the partnership or LLC tax free, which means that owners of LLC's should avoid self-insured health benefit programs.

#### **17.15      Life Insurance**

The cost of group term life insurance for non-owner employees is fully deductible by the LLC under IRC § 162(a). Employees are not taxed on group term life insurance to the extent that coverage does not exceed \$50,000. IRC § 79. Group term life insurance coverage may not discriminate in favor of key employees with regard to eligibility to participate or the type or amount of insurance provided. IRC § 79(d)(2). If the discrimination tests are failed, then the greater of the actual cost of the first \$50,000 of insurance or the Treas. Reg. § 1.79-3(d)(2) Table I rate must be included in the taxable income of key employees.

Group term life insurance, even below \$50,000, is not deductible or excludable from income by a self employed person, including an LLC owner.

#### **17.16      Disability Insurance**

The LLC's payments of disability insurance premiums for non-owner employees are deductible under IRC § 162(a). As long as the requirements of Revenue Ruling 58-90, 1958-1 C.B. 88, are met, there are no discrimination rules applicable to disability plans, and employees are not taxed on the cost of disability insurance provided by an employer. IRC § 106. Wage continuation payments made to an employee by an employer or by an insurance policy paid for by the employer are included in the non-owner employee's gross income. IRC § 105(a). If an employee purchases disability insurance with his after-tax dollars, then wage continuation payments are not taxable when received. If an employee purchases disability insurance on a pre-tax basis through a cafeteria plan, however, wage continuation payments will be taxable when received.

The Internal Revenue Code does not allow a self employed person (like an LLC owner), partner or two percent or more S corporation shareholder to deduct the cost of disability insurance premiums. Subject to the rules of IRC § 104, disability payments are received tax free by persons falling within these categories.

**17.17      Cafeteria Plans**

A cafeteria plan is a plan under IRC § 125 in which participants may choose from among two or more benefits consisting of cash and certain "qualified benefits." These qualified benefits are fringe benefits such as health, life and disability insurance, dependent care coverage or medical expense reimbursement, which can be purchased through the plan using pre-tax dollars. Benefits under a cafeteria plan are not subject to FICA or income tax and, as a result, cafeteria plans often result in substantial savings to a corporation or LLC and its non-owner employees.

Self employed persons (including LLC owners and two percent or more S corporation shareholders) are not eligible to participate in IRC § 125 plans (Proposed Treas. Reg. § 1.125-1 Q&A 4), but are eligible for a dependent care plan under IRC § 129.

A cafeteria plan must comply with technical rules included in IRC § 125 that limit the benefit choices available under the plan, prohibit discrimination in favor of highly compensated and key employees and govern how and when employees may elect benefits under the plan. If a cafeteria plan does not comply with these rules, then the benefit over which the employee has an election, or the cash that he would receive if he did not purchase that benefit, will be deemed to have been "constructively" received during the plan year by the employee. The benefits will then be taxed to the employee despite the fact that the benefit, had he received it without any choices, would not have been taxable.

Cafeteria plans may be structured as premium-only plans where employees simply pay for their share of health, life or disability insurance premiums on a pre-tax basis. Some cafeteria plans utilize more complicated accounts which cover reimbursement of uninsured medical expenses during a year, up to a maximum amount set aside, and provide an employee cash credit to be used to purchase benefits from the plan's menu. IRC § 125.

**17.18      Dependent Care Assistance Plan**

Under a dependent care assistance plan, employees and partners or LLC owners can exclude from their income amounts paid or incurred by the employer for dependent care assistance, and the employer still receives a deduction for the cost of the assistance. IRC § 129. The maximum which an employee can exclude from income is \$5,000 per year (lower if married, filing separate returns). IRC § 129(a)(2).

Dependent care assistance plans must be in writing and must not discriminate in favor of highly compensated employees. IRC § 129(d). No more than 25 percent of the benefits paid during the year may be provided to shareholders or owners (or their spouses or dependents), each of whom own more than five percent of the LLC's interests. IRC § 129(d)(4). There are additional restrictions relating to the allocation of benefits among highly and non-highly compensated employees which must be satisfied.

**17.19      COBRA Continuation Coverage**

The Consolidated Omnibus Budget Reconciliation Act of 1986 ("COBRA") requires group health plans maintained by employers employing 20 or more employees to offer all covered employees and their qualified beneficiaries the opportunity to elect to continue their coverage for a statutorily prescribed period under the plan (at the employee's expense) if their coverage would otherwise end because of certain events such as death, termination of employment, reduction of hours, divorce or legal separation, medicare coverage, loss of dependent status for a child or bankruptcy. IRC § 4980B. COBRA has detailed notice requirements that generally are triggered when an employee becomes covered by a group health plan and upon the occurrence of a qualifying event.



**Endnotes to Chapter 17**

1. See paragraph 17.12 for the remaining differences between qualified plans for C corporations and an LLC correctly formed to be taxed as a partnership.
2. Subject to the same restrictions discussed at paragraph 17.5 above for entities taxed as partnerships (including most LLCs).



## **18.1 REGISTERED LIMITED LIABILITY PARTNERSHIPS**

**by  
William G. Strench**

The "registered limited liability partnership" ("LLP") is merely a new form of an existing type of entity, the general partnership. The LLP form was created by various amendments to the Kentucky Uniform Partnership Act ("KUPA") in 1994. These amendments permit a general partnership to elect LLP status and thereby limit the joint and several liability of its general partners under certain circumstances. Other than the limitation on liability provisions and the filing requirements, LLPs are governed in all respects by the same statutory and common law provisions applicable to general partnerships. KRS § 362.175(1).

### **18.2 Historical Background**

The first LLP legislation was enacted in Texas in 1991. Subsequent LLP legislation was adopted in Louisiana in 1992 and in Delaware, the District of Columbia and North Carolina in 1993. In addition to the Kentucky LLP legislation, LLP legislation was adopted in numerous other states during 1994. The purpose of these enactments was to provide a mechanism to limit the traditional joint and several liability of one partner in a partnership for the wrongful acts and omissions of others. Although the adoption of LLC statutes provided a mechanism for a business to operate in unincorporated form without exposing its members to the liabilities of the entity, it was thought that for a variety of reasons, many businesses would be unable to operate as an LLC or would be unable to convert to an LLC.

### **18.3 Liability Protection Afforded by LLP Status**

Until the LLP legislation was enacted, partners of every general partnership were jointly liable for all debts and obligations of the partnership. Former KRS § 362.220(2). Under KRS § 362.210 and KRS § 362.220(1) prior to amendment, partners were jointly and severally liable for losses or injuries suffered by third parties if the loss or injury resulted from the wrongful act or omission of a partner acting in the ordinary course of the business of the partnership or with the authority of the other partners. Partners were also jointly and severally liable for losses incurred by third parties that resulted from the misapplication of money or property received by any partner acting within the scope of his apparent authority. Former KRS § 362.215. Furthermore, under former KRS § 362.235, each partner of a general partnership was required to make contributions to the partnership representing his proportionate share of the losses sustained by the partnership including losses reasonably incurred by any partner in the ordinary and proper conduct of the partnership's business.

Under the amended KUPA, a partner in an LLP is not liable, directly or indirectly, for the debts, obligations and liabilities of the partnership arising out of the negligence, wrongful acts, or misconduct committed by another partner or by an employee, agent or representative of the partnership. Unlike the LLP provisions adopted in other jurisdictions, KRS § 362.220(2) specifically includes negligence claims arising under contract law theories (*e.g.*, the assertion of a breach of an implied warranty in a contract), as a liability that is limited. A non-negligent partner of an LLP is also not subject to the general KUPA indemnification and contribution obligations for partnership obligations paid by other partners. KRS § 362.235.

### **18.4 Liabilities Not Eliminated**

The amendments to KUPA do not limit any liabilities of the LLP itself. Thus, the assets of an LLP continue to be at risk for the actions of any partner. Liabilities of a partner for his own negligence, wrongful acts or misconduct are specifically excluded from the limitation on liability provision. KRS §

362.220(3). It is likely that the negligent supervision of those under a partner's control would be subject to this exclusion. Liabilities which arise prior to the election of the partnership to be treated as an LLP are not limited. KRS § 362.220(2). Contractual liabilities, other than contractual claims which are in essence negligence claims (e.g., breach of an implied warranty), are also unaffected by the KUPA amendments. Thus, partners of an LLP would be liable for partnership obligations under leases, bank financings and trade credits absent a non-recourse or release arrangement.

#### **18.5        Name of the LLP**

The name of the LLP must contain the words "Registered Limited Liability Partnership" or the abbreviation "LLP" as the last words or letters of its name. The name must not be the same as, and must be distinguished from, the names of all other entities organized, reserved or registered in Kentucky. KRS § 362.565.

#### **18.6        Formation of an LLP**

Only partnerships formed under the KUPA may become LLPs. Thus, to elect LLP status a business must be "an association of two (2) or more persons to carry on as co-owners a business for profit." KRS § 362.175. To elect LLP status, a partnership must file, pursuant to KRS § 362.555(1), a "statement" with the Secretary of State containing the following information:

- (a)     name of the partnership;
- (b)     address of the principal office;
- (c)     the number of partners;
- (d)     the names of the partners; and
- (e)     a brief statement of the business in which the partnership engages.

Although the statutory language is not clear, it would appear that the requirement to provide a "brief statement of the business in which the partnership engages" is not intended to limit the ability of the LLP to engage in other types of business. The statement must be executed by a majority in interest of the partners or by one or more partners authorized to execute the statement. KRS § 362.555(2).

Registration is effective for one year. During the 60-day period prior to expiration of the one year period, a "renewal statement" must be filed to continue the partnership's LLP status. Registration pursuant to a renewal statement will expire one year after the registration would have expired if the last renewal had not occurred. A renewal statement requires the same type of information as the original statement. KRS § 362.555(5). If the LLP fails to renew, the protection from liability under KRS § 362.220(2) is not available in a proceeding by any person who did business with the partnership during the period it failed to qualify if the person did not at the time have actual knowledge that the partnership was an LLP.

Status as an LLP is not affected by changes of information in the statement or renewal statement. Therefore, it is only necessary to update the information in any statement or renewal statement once a year in connection with the LLP's annual renewal. KRS § 362.555(6). However, since withdrawals of existing partners and admissions of new partners results in the formation of a new partnership, arguably a new filing must be made upon any change in the composition of the LLP's partners.

A filing fee of \$200.00 must accompany each statement or renewal filed with the Secretary of State. Unlike the LLP legislation adopted in some jurisdictions (e.g., Texas and Delaware), no insurance or financial responsibility conditions must be met to qualify as a Kentucky LLP.



**18.7      Foreign LLPs**

Before transacting business in Kentucky, LLPs formed under the laws of other jurisdictions must register and renew annually with the Secretary of State in the same manner as domestic LLPs. KRS § 362.585.

**18.8      Conclusion**

Although the LLP form offers partners a greater degree of protection than the general partnership form, partners of an LLP still have significantly fewer protections against liability than members of an LLC. Therefore, it will generally be more advantageous for a business to be organized as an LLC rather than an LLP absent tax considerations, practical difficulties in converting from partnership to LLC form, or the inappropriateness of an LLC form for certain professional businesses.



## **SUMMARY AND COMPARATIVE CHARTS**

## Comparison Chart of Kentucky LLCs and Other Business Entities

	Limited Liability Company	Limited Partnership	S Corporation
<b>Limited Liability</b>	Members enjoy limited liability.	Limited partners generally enjoy limited liability; general partner maintains personal liability.	Shareholders enjoy limited liability.
<b>Participation in Management</b>	No restrictions. Members or Managers can manage. Member or Managers can delegate management.	Participation by general partners only: if limited partners participate in management, they lose limited liability.	No restrictions. Shareholders can serve as directors; directors can delegate management.
<b>Transferability of Ownership Interests</b>	Restrictions are imposed by LLC statute, as modified by operating agreement.	Restrictions may be imposed by the partnership agreement.	Restrictions are imposed by statute and may be imposed by a shareholders' agreement.
<b>Continuity of Life</b>	Yes.	Yes.	Yes.
<b>Certainty of Tax Status</b>	Yes, if sole member taxes as "disregarded entity"; if two or more members taxes as partnership unless elect out.	Partnership tax treatment guaranteed unless elect corporation status.	Yes, if election properly filed. However, any shareholder may cause loss of tax status.
<b>Qualification</b>	No restrictions. Can now have single member or multiple member LLCs.	A limited partnership needs a general partner and one or more limited partners.	There are various eligibility requirements, including a restriction on the number and type of shareholders and on the ownership of subsidiaries.
<b>Number of Owners</b>	One or more.	At least 2.	1 to 75.
<b>Types of Owner</b>	Any.	Any.	Ownership limited to U.S. residents and citizens, nonprofit corporations and certain domestic trusts.
<b>Classes of Ownership Interests</b>	One or more classes are permitted.	One or more classes are permitted.	One. However, there can be differences in voting rights.
<b>Ability to Do Business in Other States</b>	Yes.	Yes.	Yes.

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## Comparison Chart of Kentucky LLCs and Other Business Entities

	Limited Liability Company	Limited Partnership	S Corporation
Levels of Income Tax	Member level only.	Partner level only.	Shareholder level only unless election is made when corporation holds appreciated assets.
Special Allocations of Income and Loss	Yes.	Yes.	No.
Deductibility of Losses	Members may deduct their allocable share of the LLC's losses only to the extent of their tax basis in their LLC interest, which includes their allocable share of LLC debt (recourse and nonrecourse).	Partners may deduct their allocable share of the partnership's losses only to the extent of their tax basis in their partnership interest, which includes their allocable share of partnership debt (recourse and nonrecourse.)	Shareholders may deduct their allocable share of the S corporation's losses only to the extent of their tax basis in their S corporation shares, which does <b>not</b> include corporate level debt.
At-Risk Limitations	Applicable to members.	Applicable to partners.	N/A.
Fiscal Year	Generally follows fiscal year of majority owner.	Generally follows fiscal year of majority partner.	Generally calendar, unless valid purpose for fiscal year.
Cash Distributions	Nontaxable to the extent of a member's tax basis in his LLC interest.	Nontaxable to the extent of a partner's tax basis in his partnership interest.	Generally nontaxable to the extent of the shareholder's tax basis in his stock.
Liquidating Distributions	Nontaxable to the extent of a member's tax basis in his LLC interest; generally appreciated assets distributed tax-free.	Nontaxable to the extent of a partner's tax basis in his partnership interest; generally appreciated assets distributed tax-free.	Generally nontaxable at corporation level and taxable at shareholder level as a result of flow-through of corporate tax items; appreciated assets treated as taxable at corporate level.

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## Summary of Some Key Aspects of Kentucky Limited Liability Companies

Issue	Treatment Under Kentucky LLC Act	Comments
Powers	An LLC can engage in any lawful purpose, has a broad range of express powers and can do "all things necessary and convenient" to carry out its business.	LLC Act's provisions are comparable to the Kentucky Revised Model Business Corporation Act.
Restrictions on Owners	Any person or form of entity may be a member (owner) of an LLC; an LLC can now have one owner.	No restrictions on owners comparable to S corporations (which cannot have more than 75 shareholders or any corporation, partnership or non-U.S. shareholders.)
Name	Name must include words "limited liability company" or "limited company" or abbreviations "LC" or "LLC". An LLC providing professional services must include "PLC" or "PLLC".	New name will be required for any existing business converting to LLC form. An LLC may now file an assumed name like other businesses under KRS 365.015.
Use of Professionals	An LLC may provide "professional services."	Offers professionals protection against "vicarious liability"; professionals are, however, liable for their own negligence. Look to specific professionals regulatory body to see if it is acceptable.
Organizational Documents	Articles of organization must be filed with Kentucky Secretary of State. Operating agreement may be written or oral, but is not filed publicly.	Operating agreement should be in written form. Both single member LLCs and multiple member LLCs should have written operating agreements.
Management Structure	An LLC is managed by members unless articles of organization provide for a manager or managers to manage the LLC.	Substantial flexibility exists in structuring an LLC's management.
Limited Liability	Members of an LLC are not personally liable for the LLC's liabilities.	Comparable to the treatment of shareholders in a corporation.
Restrictions on Transfer of Interests	Interests may not be transferred without consent of all members; however, economic rights may be transferred.	Can be varied by operating agreement (e.g., changed to consent by majority interest.)
Federal and Kentucky Tax Treatment	An LLC will be classified as a partnership or "disregarded entity" depending on the number of members unless LLC elects to be treated as corporation.	Check the Box Regulations did away with partnership classification rules. Kentucky LLC Act amended to take this into account.

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## TABLE OF AUTHORITIES





## TABLE OF AUTHORITIES

### CONSTITUTIONAL PROVISIONS

Ky. Const. § 116 .....	13, 16
Ky. Const. § 193 .....	109
Ky. Const. § 208 .....	109

### KRS CHAPTERS

KRS Chapter 271B .....	11, 75, 122, 123, 218, 224
KRS Chapter 273 .....	152
KRS Chapter 274 .....	208, 209, 218
KRS Chapter 275 .....	51, 212, 213, 215, 218, 219, 222
KRS Chapters 310 through 335 .....	207
KRS Chapter 355 .....	69
KRS Chapter 362 .....	2, 19, 75, 122, 218, 219, 224

### KRS SECTIONS

KRS § 136.070 .....	137
KRS § 141.010 .....	51
KRS § 141.010(24) .....	51
KRS § 141.040 .....	51
KRS § 141.050(1) .....	51
KRS § 141.203 .....	225
KRS § 141.206 .....	51
KRS § 141.208 .....	11, 13, 51
KRS § 141.208(1) .....	51
KRS § 141.208(2) .....	137
KRS § 190 .....	22
KRS § 265.015(19) .....	207
KRS § 265.154(1) .....	106
KRS § 271B.1-200 .....	77
KRS § 271B.1-220 .....	22, 77
KRS § 271B.1-240 .....	77
KRS § 271B.2-010 .....	75
KRS § 271B.2-020 .....	76
KRS § 271B.2-020(2)(b)(5) .....	107
KRS § 271B.2-030(1) .....	76
KRS § 271B.2-040 .....	79, 107
KRS § 271B.2-060 .....	78
KRS § 271B.3-020 .....	78
KRS § 271B.3-020(1)(a) .....	115
KRS § 271B.4-010(1)(a) .....	78

KRS § 271B.5-010 .....	76
KRS § 271B.5-040(1) .....	79
KRS § 271B.5-040(2) .....	79
KRS § 271B.6-220(2) .....	106
KRS § 271B.6-270 .....	21
KRS § 271B.6-400(3)(a)-(b) .....	110
KRS § 271B.6-400(5)(c) .....	110
KRS § 271B.6-400(6) .....	110
KRS § 271B.8-010(2) .....	20
KRS § 271B.8-050(5) .....	104
KRS § 271B.8-300(5)(b) .....	85, 105
KRS § 271B.8-310 .....	105
KRS § 271B.8-330(1)(b) .....	110
KRS § 271B.8-420 .....	105
KRS § 271B.11-080 .....	125
KRS § 271B.14-050 .....	114
KRS § 271B.14-060 .....	115
KRS § 271B.14-070 .....	115
KRS § 271B.14-200 .....	114
KRS § 271B.14-200(1) .....	80
KRS §§ 271B.14-210(1),(2) .....	114
KRS § 271B.14-220(1) .....	114
KRS § 271B.14-220(1)(a)-(e) .....	114
KRS § 271B.14-220(2) .....	114
KRS § 271B.14-220(3) .....	114
KRS § 271B.14-230 .....	114
KRS § 271B.14-300 .....	114
KRS § 271B.15-010(2) .....	80
KRS § 271B.15-020(1), (5) .....	80
KRS § 271B.15-020(4) .....	80
KRS § 271B.15-050(3) .....	80
KRS § 271B.15-200 .....	80
KRS § 271B.16-020 .....	106
KRS § 271B.15-300(1) .....	80
KRS § 271B.300(1)(a)-(c) .....	105
KRS § 274.005(3) .....	13, 76
KRS § 274.015 .....	23
KRS § 274.055(1) .....	106, 217
KRS §§ 275.001-.455 .....	11
KRS § 275.005 .....	78, 207, 219
KRS § 275.010 .....	13, 23, 76, 78, 207, 208, 212, 213, 216
KRS § 275.010(1) .....	78
KRS § 275.010(2) .....	78, 208
KRS § 275.010(3) .....	78
KRS § 275.015 .....	12, 77, 225

KRS § 275.015(2) .....	125
KRS § 275.015(6)(a)-(c) .....	79
KRS § 275.015(8) .....	12, 38, 76
KRS § 275.015(11) .....	104
KRS § 275.015(12) .....	103, 106
KRS § 275.015(13) .....	77
KRS § 275.015(14) .....	12, 77, 106
KRS § 275.015(15) .....	12
KRS § 275.015(18) .....	76, 212
KRS § 275.015(19) .....	13, 76, 207
KRS § 275.020 .....	12, 75, 76, 104
KRS § 275.020(2) .....	76
KRS § 275.025 .....	11, 125, 127, 224
KRS § 275.025(1)(d) .....	103
KRS § 275.025(1)(e) .....	20
KRS § 275.025(1)(f) .....	76
KRS § 275.025(2) .....	11, 76, 213
KRS § 275.025(3) .....	12, 13, 76, 219
KRS § 275.025(4) .....	12, 76
KRS § 275.030 .....	76
KRS §§ 275.030(2) .....	76
KRS § 275.030(3)(a) .....	77
KRS § 275.030(3)(b) .....	77
KRS § 275.035 .....	77
KRS § 275.040 .....	77
KRS § 275.045 .....	11, 77
KRS § 275.045(11) .....	76, 80
KRS § 275.055 .....	22, 77
KRS § 275.060 .....	12, 76
KRS § 275.060(3) .....	76
KRS § 275.065 .....	77
KRS § 275.065(13) .....	78
KRS § 275.085 .....	225
KRS § 275.095 .....	12, 13, 79, 107
KRS § 275.100 .....	3
KRS § 275.100(1) .....	78
KRS § 275.100(2) .....	78
KRS § 275.100(5) .....	78
KRS § 275.105 .....	78
KRS § 275.110 .....	78
KRS § 275.115(1) .....	79
KRS § 275.130(1) .....	79
KRS § 275.130(2) .....	79
KRS § 275.135 .....	220
KRS § 275.135(1) .....	103, 104, 106, 226

KRS § 275.135(2) .....	20, 103
KRS § 275.135(2)(a) .....	103, 106, 226
KRS § 275.135(2)(a)-(b) .....	103
KRS § 275.135(2)(b) .....	104
KRS § 275.135(3) .....	104
KRS § 275.135(4) .....	20, 104
KRS § 275.135(5) .....	12, 104
KRS § 275.145 .....	106
KRS § 275.145(2)(b) .....	106
KRS § 275.150 .....	11, 12, 106, 213, 215, 216, 217, 219, 221
KRS § 275.150(1) .....	13, 86
KRS § 275.150(2) .....	6, 12, 13, 87
KRS § 275.154(1) .....	106
KRS § 275.155 .....	117, 215, 221
KRS § 275.160 .....	216
KRS § 275.160(1) .....	108
KRS § 275.160(2) .....	108
KRS § 275.165 .....	12, 220, 225
KRS § 275.165(2) .....	12
KRS § 275.165(2)(a) .....	12, 104
KRS § 275.165(2)(b) .....	12, 104
KRS § 275.165(2)(c) .....	104
KRS § 275.170 .....	12
KRS § 275.170(1) .....	85, 105
KRS § 275.170(2)(a) .....	114
KRS § 275.170(2)(b) .....	105
KRS § 275.170(3) .....	104
KRS § 275.175 .....	77, 91
KRS § 275.175(1) .....	12, 76, 104, 105, 109
KRS § 275.175(2) .....	84
KRS § 275.175(2)(a) .....	77, 78, 103
KRS § 275.175(2)(a)-(c) .....	104
KRS § 275.175(2)(b) .....	77
KRS § 275.175(2)(c) .....	76, 77
KRS § 275.175(3) .....	12, 105
KRS § 275.180 .....	105, 225
KRS § 275.180(2) .....	220
KRS § 275.185 .....	22, 84, 90, 91
KRS § 275.185(e)(1)-(3) .....	106
KRS § 275.185(1) .....	12, 106
KRS § 275.185(1)(a)-(d) .....	106
KRS § 275.185(1)(d) .....	78
KRS § 275.185(2) .....	106
KRS § 275.185(3) .....	106
KRS § 275.185(4) .....	13, 106, 107

KRS § 275.190 .....	226
KRS § 275.190(1) .....	80
KRS § 275.190(1)(a)-(d) .....	80
KRS § 275.190(2)(b) .....	106
KRS § 275.195 .....	12, 109
KRS § 275.200 .....	12, 13
KRS § 275.200(1) .....	109
KRS § 275.200(2) .....	109
KRS § 275.200(4)-(5) .....	109
KRS § 275.205 .....	12, 78, 103, 109, 220
KRS § 275.210 .....	12, 103, 109, 110, 220
KRS § 275.215 .....	110
KRS § 275.220 .....	12
KRS § 275.220(1) .....	110
KRS § 275.220(2) .....	110
KRS § 275.225 .....	110, 139, 216
KRS § 275.225(1) .....	110
KRS § 275.225(1)(a)-(b) .....	110
KRS § 275.225(2) .....	110
KRS § 275.225(3)(a)-(b) .....	110
KRS § 275.225(4) .....	110
KRS § 275.225(5) .....	110
KRS § 275.225(6) .....	110
KRS § 275.230 .....	13, 139, 216
KRS § 275.230(1) .....	93, 110
KRS § 275.230(2)(a)-(b) .....	110
KRS § 275.230(3) .....	110
KRS § 275.235 .....	110
KRS § 275.240 .....	111, 221
KRS § 275.240(1) .....	110
KRS § 275.240(2) .....	110, 111
KRS § 275.245(1) .....	111
KRS § 275.245(2) .....	111
KRS § 275.245(2)(a) .....	111
KRS § 275.245(2)(b) .....	111
KRS § 275.245(3) .....	111
KRS § 275.245(4) .....	111
KRS § 275.245(5) .....	111
KRS § 275.245(5)(b) .....	111
KRS § 275.250 .....	222
KRS § 275.255 .....	223
KRS § 275.255(1)(a) .....	13, 111
KRS § 275.255(1)(b) .....	13, 111
KRS § 275.255(1)(c) .....	13, 111, 224
KRS § 275.255(1)(d) .....	111, 223

KRS § 275.255(1)(e)-(f) .....	111
KRS § 275.255(2) .....	12, 111
KRS § 275.255(3) .....	111
KRS § 275.260 .....	112, 227
KRS § 275.265 .....	78, 112, 223
KRS § 275.265(1) .....	13, 78, 103, 112, 223
KRS § 275.265(2) .....	112
KRS § 275.265(3) .....	112
KRS § 275.265(4) .....	112
KRS § 275.265(a) .....	113, 223
KRS § 275.270 .....	96, 113
KRS § 275.275 .....	12
KRS § 275.275(1)(a) .....	111
KRS § 275.275(2)(a)-(b) .....	111
KRS § 275.275(2)(b) .....	111
KRS § 275.280 .....	92, 113, 227
KRS § 275.280(1)(a)-(b) .....	113
KRS § 275.280(1)(f)-(j) .....	113
KRS § 275.280(2) .....	113
KRS § 275.280(3) .....	6, 13, 14, 113, 137
KRS § 275.285 .....	13, 113, 168, 169, 175, 227
KRS § 275.285(2) .....	113, 137
KRS § 275.285(3)(a) .....	103
KRS § 275.290 .....	6
KRS § 275.290(1) .....	114
KRS § 275.290(2) .....	114
KRS § 275.290(3) .....	114
KRS § 275.295 .....	7, 13, 221, 227
KRS § 275.295(1)(a) .....	80, 114
KRS § 275.295(1)(b) .....	79, 114
KRS § 275.295(1)(c) .....	79, 114
KRS § 275.295(2)(a) .....	114
KRS § 275.295(2)(b) .....	114
KRS § 275.295(3)(a)(i)-(v) .....	114
KRS § 275.295(3)(b) .....	114
KRS § 275.295(3)(c) .....	114
KRS § 275.295(4)(a)-(d) .....	114
KRS § 275.300(1)(b) .....	114
KRS § 275.300(2) .....	114
KRS § 275.300(2)(a)-(d) .....	114
KRS § 275.300(3)(a)-(h) .....	114
KRS § 275.305(1)(a) .....	114
KRS § 275.305(1)(b) .....	104, 114
KRS § 275.305(2) .....	114
KRS § 275.305(3) .....	114

KRS § 275.310 .....	91
KRS § 275.310(1) .....	114
KRS § 275.310(2) .....	115
KRS § 275.310(3) .....	115
KRS § 275.315 .....	13
KRS § 275.320(2) .....	115
KRS § 275.320(3) .....	115
KRS § 275.325(2)(b) .....	115
KRS § 275.325(2)(c) .....	115
KRS § 275.325(3)(c) .....	115
KRS § 275.325(4)(a) .....	115
KRS § 275.325(4)(b) .....	115
KRS § 275.330 .....	115
KRS § 275.335(1) .....	117
KRS § 275.335(2) .....	117
KRS § 275.340 .....	117
KRS § 275.345 .....	125, 214, 227
KRS § 275.345(1) .....	125
KRS §§ 275.350 .....	227
KRS § 275.350(1) .....	125
KRS § 275.350(2) .....	125
KRS § 275.355 .....	126, 227
KRS § 275.360 .....	126
KRS § 275.360(c) .....	125
KRS § 275.365 .....	126, 227
KRS § 275.365(7) .....	126
KRS § 275.365(8) .....	126
KRS § 275.365(9) .....	227
KRS § 275.370 .....	125, 214, 227
KRS § 275.370(a)(2) .....	77
KRS § 275.370(2) .....	77, 125, 219
KRS § 275.370(3) .....	125, 219
KRS § 275.370(3)(a)-(c) .....	77
KRS § 275.370(3)(d) .....	77, 125
KRS § 275.370(4) .....	125
KRS § 275.370(5) .....	77, 125, 126, 219, 227
KRS § 275.375 .....	219
KRS § 275.375(1) .....	77, 125
KRS § 275.375(2) .....	125
KRS § 275.375(2)(a) .....	125
KRS § 275.375(2)(a)-(c) .....	77
KRS § 275.380(1)(a) .....	79
KRS § 275.380(1)(b) .....	80
KRS § 275.380(2) .....	80
KRS § 275.385 .....	13

KRS § 275.385(1) .....	80
KRS §§ 275.385(2)(a)-(k) .....	80
KRS § 275.390(1) .....	80
KRS § 275.390(4) .....	80
KRS § 275.390(5) .....	80
KRS § 275.395 .....	13
KRS § 275.395(1)(a)-(g) .....	80
KRS § 275.395(2) .....	80
KRS § 275.400(1) .....	80
KRS § 275.400(2) .....	80
KRS § 275.405(1) .....	80
KRS § 275.405(2) .....	13, 80
KRS § 275.405(3) .....	13, 79, 80
KRS § 275.410 .....	78, 79
KRS § 275.410(1) .....	80
KRS § 275.410(1)(a) .....	80
KRS § 275.410(1)(b) .....	80
KRS § 275.415 .....	80
KRS § 275.415(1) .....	80
KRS § 275.415(2) .....	80
KRS § 275.420 .....	80
KRS § 275.425 .....	80
KRS § 275.435(1) .....	80
KRS § 275.435(2)(a)-(e) .....	80
KRS § 275.440 .....	80
KRS § 275.440(1) .....	80
KRS § 287.030(2) .....	16, 23
KRS § 295.300(1) .....	114
KRS § 304.3-070(1) .....	16, 23
KRS § 311.595(18) .....	208
KRS § 313.240 .....	208
KRS § 325.220 .....	226
KRS § 325.220(6) .....	212
KRS § 325.300 .....	208
KRS § 325.301(1)(a) .....	212
KRS § 355.8-103 .....	222
KRS § 355.9-101 .....	222
KRS § 355.9-106 .....	223
KRS § 355.9-115 .....	223
KRS § 355.9-302 .....	223
KRS § 355.9-318 .....	223
KRS § 355.9-401 .....	222
KRS § 355.9-401(1)(c) .....	222
KRS § 355.9-401(5) .....	222
KRS § 355.9-401(5)(e) .....	222



KRS § 355.9-401(5)(f) .....	222
KRS § 355.9-401(5)(k) .....	222
KRS § 355.9-501 .....	223
KRS § 362.175 .....	242
KRS § 362.175(1) .....	241
KRS § 362.190(1) .....	103
KRS § 362.190(4) .....	20
KRS § 362.210 .....	241
KRS § 362.215 .....	241
KRS § 362.220 .....	11, 20, 106, 219
KRS § 362.220(1) .....	231
KRS § 362.220(2) .....	19, 241, 242
KRS § 362.220(3) .....	241
KRS § 362.230 .....	126
KRS § 362.235 .....	20, 241
KRS § 362.245 .....	106
KRS § 362.280 .....	111
KRS § 362.285 .....	227
KRS § 362.300 .....	113
KRS § 362.325 .....	126
KRS § 362.401(7) .....	11
KRS § 362.401(9) .....	78
KRS § 362.403(1) .....	78
KRS § 362.403(2) .....	107
KRS § 362.407 .....	76
KRS §§ 362.409-362.546 .....	125
KRS § 362.409 .....	106
KRS § 362.415 .....	23, 76
KRS § 362.417(1) .....	106
KRS § 362.425 .....	22
KRS § 362.433 .....	111
KRS § 362.437 .....	11
KRS § 362.437(1) .....	20
KRS § 362.437(2) .....	20
KRS § 362.437(4) .....	107
KRS § 362.447(2) .....	11, 106
KRS § 362.463 .....	113
KRS § 362.465 .....	113
KRS § 362.469(1) .....	110
KRS § 362.469(2) .....	110
KRS § 362.481 .....	112, 227
KRS § 362.487 .....	169, 175
KRS § 362.489 .....	114
KRS § 362.507(2) .....	80
KRS § 362.507(3) .....	71

KRS § 362.536(c) .....	126
KRS § 362.555(1) .....	242
KRS § 362.555(2) .....	242
KRS § 362.555(5) .....	242
KRS § 362.555(6) .....	242
KRS § 362.565 .....	242
KRS § 362.585 .....	233
KRS § 362.605 .....	115
KRS § 365.015 .....	69, 79
KRS § 365.015(1) .....	69
KRS § 365.015(3) .....	79
KRS § 365.105(2)(a) .....	219
KRS § 378.010 .....	173
KRS §§ 386.370-386.440 .....	79
KRS § 446.010(8) .....	109

#### OTHER STATE STATUTES

Cal. Corp. Code §17002 .....	157
Cal. Corp. Code § 17153 .....	156
Colo. Rev. Stat. § 7-80-101 through 913 .....	11
Del. Code Ann. Tit. 6, §§ 18-107 and 108 .....	156
Del. Code Ann. Tit. 6, §18-106(b) .....	157
Del. Code Ann §§ 18-101 through -1107 .....	11
Fla. Stat. Ann. §§ 608.401 to 608.471 (West, 1992 Cum. Supp.) .....	11
Ga. Code Ann. §14-11-201(b) .....	157
Il. Compiled Stat. Ann. Art. 805 §§ 180/1-1 <i>et seq.</i> .....	11
MD-Corps & Assoc'n Code Ann §§ 4A-101 through 4A-1103 .....	11
Nev. Rev. Stat. §§ 86.276 through .322 (1991) .....	11
N.Y.L.L.C. Law §201 .....	157
Tenn. Code Ann. §48-247-103(d) .....	219
Tex. Bus. Corp. Code Ann. Art. 158n-101 <i>et seq.</i> .....	11
Va. Code Ann §13.1-1008 .....	157
W.Va. Code §§ 31-1A-1 through 31-1A-69 .....	11
Wyom. Sess. Laws 512 .....	11
Wyom. Stat. §§ 17-15-101 to -136 (1977) .....	11
Wyom. Stat. §§ 17-15-101 to 17-15-136 (1977) .....	11

#### INTERNAL REVENUE CODE

IRC § 1(h) .....	27
IRC § 11 .....	11, 26
IRC § 11(b)(2) .....	26
IRC §§ 55-59 .....	27
IRC § 59A .....	26
IRC § 72(m)(2) .....	235

IRC § 79 .....	37, 236
IRC § 79(d)(2) .....	236
IRC § 83 .....	27
IRC § 101 .....	136
IRC § 101(b)(3) .....	38, 133
IRC § 104 .....	236
IRC § 105(a) .....	236
IRC § 105(b) .....	236
IRC § 105(h) .....	236
IRC § 106 .....	236
IRC §§ 108(a)(1)(A) & (B) .....	38
IRC § 125 .....	237
IRC § 129 .....	237
IRC § 129(a)(2) .....	227
IRC § 129(d) .....	237
IRC § 129(d)(4) .....	237
IRC § 162(a) .....	235, 236
IRC § 162(l) .....	235, 236
IRC § 162(m) .....	29
IRC § 164(f) .....	130
IRC §§ 165(g)(1) & (2) .....	29
IRC § 172(d)(4)(D) .....	235
IRC § 197 .....	143
IRC § 213 .....	235, 236
IRC § 267 .....	28
IRC § 280H .....	37
IRC § 301 .....	11
IRC § 301(c) .....	28
IRC § 302(b) .....	28
IRC § 306 .....	29
IRC § 311 .....	32
IRC § 311(b)(1) .....	28
IRC § 312(a)(3) .....	28
IRC § 316 .....	28
IRC § 312(b) .....	28
IRC § 332 .....	134
IRC § 336 .....	29, 32
IRC § 336(a) .....	28
IRC § 336(d) .....	28
IRC § 341 .....	29
IRC § 351 .....	27, 28, 30, 33
IRC § 351(e)(1) .....	27
IRC § 354 .....	32
IRC § 355 .....	29, 32
IRC § 356(a) .....	29

IRC § 357(a) .....	28
IRC § 357(b) .....	28
IRC § 357(c) .....	28
IRC § 358 .....	27
IRC § 368 .....	29, 194
IRC § 368(a)(1)(F) .....	134, 135, 167
IRC § 401(a) .....	231, 232
IRC §§ 401(a)(4) & (5) .....	233
IRC § 401(a)(13) .....	235
IRC § 401(a)(27)(A) .....	232
IRC § 401(c)(2) .....	232, 235
IRC § 401(c)(3) .....	235
IRC § 401(c)(2)(A) .....	130
IRC § 401(k) .....	233
IRC § 401(m) .....	233
IRC § 402 .....	231
IRC § 402(e)(4)(D) .....	235
IRC § 402(g)(9) .....	233
IRC § 404 .....	231, 232
IRC § 404(a)(5) .....	234
IRC § 404(a)(8)(C) .....	235
IRC § 414(j) .....	232
IRC § 422 .....	195
IRC § 441 .....	37
IRC § 441(i) .....	37
IRC § 444 .....	37
IRC § 444(c)(1) .....	37, 131
IRC § 446 .....	213
IRC § 448 .....	131
IRC § 448(a) .....	213
IRC §§ 448(a)(1) & (2) .....	131
IRC § 448(a)(3) .....	131
IRC § 448(d)(2) .....	131
IRC § 448(d)(3) .....	132
IRC § 461(i)(3) .....	132
IRC § 461(i)(4) .....	132
IRC § 464(e)(2) .....	132
IRC § 465 .....	140
IRC § 465(a) .....	31
IRC § 465(a)(1)(B) .....	26
IRC § 465(b) .....	31, 140
IRC § 465(b)(2)(A) .....	140
IRC § 469 .....	31
IRC § 469(a)(2)(B) .....	26
IRC § 469(h) .....	31, 35

IRC § 469(h)(2) .....	129
IRC § 469(i) .....	32
IRC § 501(c)(3) .....	147, 150, 152, 153, 155, 156
IRC § 501(e)(2) .....	157
IRC § 512 .....	155
IRC § 513 .....	155
IRC §§ 531-537 .....	26
IRC §§ 541-565 .....	26
IRC § 542(a) .....	26
IRC § 702(b) .....	91
IRC § 704 .....	90
IRC § 704(a) .....	34
IRC § 704(b) .....	34
IRC § 704(c) .....	34, 135, 142
IRC § 704(c)(1) .....	39
IRC § 704(c)(1)(A) .....	34
IRC § 704(c)(1)(B) .....	34
IRC § 704(d) .....	35
IRC § 704(e) .....	35, 176, 177
IRC § 705 .....	33
IRC § 706(b) .....	37, 131
IRC § 707(a)(2)(B) .....	33
IRC § 707(c) .....	130, 214
IRC § 708 .....	133, 143
IRC § 708(b)(1) .....	36
IRC § 708(b)(1)(B) .....	48
IRC § 708(b)(2)(B) .....	48
IRC § 721 .....	133, 134, 135, 142, 162
IRC § 721(a) .....	33, 178
IRC § 721(b) .....	178, 179
IRC § 722 .....	33
IRC § 723 .....	33
IRC § 731 .....	133, 134
IRC §§ 731(a) .....	129
IRC § 731(a)(1) .....	36
IRC § 731(a)(2) .....	36
IRC § 731(b) .....	35
IRC § 731(c) .....	129
IRC § 732 .....	35
IRC § 734 .....	35
IRC § 735 .....	36
IRC § 736 .....	129, 234
IRC § 737 .....	34
IRC § 741 .....	143
IRC § 742 .....	33

IRC § 751 .....	36, 129
IRC § 751(b) .....	35, 129
IRC § 752 .....	33, 133, 220
IRC § 752(a) .....	33
IRC § 752(b) .....	33, 133, 134
IRC § 754 .....	35, 39, 142
IRC § 1032 .....	28
IRC § 1044 .....	29
IRC § 1201 .....	11, 26
IRC § 1202 .....	29
IRC § 1223(1) .....	133
IRC § 1231 .....	180
IRC § 1239 .....	143
IRC § 1244 .....	29
IRC § 1256(e)(3)(B) .....	132
IRC § 1256(e)(3)(C) .....	213
IRC §§ 1361 .....	30
IRC § 1361(b) .....	11, 30
IRC § 1362(d)(3) .....	30
IRC § 1362(f) .....	38
IRC § 1363(d) .....	32
IRC § 1366(d) .....	31
IRC § 1366(d)(1) .....	31
IRC § 1366(e) .....	31
IRC § 1367(a) .....	31
IRC § 1368(b) .....	32
IRC § 1368(c)(1) .....	32
IRC §§ 1368(c)(2) & (3) .....	32
IRC § 1368(e)(1) .....	32
IRC § 1371(c)(1) .....	32
IRC § 1371(d)(2) .....	32
IRC § 1372 .....	236
IRC § 1374 .....	32
IRC § 1375 .....	32
IRC § 1375(d) .....	32
IRC § 1378 .....	37
IRC § 1379(d) .....	235
IRC § 1401(a) .....	130
IRC § 1402 .....	235
IRC § 1402(a) .....	130
IRC § 1402(a)(13) .....	5, 130, 214
IRC § 2033 .....	165
IRC § 2036 .....	176
IRC § 2036(a) .....	176
IRC § 2036(a)(2) .....	176

IRC § 2036(b) .....	164, 176
IRC § 2038 .....	176
IRC § 2042 .....	165
IRC § 2401 .....	14
IRC § 2503(b) .....	165, 177
IRC § 2701 .....	137, 166, 167, 168, 178
IRC § 2701(a)(2) .....	137
IRC § 2703 .....	162, 175, 183, 184
IRC § 2704 .....	137
IRC § 2704(a) .....	137, 177, 178
IRC § 2704(b) .....	137, 163, 168, 169, 174, 175, 184
IRC § 2704(b)(3)(B) .....	137
IRC § 4975(d) .....	37, 133
IRC § 4975(f)(6) .....	235
IRC § 4980B .....	237
IRC § 6110(j)(3) .....	132
IRC §§ 6221-6233 .....	131
IRC § 6231 .....	131
IRC § 6501(c)(9) .....	181
IRC § 6655(g)(4) .....	32
IRC § 6662 .....	62
IRC § 6662(d)(2)(C)(ii) .....	132
IRC § 7519 .....	37, 131
IRC § 7701 .....	3, 7
IRC § 7701(a) .....	60
IRC § 7701(a)(2) .....	61
IRC § 7701(a)(3) .....	46, 51, 60
IRC § 7701(i) .....	60
IRC § 7704 .....	38, 53, 61
IRC § 7704(a) .....	63
IRC § 7704(c) .....	63

#### TREASURY REGULATIONS

Treas. Reg. § 1.56(g)-1(c)(5) .....	136
Treas. Reg. § 1.72-16(b) .....	235
Treas. Reg. § 1.79-0 .....	38
Treas. Reg. § 1.79-3(d)(2) .....	236
Treas. Reg. § 1.125-1 .....	237
Treas. Reg. § 1.172-3(a)(3)(iv) .....	235
Treas. Reg. § 1.448-1T(b)(2) .....	132
Treas. Reg. § 1.448-1T(b)(3) .....	213
Treas. Reg. § 1.448-1T(c) .....	131
Treas. Reg. § 1.448-1T(e)(4)(i) .....	131
Treas. Reg. § 1.448-1T(e)(5) .....	131

Treas. Reg. § 1.469-2T(d)(6) .....	31
Treas. Reg. § 1.469-5T .....	32
Treas. Reg. § 1.469-5T (a)(1)-(7) .....	129
Treas. Reg. §§ 1.469-5T(a)(1),(5) & (6) .....	35
Treas. Reg. § 1.469-5T(e)(2) .....	35, 129
Treas. Reg. § 1.469-5T(e)(3)(i)(B) .....	129
Treas. Reg. §§ 1.469-9 5T(a)(1), (5) or (6) .....	35
Treas. Reg. § 1.501(c)(3)-1(e) .....	155
Treas. Reg. § 1.701-2 .....	36
Treas. Reg. § 1.702-1(b) .....	91
Treas. Reg. § 1.704-1(b)(2) .....	34
Treas. Reg. § 1.704-1(b)(2)(ii) .....	34
Treas. Reg. § 1.704-1(b)(iii) .....	34
Treas. Reg. § 1.704-1(e) .....	35
Treas. Reg. § 1.704-2(e) .....	35
Treas. Reg. § 1.708-1(b)(1)(ii) .....	133
Treas. Reg. § 1.742-1 .....	136
Treas. Reg. § 1.752-1(a)(1) .....	33
Treas. Reg. § 1.752-1(a)(2) .....	34
Treas. Reg. § 1.752-2 .....	33
Treas. Reg. § 1.752-3(a) .....	34
Treas. Reg. § 1.1361-1(b) .....	11
Treas. Reg. § 1.1402(a)-2 (proposed) .....	220
Treas. Reg. § 1.1402(a)-2(d) .....	130
Treas. Reg. § 1.1402(a)-2(h) .....	130
Treas. Reg. § 20.2031-2(f) .....	165
Treas. Reg. § 25.2503-3(b) .....	177
Treas. Reg. § 25.2703-1(a)(3) .....	183
Treas. Reg. § 31.3401(c)-1 .....	38
Treas. Reg. § 301.6231(a)(7)-2 .....	131
Treas. Reg. § 301.7701 .....	11, 13
Treas. Reg. § 301.7701-2 .....	127
Treas. Reg. § 301.7701-2(a) (proposed) .....	55, 61
Treas. Reg. § 301.7701-2(a)(1) .....	53
Treas. Reg. § 301.7701-2(a)(2) .....	54, 61
Treas. Reg. § 301.7701-2(a)(3) .....	54, 61
Treas. Reg. § 301.7701-2(b)-(d) .....	53
Treas. Reg. § 301.7701-2(b)(1) .....	61
Treas. Reg. § 301.7701-2(c)(2) .....	61
Treas. Reg. § 301.7701-2(c)(2)(i) .....	38
Treas. Reg. § 301.7701-2(d) .....	62
Treas. Reg. § 301.7701-3 .....	49, 127, 225
Treas. Reg. § 301.7701-3(a) .....	61, 62
Treas. Reg. § 301.7701-3(b) .....	61, 62
Treas. Reg. § 301.7701-3(c) .....	62



Treas. Reg. § 301.7701-3(d) .....	62
Treas. Reg. § 301.7701-3(f) .....	62
Treas. Reg. § 301.7701-2 .....	58
Treas. Reg. § 301.7701-2(a)(1) (proposed) .....	54
Treas. Reg. § 301.7701-4(a) .....	60
Treas. Reg. §§ 301.77012-1-3 .....	161

## REVENUE RULINGS

Rev. Rul. 54-613 .....	130
Rev. Rul. 56-23 .....	54
Rev. Rul. 57-546 .....	54
Rev. Rul. 63-107 .....	63
Rev. Rul. 71-434 .....	49
Rev. Rul. 72-92 .....	54
Rev. Rul. 75-525 .....	130
Rev. Rul. 77-214 .....	49
Rev. Rul. 79-18 .....	156
Rev. Rul. 79-106 .....	53
Rev. Rul. 83-147 .....	165
Rev. Rul. 84-11 .....	63
Rev. Rul. 84-52 .....	133, 135
Rev. Rul. 84-53 .....	133
Rev. Rul. 88-8 .....	49, 61
Rev. Rul. 88-32 .....	179
Rev. Rul. 88-76 .....	43, 56, 61
Rev. Rul. 88-79 .....	49
Rev. Rul. 89-12 .....	49
Rev. Rul. 93-4 .....	49
Rev. Rul. 93-5 .....	49, 56
Rev. Rul. 93-6 .....	49, 56
Rev. Rul. 93-12 .....	137, 171
Rev. Rul. 93-30 .....	49, 56
Rev. Rul. 93-38 .....	49, 56
Rev. Rul. 93-49 .....	56
Rev. Rul. 93-50 .....	49, 56
Rev. Rul. 93-53 .....	56
Rev. Rul. 93-81 .....	56
Rev. Rul. 93-91 .....	56
Rev. Rul. 93-92 .....	56
Rev. Rul. 93-93 .....	56
Rev. Rul. 94-5 .....	56
Rev. Rul. 94-6 .....	56
Rev. Rul. 94-30 .....	49, 56
Rev. Rul. 94-46 .....	49

Rev. Rul. 94-51 .....	56
Rev. Rul. 94-79 .....	56
Rev. Rul. 95-9 .....	56
Rev. Rul. 95-37 .....	220
Rev. Rul. 98-15 .....	145, 147, 148, 150, 155
Rev. Rul. 98-37 .....	49
Rev. Rul. 99-5 .....	63, 135, 162, 142
Rev. Rul. 99-6 .....	63, 135, 136, 143

## REVENUE PROCEDURES

Rev. Proc. 65-27, 1965-2 C.B. 1017 .....	54
Rev. Proc. 82-2, 1982-1 C.B. 367 .....	157
Rev. Proc. 83-15, 1983-1 C.B. 224 .....	55
Rev. Proc. 84-22, 1984-1 C.B. 449 .....	55
Rev. Proc. 85-22, 1985-1 C.B. 550 .....	55
Rev. Proc. 86-3, 1986-1 C.B. 416 .....	55
Rev. Proc. 87-3, 1987-1 C.B. 523 .....	55
Rev. Proc. 88-3, 1988-1 C.B. 579 .....	55
Rev. Proc. 88-44, 1988-2 C.B. 634 .....	56
Rev. Proc. 89-12, 1984-1 C.B. 798 .....	44, 49, 56, 57, 58
Rev. Proc. 92-33, 1992-1 C.B. 782 .....	49
Rev. Proc. 93-27, 1993-2 C.B. 343 .....	33
Rev. Proc. 95-10, 1995-1 C.B. 501 .....	43, 44, 49

## PRIVATE LETTER RULINGS

Priv. Ltr. Rul. 8106082 .....	55
Priv. Ltr. Rul. 8338127 .....	156, 157
Priv. Ltr. Rul. 8541108 .....	156, 157
Priv. Ltr. Rul. 8937010 .....	56, 57
Priv. Ltr. Rul. 9010027 .....	57
Priv. Ltr. Rul. 9012024 .....	178
Priv. Ltr. Rul. 9029019 .....	57
Priv. Ltr. Rul. 9030013 .....	57
Priv. Ltr. Rul. 9119029 .....	57
Priv. Ltr. Rul. 9147017 .....	57
Priv. Ltr. Rul. 9210019 .....	56, 57
Priv. Ltr. Rul. 9218078 .....	56, 57
Priv. Ltr. Rul. 9219022 .....	57
Priv. Ltr. Rul. 9227033 .....	56, 57
Priv. Ltr. Rul. 9242025 .....	56, 57
Priv. Ltr. Rul. 9308027 .....	57
Priv. Ltr. Rul. 9308039 .....	56
Priv. Ltr. Rul. 9313009 .....	57
Priv. Ltr. Rul. 9320019 .....	56

Priv. Ltr. Rul. 9320045 .....	56
Priv. Ltr. Rul. 9308039 .....	57
Priv. Ltr. Rul. 9320045 .....	57
Priv. Ltr. Rul. 9321047 .....	56, 57, 213
Priv. Ltr. Rul. 9321070 .....	56
Priv. Ltr. Rul. 9325048 .....	56
Priv. Ltr. Rul. 9330032 .....	56
Priv. Ltr. Rul. 9404021 .....	56
Priv. Ltr. Rul. 9407030 .....	214
Priv. Ltr. Rul. 9415005 .....	214, 220
Priv. Ltr. Rul. 9415007 .....	176
Priv. Ltr. Rul. 9432018 .....	5
Priv. Ltr. Rul. 9438030 .....	157, 220
Priv. Ltr. Rul. 9452024 .....	5
Priv. Ltr. Rul. 9517029 .....	156
Priv. Ltr. Rul. 9525058 .....	5
Priv. Ltr. Rul. 9607005 .....	179
Priv. Ltr. Rul. 9735003 .....	182
Priv. Ltr. Rul. 199947034 .....	167, 168

#### GENERAL COUNSEL MEMORANDA

Gen. Couns. Mem. 36293 .....	155, 156
Gen. Couns. Mem. 39005 .....	146, 156, 157
Gen. Couns. Mem. 39444 .....	155, 156, 157
Gen. Couns. Mem. 39546 .....	156
Gen. Couns. Mem. 39732 .....	155, 156, 157
Gen. Couns. Mem. 39862 .....	146, 155, 157
Gen. Couns. Mem. 37127 .....	54
Gen. Couns. Mem. 37953 .....	54
Gen. Couns. Mem. 39395 .....	53
Gen. Couns. Mem. 39798 .....	57

#### TREASURY DECISIONS

T.D. 6503, 1960-2 C.B. 409 .....	53, 54
T.D. 6797, 1965-1 C.B. 533 .....	54
T.D. 7515, 1977-2 C.B. 482 .....	54
T.D. 8697 .....	59, 61, 62

#### CASES

<u>Abu-Nassar v. Elders Futures, Inc.</u> , No. 88-CIV-7906 (S.D.N.Y. March 28, 1991) .....	109
<u>Advanced Orthopedics, L.L.C. v. Moon</u> , 656 So. 2d 1103 (La.App. 1995) .....	76
<u>Bank of Augusta v. Earle</u> , 38 U.S. (13 Pet.) 519 .....	108
<u>Boyd v. Badenhausen</u> , 556 S.W.2d 896 (Ky. 1977) .....	217
<u>Bush #1 c/o Stone Street Lands Co. v. Comm'r</u> , 48 T.C. 218 (1967) .....	53

<u>Campbell v. Commissioner</u> , 943 F.2d 815 (8th Cir. 1991), <i>aff'g</i> in part, <i>rev'g</i> in part, T.C. Memo 1990-162 (1990) .....	33
<u>Canson v. International Business Machines Corp.</u> , 200 A. 2d 33 (1964) .....	79
<u>Crummey v. Commissioner</u> , 397 F.2d 82 (9th Cir. 1968) .....	165
<u>Diamond v. Commissioner</u> , 56 T.C. 530 (1971), <i>aff'd</i> 492 F.2d. 286 (7th Cir. 1974) .....	33
<u>Ditty v. Checkrite, Ltd., Inc.</u> , 973 F.Supp. 1320 (D. Utah 1997) .....	107
<u>Downey v. Swan</u> , 454 N.Y.S.2d 895 (N.Y. App. Div. 1981) .....	109
<u>Estate of Berg v. Commissioner</u> , 61 T.C.M. 2949 (1991) .....	173
<u>Estate of Brown v. Commissioner</u> , Docket Nos. 7495-95 and 14899-96 .....	184
<u>Estate of Dorothy Schauerhamer</u> , T.C. Memo 1997-242 .....	176
<u>Estate of Knipp v. Commissioner</u> , 25 T.C. 153 (1955) .....	165
<u>Estate of Murphy v. Commissioner</u> , T.C. Memo 1990-472 .....	183
<u>Estate of White v. Commissioner</u> , Docket No. 14412-97 .....	184
<u>First and Peoples Bank v. Fielder</u> , 323 S.W.2d 853 (Ky. 1959) .....	126
<u>Gattoni v. Zaccaro</u> , 1997 WL 139410 (Conn. Super., March 7, 1997) .....	110
<u>General Utilities &amp; Operating Co. v. Helvering</u> , 296 U.S. 200 (1935) .....	29
<u>Glensder Textile Co. v. Comm'r</u> , 46 B.T.A. 176 (1942), <i>acq.</i> 1941-2 C.B. 8 .....	55
<u>Hill-Davis Co. v. Atwell</u> , 10 P.2d 463 (Ca. 1932) .....	108
<u>Home Interiors &amp; Gifts, Inc. v. Commissioner</u> , 73 T.C. Memo 1142 (1980) .....	29
<u>Hopkins Advertising and Public Relations, Inc. v. Morris</u> , 1997 WL 306653 (Conn. Super May 29, 1997) .....	78
<u>THS Acquisition Services XV, Inc. v. Kings Harbor Care Center</u> , No. 98-CIV-7621, 1999 WL 223152 (S.D.N.Y. 1999) .....	109
<u>Hynes v. Comm'r</u> , 74 T.C. 1266 (1980) .....	53
<u>ING (U.S.) Securities, Futures &amp; Options, Inc. v. Bingham Investment Fund, L.L.C.</u> , 934 F.Supp. 987 (N.D. Il. 1996) .....	117
<u>Ing v. Liberty Nat'l Bank</u> , 216 Ky. 467 (1926) .....	109
<u>I. M. Equipment and Transportation, Inc. v. Gemstone, L.L.C.</u> , 1998 WL 573255 (Conn. Super. Aug 25, 1998) .....	103
<u>James v. Stokes</u> , 261 S.W. 868 (1924) .....	173
<u>Johnson v. Commissioner</u> , T.C. Memo 1990-461 (1990) .....	130
<u>Kleinsasser v. United States</u> , 707 F.2d 1024 (9th Cor. 1983) .....	60
<u>Kurzner v. U. S.</u> , 413 F.2d 97 (5th Cir. 1969) .....	54
<u>Larson v. Comm'r</u> , 66 T.C. 159 (1976), <i>acq.</i> 1979-1 C.B. 1 .....	53, 54, 55, 56
<u>McCauslen v. Commissioner</u> , 45 T.C. 588 (1966) .....	136, 143
<u>McDonough v. McGowan</u> , 177 S.W. 277 (1915) .....	173
<u>Means v. Limpia Royalties</u> , 115 S.W.2d 468 (Tex.Ct.App. 1938) .....	109
<u>Moore v. Commissioner</u> , 62 T.C.M. 1128 (1991) .....	171
<u>Morris v. Commissioner</u> , Docket No. 19620-97 .....	184
<u>Morrissey v. Commissioner</u> , 296 U.S. 344 (1935) .....	53, 59
<u>Munday v. Mayfair Diagnostic Laboratory</u> , 831 S.W.2d 912 (Ky. 1992) .....	69
<u>In re Multimedia Communications Group Wireless Assoc. of Liberty County; Mills v. Webster</u> , 212 B.R. 1006 (Bankr. M.D. Fla. 1997) .....	107
<u>New Horizons Supply Cooperative v. Haack</u> , 1999 WL 33499 (Wis.App. Jan 28, 1999) .....	114
<u>Northern Tankers (Cyprus) Ltd v. Backstrom</u> , 967 F.Supp. 1391 (D. Conn. 1997) .....	107
<u>Page v. Roscoe, LLC</u> , 497 S.E.2d 422 (N.C. Ct. App. 1998) .....	116

<u>Pearce v. Stone</u> , 720 P.2d 542 (Arizona 1986) .....	173
<u>Perry v. Commissioner</u> , 47 T.C. 159 (1966) .....	31
<u>Perry v. Ernest R. Hamilton Associates, Inc.</u> , 485 S.W. 2d 505 (Ky. 1972) .....	69
<u>Poore v. Fox Hollow Enterprises</u> , 1994 WL 150872 (Del. Super., March 29, 1994) .....	117
<u>Pope &amp; Talbot, Inc. v. Commissioner</u> , 162 F. 3d 1236 (9th Cir. 1999) <i>aff'g</i> 104 T.C. 574 .....	134
<u>Quaker Hills, Inc. v. Parr</u> , 364 P.2d 1056 (Colo. 1961) .....	79
<u>Richlands Medical Association v. Commissioner</u> , T.C. Memo 1990-660 (1990), <i>aff'd</i> without published opinion, 953 F.2d 639 (4th C.r. 1992) .....	29
<u>Robertson v. Southwood</u> , 447 N.W.2d 616 (Neb. 1989) .....	126
<u>Rowland v. California Men's Colony</u> , 113 S.Ct. 716 (1993) .....	117
<u>SEC v. Professional Assocs.</u> , 731 F.2d. 349 (6th Cir. 1993) .....	190
<u>SEC v. W. J. Howey Co.</u> , 328 U.S. 293 (1946) .....	132, 189
<u>Selfe v. United States</u> , 778 F.2d 769 (11th Cir. 1985) .....	31
<u>Smith v. Isaacs</u> , 777 S.W.2d 912 (Ky. 1989) .....	217
<u>St. John v. United States</u> , 84-1 USTC ¶ 9158 (C.D. Ill. 1983) .....	33
<u>Taylor v. Axton-Fisher Tobacco Co.</u> , 295 Ky. 226, 173 s.W.2d 377 (Ky. 1943) .....	110
<u>Telamarketing Comm. v. Liberty Partners</u> , 798 S.W.2d 462 (Ky. 1990) .....	115
<u>Thompson v. Schmidt</u> , 274 S.W.2d 554 (Tex. 1925) .....	109
<u>Trenchard v. Commissioner</u> , T.C. Memo 1995-121 .....	162
<u>United States v. Bestfoods</u> , 141 L. Ed. 2d 43 (1998) .....	139
<u>United States v. Byrum</u> , 408 U.S. 125 (1972) .....	176
<u>United States v. Kintner</u> , 216 F.2d 418 (9th Cir. 1954) .....	53
<u>United States v. Kraig</u> , 99 F.3d 1361 (6th Cir. 1997) .....	173
<u>Virginia Partners, Ltd. v. Day</u> , 738 S.W.2d 837 (Ky.App. 1979) .....	71, 107
<u>Water, Waste &amp; Land, Inc. v. Lanham</u> , Slip. Op., 97-SC-199 (March 9, 1998) .....	78
<u>White v. Winchester Land Dev. Corp.</u> , 584 S.W.2d 56 (Ky.Ct.App. 1979) .....	107
<u>Williamson v. Tucker</u> , 645 F.2d. 404 (5th Cir. 1981) .....	189
<u>Zuckman v. U. S.</u> , 524 F.2d 729 (Ct.Cl.), <i>cert. denied</i> , 419 U.S. 844 (1974) .....	53

#### ARTICLES/PERIODICALS/OTHER AUTHORITIES

B. Bittker and J. Eustice, <i>Federal Income Taxation of Corporations and Shareholders</i> , (6 <sup>th</sup> ed 1994) .....	28, 54
Bahls, <i>Application of Corporate Common Law Doctrines to Limited Liability Companies</i> , 55 MONT. L. REV. 43 (1994) .....	107
Barton, <i>Much Ado About a Nothing: The Taxation of Disregarded Entities</i> , TAX NOTES TODAY (June 30, 1997) .....	61
Bernard, <i>Recent Developments Affect Choice of Entity Decisions</i> , 58 TAX'N FOR ACCOUNTANTS 4 (January, 1997) .....	63
Booth, Lady E. and Thomas E. Rutledge, <i>Centralized Management and Revenue Procedure 89- 12:     The Search for a Consistent Answer</i> , 2 L.L.C. RPTR. 94-209 (March/April 1994) .....	58
Booth, Richard A., <i>Fiduciary Duty, Contract, and Waiver in Partnerships and Limited Liability Companies</i> , 1. J. SMALL AND EMERGING BUS. LAW 55 (Spring 1997) .....	105
Callison, J. William, <i>Blind Men and Elephants: Fiduciary Duties Under the Revised Uniform Partnership Act,     Uniform Limited Liability Company Act, and Beyond</i> , 1. J. SMALL AND EMERGING BUS. LAW 109 (Spring 1997) .....	105
Callison, J. William, <i>Partnership Law and Practice</i> (1992) .....	109, 110
Cohen-Whelan, <i>Individual Responsibility in the Wake of Limited Liability</i> , 32 U.S.F.L. REV. 1 (Spring 1997) .....	107

Coleman & Keatinge, <i>Universal [Contractual] Organization Act</i> , paper presented to the ABA Section of Business Law, Committees on Taxation and Partnerships and Unincorporated Business Organizations (August 7, 1995) .....	59
Demott, Deborah A., <i>Fiduciary Preludes: Likely Issues for LLCs</i> , 66 U. COLO. L. REV. 1043 (1995) .....	105
Dickerson, Claire M., <i>Equilibrium Destabilized: Fiduciary Duties Under the Uniform Limited Liability Company Act</i> , 256 STETSON L. REV. 417 (Winter, 1995) .....	105
Fisher, Richard A., <i>Classification Under Section 7701: Yesterday, Today and Tomorrow</i> , 30 TAX LAWYER 627 (1977) .....	55
Fox, <i>Piercing the Veil of Limited Liability Companies</i> , 62 GEO. WASH. L. REV. 1143 (1994) .....	107
Geu, Thomas E., <i>Understanding the Limited Liability Company: A Basic Comparative Primer, (Part One)</i> , 37 S.D.L.REV. 44 (1992) .....	55
Gussett, Sheryl A., <i>Bankruptcy Remote Entities in Structured Financings</i> , AM. BANKR.J. (March 15, 1996) .....	229
Hamill, Susan P. and Mitchel H. Boles, <i>Management and Fiduciary Duties in Limited Liability Companies</i> , Q243-ALI/ABA-77 (March 21, 1996) .....	105
Hibschweiler & Kopin, <i>LLCs are Generally –But Not Always –The Right Choice</i> , 58 TAX'N FOR ACCOUNTANTS, 159 (March, 1997) .....	63
Hirani, <i>States Must Address Business Entity Issue Following IRS Check-the-Box Rules</i> , 22 DAILY TAX REPORT G-8 (February 3, 1997) .....	62
Jackel & Dance, <i>Selected Federal Income Aspects of Changing the Tax Status of Business Entities</i> , TAX STRATEGIES FOR CORPORATE ACQUISITIONS, DISPOSITIONS, SPIN- OFFS, JOINT VENTURES, FINANCINGS, REORGANIZATIONS AND RESTRUCTURINGS (PLI, Westlaw, 405 PLI/Tax 251) .....	63
Johnson, <i>Limited Liability for Lawyers: General Partners Need Not Apply</i> , 51 BUSINESS LAWYER 85 (November, 1975) .....	107
Johnson, <i>Risky Business: Choice of Law and the Unincorporated Entity</i> , 1 J.S.E.B.L. 249 (1997) .....	79
Kirchheimer, Barbara, <i>Revenue Constraints and Lack of Momentum May Hinder S Corp Reform</i> , Danforth Aide Says, TAX NOTES TODAY (Tax Analyst) December 22, 1993 .....	56
Lodge, Frederick Z., Robert E. Michael and Christopher Dewees, <i>Bankruptcy Remote Structures in Mortgage Loans</i> , 10 PROB. & PROP. 49 (1996) .....	229
Martel, John G., <i>Default Fiduciary Duty rules Under Oregon's Limited Liability Company Act</i> , 73 OR. L. REV. 121 (Spring, 1994) .....	105
Matheson & Olson, <i>A Call for a Unified Business Organization Law</i> , 65 GEO. WASH. L. REV. 1 (November, 1996) .....	59
McKee & Kuller, <i>Issues Relating to Choice of Entity, Entity Characterization and Partnership Anti-Abuse Rules</i> , TAX PLANNING FOR DOMESTIC AND FOREIGN PARTNERSHIPS, LLCs, JOINT VENTURES AND OTHER STRATEGIC ALLIANCES (PLI, Westlaw, 398 PLI/Tax 9) .....	63
McKee, Nelson & Whitmire, <i>Federal Taxation of Partnerships and Partners</i> (1994 ed.) .....	54
Miller, <i>The Tax Nothing</i> , TAX PLANNING FOR DOMESTIC AND FOREIGN PARTNERSHIPS, LLCs, JOINT VENTURES, AND OTHER STRATEGIC ALLIANCES, PLI Handbook (Westlaw, 398 PLI/Tax 9) .....	61
Miller, <i>The Tax Nothing</i> , TAX NOTES TODAY (February 3, 1997) .....	61
Miller, Sandra K., <i>What Remedies Should be Made Available to the Dissatisfied Participant in a Limited Liability Company?</i> , 44 AM. U.L. REV. 465 (December, 1994) .....	103
Miller, Sandra K., <i>What Standards of Conduct Should Apply to Members and Managers of Limited Liability Companies?</i> , 68 ST. JOHN'S L. REV. 21 (1994) .....	105
Mills, <i>Exempt Financing and Exempt Status Can Cloud Hospital Joint Ventures</i> , 7 J. Tax'n of Exempt Orgs. 252 (May/June 1996) .....	155
Mills, <i>Whole Hospital Ventures Raise Questions About Exemption</i> , 7 J. Tax'n of Exempt Orgs. 204 (March/April 1996) .....	155

Oesterle & Gazur, <i>What's In a Name?: An Argument for a Small Business "Limited Liability Entity" Statute (With Three Subsets of Default Rules)</i> , 32 WAKE FOREST L. REV. 215 (Spring, 1997) .....	59
Pillow, Schmalz & Starr, <i>Changing an Entity's Classification by Election: The First Modifications to Check-the-Box</i> , 88 J. TAX'N 143 (March, 1988) .....	63
Pillow, Schmalz & Starr, <i>Check-the-Box Proposed Regs Simplify the Entity Classification Process</i> , 85 J. OF TAX'N 72 (August 6, 1996) .....	58
Presser, <i>Piercing the Corporate Veil</i> , Clark Boardman Company (1991) .....	107
Pryde, <i>IRS' Check-the-Box Rules Under Scrutiny By Joint Tax Committee Staff, Kies Says</i> , DAILY TAX REPORT (November 15, 1996) .....	59
Reichler, Richard, <i>Implications of the IRS's Withdrawal of its Proposals to Amend the Kintner Regs.</i> , 6 J. TAX'N 138 (1977) .....	55
Ribstein, Larry E. & Robert R. Keatinge, RIBSTEIN AND KEATINGE ON LIMITED LIABILITY COMPANIES (1993) .....	104, 111, 156
Rodriguez, Joseph A., <i>Wyoming Limited Liability Companies: Limited Liability and Taxation Concerns in Other Jurisdictions</i> , 27 LAND AND WATER L. REV. 539 (1992) .....	55
Rutledge, <i>Comparison of LLC Revenue Rulings</i> , LLC RPTR. (Jan./Feb., 1995) .....	56
Rutledge, <i>IRS Considers End to Kintner Analysis of Unincorporated Associations</i> , 18 LLCADVISOR 4 (May, 1995) .....	58
Rutledge, <i>It Just Doesn't Matter, Or Why You Don't Need a Definite Date of Dissolution</i> , 94 LLC RPTR. 407 (July/August 1994) .....	76
Rutledge, <i>Make Sure They Know You Are an LLC: Member Personally Liable When Acting on Behalf of an Undisclosed LLC</i> , LLC ADVISOR (July, 1998) .....	78
Rutledge, <i>To Boldly Go Where You Have Not Been Told You May Go: The Restatement's View of LLCs and LLPs in Interstate Transactions</i> , LLC ADVISOR, (April, 1995) .....	79, 108
Rutledge & Ballantine, <i>Kentucky Supreme Court Rejects Use of LLCs and LLPs by Attorneys</i> , BAR BRIEFS (December, 1995) .....	76
Rutledge and Ballantine, <i>Kentucky Supreme Court Rejects Use of LLCs, LLPs and PSCs by Attorneys</i> , BENCH AND BAR (Winter, 1996) .....	76
Rutledge & Martin, <i>The Proposed Check-the-Box Classification Regulations: What Might They Mean For You</i> , 1 LLC ADVISOR 4 (June 21, 1996) .....	58
Rutledge & Martin, <i>Yes Virginia, There is a Santa Clause: The Service Delivers Check-the-Box</i> , 1 LLC ADVISOR 4 (December, 1996) .....	59
Schwidetzky, <i>Is It Time to Give the S Corporation a Proper Burial?</i> , 13 VA. TAX REV. 591 (1996) .....	63
Seemann, Ernest A., <i>The Florida Limited Liability Company: An Update</i> , 14 NOVA L. REV. 902 (1990) .....	55
Short, <i>Overview of Beverly-Killea Limited Liability Company Act (Publication #1L, Beverly Hills Bar Association, 1994)</i> .....	157
Slider, <i>Check-the-Box Proposed Regulations Make LLCs Even More Appealing</i> , 3 JLLC 51 (Fall 1996) .....	157
Smith, <i>What Are States Doing on the Check-the-Box Regs?</i> TAX NOTES TODAY (August 18, 1997) .....	61
Taylor, <i>Beyond Check-the-Box - Neglected Issues</i> , 75 TAXES 671 (December, 1997) .....	63
Thompson, <i>The Limits of Liability in the New Limited Liability Entities</i> , 32 WAKE FOREST L. REV. 1 (Spring 1997) .....	107
Tselikis, Gregory A., <i>Bankruptcy-Proofing Your Commercial Transaction: Reality or Myth?</i> , 13 ME. B.J., 234 (1998) .....	229
Welborn, Caryl B., <i>Fiduciary Duties: How Far Can the Partnership or Operating Agreement Go?</i> , 1 LLC ADVISOR 4 (July 23, 1996) .....	105
Wirtz, Francis J. and Kenneth L. Haris, <i>Tax Classification of the One-Member Limited Liability Company</i> , TAX NOTES TODAY (Tax Analyst) (June 28, 1993) available on LEXIS, 93 TNT 140-53 .....	53, 61
Wolf-Smith, Risa Lynn and Robert R. Keatinge, <i>Start with Limited Partnership Agreement</i> , 1 J. OF LIMITED LIABILITY COMPANIES 37 (1994) .....	77

Woodford, Elizabeth C., <i>The Ethical Implications of the Limited Liability Status in the Practice of Law</i> , 87 Ky. L.J. 489 (1998-99) .....	76
ABA Tax Lawyers Embrace Check-the-Box Proposal and Say Extend it to Foreign Organizations, TAX NOTES TODAY (July 26, 1995) .....	58
AICPA Strongly Supports Check-the-Box Proposal for Domestic and Foreign Entities, TAX NOTES TODAY (July 28, 1995) .....	58
Attorney Says Proposed Norwegian Law Could Affect Per Se Corporations List, TAX NOTES TODAY (October 24, 1996) .....	60
California Franchise Tax Board Opposes Single-Member Business Entity Election, TAX NOTES TODAY (August 1, 1996) .....	59
California Groups Discussing Conforming to Federal Entity Classification Rules, DAILY TAX REPORT (February 24, 1997) .....	62
Changes to Check-the-Box Regs Not Being Considered, IRS Official Says, DAILY TAX REPORT (August 4, 1997) .....	60
Check-the-Box Chaos? The State Tax Treatment Factor, TAX NOTES TODAY (May 29, 1997) .....	61
Congress May Examine IRS' Position on LLCs in Future; Subchapter S Bill Gains Speed, 72 DAILY TAX RPT. (BNA) G-7 (April 15, 1994) .....	57
Draft, Uniform Limited Liability Company Act, National Conference on Commissioners on Uniform State Laws, dated July 29-August 5 1993 .....	11
Electric Industry Group Says Some Per Se Corporations Should be Partnerships, TAX NOTES TODAY (August 22, 1996) .....	61
Internal Revenue Service Notice of Proposed Rulemaking and Hearing on Simplification of Entity Classification Rules, P.S. 43-95 (May 9, 1996) .....	58
IRS Approval of Simplified Business Classification System Urged at Hearing, DAILY TAX REPORT (July 21, 1995) .....	58
JCT to Review Check-the-Box Rules, TAX NOTES TODAY (November 15, 1996) .....	59
Lawyer Recommends Changes to Per Se Corporations List, TAX NOTES TODAY (August 21, 1996) .....	61
Lawyers Suggest Changes to Per Se Corporation List, TAX NOTES TODAY (October 3, 1996) .....	60
Netherland Antilles Asks IRS to Reconsider Mandatory Corporate Classification, TAX NOTES TODAY (August 22, 1996) .....	61
Netherlands Antilles Banks Object to Per Se Corporations List in Regs., TAX NOTES TODAY (August 22, 1996) .....	60
Proposed Regulations on 'Limited Liability Companies' Are Criticized as Contrary to Congressional Intent and Detrimental To Overseas Investment, 15 TAX NOTES (Tax Analyst) 187 (April 19, 1982) .....	55
Restatement of Conflicts (2d) .....	79, 88, 89
Ruling Guidelines for Determining Whether a Limited Liability Company is a Partnership of an Association Taxable as a Corporation (dated September 14, 1993), reprinted in LIMITED LIABILITY COMPANIES AND LIMITED LIABILITY PARTNERSHIPS (Prentice-Hall 1993) .....	58
Subcommittee on Limited Liability Companies, ABA Business Law Section, Partnership Committee, Prototype LLC Act dated November 19, 1992 .....	11
Surge in Limited Liability Co. Laws Seen Driving More to Corporate Integration, 58 DAILY TAX RPT. (BNA) G-2 (May 26, 1993) .....	56
Tax Aide Discusses LLCs, S Corporations, and Health Care, TAX NOTES TODAY (Tax Analyst) April 15, 1994 .....	57



**STATUTORY APPENDIX**

**[KRS CHAPTER 275]**

**KRS CHAPTER 275  
LIMITED LIABILITY COMPANIES**

<b>Section</b>		<b>Section</b>	
275.001	SHORT TITLE FOR CHAPTER	275.115	REGISTERED OFFICE; REGISTERED AGENT
275.003	CONSTRUCTION OF CHAPTER	275.120	CHANGE OF REGISTERED OFFICE OR REGISTERED AGENT
275.005	PURPOSE OF LIMITED LIABILITY COMPANY	275.125	RESIGNATION OF REGISTERED AGENT
275.010	POWERS OF LIMITED LIABILITY COMPANIES	275.130	SERVICE OF PROCESS
275.015	DEFINITIONS FOR CHAPTER	275.135	MEMBERS OR MANAGERS AS AGENTS
275.020	PROCEDURE FOR FORMING LIMITED LIABILITY COMPANY	275.140	EFFECT OF STATEMENTS BY MEMBERS OR MANAGERS
275.025	CONTENTS OF ARTICLES OF ORGANIZATION	275.145	EFFECT OF NOTICE TO MEMBERS OR MANAGERS
275.030	AMENDMENT OF ARTICLES OF ORGANIZATION	275.150	IMMUNITY FROM PERSONAL LIABILITY
275.035	RESTATEMENT OF ARTICLES OF ORGANIZATION	275.155	PROPER PARTIES TO PROCEEDINGS
275.040	STATEMENT OF CHANGE OF MAILING ADDRESS	275.160	OPERATIONS OUTSIDE KENTUCKY; KENTUCKY LAW CONTROLLING IN CASES OF CONFLICT
275.045	REQUIREMENTS FOR DOCUMENTS TO BE ENTITLED TO FILING BY SECRETARY OF STATE	275.165	MANAGEMENT OF COMPANY
275.050	PRESCRIBED FORMS	275.170	LIABILITY OF MANAGEMENT FOR CERTAIN CONDUCT; MEMBER'S DUTIES AS MEMBER IN MANAGED LIMITED LIABILITY COMPANY
275.055	FEES FOR FILING DOCUMENTS WITH SECRETARY OF STATE	275.175	NUMBER OF VOTES REQUIRED TO DO BUSINESS
275.060	EFFECTIVE DATE AND TIME OF DOCUMENT	275.180	OPERATING AGREEMENT PROVISIONS ON PERSONAL LIABILITY AND INDEMNIFICATION
275.065	ARTICLES OF CORRECTION	275.185	REQUIRED RECORDS; INSPECTION RIGHT OF MEMBER
275.070	DUTY OF SECRETARY OF STATE TO FILE DOCUMENT; MANNER OF FILING; EFFECT OF FILING OR REFUSAL TO FILE	275.190	ANNUAL REPORT
275.075	APPEAL OF REFUSAL OF SECRETARY OF STATE TO FILE DOCUMENT	275.195	CONSIDERATION FOR ISSUANCE OF INTEREST
275.080	EFFECT OF CERTIFICATE OF SECRETARY OF STATE ATTACHED TO COPY OF FILED DOCUMENT	275.200	OBLIGATION TO MAKE CONTRIBUTION; COMPROMISE
275.085	CERTIFICATE OF EXISTENCE; CERTIFICATE OF AUTHORIZATION	275.205	ALLOCATION OF PROFITS AND LOSSES AMONG MEMBERS
275.090	PROHIBITION AGAINST KNOWINGLY SIGNING FALSE DOCUMENT; PENALTY	275.210	DISTRIBUTION OF CASH OR OTHER ASSETS
275.095	JOINT AND SEVERAL LIABILITY FOR KNOWINGLY PURPORTING TO ACT FOR NONEXISTENT ORGANIZATION	275.215	EFFECT OF EVENT OF DISASSOCIATION WHICH DOES NOT CAUSE DISSOLUTION—REPEALED
275.100	NAME OF LIMITED LIABILITY COMPANY	275.220	MEMBER NOT ENTITLED TO DISTRIBUTION OTHER THAN IN CASH; RESTRICTION ON IN-KIND DISTRIBUTION
275.105	RESERVED LIMITED LIABILITY COMPANY NAME	275.225	CIRCUMSTANCES PREVENTING DISTRIBUTION; DETERMINATION
275.110	REGISTRATION OF NAME OF FOREIGN LIMITED LIABILITY COMPANY		

Section		Section	
275.230	LIABILITY FOR UNLAWFUL DISTRIBUTION; EFFECT OF UNLAWFUL DISTRIBUTION; LIMITATION OF ACTION	275.360	ARTICLES OF MERGER
275.235	MEMBER'S RIGHTS AND REMEDIES WHEN ENTITLED TO RECEIVE A DISTRIBUTION	275.365	EFFECT OF MERGER
275.240	TITLE TO PROPERTY HELD BY COMPANY	275.370	CONVERSION OF PARTNERSHIP OR LIMITED PARTNERSHIP TO LIMITED LIABILITY COMPANY
275.245	TRANSFER OF PROPERTY HELD IN NAME OF COMPANY	275.375	EFFECT OF CONVERSION
275.250	STATUS OF COMPANY INTEREST AS PERSONAL PROPERTY	275.380	LAWS GOVERNING FOREIGN LIMITED LIABILITY COMPANY
275.255	ASSIGNMENT OF INTEREST	275.385	TRANSACTION OF BUSINESS BY FOREIGN LIMITED LIABILITY COMPANY
275.260	JUDICIAL ASSIGNMENT OF MEMBER'S COMPANY INTEREST	275.390	CERTIFICATE OF AUTHORITY REQUIRED OF FOREIGN LIMITED LIABILITY COMPANY FOR ACCESS TO COURTS; CIVIL PENALTY FOR VIOLATION
275.265	ASSIGNEE OF AN INTEREST AS A MEMBER OF THE COMPANY	275.395	APPLICATION FOR CERTIFICATE OF AUTHORITY FOR FOREIGN LIMITED LIABILITY COMPANY
275.270	MEMBER'S LEGAL REPRESENTATIVE TO HAVE RIGHTS OF ASSIGNEE IF MEMBER DIES OR IS DECLARED INCOMPETENT— REPEALED	275.400	AMENDED CERTIFICATE OF AUTHORITY FOR FOREIGN LIMITED LIABILITY COMPANY
275.275	ADMISSION TO MEMBERSHIP IN COMPANY	275.405	EFFECT OF CERTIFICATE OF AUTHORITY FOR FOREIGN LIMITED LIABILITY COMPANY
275.280	CESSATION OF MEMBERSHIP	275.410	NAME USED BY FOREIGN LIMITED LIABILITY COMPANY
275.285	DISSOLUTION OF COMPANY	275.415	REGISTERED OFFICE AND REGISTERED AGENT FOR FOREIGN LIMITED LIABILITY COMPANY
275.290	JUDICIAL DISSOLUTION	275.420	CHANGE OF REGISTERED OFFICE OR REGISTERED AGENT FOR FOREIGN LIMITED LIABILITY COMPANY
275.295	ADMINISTRATIVE DISSOLUTION; REINSTATEMENT	275.425	STATEMENT OF RESIGNATION OF REGISTERED AGENT OF FOREIGN LIMITED LIABILITY COMPANY
275.300	WINDING UP OF AFFAIRS; EFFECT OF DISSOLUTION	275.430	SERVICE OF PROCESS ON FOREIGN LIMITED LIABILITY COMPANY
275.305	BINDING ACTS OF MEMBER OR MANAGER; NOTICE OF DISSOLUTION	275.435	CERTIFICATE OF WITHDRAWAL FOR FOREIGN LIMITED LIABILITY COMPANY
275.310	DISTRIBUTION OF ASSETS	275.440	GROUND FOR REVOCATION OF CERTIFICATE OF AUTHORITY OF FOREIGN LIMITED LIABILITY COMPANY
275.315	ARTICLES OF DISSOLUTION	275.445	NOTICE OF DETERMINATION; REVOCATION OF CERTIFICATE; EFFECT OF REVOCATION
275.320	DISPOSITION OF CLAIMS	275.450	APPEAL OF REVOCATION
275.325	PUBLICATION OF NOTICE OF DISSOLUTION; BARRED CLAIMS; ENFORCEABLE CLAIMS	275.455	EXERCISE OF POWERS BY KENTUCKY COMPANY IN ANY STATE OR COUNTRY
275.330	USE OF COMPANY'S NAME IN JUDICIAL ACTIONS		
275.335	PERSONS WHO MAY SUE IN COMPANY'S NAME		
275.340	EFFECT OF DETERMINATION THAT MEMBER OR MANAGER LACKS AUTHORITY TO SUE ON BEHALF OF COMPANY		
275.345	RIGHT OF COMPANY TO MERGE WITH OTHER BUSINESS ENTITIES		
275.350	APPROVAL OF PROPOSED MERGER		
275.355	PLAN OF MERGER		



**KRS CHAPTER 275  
LIMITED LIABILITY COMPANIES**

**275.001      SHORT TITLE FOR CHAPTER**

This chapter shall be known and may be cited as the "Kentucky Limited Liability Company Act."

**275.003      CONSTRUCTION OF CHAPTER**

It shall be the policy of the General Assembly through this chapter to give maximum effect to the principles of freedom of contract and the enforceability of operating agreements. Unless displaced by particular provisions of this chapter, the principles of law and equity shall supplement this chapter. Although this chapter is in derogation of common law, the rules of construction that require strict construction of statutes which are in derogation of common law shall not apply to its provisions. This chapter shall not be construed to impair the obligations of any contract existing when this chapter, or any amendment of it, becomes effective, nor to affect any action or proceeding begun or right accrued before the chapter or amendment takes effect.

**275.005      PURPOSE OF LIMITED LIABILITY COMPANY**

A limited liability company may be organized under this chapter for any lawful purpose, including the provision of one (1) or more professional services conducted in or outside the Commonwealth. Except as otherwise provided in KRS 275.150, if the purpose for which a limited liability company is organized or its activities make it subject to one (1) or more special provisions of law, the limited liability company shall also comply with those provisions.

**275.010      POWERS OF LIMITED LIABILITY COMPANIES**

Except as otherwise set forth in this chapter or unless the articles of organization or operating agreement provide otherwise, every limited liability company shall have the powers to do all things necessary or convenient to carry out its business and affairs. Professional limited liability companies shall be governed by the laws, whether statutory or common law, applicable to other limited liability companies. Except for those provisions concerning the personal liability of members, managers, employees, and agents of a limited liability company, nothing in this chapter shall restrict, limit, or expand in any manner the authority and duty of any regulating board to:

- (1) License individual persons providing professional services; and
- (2) Regulate the practice of persons providing professional services which are within the jurisdiction of the regulating board, even though the persons are members, managers, employees, or agents of a professional limited liability company, or provide professional services through a professional limited liability company, including the establishment of regulations concerning:
  - (a) The qualifications of members or managers of a professional limited liability company;
  - (b) The transfer of limited liability company interests in a professional limited liability company;  
or
  - (c) The provision of one (1) or more professional services through a professional limited liability company.

## 275.015 DEFINITIONS FOR CHAPTER

As used in this chapter, unless the context otherwise requires:

- (1) "Articles of organization" means the articles filed in conformity with the provisions of KRS 275.020 and 275.025, and those articles as amended or restated.
- (2) "Business entity" means domestic and foreign limited liability companies, general and limited partnerships, including registered limited liability partnerships, corporations, business trusts, and sole proprietorships.
- (3) "Corporation" means a profit or nonprofit corporation formed under the laws of any state or a foreign country.
- (4) "Court" means every court having jurisdiction in the case.
- (5) "Event of disassociation" means an event that causes a person to cease to be a member as provided in KRS 275.280.
- (6) "Foreign limited liability company" means an organization that is:
  - (a) An unincorporated association;
  - (b) Organized under laws of a state other than the laws of this Commonwealth, or under the laws of any foreign country; and
  - (c) Organized under a statute pursuant to which an association may be formed that affords to each of its members limited liability with respect to the liabilities of the entity.
- (7) "Knowledge" means actual knowledge of a fact.
- (8) "Limited liability company" or "domestic limited liability company" means a limited liability company formed under this chapter having one (1) or more members.
- (9) "Limited liability company interest" or "interest in the limited liability company" means the interest that may be issued in accordance with KRS 275.195.
- (10) "Limited partnership" means a limited partnership formed under the laws of the Commonwealth or any other state or a foreign country.
- (11) "Majority-in-interest of the members" means those members entitled to cast a majority of the votes to be cast by the members on any matter under the terms of the operating agreement described in KRS 275.175(3).
- (12) "Manager" or "managers" means, with respect to a limited liability company that has set forth in its articles of organization that it is to be managed by managers, the person or persons designated in accordance with KRS 275.165.
- (13) "Member" or "members" means a person or persons who have been admitted to membership in a limited liability company as provided in KRS 275.275 and who have not ceased to be members as provided in KRS 275.280.
- (14) "Operating agreement" means any agreement, written or oral, among all of the members, as to the conduct of the business and affairs of a limited liability company. If a written operating agreement contains a provision to the effect that any amendment to the operating agreement of the limited liability company shall be in writing and adopted in accordance with the provisions of the operating agreement, the provision shall be enforceable in accordance with its terms, and any agreement as to the conduct of the business and affairs of the limited liability company which is not in writing and adopted in accordance with the provisions of the operating agreement shall not be considered part of the operating

agreement and shall be void and unenforceable. If a limited liability company has only one (1) member, an operating agreement shall be deemed to include:

- (a) A writing executed by the member that relates to the affairs of the limited liability company and the conduct of its business regardless of whether the writing constitutes an agreement; or
  - (b) If the limited liability company is managed by a manager, any other agreement between the member and the limited liability company as it relates to the limited liability company and the conduct of its business, regardless of whether the agreement is in writing.
- (15) "Person" means an individual, a general partnership, a limited liability partnership, including a registered limited liability partnership, a limited partnership, a domestic or foreign limited liability company, a trust, an estate, an association, a corporation, or any other legal entity.
- (16) "Principal office" means the office, in or out of the Commonwealth, so designated in writing with the Secretary of State where the principal executive offices of a domestic or foreign limited liability company are located.
- (17) "State" means a state, territory, or possession of the United States, the District of Columbia, or the Commonwealth of Puerto Rico.
- (18) "Proceeding" means civil suit and criminal, administrative, and investigative action.
- (19) "Professional limited liability company" means a limited liability company organized under this chapter or the laws of another state or foreign country for purposes that include, but are not limited to, the providing of one (1) or more professional services. Except as otherwise expressly provided in this chapter, all provisions of this chapter governing limited liability companies shall be applicable to professional limited liability companies.
- (20) "Professional services" mean the personal services rendered by physicians, osteopaths, optometrists, podiatrists, chiropractors, dentists, nurses, pharmacists, psychologists, occupational therapists, veterinarians, engineers, architects, landscape architects, certified public accountants, public accountants, physical therapists, and attorneys.
- (21) "Regulating board" means the governmental agency which is charged by law with the licensing and regulation of the practice of the profession which the professional limited liability company is organized to provide.

## **275.020 PROCEDURE FOR FORMING LIMITED LIABILITY COMPANY**

One (1) or more persons may serve as the organizer and form a limited liability company by delivering articles of organization to the Secretary of State for filing. It shall not be necessary that the person or persons be members of the limited liability company.

## **275.025 CONTENTS OF ARTICLES OF ORGANIZATION**

- (1) The articles of organization shall set forth:
  - (a) A name for the limited liability company that satisfies the requirements of KRS 275.100;
  - (b) The street address of the limited liability company's initial registered office, and the name of its initial registered agent at that office;
  - (c) The mailing address of the initial principal office of the limited liability company; and
  - (d) A statement that the limited liability company is to be managed by a manager or managers or that the limited liability company is to be managed by its members.

- (2) The term of a limited liability company shall be perpetual unless a period of duration other than perpetual is set forth in the articles of organization.
- (3) The articles of organization of a professional limited liability company shall designate the professional services to be practiced through the professional limited liability company.
- (4) The articles of organization may set forth any other matter that under this chapter is permitted to be set forth in an operating agreement not inconsistent with law.
- (5) A written statement of the initial registered agent consenting to serve in that capacity shall accompany the articles of organization.
- (6) A member of a limited liability company shall not have a vested property right resulting from any provision of the articles of organization.

#### **275.030 AMENDMENT OF ARTICLES OF ORGANIZATION**

- (1) A limited liability company may amend its articles of organization to add, change, or delete a provision that is required or permitted in the articles of organization or to delete a provision not required in the articles. The articles of organization shall be amended if:
  - (a) There is a change in the name of the limited liability company;
  - (b) There is a change in the latest date upon which the limited liability company is to dissolve;
  - (c) There is a change in whether the management of the limited liability company is vested in managers or members; or
  - (d) There is a change in any other matter set forth in the articles of organization under KRS 275.025.
- (2) Except as provided in subsection (3) of this section, or unless the articles of organization or the operating agreement provide otherwise, an amendment to the articles of organization of a limited liability company shall be approved by the members in accordance with KRS 275.175.
- (3) Unless the articles of organization or the operating agreement provide otherwise, a manager or, if there is no manager, any member may amend the articles of organization of the limited liability company without action by the members to delete:
  - (a) The name and address of the initial registered agent or initial registered office if a statement of change pursuant to KRS 275.120 is on file with the Secretary of State; or
  - (b) The mailing address of the initial principal office, if a statement of change pursuant to KRS 275.040 is on file with the Secretary of State.
- (4) To amend its articles of organization, a limited liability company shall file with the Secretary of State articles of amendment setting forth:
  - (a) The name of the limited liability company;
  - (b) The text of each amendment adopted;
  - (c) The date of each amendment's adoption; and
  - (d) A statement that the amendment was duly adopted by the managers or the members in accordance with the articles of organization, the operating agreement of the limited liability company, or this chapter.
- (5) The articles of organization may be amended in any respect as may be desired, if the articles of organization as amended contain only provisions that may be lawfully contained in articles of organization at the time of making the amendment.



**275.035 RESTATEMENT OF ARTICLES OF ORGANIZATION**

- (1) A limited liability company may restate its articles of organization by delivering to the Secretary of State for filing articles of restatement setting forth the name of the limited liability company and the text of the restated articles of organization together with a certificate stating whether the restatement contains an amendment to the articles of organization requiring member approval and, if it does, setting forth the information required by KRS 275.030(4).
- (2) Restated articles of organization shall supersede the original articles of organization and all amendments to them when the restated articles of organization become effective pursuant to KRS 275.060.
- (3) The Secretary of State may certify restated articles of organization as the articles of organization currently in effect, without including the certificate information required by subsection (1) of this section.

**275.040 STATEMENT OF CHANGE OF MAILING ADDRESS**

A limited liability company that changes the mailing address of its principal office shall deliver to the Secretary of State for filing, on a form supplied by the Secretary of State, a statement of change that sets forth:

- (1) The name of the limited liability company;
- (2) The mailing address of its principal office prior to the change; and
- (3) The new mailing address of its principal office.

**275.045 REQUIREMENTS FOR DOCUMENTS TO BE ENTITLED TO FILING BY SECRETARY OF STATE**

- (1) A document shall satisfy the requirements of this section, and of any other section of this chapter that adds to or varies these requirements, to be entitled to filing by the Secretary of State.
- (2) This chapter shall require or permit filing the document in the Office of the Secretary of State.
- (3) The document shall contain the information required by this chapter. It may also contain other information.
- (4) The document shall be typewritten or printed. The typewritten or printed portion shall be in black. Manually-signed photocopies, or other reproduced copies, of typewritten or printed documents may be filed.
- (5) The document shall be in the English language. A limited liability company name may be in a language other than English if written in English letters or Arabic or Roman numerals. Any document that may be filed by a foreign limited liability company which is duly authenticated by the official having custody of the applicable records in the state, country, or other jurisdiction under whose law the limited liability company is formed may be in a language other than English if accompanied by a reasonably-authenticated English translation.
- (6) Unless otherwise provided in any other section of this chapter, any document required by this chapter to be filed with the Secretary of State shall be executed:
  - (a) If management of the limited liability company is vested in one (1) or more managers, by any one (1) of the managers;

- (b) If management of the limited liability company is reserved to the members, by any one (1) of the members;
  - (c) If the limited liability company has not been formed, by the persons forming a limited liability company; or
  - (d) If the limited liability company is in the hands of a receiver, trustee, or other court-appointed fiduciary, by that fiduciary.
- (7) The persons executing the document shall sign it and state beneath or opposite their signatures the names of the persons and the capacity in which each signs.
- (8) The person executing the document may do so as an attorney-in-fact. Powers of attorney relating to the execution of the document shall not be required to be provided to or filed with the Secretary of State.
- (9) If the Secretary of State has prescribed a mandatory form for a document, the document shall be in or on the prescribed form.
- (10) The document shall be delivered to the Secretary of State for filing and shall be accompanied by two (2) exact or conformed copies, the correct filing fee, and any other fee or penalty required by this chapter or other law to be collected by the Office of Secretary of State.
- (11) One (1) of the exact or conformed copies shall be filed with and recorded by the county clerk of the county in which the registered office of the limited liability company is situated.

#### **275.050      PRESCRIBED FORMS**

- (1) The Secretary of State shall prescribe and furnish on request forms for:
- (a) A certificate of existence or authorization;
  - (b) An application for a certificate of authority;
  - (c) An application for a certificate of withdrawal;
  - (d) A statement of change of registered office or registered agent;
  - (e) A statement of change of principal office address;
  - (f) The annual report; and
  - (g) Amended application for certificate of authority.
- (2) The Secretary of State shall have the discretion to make mandatory the use of the forms referred to in subsection (1) of this section.
- (3) The Secretary of State may prescribe and furnish on request forms for other documents required or permitted to be filed pursuant to this chapter, but their use shall not be mandatory.

#### **275.055      FEES FOR FILING DOCUMENTS WITH SECRETARY OF STATE**

- (1) The Secretary of State shall collect the following fees when the documents described in this subsection are delivered to him for filing:
- (a) Articles of organization \_\_\_\_\_ \$40.00
  - (b) Application for certificate of authority as a foreign limited liability company \_\_\_\_\_ \$90.00

- (c) Amendment of article of organization \_\_\_\_\_ \$40.00
  - (d) Restatement of articles of organization \_\_\_\_\_ \$40.00
  - (e) Amendment and restatement of articles of organization \_\_\_\_\_ \$80.00
  - (f) Articles of dissolution with respect to a domestic limited liability company \_\_\_\_\_ \$40.00
  - (g) Limited liability company's statement of change of registered agent or change of the address of the registered office, or both \_\_\_\_\_ \$10.00
  - (h) Registered agent's statement of change of registered office for each affected limited liability company \_\_\_\_\_ \$10.00  
not to exceed a total of \_\_\_\_\_ \$1,000.00
  - (i) Limited liability company's statement of change of the mailing address of the principal office \_\_\_\_\_ \$10.00
  - (j) Application to reserve a name for use by a domestic or foreign limited liability company \_\_\_\_\_ \$15.00
  - (k) Notice of the transfer of a name reserved for use by a domestic or a foreign limited liability company \_\_\_\_\_ \$15.00
  - (l) Application for use of indistinguishable name \_\_\_\_\_ \$20.00
  - (m) Application for registered name \_\_\_\_\_ \$36.00
  - (n) Application for renewal of registered name \_\_\_\_\_ \$36.00
  - (o) Articles of merger \_\_\_\_\_ \$50.00
  - (p) Application for amended certificate of authority \_\_\_\_\_ \$40.00
  - (q) Application for certificate of withdrawal \_\_\_\_\_ \$ 40.00
  - (r) Articles of correction \_\_\_\_\_ \$ 20.00
  - (s) Certificate of existence or authorization \_\_\_\_\_ \$ 10.00
  - (t) Reinstatement penalty following administrative dissolution \_\_\_\_\_ \$100.00
  - (u) Annual report \_\_\_\_\_ \$15.00
  - (v) Any other document required or permitted to be filed by this chapter \_\_\_\_\_ \$ 15.00
- (2) The Secretary of State shall collect a fee of ten dollars (\$10) each time process is served on the Secretary of State under this chapter. The party to a proceeding causing service of process shall be entitled to recover this fee as costs if the party prevails in the proceeding.
- (3) The Secretary of State shall collect the following fees for copying and certifying the copy of any filed documents relating to a domestic or foreign limited liability company:
- (a) Fifty cents (\$0.50) a page for copying; and
  - (b) Five dollars (\$5) for the certificate.
- (4) The county clerk shall receive a fee pursuant to KRS 64.012 for recording and issuing reports, articles, and statements pertaining to limited liability companies.

#### **275.060 EFFECTIVE DATE AND TIME OF DOCUMENT**

- (1) Except as provided in subsection (2) of this section and KRS 275.065(3), a document shall be effective at the time of filing on the date it is filed, as evidenced by the Secretary of State's date and time endorsement on the original document, or at the time specified in the document as its effective time on the date it is filed.
- (2) A document may specify a delayed effective time and date; and if it does so and is filed pursuant to subsection (1) of this section, the document shall become effective at the time and date specified. If a delayed effective date but no time is specified, the document shall be effective at the close of business on that date. A delayed effective date for a document shall not be later than the ninetieth day after the date it is filed.
- (3) A document filed in accordance with this section shall be effective regardless of a failure to file the document with the county clerk pursuant to KRS 275.045(11).

#### **275.065 ARTICLES OF CORRECTION**

- (1) A domestic or foreign limited liability company may correct a document filed by the Secretary of State in accordance with subsection (2) of this section if the document:
  - (a) Contains an incorrect statement; or
  - (b) Was defectively executed, attested, sealed, verified, or acknowledged.
- (2) A document shall be corrected:
  - (a) By preparing articles of correction that:
    1. Describe the document, including its filing date, or have attached a copy of the document to the articles of correction;
    2. Specify the incorrect statement and the reason it is incorrect or the manner in which the execution was defective; and
    3. Correct the incorrect statement or defective execution; and
  - (b) By delivering the articles of correction to the Secretary of State for filing.
- (3) Articles of correction shall be effective on the effective date of the document they correct except as to persons relying on the uncorrected document adversely affected by the correction. As to those persons, articles of correction shall be effective when filed.

#### **275.070 DUTY OF SECRETARY OF STATE TO FILE DOCUMENT; MANNER OF FILING; EFFECT OF FILING OR REFUSAL TO FILE**

- (1) If a document delivered to the Secretary of State for filing satisfies the requirements of KRS 275.045, the Secretary of State shall file it.
- (2) The Secretary of State shall file a document by stamping or otherwise endorsing "Filed," together with the Secretary of State's name and official title and the date and time of receipt, on both the original and the document copies and on the receipt for the filing fee. After filing a document, except as provided in KRS 275.125 and 275.420, the Secretary of State shall deliver the document copies, with the filing fee receipt, or acknowledgment of receipt if no fee is required, attached, to the domestic or foreign limited liability company or its representative.

(3) If the Secretary of State refuses to file a document, the Secretary of State shall return it to the domestic or foreign limited liability company or its representative within five (5) days after the document was delivered, together with a brief, written explanation of the reason for the refusal.

(4) The Secretary of State's duty to file documents under this section shall be ministerial. The filing or refusal to file a document by the Secretary of State shall not:

- (a) Affect the validity or invalidity of the document in whole or part;
- (b) Relate to the correctness or incorrectness of information contained in the document; or
- (c) Create a presumption that the document is valid or invalid or that information contained in the document is correct or incorrect.

#### **275.075 APPEAL OF REFUSAL OF SECRETARY OF STATE TO FILE DOCUMENT**

(1) If the Secretary of State refuses to file a document delivered for filing, the domestic or foreign limited liability company may appeal the refusal to the Franklin Circuit Court. The appeal shall be commenced by petitioning the court to compel filing the document and by attaching to the petition the document and the Secretary of State's explanation of the refusal to file.

(2) The court may summarily order the Secretary of State to file the document or take other action the court considers appropriate.

(3) The court's final decision may be appealed as are other civil proceedings.

#### **275.080 EFFECT OF CERTIFICATE OF SECRETARY OF STATE ATTACHED TO COPY OF FILED DOCUMENT**

A certificate attached to a copy of the document filed by the Secretary of State, bearing his signature, which may be in facsimile, and the seal of this Commonwealth, shall be conclusive evidence that the original document is on file with the Secretary of State.

#### **275.085 CERTIFICATE OF EXISTENCE; CERTIFICATE OF AUTHORIZATION**

(1) Anyone may apply to the Secretary of State to furnish a certificate of existence for a domestic limited liability company or a certificate of authorization for a foreign limited liability company.

(2) A certificate of existence or a certificate of authorization shall set forth:

- (a) The domestic limited liability company's name or the foreign limited liability company's name used in this Commonwealth;
- (b) That the domestic limited liability company is duly organized under the law of this Commonwealth, and the date of its organization, or that the foreign limited liability company is authorized to transact business in this Commonwealth;
- (c) That all fees and penalties owed to the Secretary of State have been paid, if:
  - 1. Payment is reflected in the records of the Secretary of State; and
  - 2. Nonpayment affects the existence or authorization of the domestic or foreign limited liability company;
- (d) That articles of dissolution have not been filed;

(e) That most recent annual report required by KRS 275.190 has been delivered to the Secretary of State; and

(f) Other facts of record in the office of the Secretary of State that may be requested by the applicant.

(3) Subject to any qualifications stated in the certificate itself, the certificate of existence or authorization issued by the Secretary of State may be relied upon as conclusive evidence that the domestic or foreign limited liability company is in existence or authorized to transact business in this Commonwealth.

**275.090 PROHIBITION AGAINST KNOWINGLY SIGNING FALSE DOCUMENT;  
PENALTY**

(1) It shall be unlawful for any person to sign a document the person knows is false in any material respect with intent that the document be delivered to the Secretary of State for filing.

(2) Any person who violates the provisions of this section shall be guilty of a Class B misdemeanor punishable by a fine not to exceed one hundred dollars (\$100).

**275.095 JOINT AND SEVERAL LIABILITY FOR KNOWINGLY PURPORTING TO  
ACT FOR NONEXISTENT ORGANIZATION**

All persons purporting to act as or on behalf of a limited liability company, knowing there has been no organization under this chapter, shall be jointly and severally liable for all liabilities created while so acting.

**275.100 NAME OF LIMITED LIABILITY COMPANY**

(1) The name of each limited liability company as set forth in its articles of organization shall contain the words "limited liability company" or "limited company" or the abbreviations "LLC" or "LC." The name of each limited liability company which is a professional limited liability company shall contain the words "professional limited liability company" or "professional limited company" or the abbreviations "PLLC" or "PLC." The word "Limited" may be abbreviated as "Ltd." and the word "Company" may be abbreviated as "Co."

(2) Except as authorized by subsections (3) and (4) of this section, the name of a limited liability company shall be distinguishable from any name on record with the Secretary of State.

(3) A limited liability company may apply to the Secretary of State for authorization to use a name that is not distinguishable upon the Secretary of State's records from one (1) or more of the names described in subsection (2) of this section. The Secretary of State shall authorize use of the name applied for if:

(a) The other business entity consents to the use in writing and submits an undertaking in form satisfactory to the Secretary of State to change its name to a name that is distinguishable upon the records of the Secretary of State from the name of the applying limited liability company; or

(b) The applicant delivers to the Secretary of State a certified copy of the final judgment of a court of competent jurisdiction establishing the applicant's right to use the name applied for in this Commonwealth.

(4) A limited liability company may use the name, including the fictitious name, with any modification required by this section or KRS 275.410 of another business entity that is used in this Common-

wealth if the other business entity is organized or authorized to transact business in this Commonwealth and the limited liability company:

- (a) Has merged with the other business entity;
  - (b) Has been formed by reorganization of the other business entity; or
  - (c) Has acquired all or substantially all of the assets, including the business name, of the other business entity.
- (5) This chapter shall not control the use of fictitious names.
- (6) The filing of articles of organization under the particular name of the limited liability company shall not automatically prevent the use of that name or protect that name from use by other persons.

#### **275.105 RESERVED LIMITED LIABILITY COMPANY NAME**

- (1) A person may apply to the Secretary of State to reserve the exclusive use of a limited liability company name, including the fictitious name, for a foreign limited liability company whose limited liability company name is not available for use in this Commonwealth. If the Secretary of State finds that the limited liability company name applied for is available, the Secretary of State shall reserve the name for the applicant's exclusive use for one (1) nonrenewable period of one hundred twenty (120) days.
- (2) The holder of a reserved limited liability company name may transfer the reservation to another person by delivering to the Secretary of State a notice of the transfer, executed by the applicant for whom the name was reserved, and specifying the name and address of the transferee.

#### **275.110 REGISTRATION OF NAME OF FOREIGN LIMITED LIABILITY COMPANY**

- (1) A foreign limited liability company may register its name, or its name with any addition required by KRS 275.410(1)(a), if the name is distinguishable upon the records of the Secretary of State as required under KRS 275.100.
- (2) A foreign limited liability company shall register its name, or its name with any addition required by KRS 275.410(1)(a), by delivering to the Secretary of State for filing an application setting forth:
- (a) Its name, or its name with any addition required by KRS 275.410(1)(a);
  - (b) The state or country and date of its organization;
  - (c) A brief description of the nature of the business in which it is engaged; and
  - (d) A statement that the foreign limited liability company validly exists as a limited liability company under the laws of the jurisdiction of its formation.
- (3) The name shall be registered for the applicant's exclusive use upon the effective date of the application.
- (4) A foreign limited liability company whose registration is effective may renew it for successive years by delivering to the Secretary of State for filing a renewal application between October 1 and December 31 of the preceding year. The renewal application shall comply with the requirements of subsection (2) of this section and when filed shall renew the registration for the following calendar year.
- (5) A foreign limited liability company whose registration is effective may thereafter qualify as a foreign limited liability company under the registered name or consent in writing to the use of that name by a limited liability company thereafter organized under this chapter or by another foreign lim-

ited liability company thereafter authorized to transact business in this Commonwealth. The registration shall terminate when the domestic limited liability company is organized or the foreign limited liability company qualifies or consents to the qualification of another foreign limited liability company under the registered name.

#### **275.115 REGISTERED OFFICE; REGISTERED AGENT**

(1) Each domestic limited liability company and each foreign limited liability company authorized to transact business in the Commonwealth pursuant to KRS 275.380 to 275.450 shall continuously maintain in this Commonwealth:

- (a) A registered office that may be the same as any of its places of business; and
- (b) A registered agent who shall be either:
  - 1. An individual who is a resident of this Commonwealth and whose business office is identical with the registered office;
  - 2. A domestic corporation, domestic limited liability company, or not-for-profit domestic corporation whose business office is identical with the registered office; or
  - 3. A foreign corporation, foreign limited liability company, or not-for-profit foreign corporation authorized to transact business in this Commonwealth whose business office is identical with the registered office.

(2) Unless the registered agent signs the document making the appointment, the appointment of a registered agent or a successor registered agent on whom process may be served shall not be effective until the agent delivers a statement in writing to the Secretary of State accepting the appointment.

#### **275.120 CHANGE OF REGISTERED OFFICE OR REGISTERED AGENT**

(1) A limited liability company, or a foreign limited liability company authorized to transact business in the Commonwealth pursuant to KRS 275.380 to 275.450, may change its registered office or registered agent, or both, upon filing in the office of the Secretary of State a statement of change on a form supplied by the Secretary of State that sets forth:

- (a) The name of the limited liability company or foreign limited liability company;
- (b) The street address of its current registered office;
- (c) If the current registered office is to be changed, the street address of the new registered office;
- (d) The name of its current registered agent;
- (e) If the current registered agent is to be changed, the name of the new registered agent and the new registered agent's written consent; and
- (f) That after the change or changes are made, the street addresses of its registered office and the business office of its registered agent will be identical.

(2) If a registered agent changes the street address of the registered agent's business office to another place within this Commonwealth, the registered agent shall change the street address of the registered office of any limited liability company or foreign limited liability company of which the registered agent is a registered agent by notifying the limited liability company in writing of the change, and delivering to the Secretary of State for filing a statement that complies with the requirements of subsection (1) of this section and recites that the limited liability company has been notified of the change.



(3) The change of address of the registered office or registered agent shall be effective on delivery of the statement to the Secretary of State. The appointment of a new registered agent shall be effective on delivery of the statement to the Secretary of State and on receipt by the Secretary of State of evidence that the new registered agent has accepted appointment pursuant to KRS 275.115(2).

#### **275.125 RESIGNATION OF REGISTERED AGENT**

(1) A registered agent may resign as registered agent by signing and delivering to the Secretary of State for filing the executed original and two (2) exact or conformed copies of a statement of resignation. The statement may also include a statement that the registered office is also discontinued.

(2) After filing the statement, the Secretary of State shall mail one (1) copy to the registered office, if not discontinued, and the other copy to the limited liability company at its principal office.

(3) The agency appointment shall be terminated, and the registered office discontinued if so provided, on the thirty-first day after the date on which the statement was filed.

#### **275.130 SERVICE OF PROCESS**

(1) A domestic or foreign limited liability company's registered agent shall be the limited liability company's agent for service of process, notice, or demand required or permitted by law to be served on the limited liability company.

(2) If a domestic or foreign limited liability company has no registered agent in this Commonwealth, or the registered agent cannot with reasonable diligence be served, the limited liability company may be served by registered or certified mail, return receipt requested, addressed to the limited liability company at its principal office. Service shall be perfected under this subsection at the earliest of:

- (a) The date the limited liability company receives the mail;
- (b) The date shown on the return receipt, if signed on behalf of the limited liability company; or
- (c) Five (5) days after its deposit in the United States mail, as evidenced by the postmark, if mailed postpaid and correctly addressed.

(3) This section shall not prescribe the only means, or necessarily the required means, of serving a domestic or foreign limited liability company.

#### **275.135 MEMBERS OR MANAGERS AS AGENTS**

(1) Except as provided in subsection (2) of this section, every member shall be an agent of the limited liability company for the purpose of its business or affairs, and the act of any member, including, but not limited to, the execution in the name of the limited liability company of any instrument, for apparently carrying on in the usual way the business or affairs of the limited liability company of which he is a member, shall bind the limited liability company, unless the member so acting has, in fact, no authority to act for the limited liability company in the particular matter, and the person with whom the member is dealing has knowledge or has received notification of the fact that the member has no such authority.

(2) If the articles of organization provide that management of the limited liability company is vested in a manager or managers:

- (a) No member, solely by reason of being a member, shall be an agent of the limited liability company; and

(b) Every manager shall be an agent of the limited liability company for the purpose of its business or affairs, and the act of any manager, including, but not limited to, the execution in the name of the limited liability company of any instrument, for apparently carrying on in the usual way the business or affairs of the limited liability company of which he is the manager shall bind the limited liability company, unless the manager so acting has, in fact, no authority to act for the limited liability company in the particular matter, and the person with whom the manager is dealing has knowledge or has received notification of the fact that the manager has no such authority.

(3) An act of a manager or a member which is apparently not for the carrying on in the usual way of the business or affairs of the limited liability company shall not bind the limited liability company unless, at the time of the transaction or at any other time, the act is authorized in accordance with the operating agreement.

(4) An act of a manager or member in contravention of a restriction on authority shall not bind the limited liability company to persons having knowledge of the restriction.

(5) Unless otherwise set forth in a written operating agreement, a member or manager of a limited liability company has the power and authority to delegate to one (1) or more other persons the member's or manager's powers to manage or control the business and affairs of the limited liability company, including without limitation the power to delegate to agents and employees of a member, manager, or limited liability company or to delegate by an agreement to other persons. This delegation by a member or manager of a limited liability company shall not cause the member or manager to cease to be a member or manager of the limited liability company.

#### **275.140 EFFECT OF STATEMENTS BY MEMBERS OR MANAGERS**

(1) Except as provided in subsection (2) of this section, an admission, statement, or representation made by any member concerning the business or affairs of a limited liability company within the scope of the member's authority as provided for by this chapter shall be evidence against the limited liability company.

(2) If the articles of organization provide that management of the limited liability company is vested in a manager or managers:

(a) An admission, statement, or representation made by a manager concerning the business or affairs of a limited liability company within the scope of the manager's authority as provided for by this chapter shall be evidence against the limited liability company; and

(b) The admission, statement, or representation of any member, acting solely in the capacity of a member, shall not constitute evidence against the limited liability company.

#### **275.145 EFFECT OF NOTICE TO MEMBERS OR MANAGERS**

(1) Except as provided in subsection (2) of this section, notice to any member of any matter relating to the business or affairs of the limited liability company, and the knowledge of the member acting in the particular matter, acquired while a member or known at the time of becoming a member, and the knowledge of any other member who reasonably could and should have communicated the knowledge to the acting member, shall operate as notice to or knowledge of the limited liability company, except in the case of a fraud on the limited liability company committed by or with the consent of that member.

(2) If the articles of organization provide that management of the limited liability company is vested in a manager or managers:

(a) Notice to any manager of any matter relating to the business or affairs of the limited liability company, and the knowledge of the manager acting in the particular matter, acquired while a man-

ager or known at the time of becoming a manager, and the knowledge of any other manager who reasonably could and should have communicated the knowledge to the acting manager, shall operate as notice to or knowledge of the limited liability company, except in the case of a fraud on the limited liability company committed by or with the consent of that manager; and

(b) Notice to or knowledge of any member of the limited liability company while the member is acting solely in the capacity of a member shall not constitute notice to or knowledge of the limited liability company.

#### **275.150 IMMUNITY FROM PERSONAL LIABILITY**

(1) Except as provided in subsection (2) of this section or as otherwise specifically set forth in other sections in this chapter, no member, manager, employee, or agent of a limited liability company, including a professional limited liability company, shall be personally liable by reason of being a member, manager, employee, or agent of the limited liability company, under a judgment, decree, or order of a court, agency, or tribunal of any type, or in any other manner, in this or any other state, or on any other basis, for a debt, obligation, or liability of the limited liability company, whether arising in contract, tort, or otherwise. The status of a person as a member, manager, employee, or agent of a limited liability company, including a professional limited liability company, shall not subject the person to personal liability for the acts or omissions, including any negligence, wrongful act, or actionable misconduct, of any other member, manager, agent, or employee of the limited liability company.

(2) Notwithstanding the provisions of subsection (1) of this section, under a written operating agreement or under another written agreement, a member or manager may agree to be obligated personally for any of the debts, obligations, and liabilities of the limited liability company.

#### **275.155 PROPER PARTIES TO PROCEEDINGS**

A member of a limited liability company shall not be a proper party to a proceeding by or against a limited liability company, solely by reason of being a member of the limited liability company, except if the object of the proceeding is to enforce a member's right against or liability to the limited liability company or as otherwise provided in an operating agreement.

#### **275.160 OPERATIONS OUTSIDE KENTUCKY; KENTUCKY LAW CONTROLLING IN CASES OF CONFLICT**

(1) A limited liability company may conduct its business, carry on its operations, and exercise the power granted by this chapter in any state or in any foreign country.

(2) The personal liability of members, managers, employees, and agents of a limited liability company to any person or in any action or proceeding for the debts, obligations, or liabilities of a limited liability company or for the acts or omissions of other members, managers, employees, or agents of a limited company shall be governed solely and exclusively by this chapter and the laws of this Commonwealth. When a conflict arises between the law of this state and the laws of any other state with regard to the liability of the members of the limited liability company for the debts, obligations, and liabilities of the limited liability company, or of the acts or omissions of other members, managers, employees, or agents of the limited liability company, this Commonwealth's law shall be deemed to govern in determining the liability.

**275.165      MANAGEMENT OF COMPANY**

(1) Unless the articles of organization vest management of the limited liability company in a manager or managers, management of the business and affairs of the limited liability company shall vest in the members. Subject to any provisions in the articles of organization, the operating agreement or this chapter restricting or enlarging the management rights and duties of any person or group or class of persons, the members shall have the right and authority to manage the affairs of the limited liability company and to make all decisions with respect thereto.

(2) If the articles of organization vest management of the limited liability company in one (1) or more managers, except to the extent otherwise provided in the articles of organization, the operating agreement, or this chapter, the manager or managers shall have exclusive power to manage the business and affairs of the limited liability company. Unless otherwise provided in the articles of organization or the operating agreement, managers:

(a) Shall be designated, appointed, elected, removed, or replaced by a vote, approval, or consent of the majority-in-interest of the members;

(b) Shall not be required to be members of the limited liability company or natural persons; and

(c) Unless they are sooner removed or sooner resign, shall hold office until their successors shall have been elected and qualified.

**275.170      LIABILITY OF MANAGEMENT FOR CERTAIN CONDUCT; MEMBER'S  
DUTIES AS MEMBER IN MANAGED LIMITED LIABILITY COMPANY**

Unless otherwise provided in an operating agreement:

(1) A member or manager shall not be liable, responsible, or accountable in damages or otherwise to the limited liability company or the members of the limited liability company for any action taken or failure to act on behalf of the limited liability company unless the act or omission constitutes wanton or reckless misconduct.

(2) Each member and manager shall account to the limited liability company and hold as trustee for it any profit or benefit derived by that person without the consent of more than one-half (1/2) by number of the disinterested managers, one-half (1/2) by number of other persons participating in the management of the business or affairs of the limited liability company, or the majority-in-interest of the members:

(a) Any transaction connected with the conduct or winding up of the limited liability company; or

(b) Any use by the member or manager of its property, including, but not limited to, confidential or proprietary information of the limited liability company or other matters entrusted to the person as a result of his status as manager or member.

(3) One who is a member of the limited liability company in which management is vested in managers under KRS 275.165(2) and who is not a manager shall have no duties to the limited liability company or the other members solely by reason of acting in his capacity as a member.

**275.175      NUMBER OF VOTES REQUIRED TO DO BUSINESS**

(1) Unless otherwise provided in the articles of organization, a written operating agreement, or this chapter, the affirmative vote, approval, or consent of a majority-in-interest of the members, if management of the limited liability company is vested in the members, or of the managers, if the

management of the limited liability company is vested in managers, shall be required to decide any matter connected with the business affairs of the limited liability company.

(2) Unless otherwise provided in writing in the operating agreement, the affirmative vote, approval, or consent of the majority-in-interest of the members shall be required to:

- (a) Amend a written operating agreement;
- (b) Authorize a manager or member to do any act on behalf of the limited liability company that contravenes a written operating agreement, including any written provision thereof which expressly limits the purpose, business, or affairs of the limited liability company or the conduct thereof; or
- (c) Amend the articles of organization to change the management of the limited liability company from members to managers or from managers to members.

(3) Unless otherwise provided in the articles of organization, a written operating agreement, or this chapter, for all purposes of this chapter, the members of a limited liability company shall vote, approve, or consent in proportion to their contributions, based upon the agreed value as stated in the records of the limited liability company as required by KRS 275.185, made by each member to the extent they have been received by the limited liability company and have not been returned.

#### **275.180 OPERATING AGREEMENT PROVISIONS ON PERSONAL LIABILITY AND INDEMNIFICATION**

A written operating agreement may:

- (1) Eliminate or limit the personal liability of a member or manager for monetary damages for breach of any duty provided for in KRS 275.170; and
- (2) Provide for indemnification of a member or manager for judgments, settlements, penalties, fines, or expenses incurred in a proceeding to which a person is a party because the person is or was a member or manager.

#### **275.185 REQUIRED RECORDS; INSPECTION RIGHT OF MEMBER**

(1) A limited liability company shall keep at its principal office or other location as set forth in a written operating agreement, the following:

- (a) A current list, and all past lists, setting forth the full name and last known mailing address of each member and manager, if any;
- (b) A copy of the articles of organization and all amendments thereto, together with executed copies of any power of attorney pursuant to which any articles of amendment have been executed;
- (c) Copies of the limited liability company's federal, state, and local income tax returns and financial statements, if any, for the three (3) most recent years or, if those returns and statements were not prepared, copies of the information and statements provided to, or which should have been provided to, the members to enable them to prepare their federal, state, and local tax returns for those years;
- (d) Copies of any effective written operating agreements and all amendments thereto, and copies of any written operating agreements no longer in effect; and
- (e) Unless contained in writing in an operating agreement:

1. A writing setting forth the amount of cash, if any, and a statement of the agreed value of other property or services, if any, contributed by each member and the times at which or events upon the happening of which any additional contributions are to be made;
  2. A writing stating events, if any, upon the happening of which the limited liability company is to be dissolved and its affairs wound up; and
  3. Other writings, if any, prepared pursuant to a requirement, if any, in an operating agreement.
- (2) Upon reasonable written request, a member may, at the member's own expense, inspect and copy during ordinary business hours any limited liability company record, where the record is located or at a reasonable location.
- (3) Members, if the management of the limited liability company is vested in the members, or managers, if management of the limited liability company is vested in managers, shall render, to the extent the circumstances render it just and reasonable, true and full information of all matters affecting the members to any member, and the member's agent, and to the legal representative of any deceased member or of any member under legal disability.
- (4) Failure of the limited liability company to keep or maintain any of the records or information required pursuant to this section shall not be grounds for imposing liability on any member or manager for the debts and obligations of the limited liability company.

#### 275.190 ANNUAL REPORT

- (1) Each domestic limited liability company, and each foreign limited liability company authorized to transact business in this Commonwealth, shall deliver to the Secretary of State for filing an annual report that sets forth:
- (a) The name of the limited liability company and the state or country under whose law it is organized;
  - (b) The address of its registered office and the name of its registered agent at that office in this state;
  - (c) The address of its principal office; and
  - (d) The names and business addresses of its managers, if management is vested in managers, or one (1) or more designated members, if management is vested in members.
- (2) Information in the annual report shall be current as of the date the annual report is executed on behalf of the limited liability company.
- (3) The first annual report shall be delivered to the Secretary of State between January 1 and June 30 of the year following the calendar year in which a domestic limited liability company was organized or a foreign limited liability company was authorized to transact business. Subsequent annual reports shall be delivered to the Secretary of State between January 1 and June 30 of the following calendar years.
- (4) If an annual report does not contain the information required by this section, the Secretary of State shall promptly notify the reporting domestic or foreign limited liability company in writing and return the report to it for correction.

## **275.195 CONSIDERATION FOR ISSUANCE OF INTEREST**

A limited liability company interest may be issued in exchange for consideration consisting of cash, property, services rendered, or a promissory note or other obligation to contribute cash or property or to perform services.

## **275.200 OBLIGATION TO MAKE CONTRIBUTION; COMPROMISE**

- (1) A promise by a member to contribute to the limited liability company shall not be enforceable unless set forth in a writing signed by the member.
- (2) Unless otherwise provided in an operating agreement, a member shall be obligated to the limited liability company to perform any enforceable promise to contribute cash or property or to perform services, even if the member is unable to perform because of death, disability, or other reason.
- (3) If a member does not make the required contribution of property or services, the member shall be obligated, at the option of the limited liability company, to contribute cash equal to that portion of value of the stated contribution that has not been made.
- (4) Unless otherwise provided in an operating agreement, the obligation of a member to make a contribution may be compromised only with the unanimous consent of the members.
- (5) Notwithstanding any compromise approved pursuant to subsection (4) of this section, a creditor of a limited liability company who extends credit or otherwise acts in reliance on the obligation after the member executes a writing which reflects the obligation and before the compromise may enforce the original obligation.

## **275.205 ALLOCATION OF PROFITS AND LOSSES AMONG MEMBERS**

Profits and losses of a limited liability company shall be allocated among the members and among classes of members in the manner provided in the operating agreement. If a written operating agreement does not otherwise provide, profits and losses shall be allocated on the basis of the agreed value, as stated in the records of the limited liability company as required by KRS 275.185, of the contributions made by each member to the extent they have been received by the limited liability company and have not been returned.

## **275.210 DISTRIBUTION OF CASH OR OTHER ASSETS**

Except as otherwise provided in KRS 275.310, distributions of cash or other assets of a limited liability company shall be allocated among the members and among classes of members in the manner provided in writing in an operating agreement. If the operating agreement does not so provide in writing, each member shall share in any distribution on the basis of the agreed value, as stated in the records of the limited liability company as required by KRS 275.185, of the contributions made by each member to the extent they have been received by the limited liability company and have not been returned. A member shall be entitled to receive distributions described in this section from a limited liability company to the extent and at the times or upon the happenings of the events specified in an operating agreement or at the times determined by the members or managers pursuant to KRS 275.175.

**275.215 EFFECT OF EVENT OF DISASSOCIATION WHICH DOES NOT CAUSE  
DISSOLUTION— REPEALED**

**275.220 MEMBER NOT ENTITLED TO DISTRIBUTION OTHER THAN IN CASH;  
RESTRICTION ON IN-KIND DISTRIBUTION**

Unless otherwise provided in a written operating agreement:

- (1) A member, regardless of the nature of the member's contribution, shall not have a right to demand and receive any distribution from the limited liability company in any form other than cash; and
- (2) A member shall not be compelled to accept from a limited liability company a distribution of any asset in kind to the extent that the percentage of the asset distributed to the member exceeds the percentage that the member would have shared in a cash distribution equal to the value of the property at the time of distribution.

**275.225 CIRCUMSTANCES PREVENTING DISTRIBUTION; DETERMINATION**

- (1) No distribution shall be made if, after giving effect to the distribution:
  - (a) The limited liability company would not be able to pay its debts as they become due in the usual course of business; or
  - (b) The limited liability company's assets would be less than the sum of its liabilities plus, unless otherwise provided in an operating agreement, the amount that would be needed, if the limited liability company were to be dissolved at the time of the distribution, to satisfy the preferential rights of other members upon dissolution which are superior to the rights of the member receiving the distribution.
- (2) The limited liability company may base a determination that a distribution is not prohibited under subsection (1) of this section either on:
  - (a) Financial statements prepared on the basis of accounting practices and principles that are reasonable under the circumstances; or
  - (b) A fair valuation or other method that is reasonable under the circumstances.
- (3) Except as provided in subsection (5) of this section, the effect of a distribution under subsection (1) of this section shall be measured as of:
  - (a) The date the distribution is authorized if the payment occurs within one hundred twenty (120) days after the date of authorization; or
  - (b) The date payment is made if it occurs more than one hundred twenty (120) days after the date of authorization.
- (4) A limited liability company's indebtedness to a member incurred by reason of a distribution made in accordance with this section shall be at parity with the limited liability company's indebtedness to its general unsecured creditors, except to the extent subordinated by agreement.
- (5) If terms of the indebtedness provide that payment of principal and interest is to be made only if, and to the extent that, payment of a distribution to members could then be made under this section, indebtedness of a limited liability company, including indebtedness issued as a distribution, shall not be a liability for purposes of determinations made under subsection (1) of this section.



- (6) If the indebtedness is issued as a distribution, each payment of principal or interest on the indebtedness shall be treated as a distribution, the effect of which shall be measured on the date the payment is actually made.

**275.230 LIABILITY FOR UNLAWFUL DISTRIBUTION; EFFECT OF UNLAWFUL DISTRIBUTION; LIMITATION OF ACTION**

- (1) A member or manager who votes for or assents to a distribution in violation of an operating agreement or KRS 275.225 shall be personally liable to the limited liability company for the amount of the distribution that exceeds the amount that could have been distributed without violating KRS 275.225 or an operating agreement if it is established that the member or manager did not comply with KRS 275.170.
- (2) Each member or manager held liable under subsection (1) of this section for an unlawful distribution shall be entitled to contribution:
- (a) From each other member or manager who could be held liable under subsection (1) of this section for the unlawful distribution; and
  - (b) From each member for the amount the member received in violation of KRS 275.225 or an operating agreement.
- (3) A proceeding under this section shall be barred unless it is commenced within two (2) years after the date on which the effect of the distribution is measured under KRS 275.225(3).

**275.235 MEMBER'S RIGHTS AND REMEDIES WHEN ENTITLED TO RECEIVE A DISTRIBUTION**

At the time a member becomes entitled to receive a distribution, the member shall have the status of, and shall be entitled to all remedies available to, a creditor of the limited liability company with respect to the distribution.

**275.240 TITLE TO PROPERTY HELD BY COMPANY**

- (1) Property transferred to or otherwise acquired by a limited liability company shall be the property of the limited liability company and not of the members individually.
- (2) Property may be acquired, held, and conveyed in the name of the limited liability company. Any estate in real property may be acquired in the name of the limited liability company, and title to any interest so acquired shall vest in the limited liability company rather than in the members individually.

**275.245 TRANSFER OF PROPERTY HELD IN NAME OF COMPANY**

- (1) Except as provided in subsection (2) of this section, property of the limited liability company held in the name of the limited liability company may be transferred by an instrument of transfer executed by any member so authorized in the name of the limited liability company.
- (2) If the articles of organization provide that management of the limited liability company is vested in a manager or managers:

(a) Title to property of the limited liability company that is held in the name of the limited liability company may be transferred by an instrument of transfer executed by any manager so authorized in the name of the limited liability company; and

(b) A member, solely by reason of being a member, shall not have authority to transfer property of the limited liability company.

#### **275.250 STATUS OF COMPANY INTEREST AS PERSONAL PROPERTY**

A limited liability company interest shall be personal property.

#### **275.255 ASSIGNMENT OF INTEREST**

(1) Unless otherwise provided in writing in an operating agreement:

(a) A limited liability company interest shall be assignable in whole or in part;

(b) An assignment shall entitle the assignee to receive, to the extent assigned, only the distributions to which the assignor would be entitled;

(c) An assignment of a limited liability company interest shall not dissolve the limited liability company or entitle the assignee to participate in the management and affairs of the limited liability company or to become or exercise any rights of a member other than the right to receive distributions pursuant to subsection (1)(b) of this section;

(d) Until the assignee of a limited liability company interest becomes a member pursuant to KRS 275.265(1), the assignor shall continue to be a member and to have the power to exercise any rights of a member, subject to the members' right to remove the assignor pursuant to KRS 275.280(1)(c) 2.;

(e) Until an assignee of a limited liability company interest becomes a member, the assignee shall have no liability as a member solely as a result of the assignment; and

(f) The assignor of a limited liability company interest shall not be released from liability as a member solely as result of the assignment.

(2) An operating agreement may provide that a member's limited liability company interest may be evidenced by a certificate of limited liability company interest issued by the limited liability company and may also provide for the assignment or transfer of any interest represented by the certificate.

(3) Unless otherwise provided in an operating agreement, the pledge of or granting of a security interest, lien, or other encumbrance in or against any or all of the limited liability company interest of a member shall not constitute an assignment and shall not cause the member to cease to be a member or cease to have the power to exercise any rights or powers of a member.

#### **275.260 JUDICIAL ASSIGNMENT OF MEMBER'S COMPANY INTEREST**

On application to a court of competent jurisdiction by any judgment creditor of a member, the court shall charge the member's limited liability company interest with payment of the unsatisfied amount of judgment with interest thereon. To the extent so charged, the judgment creditor shall have only the rights of an assignee of the member's limited liability company interest. This chapter shall not deprive any member of the benefit of any exemption laws applicable to the member's limited liability company interest.

**275.265 ASSIGNEE OF AN INTEREST AS A MEMBER OF THE COMPANY**

- (1) Unless otherwise provided in a written operating agreement, an assignee of a limited liability company interest shall become a member only if a majority- in-interest of the members consent. The consent of a member may be evidenced in any manner specified in writing in an operating agreement, but in the absence of specification, consent shall be evidenced by one (1) or more written instruments, dated and signed by the requisite members.
- (2) An assignee who becomes a member shall have, to the extent assigned, the rights and powers and shall be subject to the restrictions and liabilities of a member under the articles of organization, any written operating agreement, and this chapter. An assignee who becomes a member also shall be liable for any obligations of his assignor to make contributions under KRS 275.200. However, the assignee shall not be obligated for liabilities of which the assignee had no knowledge at the time he became a member and which could not be ascertained from the articles of organization or any written operating agreement.
- (3) Unless otherwise provided in a written operating agreement, the assignor shall not be released from his liability to the limited liability company under KRS 275.200, whether or not an assignee of a limited liability company interest becomes a member.
- (4) Unless otherwise provided in a written operating agreement, a member who assigns his entire limited liability company interest shall cease to be a member or to have the power to exercise any rights of the member when the assignee becomes a member with respect to the entire assigned interest.
- (5) Unless otherwise set forth in the operating agreement, a successor in interest to a member who is disassociated from the limited liability company shall have the rights and obligations of an assignee with respect to the member's interest.

**275.270 MEMBER'S LEGAL REPRESENTATIVE TO HAVE RIGHTS OF ASSIGNEE IF MEMBER DIES OR IS DECLARED INCOMPETENT—REPEALED**

**275.275 ADMISSION TO MEMBERSHIP IN COMPANY**

- (1) Subject to subsection (2) of this section, a person may become a member in a limited liability company:
  - (a) In the case of the person acquiring a limited liability company interest directly from a limited liability company, upon compliance with an operating agreement or, if an operating agreement does not so provide in writing, upon the written consent of all members; and
  - (b) In the case of an assignee of the limited liability company interest, as provided in KRS 275.255 and 275.265.
- (2) The effective time of admission of a member to a limited liability company shall be the later of:
  - (a) The date the limited liability company is formed; or
  - (b) The time provided in the operating agreement or, if no time is provided, when the person's admission is reflected in the records of the limited liability company.

**275.280 CESSATION OF MEMBERSHIP**

- (1) A person shall disassociate from the limited liability company and cease to be a member of a limited liability company upon the occurrence of one (1) or more of the following events:

- (a) Subject to the provisions of subsection (3) of this section, the member withdraws by voluntary act from the limited liability company;
- (b) The member ceases to be a member of the limited liability company as provided in KRS 275.265;
- (c) The member is removed as a member:
  - 1. In accordance with a written operating agreement; or
  - 2. Unless otherwise provided in a written operating agreement, when the member assigns all of the member's interest in the limited liability company, upon receipt of the written consent of a majority-in-interest of the members who have not assigned their interest;
- (d) Unless otherwise provided in a written operating agreement or by written consent of majority-in-interest of the members, at the time the member:
  - 1. Makes an assignment for the benefit of creditors;
  - 2. Files a voluntary petition in bankruptcy;
  - 3. Is adjudicated bankrupt or insolvent;
  - 4. Files a petition or answer seeking for the member any reorganization, arrangement, composition, readjustment, liquidation, dissolution, or similar relief under any statute, law, or regulation;
  - 5. Files an answer or other pleading admitting or failing to contest the material allegations of a petition filed against the member in any proceeding of this nature; or
  - 6. Seeks, consents to, or acquiesces in the appointment of a trustee, receiver, or liquidator of the member or of all or any substantial part of the member's property;
- (e) Unless otherwise provided in a written operating agreement or by written consent of a majority-in-interest of the members remaining at the time, if within one hundred twenty (120) days after the commencement of any proceeding against the member seeking reorganization, arrangement, composition, readjustment, liquidation, dissolution, or similar relief under any statute, law, or regulation, the proceeding has not been dismissed, or if within one hundred twenty (120) days after the appointment without the member's consent or acquiescence of a trustee, receiver, or liquidator of the member, or of all or any substantial part of the member's properties, the appointment is not vacated or stayed or within one hundred twenty (120) days after the expiration of any stay, the appointment is not vacated;
- (f) Unless otherwise provided in a written operating agreement or by written consent of a majority-in-interest of the members remaining at the time, in the case of a member that is an individual:
  - 1. The member's death; or
  - 2. The entry of an order by a court of competent jurisdiction adjudicating the member incompetent to manage his or her person or estate;
- (g) Unless otherwise provided in a written operating agreement or by written consent of a majority-in-interest of the members remaining at the time, in the case of a member that is a trust or is acting as a member by virtue of being a trustee of a trust, the termination of the trust, but not merely the substitution of a new trustee;
- (h) Unless otherwise provided in a written operating agreement or by written consent of a majority-in-interest of the members remaining at the time, in the case of a member that is a separate limited liability company, the dissolution and commencement of winding up of the separate limited liability company;

- (i) Unless otherwise provided in a written operating agreement or by written consent of the majority-in-interest of the members remaining at the time, in the case of a member that is a corporation, the filing of articles of dissolution or the equivalent for the corporation or the revocation of its articles of incorporation and the lapse of ninety (90) days after notice to the corporation of revocation without a reinstatement of its articles of incorporation; or
  - (j) Unless otherwise provided in a written operating agreement or by written consent of a majority-in-interest of the members remaining at the time, in the case of an estate, the distribution by the fiduciary of the estate's entire interest in the limited liability company.
- (2) The members may provide in a written operating agreement for other events the occurrence of which shall result in a person ceasing to be a member of the limited liability company.
- (3) Unless otherwise provided in a written operating agreement, a member has no right to withdraw from a limited liability company. If the written operating agreement does not specify a time a member may withdraw, a member shall not withdraw without the consent of all other members remaining at the time.

#### **275.285 DISSOLUTION OF COMPANY**

A limited liability company shall be dissolved and its affairs wound up upon the happening of the first to occur of the following:

- (1) The expiration of the term of the limited liability company set forth in the articles of organization, if any, or upon the occurrence of events specified in the articles of organization or a written operating agreement;
- (2) Unless otherwise set forth in the operating agreement, the written consent of a majority-in-interest of the members of a limited liability company;
- (3) Entry of a decree of judicial dissolution under KRS 275.290; or
- (4) Filing of a certificate of dissolution by the Secretary of State under KRS 275.295.

#### **275.290 JUDICIAL DISSOLUTION**

- (1) The Circuit Court, for the county in which the principal office of the limited liability company is located, or, if none, in the county of the registered office, may dissolve a limited liability company in a proceeding by a member if it is established that it is not reasonably practicable to carry on the business of the limited liability company in conformity with the operating agreement.
- (2) Any decree dissolving the limited liability company pursuant to subsection (1) of this section shall specify the effective date of the dissolution, and the clerk of the court shall deliver a certified copy of the decree to the Secretary of State, who shall file it.
- (3) After entering the decree of dissolution, the court shall direct the winding up and liquidation of the limited liability company's business and affairs in accordance with KRS 275.300 and the notification of claimants in accordance with KRS 275.320 and 275.325.

#### **275.295 ADMINISTRATIVE DISSOLUTION; REINSTATEMENT**

- (1) The Secretary of State may commence a proceeding to administratively dissolve a limited liability company if:

- (a) The limited liability company does not deliver its annual report to the Secretary of State within sixty (60) days after the annual report is due;
  - (b) The limited liability company is without a registered agent or registered office in Kentucky for at least sixty (60) days; or
  - (c) The limited liability company does not notify the Secretary of State within sixty (60) days after its registered agent or registered office has been changed, its registered agent has resigned, or its registered office has been discontinued.
- (2) (a) If the Secretary of State determines that one (1) or more grounds exist under subsection (1) of this section for dissolving a limited liability company, the Secretary of State shall serve the limited liability company with written notice of the determination.
- (b) If the limited liability company does not correct each ground for dissolution or demonstrate to the reasonable satisfaction of the Secretary of State that each ground determined by the Secretary of State does not exist within sixty (60) days from the date on which notice was mailed, the Secretary of State shall administratively dissolve the limited liability company by signing a certificate of dissolution that states the ground or grounds for dissolution and its effective date. The Secretary of State shall file the original of the certificate and serve a copy on the limited liability company by mailing the notice by first class mail to the limited liability company at its registered office.
- (3) (a) A limited liability company administratively dissolved under subsection (2) of this section may apply to the Secretary of State for reinstatement at any time after the effective date of dissolution. The application shall:
- 1. State the name of the limited liability company and the effective date of its administrative dissolution;
  - 2. State that the ground or grounds for dissolution either did not exist or have been eliminated;
  - 3. State that the limited liability company's name satisfies the requirements under KRS 275.100;
  - 4. Contain a certificate from the Kentucky Revenue Cabinet stating that all taxes owed by the limited liability company have been paid; and
  - 5. Be accompanied by the reinstatement penalty and the current fee on filing each delinquent report as provided for in KRS 275.055(1).
- (b) If the Secretary of State determines that the application contains the information required by paragraph (a) of this subsection and that the information is correct, the Secretary of State shall:
- 1. Cancel the certificate of dissolution and prepare a certificate of existence that states the determination and the effective date of existence; and
  - 2. Serve a copy on the limited liability company.
- (c) When the reinstatement is effective, the reinstatement shall relate back to and take effect as of the effective date of the administrative dissolution, and the limited liability company shall resume carrying on business as if the administrative dissolution had never occurred.
- (4) (a) If the Secretary of State denies a limited liability company's application for reinstatement following administrative dissolution, the Secretary of State shall serve the limited liability company with a written notice that explains the reason or reasons for denial by mailing notice by first-class mail to the limited liability company at its registered office or, if none, to the last principal office identified on the most recent annual report.

(b) The limited liability company may appeal the denial of reinstatement to the Circuit Court of the county where the limited liability company's principal office, or, if there is none in Kentucky, its registered office, is located within thirty (30) days after service of the notice of denial by doing the following:

1. Filing a petition with the court to set aside the dissolution; and
2. Attaching to the petition a copy of the Secretary of State's certificate of dissolution, the limited liability company's application for reinstatement, and the Secretary of State's notice of denial.

(c) The court may order the Secretary of State to reinstate the dissolved limited company or may take other action the court considers appropriate.

(d) The court's final decision may be appealed as are other civil proceedings.

### **275.300 WINDING UP OF AFFAIRS; EFFECT OF DISSOLUTION**

Unless otherwise provided in a written operating agreement:

- (1) The business or affairs of the limited liability company may be wound up:
  - (a) By the members or managers who have authority pursuant to KRS 275.165 to manage the limited liability company prior to dissolution; or
  - (b) If one (1) or more of the members or managers have engaged in wrongful conduct, or upon other cause shown, by the Circuit Court for the county in which the principal office of the limited liability company is located or in which the registered office of the limited liability company is located, on application of any member, any member's legal representative, or assignee.
- (2) A dissolved limited liability company shall continue its existence but shall not carry on any business except that appropriate to wind up and liquidate its business and affairs, including:
  - (a) Collecting its assets;
  - (b) Disposing of its properties that will not be distributed in kind to its members;
  - (c) Discharging or making provision for discharging its liabilities;
  - (d) Distributing its remaining property among its members according to their interests; and
  - (e) Doing every other act necessary to wind up and liquidate its business and affairs.
- (3) Dissolution of a limited liability company shall not:
  - (a) Transfer title to the limited liability company's property;
  - (b) Prevent transfer of a limited liability company interest, although the authorization to dissolve may provide for the limited liability company restricting the transfer of the limited liability company's interest;
  - (c) Subject its members or managers to standards of conduct different from those prescribed herein;
  - (d) Change quorum or voting requirements for its members or managers; change provisions for selection, resignation, or removal of its members or managers; or change provisions for amending its operating agreement;
  - (e) Prevent commencement of a proceeding by or against the limited liability company in its name;
  - (f) Abate or suspend a proceeding pending by or against the limited liability company on the effective date of dissolution;

- (g) Terminate the authority of the registered agent of the limited liability company; or
- (h) Alter the obligations and responsibilities of the limited liability company as prescribed by applicable federal or state law with regard to the filing or examination of all federal and state tax returns or the payment, assessment, or collection of any federal or state tax due with respect to those returns.

#### **275.305 BINDING ACTS OF MEMBER OR MANAGER; NOTICE OF DISSOLUTION**

(1) Except as provided in subsections (3) and (4) of this section, after dissolution of the limited liability company, each member or manager having authority to wind up the limited liability company's business and affairs may bind the limited liability company:

- (a) By any act appropriate for winding up the limited liability company's affairs or completing transactions unfinished at dissolution; and
- (b) By any other act that would have bound the limited liability company if it had not been dissolved, if the other party to the transaction did not have notice of the dissolution.

(2) The filing of articles of dissolution pursuant to KRS 275.315, the entry of a decree of dissolution pursuant to KRS 275.290, or the filing of a certificate of dissolution pursuant to KRS 275.295 shall be presumed to constitute notice of dissolution for purposes of subsection (1)(b) of this section.

(3) An act of a member or manager which is not binding on the limited liability company pursuant to subsection (1) of this section shall be binding if it is otherwise authorized by the limited liability company.

(4) An act of a member or manager which would be binding under subsection (1) of this section, or would be otherwise authorized but which is in contravention of a restriction on authority, shall not bind the limited liability company to persons having knowledge of the restriction.

#### **275.310 DISTRIBUTION OF ASSETS**

Upon the winding up of a limited liability company, the assets shall be distributed as follows:

- (1) Payment, or adequate provisions for payment, shall be made to creditors, including, to the extent permitted by law, members who are creditors in satisfaction of liabilities of the limited liability company;
- (2) Unless otherwise provided in a written operating agreement, to members or former members in satisfaction of liabilities for distributions under KRS 275.210; and
- (3) Unless otherwise provided in a written operating agreement, to members and former members first for the return of their contributions and second in proportion to the members' respective rights to share in distributions from the limited liability company prior to dissolution.

#### **275.315 ARTICLES OF DISSOLUTION**

After the dissolution of the limited liability company pursuant to KRS 275.285(1), (2), or (3), the limited liability company shall file articles of dissolution with the Secretary of State which set forth:

- (1) The name of the limited liability company;
- (2) A statement of the subsection of KRS 275.285 pursuant to which the limited liability company has dissolved;



- (3) The effective date, which shall be a date certain, of the dissolution; and
- (4) Any other information the members or managers filing the articles of dissolution shall deem proper.

#### **275.320 DISPOSITION OF CLAIMS**

- (1) Upon dissolution pursuant to KRS 275.285, a limited liability company may dispose of the known claims against it by filing, if required, articles of dissolution pursuant to KRS 275.315 and by following the procedures described in this section.
- (2) The limited liability company shall notify its known claimants in writing of the dissolution at any time after the effective date of dissolution. The written notice shall:
  - (a) Describe information that must be included in a claim;
  - (b) Provide a mailing address where a claim may be sent;
  - (c) State the deadline, which may not be fewer than one hundred twenty (120) days after the later of the date of the written notice, if required, or the filing of articles of dissolution pursuant to KRS 275.315, by which the limited liability company must receive the claim; and
  - (d) State that the claim will be barred if not received by the deadline.
- (3) A claim against the limited liability company shall be barred:
  - (a) If a claimant who is given written notice under subsection (2) of this section does not deliver the claim to the limited liability company by the deadline;
  - (b) If a claimant whose claim was rejected by the limited liability company does not commence a proceeding to enforce the claim within ninety (90) days after the date of the rejection notice.
- (4) For purposes of this section, "claim" shall not include a contingent liability or a claim based on an event occurring after the effective date of dissolution.

#### **275.325 PUBLICATION OF NOTICE OF DISSOLUTION; BARRED CLAIMS; ENFORCEABLE CLAIMS**

- (1) A dissolved limited liability company may publish notice of its dissolution pursuant to this section.
- (2) The notice shall:
  - (a) Be published once in a newspaper of general circulation in the county where the limited liability company's principal office, or, if none in this state, its registered office, is or was last located;
  - (b) Describe the information that must be included in a claim and provide a mailing address where the claim may be sent; and
  - (c) State that a claim against the limited liability company will be barred unless a proceeding to enforce the claim is commenced within two (2) years, or five (5) years for a professional limited liability company, after the publication of the notice.
- (3) If the dissolved limited liability company publishes a newspaper notice in accordance with subsection (2) of this section and, if required, files articles of dissolution pursuant to KRS 275.315, the claim of each of the following claimants shall be barred unless the claimant commences a proceeding to enforce the claim against the limited liability company within two (2) years, or five (5) years for a professional limited liability company, after the later of publication date of the newspaper notice or the

filing of the articles of dissolution pursuant to KRS 275.315, the filing of a certificate of dissolution by the Secretary of State pursuant to KRS 275.295(2)(b), or the filing of a decree of judicial dissolution by the Secretary of State pursuant to KRS 275.290(2):

- (a) A claimant who did not receive written notice under KRS 275.320;
  - (b) A claimant whose claim was timely sent to the limited liability company but not acted on;
  - (c) A claimant whose claim is contingent or based on an event occurring after the effective date of dissolution.
- (4) A claim may be enforced under this section:
- (a) Against the limited liability company, to the extent of its undistributed assets; or
  - (b) If the assets have been distributed in liquidation, against a member of the limited liability company to the extent of his pro rata share of the claim or the assets of the limited liability company distributed to him in liquidation, whichever is less, but a member's total liability for all claims under this section shall not exceed the total amount of assets, less liabilities assumed or taken subject to, distributed to him.

#### **275.330 USE OF COMPANY'S NAME IN JUDICIAL ACTIONS**

Suit may be brought by or against the limited liability company in its own name.

#### **275.335 PERSONS WHO MAY SUE IN COMPANY'S NAME**

Unless otherwise provided in a written operating agreement, a suit on behalf of the limited liability company may be brought in the name of the limited liability company only by:

- (1) One (1) or more members of a limited liability company, whether or not the operating agreement vests management of the limited liability company in one (1) or more managers, who are authorized to sue by the vote of more than one half (1/2) of the number of members eligible to vote thereon, unless the vote of all members shall be required pursuant to KRS 275.175(1). In determining the vote required under KRS 275.175, the vote of any member who has an interest in the outcome of the suit that is adverse to the interest of the limited liability company shall be excluded; or
- (2) One (1) or more managers of the limited liability company, if an operating agreement vests management of the limited liability company in one (1) or more managers, who are authorized to do so by the vote required pursuant to KRS 275.175 of the managers eligible to vote thereon. In determining the required vote, the vote of any manager who has an interest in the outcome of the suit that is adverse to the interest of the limited liability company shall be excluded.

#### **275.340 EFFECT OF DETERMINATION THAT MEMBER OR MANAGER LACKS AUTHORITY TO SUE ON BEHALF OF COMPANY**

A determination that a member or manager does not have authority to sue on behalf of the limited liability company shall not be asserted as a defense to an action brought by the limited liability company or as a basis for the limited liability company to bring a subsequent suit on the same cause of action.

**275.345 RIGHT OF COMPANY TO MERGE WITH OTHER BUSINESS ENTITIES**

- (1) Unless otherwise provided in writing in a written operating agreement, and subject to any law applicable to business entities other than limited liability companies, one (1) or more limited liability companies may merge with or into one (1) or more other business entities with the limited liability company or other business entity being the surviving or resulting limited liability company or other business entity.
- (2) Rights or securities of or interests in a business entity that is a party to the merger may be exchanged for or converted into cash, property, obligations, rights, or securities of or interests in the surviving or resulting business entity or of any other business entity.

**275.350 APPROVAL OF PROPOSED MERGER**

- (1) Unless otherwise provided in a written operating agreement, a limited liability company that is a party to a proposed merger shall approve the plan of merger in KRS 275.355 by a majority-in-interest of the members.
- (2) Each business entity that is a party to a proposed merger shall approve the plan of merger in the manner and by the vote required by the laws applicable to the business entity.
- (3) Each business entity that is a party to the merger shall have the rights to abandon the merger as provided for in the plan of merger or in the laws applicable to the business entity.

**275.355 PLAN OF MERGER**

- (1) Each constituent business entity shall enter into a written plan of merger, which shall be approved in accordance with KRS 275.350.
- (2) The plan of merger shall set forth:
  - (a) The name of each constituent business entity that is a party to the merger and the name of the surviving business entity into which each constituent business entity proposes to merge;
  - (b) The terms and conditions of the proposed merger, including but not limited to, a statement which sets forth whether limited liability is retained by the surviving business entity;
  - (c) The manner and basis of converting the interests in each limited liability company and the interests in each business entity that is a party to the merger into interests, shares, or other securities or obligations, as the case may be, of the surviving entity, or of any other business entity, or, in whole or in part, into cash or other property;
  - (d) The amendments to the articles of organization of a limited liability company, or articles of incorporation of a corporation or certificate of limited partnership, as the case may be, of the surviving business entity as are desired to be effected by the merger, or that no changes are desired;
  - (e) Other provisions relating to the proposed merger that are deemed necessary or desirable.

**275.360 ARTICLES OF MERGER**

- (1) The business entity surviving from the merger shall deliver to the Secretary of State for filing articles of merger duly executed by each constituent business entity setting forth:

- (a) The name and jurisdiction of formation or organization of each constituent business entity which is to merge;
  - (b) The plan of merger;
  - (c) The name of the surviving business entity;
  - (d) A statement that the plan of merger was duly authorized and approved by each constituent business entity in accordance with KRS 275.350; and
  - (e) If the surviving entity is not a business entity organized under the laws of this Commonwealth, a statement that the surviving business entity:
    - 1. Agrees that it may be served with process in this Commonwealth in any proceeding for enforcement of any obligation of any constituent business entity party to the merger that was organized under the laws of this Commonwealth, as well as for enforcement of any obligation of the surviving business entity arising from the merger; and
    - 2. Appoints the Secretary of State as its agent for service of process in any such proceeding. The surviving entity shall specify the address to which a copy of the process shall be mailed to it by the Secretary of State.
- (2) A merger shall take effect upon the later of the effective date of the filing of the articles of merger or the date set forth in the articles of merger.
- (3) The articles of merger shall be executed by a limited liability company that is a party to the merger in the manner provided for in KRS 275.045 and shall be filed with the Secretary of State in the manner provided for in KRS 275.045.
- (4) A plan of merger approved in accordance with KRS 275.350 may effect any amendment to an operating agreement for a limited liability company if it is the surviving company in the merger. An approved plan of merger may also provide that the operating agreement of any constituent limited liability company to the merger, including a limited liability company formed for the purpose of consummating a merger, shall be the operating agreement of the limited liability company that is the surviving business entity. Any amendment to an operating agreement or adoption of a new operating agreement made pursuant to this subsection shall be effective at the effective time or date of the merger. The provisions of this subsection shall not be construed to limit the accomplishment of a merger or of any of the matters referred to in this section by any other means provided for in an operating agreement or other agreement or as otherwise permitted by law.

#### **275.365 EFFECT OF MERGER**

A merger shall have the following effects:

- (1) The constituent business entities that are parties to the merger shall be a single entity, which shall be the entity designated in the plan of merger as the surviving business entity.
- (2) Each party to the merger, except the surviving business entity, shall cease to exist.
- (3) The surviving business entity shall possess all the rights, privileges, immunities, and powers of each constituent business entity and shall be subject to all the restrictions, disabilities, and duties of each of the constituent entities to the extent the rights, privileges, immunities, powers, restrictions, disabilities, and duties are applicable to the type of business entity that is the surviving business entity.
- (4) All property, real, personal, and mixed, and all debts due on whatever account, including promises to make capital contributions and subscriptions for shares, and all other choices in action, and all and every other interest of, belonging to, or due to each of the constituent business entities shall be vested in the surviving business entity without further act or deed.

- (5) The title to all real estate and any interest therein, vested in any constituent business entity shall not revert or be in any way impaired by reason of the merger.
- (6) The surviving entity shall thenceforth be liable for all liabilities and obligations of each of the constituent business entities merged, and any claim existing or action or proceeding pending by or against any constituent business entity may be prosecuted as if the merger had not taken place, or the surviving business entity may be substituted in the action.
- (7) Neither the rights of creditors nor any liens on the property of any constituent business entity shall be impaired by the merger.
- (8) The interests in a limited liability company or other business entities that are to be converted or exchanged into interests, other securities, cash, obligations, or other property under the terms of the plan of merger are so converted and the former holders thereof are entitled only to the rights provided in the plan of merger or the rights otherwise provided by law.
- (9) A partner or, in the case of a limited partnership, a general partner who becomes a member of a limited liability company as a result of a merger, as the case may be, shall remain liable as a partner or general partner for an obligation incurred by the partnership or limited partnership before the merger takes effect. The partner's or general partner's liability for all other obligations of the limited liability company incurred after the merger takes effect shall be that of a member as provided in this chapter. A limited partner who becomes a member as a result of a merger shall remain liable only as a limited partner for an obligation incurred by the limited partnership before the merger takes effect.

#### 275.370 CONVERSION OF PARTNERSHIP OR LIMITED PARTNERSHIP TO LIMITED LIABILITY COMPANY

- (1) A partnership or limited partnership may be converted to a limited liability company pursuant to this section.
- (2) The terms and conditions of a conversion of a partnership or limited partnership to a limited liability company shall, in the case of a partnership, be approved by all the partners or by a number or percentage specified for conversion in the partnership agreement or, in the case of a limited partnership, by all the partners, notwithstanding any provision to the contrary in the limited partnership agreement.
- (3) After the conversion is approved under subsection (2) of this section, the partnership or limited partnership shall file articles of organization with the office of the Secretary of State which satisfy the requirements of KRS 275.025 and include:
  - (a) A statement that the partnership or limited partnership was converted to a limited liability company from a partnership or limited partnership, as the case may be;
  - (b) Its former name;
  - (c) In the case of a partnership, a statement of the number of votes cast by the partners entitled to vote for and against the conversion and, if the vote is less than unanimous, the number or percentage required to approve the conversion under the partnership agreement and a statement that any assumed name has been canceled; and
  - (d) In the case of a limited partnership, the limited partnership shall cancel its certificate of limited partnership and any assumed name pursuant to this Commonwealth's limited partnership law.
- (4) The conversion shall take effect, in the case of a partnership, when the articles of organization are filed with the office of the Secretary of State or at any later date specified in the articles of organization or, in the case of a limited partnership, when the certificate of limited partnership is canceled.

(5) A partner or, in the case of a limited partnership, a general partner who becomes a member of a limited liability company as a result of a conversion shall remain liable as a partner or general partner for an obligation incurred by the partnership or limited partnership before the conversion takes effect. If the other party to a transaction with the limited liability company reasonably believes when entering the transaction that the member undertaking the transaction is a partner in a partnership or a general partner in a limited partnership, the member shall be liable for an obligation incurred by the limited liability company within ninety (90) days after the conversion takes effect. The partner's or general partner's liability for all other obligations of the limited liability company incurred after the conversion takes effect shall be that of a member as provided in this chapter. A limited partner who becomes a member as a result of a conversion shall remain liable only as a limited partner for an obligation incurred by the limited partnership before the conversion takes effect.

#### **275.375 EFFECT OF CONVERSION**

(1) A partnership or limited partnership that has been converted pursuant to this chapter shall be for all purposes the same entity that existed before the conversion.

(2) When a conversion takes effect:

- (a) All property owned by the converting partnership or limited partnership shall remain vested in the converted business entity;
- (b) All obligations of the converting partnership or limited partnership shall continue as obligations of the converted business entity; and
- (c) An action or proceeding pending against the converting partnership or limited partnership may be continued as if the conversion had not occurred.

#### **275.380 LAWS GOVERNING FOREIGN LIMITED LIABILITY COMPANY**

(1) Subject to the Constitution of this Commonwealth:

- (a) The laws of the state or other jurisdiction under which a foreign limited liability company is organized shall govern its organization and internal affairs and the liability of its members, except as provided in subsection (2) of this section; and
- (b) A foreign limited liability company shall not be denied registration by reason of any difference between the laws of another jurisdiction under which a foreign limited liability company is organized and the laws of this Commonwealth.

(2) A certificate of authority obtained pursuant to this chapter shall not authorize a foreign limited liability company to exercise any powers or engage in any business that a domestic limited liability company is forbidden to exercise or engage in by the laws of this Commonwealth.

#### **275.385 TRANSACTION OF BUSINESS BY FOREIGN LIMITED LIABILITY COMPANY**

(1) A foreign limited liability company shall not transact business in this Commonwealth until it obtains a certificate of authority from the Secretary of State.

(2) The following activities, among others, shall not constitute transacting business within the meaning of subsection (1) of this section:

- (a) Maintaining, defending, or settling any action, suit, or proceeding;

- (b) Holding meetings of its members or managers or carrying on other activities concerning its internal affairs;
  - (c) Maintaining bank accounts;
  - (d) Maintaining offices or agencies for the transfer, exchange, and registration of the limited liability company's securities, or maintaining trustees or depositories with respect to those securities;
  - (e) Selling through independent contractors;
  - (f) Soliciting or obtaining orders, whether by mail, through employees or agents, or otherwise, if the orders require acceptance outside this Commonwealth before they become contracts;
  - (g) Creating or acquiring indebtedness, mortgages, and security interests in real or personal property;
  - (h) Securing or collecting debts or enforcing mortgages and security interests in property securing the debts;
  - (i) Owning, without more, real or personal property;
  - (j) Conducting an isolated transaction that is completed within thirty (30) days and that is not one (1) in the course of repeated transactions of a like nature; or
  - (k) Transacting business in interstate commerce.
- (3) The list of activities in subsection (2) of this section shall not be considered exhaustive. This section shall not apply in determining the contracts or activities that may subject a foreign limited liability company to service of process or taxation in this Commonwealth or to regulation under any other law of this Commonwealth.
- (4) The term "transacting business" as used in this section shall have no effect on personal jurisdiction under KRS 454.210.

**275.390 CERTIFICATE OF AUTHORITY REQUIRED OF FOREIGN LIMITED LIABILITY COMPANY FOR ACCESS TO COURTS; CIVIL PENALTY FOR VIOLATION**

- (1) A foreign limited liability company transacting business in this Commonwealth without a certificate of authority shall not maintain an action, suit, or proceeding in any court in this Commonwealth until it obtains a certificate of authority.
- (2) The successor to a limited liability company that transacted business in this Commonwealth without a certificate of authority and the assignee of a cause of action arising out of that business shall not maintain a proceeding based on that cause of action in any court in this Commonwealth until the foreign limited liability company or its successor obtains a certificate of authority.
- (3) A court may stay a proceeding commenced by a foreign limited liability company, its successor, or assignee, until it determines whether the foreign limited liability company or its successor requires a certificate of authority. If it so determines, the court may further stay the proceeding until the limited liability company or its successor obtains the certificate of authority.
- (4) A foreign limited liability company shall be liable for a civil penalty of two dollars (\$2) for each day, but not to exceed a total of five hundred dollars (\$500) for each year, it transacts business in this Commonwealth without a certificate of authority. The Attorney General may collect all penalties due under this subsection.
- (5) Notwithstanding subsections (1) and (2) of this section, the failure of a foreign limited liability company to obtain a certificate of authority shall not impair the validity of any contract or act of the

foreign limited liability company or prevent it from defending any proceeding in this Commonwealth.

**275.395 APPLICATION FOR CERTIFICATE OF AUTHORITY FOR FOREIGN LIMITED LIABILITY COMPANY**

(1) A foreign limited liability company may apply for a certificate of authority to transact business in this Commonwealth by delivering an application to the Secretary of State for filing. The application shall set forth:

- (a) The name of the foreign limited liability company, or if its name is unavailable for use in this Commonwealth, a company name that satisfies the requirements of KRS 275.410;
- (b) The name of the state or country under whose law it is organized;
- (c) Its date of organization and, if the limited liability company has a specific date of dissolution, the latest date upon which it is to dissolve;
- (d) The street address of the office required to be maintained in the state or other jurisdiction of its formation by the laws of that state or jurisdiction or, if not so required, of the principal office of the foreign limited liability company;
- (e) The address of its registered office in this Commonwealth and the name of its registered agent at that office;
- (f) The names and usual business addresses of its current managers, if any; and
- (g) A statement that, as of the date of filing, the foreign limited liability company validly exists as a limited liability company under the laws of the jurisdiction of its formation.

(2) A written statement of the initial registered agent consenting to serve in that capacity shall accompany the certificate of authority.

**275.400 AMENDED CERTIFICATE OF AUTHORITY FOR FOREIGN LIMITED LIABILITY COMPANY**

(1) A foreign limited liability company authorized to transact business in this Commonwealth shall obtain an amended certificate of authority from the Secretary of State if it changes:

- (a) Its company name;
- (b) The latest date on which it is to dissolve; or
- (c) The state or country of its organization.

(2) The requirements of KRS 275.395 for obtaining an original certificate of authority shall apply to obtaining an amended certificate under this section.

**275.405 EFFECT OF CERTIFICATE OF AUTHORITY FOR FOREIGN LIMITED LIABILITY COMPANY**

(1) A certificate of authority shall authorize the foreign limited liability company to which it is issued to transact business in this Commonwealth subject to the right of the Commonwealth to revoke the certificate as provided in this chapter.

(2) A foreign limited liability company with a valid certificate of authority shall have the same but no greater rights as, and shall have the same but no greater privileges as, and except as otherwise



provided by this chapter shall be subject to the same duties, restrictions, penalties, and liabilities now or later imposed on, a domestic limited liability company.

(3) This chapter shall not authorize this Commonwealth to regulate the organization or internal affairs of a foreign limited liability company authorized to transact business in this Commonwealth.

#### **275.410 NAME USED BY FOREIGN LIMITED LIABILITY COMPANY**

(1) If the name of a foreign limited liability company does not satisfy the requirements of KRS 275.100, the foreign limited liability company, to obtain or maintain a certificate of authority to transact business in this Commonwealth:

(a) May add to its name for use in this Commonwealth:

1. The words "limited liability company," "limited company," "professional limited liability company," or "professional liability company." The word "limited" may be abbreviated as "Ltd" and the word "Company" may be abbreviated as "Co."; or
2. The abbreviations "LLC," "LC," "PLLC," or "PLC"; or

(b) May use a fictitious name to transact business in this Commonwealth if its real name is unavailable and it delivers to the Secretary of State for filing a certificate by a person authorized to execute documents pursuant to KRS 275.045(6) that the limited liability company has adopted the fictitious name.

(2) Except as authorized by subsections (3) and (4) of this section, the name, including a fictitious name, of a foreign limited liability company shall be distinguishable from the name of any other business entity upon the records with the Secretary of State.

(3) A foreign limited liability company may apply to the Secretary of State for authorization to use in this Commonwealth the name of another business entity, organized or authorized to transact business in this Commonwealth, that is not distinguishable upon his records from the name applied for. The Secretary of State shall authorize use of the name applied for if:

- (a) The business entity consents to the use in writing and submits an undertaking in form satisfactory to the Secretary of State to change its name to a name that is distinguishable upon the records of the Secretary of State from the name of the applying limited liability company; or
- (b) The applicant delivers to the Secretary of State a certified copy of a final judgment of a court of competent jurisdiction establishing the applicant's right to use the name applied for in this Commonwealth.

(4) A foreign limited liability company may use in this Commonwealth the name, including the fictitious name, of another business entity that is used in this Commonwealth if the business entity is organized or authorized to transact business in this Commonwealth and the foreign limited liability company:

- (a) Has merged with the other business entity;
- (b) Has been formed by reorganization of the business entity; or
- (c) Has acquired all or substantially all of the assets, including the name, of the other business entity.

(5) If a foreign limited liability company authorized to transact business in this Commonwealth changes its name to one that does not satisfy the requirements of this section, it shall not transact business in this Commonwealth under the changed name until it adopts a name satisfying the requirements of this section and obtains an amended certificate of authorization under KRS 275.400.

**275.415 REGISTERED OFFICE AND REGISTERED AGENT FOR FOREIGN LIMITED LIABILITY COMPANY**

Each foreign limited liability company authorized to transact business in this Commonwealth shall continuously maintain in this Commonwealth:

- (1) A registered office that may be the same as any of its places of business; and
- (2) A registered agent, who may be:
  - (a) An individual who resides in this Commonwealth and whose business office is identical with the registered office;
  - (b) A domestic corporation or not-for-profit domestic corporation whose business office is identical with the registered office;
  - (c) A foreign corporation or foreign not-for-profit corporation authorized to transact business in this Commonwealth whose business office is identical with the registered office; or
  - (d) A domestic limited liability company or a foreign limited liability company authorized to transact business in this Commonwealth whose business address is identical with the registered office.
- (3) The registered agent shall execute and deliver to the Secretary of State a document accepting the agency appointment, and the appointment of the agent shall not be effective until delivered to the Secretary of State.

**275.420 CHANGE OF REGISTERED OFFICE OR REGISTERED AGENT FOR FOREIGN LIMITED LIABILITY COMPANY**

- (1) A foreign limited liability company authorized to transact business in this Commonwealth may change its registered office or registered agent by delivering to the Secretary of State for filing a statement of change that sets forth:
  - (a) Its name;
  - (b) The street address of its current registered office;
  - (c) If the current registered office is to be changed, the street address of its new registered office;
  - (d) The name of its current registered agent;
  - (e) If the current registered agent is to be changed, the name of its new registered agent and the new agent's written consent, either on the statement or attached to it, to the appointment; and
  - (f) That after the change or changes are made, the street addresses of its registered office and the business office of its registered agent will be identical.
- (2) If a registered agent changes the street address of its business office, the agent shall change the street address of the registered office of any foreign limited liability company for which the agent is the registered agent by notifying the limited liability company in writing of the change and signing, either manually or in facsimile, and delivering to the Secretary of State for filing a statement of change that complies with the requirements of subsection (1) of this section and recites that the limited liability company has been notified of the change.

**275.425 STATEMENT OF RESIGNATION OF REGISTERED AGENT OF FOREIGN LIMITED LIABILITY COMPANY**

- (1) The registered agent of a foreign limited liability company may resign its agency appointment by signing and delivering to the Secretary of State for filing the original and two (2) exact or conformed copies of a statement of resignation. The statement of resignation may include a statement that the registered office is also discontinued.
- (2) After filing the statement, the Secretary of State shall attach the filing receipt to one (1) copy and mail the copy and receipt to the registered office if not discontinued. The Secretary of State shall mail the other copy to the foreign limited liability company at its principal office address shown in its most recent annual report.
- (3) The agency appointment shall be terminated, and the registered office discontinued if so provided, on the thirty-first day after the date on which the statement was filed. A foreign limited liability company that fails to maintain a registered agent in this Commonwealth shall be subject to revocation of its certificate of authority under KRS 275.440.

**275.430 SERVICE OF PROCESS ON FOREIGN LIMITED LIABILITY COMPANY**

- (1) The registered agent of a foreign limited liability company authorized to transact business in this Commonwealth shall be the company's agent for service of process, notice, or demand required or permitted by law to be served on the foreign limited liability company.
- (2) A foreign limited liability company may be served by registered or certified mail, return receipt requested, addressed to the appropriate representative of the foreign limited liability company at its principal office shown in its application for a certificate of authority or in its most recent annual report, if the foreign limited liability company:
  - (a) Has no registered agent or its registered agent cannot with reasonable diligence be served;
  - (b) Has withdrawn from transacting business in this Commonwealth under KRS 275.435; or
  - (c) Has had its certificate of authority revoked under KRS 275.445.
- (3) Service is perfected under subsection (2) of this section at the earliest of:
  - (a) The date the foreign limited liability company receives service by mail;
  - (b) The date shown on the return receipt, if signed on behalf of the foreign limited liability company; or
  - (c) Five (5) days after its deposit in the United States mail, as evidenced by the postmark, if mailed postpaid and correctly addressed.
- (4) This section shall not prescribe the only means, or necessarily the required means, of serving a foreign limited liability company.

**275.435 CERTIFICATE OF WITHDRAWAL FOR FOREIGN LIMITED LIABILITY COMPANY**

- (1) A foreign limited liability company authorized to transact business in this Commonwealth shall not withdraw from this Commonwealth until it obtains a certificate of withdrawal from the Secretary of State.

(2) A foreign limited liability company authorized to transact business in this Commonwealth may apply for a certificate of withdrawal by delivering an application to the Secretary of State for filing. The application shall set forth:

(a) The name of the foreign limited liability company and the name of the state or country under whose law it is organized;

(b) A statement that it is not transacting business in this Commonwealth and that it surrenders its authority to transact business in this Commonwealth;

(c) A statement that it revokes the authority of its registered agent to accept service on its behalf and appoints the Secretary of State as its agent for service of process in any proceeding based on a cause of action arising during the time it was authorized to transact business in this Commonwealth;

(d) A mailing address to which the Secretary of State may mail a copy of any process served on the Secretary of State under subsection (2) or (3) of this section; and

(e) A commitment to notify the Secretary of State in the future of any change in its mailing address.

(3) After the withdrawal of the limited liability company is effective, service of process on the Secretary of State under this section shall be service on the foreign limited liability company. Upon receipt of process, the Secretary of State shall mail a copy of the process to the foreign limited liability company at the mailing address set forth under subsection (2) of this section.

#### **275.440      GROUNDS FOR REVOCATION OF CERTIFICATE OF AUTHORITY OF FOREIGN LIMITED LIABILITY COMPANY**

The Secretary of State may commence a proceeding under KRS 275.445 to revoke the certificate of authority of a foreign limited liability company authorized to transact business in this Commonwealth if:

(1) The foreign limited liability company does not file its annual report to the Secretary of State within sixty (60) days after it is due;

(2) The foreign limited liability company is without a registered agent or registered office in this Commonwealth for sixty (60) days or more;

(3) The foreign limited liability company does not inform the Secretary of State under KRS 275.420 and 275.425 that its registered agent or registered office has changed, that its registered agent has resigned, or that its registered office has been discontinued within sixty (60) days of the change, resignation, or discontinuance;

(4) A member or manager of the limited liability company or person organizing the foreign limited liability company signed a document the member, manager, or person knew was false in any material respect with intent that the document be delivered to the Secretary of State for filing; or

(5) The Secretary of State receives a duly-authenticated certificate from the Secretary of State or other official having custody of limited liability company records in the state or country under whose law the foreign limited liability company is organized stating that it has been dissolved or disappeared as the result of a merger or other event.

#### **275.445      NOTICE OF DETERMINATION; REVOCATION OF CERTIFICATE; EFFECT OF REVOCATION**

(1) If the Secretary of State determines that one (1) or more grounds exist under KRS 275.440 for revocation of a certificate of authority, the Secretary of State shall serve the foreign limited liability

company with written notice of its determination by mailing the notice by first-class mail to the foreign limited liability company at its registered office.

(2) If the foreign limited liability company does not correct each ground for revocation or demonstrate to the reasonable satisfaction of the Secretary of State that each ground determined by the Secretary of State does not exist within sixty (60) days after the mailing of the notice, the Secretary of State shall revoke the foreign limited liability company's certificate of authority by signing a certificate of revocation that recites the ground or grounds for revocation and its effective date. The Secretary of State shall file the original of the certificate and serve a copy to the foreign limited liability company by mailing notice by first-class mail to the foreign limited liability company at its registered office.

(3) The authority of a foreign limited liability company to transact business in this Commonwealth shall cease on the date shown on the certificate of revocation.

(4) The Secretary of State's revocation of a foreign limited liability company's certificate of authority shall have the effect of appointing the Secretary of State as the foreign limited liability company's agent for service of process in any proceeding based on a cause of action which arose during the time the foreign limited liability company was authorized to transact business in this Commonwealth. Service of process on the Secretary of State under this subsection shall be service on the foreign limited liability company. Upon receipt of process, the Secretary of State shall mail a copy of the process to the appropriate representative of the foreign limited liability company at its principal office as shown in its most recent annual report or in any subsequent communication received from the foreign limited liability company stating the current mailing address of its principal office, or, if none are on file, in its application for a certificate of authority.

(5) Revocation of a foreign limited liability company's certificate of authority shall not terminate the authority of the registered agent of the foreign limited liability company.

#### **275.450 APPEAL OF REVOCATION**

(1) A foreign limited liability company may appeal the Secretary of State's revocation of its certificate of authority to the Franklin Circuit Court within thirty (30) days after the service of certificate of revocation. The foreign limited liability company may petition the court to set aside the revocation by attaching to the petition copies of its certificate of authority and the Secretary of State's certificate of revocation.

(2) The court may summarily order the Secretary of State to reinstate the certificate of authority or may take any other action the court considers appropriate.

(3) The court's final decision may be appealed as in other civil proceedings.

#### **275.455 EXERCISE OF POWERS BY KENTUCKY COMPANY IN ANY STATE OR COUNTRY**

A limited liability company organized and existing under this chapter may conduct its business, carry on its operations, and have and exercise the powers granted by this chapter in any state or foreign country.



## INDEX





## INDEX

*References are to monograph section numbers*

FLLC = Family Limited Liability Company

FLP = Family Limited Partnership

LLC = Limited Liability Company

PSC = Professional Service Corporation

RLLP = Registered Limited Liability Partnership

SMLLC = Single-Member Limited Liability Company

### **Abusive Partnerships**

applicability to LLCs, 3.24

disregard of transaction by IRS, 3.24

### **Accident Insurance *See* Health And Accident Insurance**

### **Accountants**

malpractice claims against, 15.2

practice in LLC form, 15.2, 16.15

practice in RLLP form, 2.5, 15.2

practice in other forms, 15.2, 16.15

prohibition of multiple services, 15.4

statutory treatment, 15.2, 16.15

### **Accounting Methods**

accrual method, 8.13

capital accounts by LLCs, 6.10, 8.5

-deficit in, 8.5

-qualified income offset provision, 8.5

capital accounts by partnerships, 3.20

cash method, use of by LLC, 3.28, 15.7

joint ventures, 14.5

LLC financial statements using cash basis, 6.14

preparation of LLC financial statements in accordance with GAAP, 6.14, 14.5

tax shelters prohibited from using cash method, 3.28, 15.7

### **Accounts Payable *See* Liabilities And Debts**

### **Accumulated Adjustment Account**

relationship to taxation of S-corporation

distributions to shareholder, 3.15

### **Accumulated Earnings Tax *See also* Taxation**

generally, 3.3, 3.15

C corporations, 3.3

S corporations, 3.15

taxation of distribution as dividend, 3.8

when imposed, 3.3

### **Adjusted Basis**

C-corporation production of earnings and profits, 3.8

contributions to S-corporations, 3.13

in an LLC, 8.3, 8.4

partnership distributions, 3.22

### **Administrative Dissolution**

generally, 6.27, 16.5

agency power after, 6.29

articles of dissolution, 6.31

as consequence of failing to maintain registered agent and registered office, 5.9, 6.27

as consequence of failing to meet annual reports requirements, 5.18, 6.27, 16.5

claims against LLC after, 6.32

distribution of assets after, 6.30

grounds for, 6.27

notice of, 6.27

petition for reinstatement, 6.27

-relation back of reinstatement, 6.27

### **Admission Of Member**

assignee of membership interest, 6.18, 6.19

effective date of, 6.17

means of, 6.17

### **Admissions**

by an LLC, generally, 6.6

### **Advantages Of LLC Form**

generally, 1.1, 3.26, 3.28

allocation of profits and losses, 6.10

distribution of profits, 6.11

ease of conversion, 5.4, 7.2, 7.3, 16.20

ease of merger transactions, 7.2

flexibility in management, 1.1, 3.28, 5.1, 6.1, 6.2, 16.12

informality, 6.1, 6.2, 16.13

in-kind distributions prohibited, 6.13

inter-entity mergers, 7.8

limited liability, 1.1, 1.7, 3.26, 5.1, 16.13

preparation of financial statements, 6.14

tax advantages, 1.1, 1.10, 1.12, 1.13, 3.1, 3.2, 3.26-28, 8.1

treatment as partnership for federal tax purposes, 1.10, 1.12, 1.13, 3.1-2, 3.26, 3.28, 4.1, 5.1, 8.1, 16.13

-classification of Ky. LLCs, 4.22

wealth transfer planning, 11.1-11.3

### **Affiliated Group**

corporation as member, taxation, 3.5

S-corporation membership prohibited, 3.11

### **Agents**

admission by used against LLC, 6.6

agency power after LLC dissolution, 6.29

- exclusive vesting of agency power in LLC managers, 6.2
- foreign LLC agent for service of process, 5.16
- indemnification for agents of LLC, 15.11
- LLC member as agent under default rules, 6.2
- liability of, 6.7, 15.3, 15.9-11
- manager-managed LLC, member loss of agency power, 6.2
- name of registered agent in articles of organization, 5.3, 16.12
- of RLLP, 18.3
- registered agent of LLC, 5.9, 16.7
- representative of incompetent member, rights of, 6.20
- reservation of agency authority in articles of organization, 6.2

## **Allocations**

- allocation of LLC liabilities, basis in an LLC, 8.4
- basis in recourse loan allocated to guarantor partner, 3.19, 8.4
- classes of membership with differing rights to, 1.6
- income, gain, loss, deduction and credit by LLC
  - generally, 8.5
  - at-risk rules, 8.6
  - capital accounts, 8.5
  - limits on, 8.6
  - passive-activity loss rules, 8.6
  - "substantial economic effect" standard, 8.5
- income, gain, loss, deduction and credit by partnerships
  - generally, 3.20, 3.28, 6.10
  - allocation of non-recourse debt, safe harbors, 3.20, 3.28
  - "substantial economic effect" standard, 3.20, 3.28, 6.10
  - wide discretion in partnership agreement, 3.20, 3.28
- IRS reallocation, family S-corp., 3.13
- liabilities to general partner of limited partnership, 3.19
- limitations on loss deductions, partnerships
  - generally, 3.21
  - at-risk limitations, 3.21
- limitations on loss deductions, S-corp., 3.13-16, 3.28
- limits on loss deductions, LLC, 8.6
- of income, gain, loss, deduction, credit by S-corp., 3.13
- of non-recourse liabilities in a partnership, 3.19
- of profits and losses to corporate general partner of limited partnership, 3.17
- of profits and losses of LLC, 1.6, 6.10, 8.5
  - per capital basis, 6.10
- qualified by articles of organization, 1.6
- qualified by operating agreement, 1.6
- reallocation of income within family partnership, 3.20
- special allocation by LLC for income, gain, loss, deduction, credit, 3.28, 6.10
- statutory rights of LLC members to receive allocations of profits and losses, 6.2

statutory treatment as per capital, 1.6, 6.10

## **Alter Ego**

as basis for personal liability, 1.7

## **Alternative Minimum Tax**

- generally, 3.3
- applied to corporations, 3.3
- applied to individuals, 3.4
- computation of, 3.3, 3.4
- life insurance proceeds, 8.24
- purpose of, 3.3

## **Ancillary Services**

generally, 15.4

## **Annual Reports**

- consequences of failure to file, 5.18, 6.27
- contents, 2.9, 5.18
- foreign corporations, 5.18
- proper delivery of as contained in certificate of existence, 16.14
- proper filing as representation in loan documents, 16.5
- Secretary of State filings, 2.9, 5.18, 16.14

## **Antitrust**

filing requirements, joint ventures, 14.6

## **Appraisals**

and wealth transfer planning, 11.4.4, 11.8.1

## **Architects *See also* Landscape Architects**

- practice in LLC form, 15.2
- status as professional service, 15.2

## **Articles Of Dissolution**

- generally, 6.31,
- as presumptive notice, 6.29,
- contents of, 6.31
- time for filing, 6.31

## **Articles Of Incorporation**

- generally, 16.12
- compared to LLC articles of organization, 1.4, 6.1, 16.12
- contents of, 1.4, 2.8, 2.9
- Secretary of State filings, 2.9, 6.1

## **Articles Of Merger**

- generally, 7.10
- amendment or cancellation of, 7.10
- execution of, 7.10
- filing of as effectuating cancellation of certificate of limited partnership, 7.10

## **Articles Of Organization**

generally, 1.4, 15.6, 5.3, 16.12

amendment of, 5.3, 6.3  
 beginning existence of LLC, 1.4, 5.3  
 cancellation of partnership assumed name, 5.4, 7.5  
 compared to corporate articles of incorporation, 1.4, 6.1, 16.12  
 contents of, 1.4, 2.9, 5.3-4, 7.5, 15.6, 16.12  
 county clerk filings, 1.4, 5.3  
 declaration of management of LLC required in, 6.2  
 designation of professional services to be performed, 5.3, 15.6  
 dissolution provided for in, 6.24  
 execution of, 5.3  
 filing by organizers of LLC, 1.4, 5.3  
 inclusion of additional matters, 5.3  
 information needed under statutory conversion, 5.3, 5.4, 7.5  
 providing for management rights of members, 5.3, 16.12  
 public record, 1.4, 2.9, 6.2  
 relationship to financing statements, 16.12  
 restatement of, 5.3  
 Secretary of State filings, 1.4, 2.9, 5.3, 6.1, 16.12  
 setting voting requirements for election and removal of managers, 6.2  
 use of in loan transactions, 16.12  
 voting requirements for amendment, 5.3, 6.3

**Asset Protection Planning** *See also* **Wealth Transfer Planning**

generally, 11.3, 11.7, 11.7.2  
 -fraudulent conveyances, 11.7.3  
 -liability shield of family LLC, 11.7.1

**Assets Of LLC** *See also* **Personal Property, Real Estate And Property**

assets of RLLP, 18.4  
 collection and disposal of during winding up phase, 6.28,  
 conversion to LLC, vesting of title, 7.6  
 distribution of during winding up, 6.30  
 -prioritization of distribution, 6.30  
 effect of merger, 7.11, 7.12, 8.17, 8.18  
 forced sale of due to restriction on in kind distributions, 6.13  
 goodwill as asset of LLC, 6.12, 8.8  
 ownership of LLC property, 6.15, 6.16  
 power to acquire, hold and convey in LLC name, 16.6  
 single-asset entities, SMLLCs, 9.6  
 subject to claims of creditors, 6.7  
 transfer of LLC property, 6.16

**Assignment** *See also* **Transfers**

admission of assignee as member, 1.8, 5.5, 6.18-19  
 assignee's acquiring management rights, 1.8, 6.18-19, 16.9  
 assignee's rights to proxy, 16.9  
 assignee's rights upon, 1.8, 6.18-19, 16.9  
 assignor ceasing membership in LLC, 6.19  
 conflicts of interest arising from, 6.18  
 deceased member's estate, 6.21

effect on liability, 6.18, 6.19  
 incompetent member's representative, 6.21  
 judgment creditor's rights as assignee, 6.20  
 not grounds for dissolution, 6.18  
 of LLC ownership interest, 1.8, 6.18, 6.19, 16.9  
 -as event of disassociation, 6.23  
 restriction against, 1.8  
 statutory right of members to vote on transfer of member's interest, 6.2  
 transfer of economic rights only, 6.18  
 transfer of management rights prohibited, 6.18, 6.19

**Assumed Name**

cancellation by partnership upon conversion to LLC form, 5.4, 7.5  
 cancellation upon merger with LLC, 7.10  
 filing of certificate of assumed name by LLC, 5.7  
 statement of cancellation of assumed name in articles of organization, 7.5

**Assumption**

of liabilities in incorporation, 3.6  
 of transferor's liabilities, taxation, 3.6  
 partnership assumption of liabilities, recognition of income by contributing partner, 3.18

**Attorneys** *See also* **Legal Profession**

conversion of practice to LLC or RLLP form, 15.3, 15.8  
 ethical violations, liability for, 15.3  
 Kentucky Bar Association, 15.3  
 Kentucky Constitutional provisions, 1.12, 2.3, 15.3, 15.5  
 Kentucky Rules of Professional Conduct and the LLC, 15.3  
 personal liability for professional acts, 6.7, 15.3, 15.9-11  
 practice in LLC form, 1.12, 15.2, 15.3  
 practice in PSC form, 15.3  
 practice in RLLP form, 15.3  
 regulation of by Kentucky Supreme Court, 1.12, 2.3, 15.3, 15.4  
 statutory designation as profession, 15.2

**Attribution Rules**

generally, 3.8  
 applicability of, 3.8

**Authority**

actions taken without proper authority, 1.7, 6.2  
 agency authority after LLC dissolution, 6.29  
 agency authority in an LLC, 6.2  
 apparent, 6.2, 18.3  
 certificate of authority for foreign LLC, 5.12  
 -acts not constituting doing business, 5.12  
 -revocation of, 5.16  
 date of authorization for distribution, impact measured, 6.14  
 delegation of, 16.17

- foreign LLC transacting business without authority, effect of, 5.13
- from licensing board to use LLC form, 1.12, 5.6, 16.15
- granting of by resolution, 16.6
- management authority as a factor in tax treatment, 1.10, 6.2
- of LLC to grant security interest, 16.6
- partnership, 18.3
- "tax matters partner" (TMP), dealing with IRS, 8.11
- to call LLC meeting, operating agreement providing for, 6.3
- to do business as foreign LLC, 1.11, 5.12, 6.8, 16.14, 16.16
- to execute and deliver loan documents, 16.11, 16.12, 16.17
- to manage LLC retained by members, default rules, 6.2
- to manage LLC vested in managers, 6.2
- to sue on behalf of LLC
  - generally, 6.34
  - consequence of lack of authority, 6.35
  - vote requirements, 6.34
- to transfer LLC property, 6.15
  - transfers without authority, 6.15
- withdrawal from qualification to do business, 5.17

#### **Banking Institutions** *See also Commercial Law And The LLC*

- incorporation of banking institution, 2.3
- practice as S-corp. prohibited, 3.11, 3.28

#### **Bankruptcy**

- as event of disassociation, 6.2, 6.23, 16.19
- bankruptcy-remote SMLLC, 9.5
- cancellation of indebtedness income
  - generally, 3.27
  - C-corp., 3.27
  - partnership, 3.27
  - S-corp., 3.27
- LLC as bankruptcy-remote entity, 16.22
- LLC distributions prohibited if rendering LLC insolvent, 6.14
- no longer triggering dissolution, 1.9, 16.19
- of member in LLC, 1.9, 6.2, 6.23, 16.19
- relationship to continuity of existence, 6.22
- statutory right of members to vote on continuation of LLC upon, 6.2

#### **Board Of Accountancy, Kentucky**

- authority to regulate, 15.2

#### **Board Of Medical Licensure, Kentucky**

- practice of medicine in LLC form, 15.2, 16.15

#### **Bona Fide Purchaser**

- rights upon transfer of LLC property, 6.16

#### **Breach**

- implied warranty of contract, 18.3, 18.4
- of membership contract on management authority, 6.2
- operating agreement limiting personal liability of manager for breach of duty, 6.4

#### **Broker-Dealer**

- generally, 12.1

#### **Built-In Gains Tax**

- net built-in gains tax, conversion of C-corp. to S-corp., 3.16
- S corporation, 3.16

#### **Bullet-Proof LLC Statute**

- generally, 1.3
- defined, 1.3

#### **Business Corporations** *See also Specific Entries*

- as member of affiliated group, 3.5
- calendar of, fiscal year, 3.27
- characteristics of, effect, 1.10, 3.1, 4.2, 8.1, 16.13
- closely held, loan documentation for as similar to LLC treatment, 16.3
- compared to LLC, tax purposes, 3.26, 3.27, 8.1
- corporate estimated tax payments, 3.16
- corporate income tax rates, generally, 3.3
- distributions by
  - deductions for, 3.8
  - in redemption of shares, 3.8
  - recognition of income, 3.8
  - taxation of, 3.8
- health care premiums, deductions, 3.27
- life insurance premiums, deductions, 3.27
- liquidation of
  - recognition of gain or loss, 3.8
  - tax treatment, 3.8
- membership in LLC, 1.4
- merger into LLC, 7.8
- passive loss rules, 3.27
- prohibition against discrimination among classes of interests, 1.4
- representations and warranties by in loan transactions, 16.5
- shareholder individual tax return, 3.5
- shareholder tax on distributions, 3.1
- shareholder tax on undistributed earnings, 3.1
- statutory residence of, 16.7

#### **Business Creditors**

- generally, 2.3
- conversion to LLC form effecting, 15.3, 15.8

#### **Business Succession Planning** *See also Wealth Transfer Planning*

- use of family entities as vehicle, 11.4.7

#### **Buy-Sell Agreements**

generally, 2.7  
use in partnerships, 2.7

### **Bylaws Of Corporation**

generally, 2.8  
compared to LLC operating agreement, 16.13  
share transfer restrictions 2.8

### **C-Corporation**

accumulated earnings tax, 3.3  
advantages of form, 3.27  
alternative minimum tax, 3.3  
as member of affiliated group, 3.5  
attribution rules, 3.6  
basis in stock  
-effect of corporate loss, 3.7  
-effect of operating income, 3.7  
-reduction, non-taxable distributions, 3.7  
-shareholder basis, 3.6, 3.7  
calendar of, fiscal year, 3.27  
capital gains tax, 3.3  
compared to LLC form, 1.1, 3.26, 3.27, 8.1  
compelled distributions, 3.2  
compensation of shareholders  
-compensation caps, 3.10  
-deductibility by corporation, 3.10  
-IRS challenges, 3.10  
-two-level taxation, avoidance of, 3.10  
consolidated tax returns, 3.5  
corporate basis in assets, 3.6  
disadvantages of form, 3.27  
distributions by  
-deductions for, 3.8  
-recognition of income, 3.8  
-taxation of, 3.8  
double-level taxation of, 1.1, 3.26, 3.27  
environmental tax, 3.3  
health insurance premiums, deductions, 3.27  
liabilities assumed in incorporation, tax treatment, 3.6  
life insurance premiums, deductions, 3.27  
liquidation, tax treatment, 3.8  
merger into LLC form, 7.8  
-tax treatment, 8.17  
merger into S-corp.  
-creation of earnings for tax purposes, 3.15  
-S-corp. payment of tax at corporate rates thereafter, 3.16  
passive loss rules, 3.27  
payment of tax on income, 3.2  
qualified pension and profit sharing plan, 3.27  
recognition of gain or loss, 3.6  
shareholder basis in stock, 3.6, 3.7  
shareholder contribution of property in exchange for stock, tax treatment, 3.6  
shareholder individual tax returns, 3.5  
shareholder tax on distributed after-tax earnings, 3.2  
single shareholder ownership, 3.27  
tax rates of, 3.2, 3.3, 3.5  
taxation as corporation, 3.1, 3.6, 3.26, 3.27

taxation on dispositions of stock, 3.9  
-gain on sale of stock, 3.9  
-shareholder recognition of loss, 3.9  
transferor's receipt of "boot", 3.6  
worthless stock, 3.9

### **Cafeteria Plans**

generally, 17.17  
defined, 17.17  
eligible participants, 3.27, 8.14, 17.17  
LLC member participation, 3.27, 8.14  
structuring of, 17.17  
tax treatment, 8.14

### **Calendar Year**

generally, 3.27

### **Capital Assets**

LLC distribution prohibited if impairing capital, 6.14  
sale of partnership capital, termination, 3.23

### **Capital Gains Tax**

generally, 3.3  
applied to corporations, 3.3  
applied to S-corporations, 3.15

### **Capital Transactions** *See also* **Liquidation Of LLC; Mergers; Shareholders; Venture Capital**

contributions to an LLC, taxation, 8.3, 14.3  
corporate basis in assets, 3.6  
distribution taxed as dividend, 3.8  
merger or consolidation with other corporation, 3.15  
recognition of gain and loss in, 3.6  
shareholder basis in stock, 3.6, 3.7  
shareholder basis, money loaned to corporation, 3.7  
shareholder contribution of property in exchange for stock, taxation, 3.6  
taxation of C-corp. distributions, 3.8  
taxation of S-corp. contributions, 3.11, 3.28  
taxation of S-corp. distributions, 3.15  
tax treatment, generally, 3.6

### **Capitalization Of LLC** *See also* **Venture Capital**

generally, 1.4, 6.9  
capital contributions, form, 1.4, 6.9  
-allocation of profits and losses based upon, 1.6  
-personal liability for, 1.7, 6.9  
capital losses, generally, 3.9  
contributions to an LLC, taxation, 8.3  
-basis in LLC, 8.4  
flexibility in capital contributions, 1.4  
flexibility in capital structure, 1.4, 5.1  
promise to make contribution, 6.9  
-enforcement after death or disability, 6.9  
-reliance upon promise to contribute, 6.9  
-writing requirement, 6.9  
tax treatment, generally, 3.2, 8.3

**Cash Method Accounting**  
generally, 3.28, 8.13, 15.7  
"ownership test", 8.13  
tax shelters precluded from using, 8.13, 15.7

**Centralized Management**  
generally, 1.10, 4.2  
as factor in determining tax treatment of LLC, 1.10, 4.2, 6.2  
LLC Act default provisions avoiding, 6.2

**Certificate Of Authority**  
amended certificate of authority, 5.14  
application for, 5.14  
authority granted under, 5.14  
contents of application, 5.14  
revocation of, 5.16  
service of foreign LLC when certificate revoked, 5.16

**Certificate Of Dissolution**  
generally, 6.29  
as presumptive notice, 6.29

**Certificate Of Existence**  
application to Secretary of State for, 16.14  
contents of, 16.14

**Certificate Of Limited Partnership**  
articles of merger effecting, 7.10  
cancellation of upon conversion to LLC form, 5.4, 7.5  
effective date of conversion, 7.5  
right to merger contingent upon filing, 7.8

**Certificate Of Withdrawal**  
generally, 5.17  
contents of application for, 5.17

**Certified Public Accountants** *See* Accountants

**Charitable Organizations** *See also* Tax-Exempt Organizations  
charitable FLPs and FLLCs, 11.4.11

**Check-The-Box Tax Regulations**  
generally, 1.3, 1.10, 1.13, 4.8, 11.4.2  
authority of IRS to issue regulations, 4.10  
conversions, 4.21  
corporations, 4.12  
eligible entities, 4.14  
-domestic, 4.15  
-foreign, 4.16  
-grandfather rules, 4.17, 4.18  
foreign per se corporations, 4.13  
Form 8832, 4.19  
Kentucky state classification of LLC, 4.22, 11.4.2  
Notice 95-14, 4.9

**Chiropractors**  
practice in LLC form, 15.2

**Choice Of Business Form**  
generally, 1.1, 2.2, 2.3  
C-corp., tax treatment, 3.27  
calendar or fiscal years, 3.27  
comparison of business forms, 1.1, 3.1, 3.27, 4.1, 6.1, 8.1  
income tax considerations, 3.1  
-overview, 3.2, 3.26, 3.27, 8.1  
LLC, 1.1, 3.26  
partnership tax treatment as reason for, 3.17-.20, 3.28, 4.1, 4.2, 8.1  
-seeking partnership tax classification, 4.1  
RLLP, 18.1, 18.3, 18.4, 18.8  
regulatory boards' authority over choice, 1.12, 5.6, 15.2, 16.15  
S-corp., tax treatment, 3.11-.16, 3.28  
state tax classification, 4.22, 8.26  
tax issues, additional considerations, 8.25

**Claims Against Dissolved LLC**  
generally, 6.32  
known claims, 6.32  
notice procedures, 6.32  
unknown claims, 6.32

**Classification Of A Kentucky LLC** *See also* Specific Entries  
tax classification, generally, 4.22, 11.4.2

**Client Relationships**  
effect of conversion to LLC form, 15.8

**Close Corporations**  
at-risk loss rules, 3.3  
calendar or fiscal year, 3.27  
compared to LLC, 1.1, 1.2  
passive activity loss rules, 3.3  
personal holding company tax, 3.3

**Collapsible Corporation Rules**  
gain on sale of stock as ordinary income, 3.9

**Collateral Estoppel**  
use against LLC, 6.35

**Commercial Law And The LLC** *See also* Specific Entries  
generally, 16.1  
articles of organization  
-generally, 16.12  
-contents of, 16.12  
assignment of ownership interests  
-assignee's acquiring management rights after consent, 1.8, 6.18, 6.19, 16.9  
-assignee's right to obtain proxy, 16.9  
-assignee's rights upon, 1.8, 6.18, 6.19, 16.9

- free transferability of interests, 1.8, 6.19, 16.13
- limitation of, 1.8, 6.18, 16.9
- authorization by licensing boards, 16.15
  - review of in due diligence check, 16.15
- certificate of existence, 16.14
- charging a member's interest in an LLC, 16.18
  - security interest's priority over charge, 16.18
- dissolution of LLC, 6.24, 16.19
  - events triggering, 6.23, 16.19
  - certificate of dissolution, 16.19
  - judicial decree of, 6.26, 16.19
- distributions of earnings, 16.4
- due diligence, 16.11
  - items of concern in, 16.11-17
- foreclosure of security interest, 16.8
- guarantees from LLC members, 16.3
- interstate activity by LLC, 16.16
- LLC resolutions, 16.17
- loan structuring, 16.2
- merger and conversion, 7.1-3, 7.8, 16.20
- loan documentation, 16.2
  - as similar to close corporation, 16.3
  - including personal guaranty, 16.3
  - prohibition of distributions of earnings, 16.4
  - provision for merger and conversion, 16.20
  - representations and warranties in, 16.5
  - waiver of right to offset, 16.10
- operating agreement, 16.13
- opinions of counsel, 16.21
- perfection of security interest in LLC property, 16.7
- pledge of ownership interest in LLC, 6.18, 16.8
  - effect of, 12.9
- representations and warranties, 16.5
- security interest in personal property, 16.6
  - granting of, 6.18, 16.6
  - holding of property in LLC name, 6.15, 16.6
  - perfection of, 16.7
- security interest in real property, 16.6
  - LLC mortgage of real property, 16.6, 16.7
  - perfection of, 16.7
- waiver of right to offset against distributions, 16.10

#### **Comparison Of Business Forms** *See also* **Specific Entries**

- allocation of income, gain, loss, deduction and credit, 3.20, 8.5
- allocation of profits and losses, 6.10
- C-corp., tax treatment, 3.5-9, 3.27, 14.3
- calendar or fiscal year, 3.27
- centralized management classification, 4.2
- corporate limited liability, 1.1, 1.7, 1.13
- dissolution process, 6.22
- distribution of profits, 6.11
- double taxation of corporate earnings, 1.1, 3.27, 14.3
- family limited partnerships and family LLCs, 11.4.13
- health insurance premiums, deductibility, 3.27
- income taxation
  - generally, 3.1
  - corporations, 3.3, 3.27
  - overview, 3.2

- partnerships, 1.1, 1.3, 1.10, 3.17
- life insurance premiums, deductibility, 3.27
- limited partnership pass-through taxation, 1.1, 3.1, 3.26
- LLC pass-through taxation, 1.1, 1.10, 3.1, 3.2-27, 4.1, 8.1
- operations, 6.1
- partnership taxation, 1.1, 1.10, 3.17-25, 4.1, 8.1, 14.3
- S-corporation, limitations, 3.11, 3.13-16, 3.28, 6.11
- S-corporation pass-through taxation, 1.1, 3.1, 3.11, 3.13, 3.26, 3.28
- self-employment taxation, 8.9, 8.10
- sole proprietorship taxation, 1.10

#### **Compensation** *See also* **Employee Benefits; Fringe Benefits; Insurance; Profit Sharing; Retirement Plans**

- distribution of LLC profits, 6.11
- distributions upon dissolution of LLC, 6.12
- dividend payment, tax treatment as, 3.3, 3.8
- family S-corp. member providing services without compensation, tax, 3.13
- in-kind distributions for LLC, 6.13
- of C-corp. shareholder
  - compensation caps, 3.10
  - deductibility by corporation, 3.10
  - IRS challenges, 3.10
  - two-level taxation, avoidance of, 3.10
- of S-corp. shareholder
  - income tax treatment, 3.10
  - self-employment tax, 3.10
  - social security tax, 3.10
  - unreasonably low compensation, 3.10
- PSCs payment of pre-compensation earnings as compensation, 3.27
- restrictions on LLC distributions, 6.14
- self-employment tax
  - application to LLC, 8.9
  - deduction of, 8.10

#### **Conflict Of Interest**

- generally, 2.1
- arising from assignment of LLC interest, 6.18
- LLC Act failure to provide mechanism for assessing, 6.4

#### **Conflict Of Law**

- generally, 6.8
- comity, 1.11, 6.8
- full faith and credit clause of U.S. Constitution, 6.8
- Kentucky law governing Kentucky LLC, 6.8
- law governing foreign LLC, 5.11, 6.8
- Restatement 2nd of Conflicts, 6.8
- statutory treatment, 6.8

#### **Consent**

- written consent to dissolve, 6.24-25

#### **Consolidated Omnibus Budget Reconciliation Act of 1986 (COBRA)**

generally, 17.19  
health and accident insurance for former employees, 17.14, 17.19  
termination of employment or insurance coverage, events causing, 17.19

#### **Consolidated Tax Return**

corporation as member of affiliated group, filing, 3.5

#### **Continuity Of Existence; Continuity Of Life**

generally, 1.10, 2.3, 2.7, 4.2, 6.23, 16.13  
administrative dissolution of LLC, 6.27, 16.5  
avoidance of dissolution by LLC members, 1.9, 1.10  
death or withdrawal of member, 1.9, 2.7, 6.22-23, departure of corporate shareholder, 2.7, dissolution of corporation, 2.7, dissolution of LLC, 6.24-28  
dissolution of partnership, 6.22  
effect of LLC member filing bankruptcy, 1.9, 6.23  
events of LLC disassociation, 1.9, 6.23, 16.19  
IRS rulings regarding, 1.10  
LLC Act default provisions avoiding, 6.1  
liquidation of partnership interest, 2.7  
merger into LLC, 7.8-12  
practical vs. legal continuity, 2.7  
qualification of LLC as partnership for tax purposes, importance of, 1.10, 4.2  
retirement of member, 2.7, 6.23  
termination of partnership, tax treatment, 3.23  
withdrawal of LLC member, 1.9, 2.7, 6.22-23

#### **Contractual Obligations *See also* Debt; Liabilities And Debt; Personal Liability**

generally, 2.5, 15.9-10  
ability to bind LLC, 6.2  
assignment of LLC interest, 6.18, 6.19, 16.9  
between LLC members with respect to agency authority, 6.2  
challenging a transfer of LLC property, 6.16  
claims against a dissolved LLC, 6.32  
delegation of management by LLC members, effect of, 2.6  
due diligence of lender in loan transaction, 16.11  
effect of bankruptcy by LLC member upon, 16.19  
effect of conversion to LLC form on, 5.4, 7.6, 7.7, 8.16, 15.8, 16.20  
effect of dissolution, 6.24, 6.26, 6.27  
effect of foreign LLC's failure to qualify, 5.13  
effect of merger upon, 7.11, 7.12, 16.20  
implied contract warranties, 18.3, 18.4  
investment contract, 12.2  
liability of LLC, 2.5, 2.6, 6.7, 15.8-11, 18.4  
liability of LLC member acting without authority, 1.7, 6.2  
liability of LLC member, manager, or employee for, 1.7, 6.7, 15.8-11  
liability of partnership, 2.6, 18.3  
liability of professional LLC, 15.8-11  
liability of RLLP, 2.5, 18.4  
LLC as contracting party, 15.8

loan documentation contract warranties, 16.5  
non-recourse liabilities  
-generally, 3.19  
-tax treatment, 3.19, 3.20, 8.6  
of LLC member regarding capital contributions, 1.4  
personal guarantees by corporate shareholders or LLC members, 1.7, 2.3, 2.5, 16.3  
promise to make LLC contribution, 6.9  
-assignee's liability for, 6.19  
-enforceability after death or disability, 6.9  
-writing requirement, 6.9  
recourse liabilities  
-generally, 3.19, 7.12  
-tax treatment, 3.19, 3.20  
security agreements, 16.6  
statutory treatment, 15.10, 18.3, 18.4

#### **Contribution Among Entity Owners**

actions seeking contribution, statute of limitations, 6.14  
from LLC member or manager due to improper distributions, 6.14, 15.10  
obligations of partners in RLLP, 18.3

#### **Contributions Toward Entity**

admission to LLC membership upon, 6.17  
assignee's liability for assignor's obligation to contribute, 6.19  
increase in partner's share of liabilities treated as contribution to capital, 3.19  
of property to a partnership, taxation  
-compared to corporation, 3.18  
-IRS analysis, 3.18  
-partner tax basis, 3.18, 3.19, 3.20  
-partnership tax basis, 3.18  
-recognition of gain or loss, 3.18, 3.20  
-treatment of as sale, 3.18  
shareholder contribution to S-corp., taxation, 3.12  
-basis, shareholder and corporation, 3.12  
-compared to C-corp., 3.12  
-property in exchange for stock, 3.12  
-recognition of gain or loss, 3.12  
shareholder contribution of property to C-corp. in exchange for stock, tax, 3.6, 3.7  
-corporate basis in, 3.6  
-effect of corporate operating income or loss, 3.6  
special allocation of gain or loss on contributed property to partnership, 3.19  
tax treatment of, generally, 3.2, 14.3  
to capital of LLC  
-generally, 6.9, 14.3  
-acceptable forms, 6.9  
-promise to contribute, 6.9  
-assignee's liability for, 6.19  
-enforceability of, 6.9  
-writing requirement, 6.9  
to LLC, tax treatment, 8.3  
-basis in an LLC, 8.4



**Conversion To LLC Form**

- generally, 5.4, 7.1, 15.8, 16.20
- approval for by partners, 5.4
- approval procedures for, 7.4
- as alternative to other transactions, 7.2
- as not an event of dissolution, 7.6
- C-corporation to LLC, tax treatment, 8.17
- cancellation of partnership's assumed name, 5.4
- check-the-box regulations, 4.21
- difficulties in as basis for choice of RLLP form, 18.8
- effect of, 5.4, 7.6
  - personal liability, 7.7
- effective date of, 7.5
- family corporations into FLLCs, 11.4.12
- filing requirements, 7.5
- impact on existing contractual relations, 5.4, 7.6, 7.7, 15.8, 16.20
- law practice, 15.8
- liability for obligations after conversion, 5.4, 7.6, 7.7, 8.16, 16.20
- loan documentation providing for, 16.20
- multi-member LLC to single-member LLC, 8.22, 9.12
- notice to parties of conversion, 7.7
- ownership of property after, 7.6
- parties to conversion, 7.4
- partnership to LLC
  - generally, 7.3
  - approval procedures, 7.4
  - available to foreign partnerships, 7.4
  - statutory treatment, 7.3
  - tax treatment, 8.16
- partnership to RLLP, tax treatment, 8.20
- practice conversions, 15.8
- procedure for, 5.4, 7.3, 7.5, 15.8, 16.20
- requiring additional information in articles of organization, 5.3, 5.4
- RLLP to LLC, tax treatment, 8.19
- S-corporation to LLC, tax treatment, 8.18
- single member LLC to multi-member LLC, 8.21, 9.11
- statutory treatment, 5.4, 7.2-4, 16.20
- use of merger to effectuate, 15.8

**Corporate Characteristics**

- generally, 1.10, 3.1, 3.27, 4.2
- centralized management, 1.10, 4.2, 6.1
- continuity of life, 1.10, 4.2, 6.1
- free transferability of interests, 1.10, 4.2, 6.1, 6.19
- history of regulations concerning, 4.3, 4.4
- LLC structuring to avoid, 4.1, 8.1

**Corporate Income Tax Rates**

- accumulated earnings tax, 3.3
- alternative minimum tax, 3.3
- at-risk loss rules, 3.3
- C-corporation capital gains tax, 3.3
- C-corporation rates, 3.3, 3.27
- environmental tax, 3.3
- passive activity loss rules, 3.3, 3.27
- personal holding company tax, 3.3

- personal service corporations, 3.3

**Corporate Veil; Entity Veil**

- generally, 1.7, 2.5, 2.9, 15.10-11
- as applied to the LLC, 1.7, 2.5, 2.9, 15.10-11
- factors as basis for piercing, 2.9
- failure to maintain corporate formalities as basis for, 2.9
- professional LLCs, 15.10-11
- single-member LLC shield, 9.2, 9.10

**Corporations**

- generally, 2.3
- accumulated earnings tax, 3.3
- alternative minimum tax, 3.3
- as member of affiliated group, taxation, 3.5
- assumption of liabilities in incorporation, 3.67
- calendar of fiscal year, 3.27
- capital gains tax, 3.3
- choice of the corporate form, 1.1, 2.3, 3.27
- compared to LLC, 6.1
- compensation of C-corp. shareholders, 3.10
- compensation of S-corp. shareholders, 3.10
- controlling persons, 2.5
- corporate characteristics, 1.10, 3.1, 4.1, 4.2, 6.1, 16.13
- corporate credit, 2.5
- corporate estimated tax payments, 3.16
- corporate veil, 1.7, 2.5, 2.9, 15.9-11
- corporation as general partner, 2.4
- director standard of conduct, 6.4
- environmental tax, 3.3
- federal taxation of, 2.4, 3.1, 3.3, 3.27, 8.1
- flow-through taxation, 1.1, 1.10, 2.5
- health insurance premiums, deductions, 3.27
- income tax rates, 3.3, 3.5, 3.27
- liability issues concerning, 2.5
- life insurance premiums, deductions, 3.27
- management, 2.3
- membership of corporation in LLC, 1.4, 6.2
- merger with LLC, 7.8
- multi-entity structures, use of, 2.4, 2.5
- ownership interests in, 2.3
- parent corporation, 2.5
- passive loss rules, 3.27
- personal guarantees, 2.5
- prohibition against discrimination among classes of interests, 1.4
- proxies, 16.9
- S-corporations, 3.11-12, 3.14-16, 3.28
- shareholder individual tax return, 3.5
- shareholder tax on distributions, 3.1
- shareholder tax on undistributed earnings, 3.1
- single-member LLCs, 9.2
- state taxation of, 2.4
- statutory residence of, 16.7
- subsidiary corporation, 2.5
- taxation of contributions to, 3.6, 14.3
- taxation of distributions, 3.8
- taxation of dispositions of stock, 3.9
- transferability of ownership interests, 4.2, 16.9
- worthless stock, 3.9

**Costs**

- comparative operating costs, LLC, 2.9
- practice in LLC form, 2.9
- reduced costs in statutory conversions or mergers, 7.2
- statutory treatment, 2.9

**County Clerk**

- articles of incorporation filed, 1.4, 5.3
- delivery of decree of dissolution by, 6.26
- financing statements filed, 16.7

**Creditors Of LLC *See also Commercial Law And The LLC, Business Creditors***

- generally, 2.5
- claims against dissolved LLC, 6.32
  - notice procedures for, 6.32
- claims against LLC assets, 6.7
- conversion to LLC form, effecting, 7.6, 15.8
- due diligence by, 16.11
- reliance upon commitment of capital contribution, 1.4
- requirement of personal guarantees, 2.5, 16.3
- secured parties, 16.6, 16.7

**Death**

- as event of disassociation, 1.9, 6.23, 16.19
- contrast transfer of corporate interest with LLC interest on death, 8.23
- death benefit exclusion, LLC member eligibility for, 3.27, 8.14
- enforceability of promise to contribute, after death, 6.9
- of LLC member, 1.9, 2.7, 6.23,
- provision for in operating agreement, 1.9
- rights of deceased member's estate, 6.21, 8.23
- statutory right to continue LLC upon death of member, 6.2
- statutory treatment, 6.2, 16.19

**Death Of Partner**

- generally, 2.7
- buy-sell agreements, 2.7
- buy-out of partner's interest, 2.10
- continuance of entity, 2.7
- passing of interest upon death, 2.10

**Death Of Shareholder**

- continuity of existence upon, 2.7
- life insurance to finance stock redemption, 2.10
- passing of shares upon death, 2.10
- redemption of shareholder's stock, 2.10
- repurchase agreements, 2.10
- tax treatment, 2.10
- valuation of stock, 2.10

**Debt *See also Liabilities And Debts***

- effect of conversion on, 5.4, 7.6, 7.7, 8.16
- effect of merger on, 7.11, 7.12

- liability of LLC member, manager, or agent for LLC debt, 1.7, 6.7
- non-recourse debt, tax treatment, 3.19, 3.20
- pre-conversion debt, liability for, 5.4, 7.7
- recourse debt, tax treatment, 3.19, 3.20
- relationship to at-risk limitations, partnerships, 3.21

**Decree Of Dissolution**

- generally, 6.26
- as presumptive notice of dissolution, 6.29
- delivery of, 6.26
- grounds for, 6.26

**Deduction Of Losses**

- generally, 3.21, 3.14, 8.6
- limits on in LLC, 8.6

**Default Agreement**

- advantages of, 1.3, 6.1
- defined, 1.3
- KY LLC Act as, 1.3, 5.5, 6.1
- LLC Act default rules governing operation in absence of contrary agreement, 6.1
- LLC Act default rules governing voting, 6.3
- LLC Act default rules on allocation of profits and losses, 6.10
- LLC Act default rules on assignment of interests, 6.18, 6.19

**Deferred Compensation Plans *See Retirement Plans*****Defined Benefit Plans *See also Retirement Plans***

- generally, 17.3
- definition, 17.3
- ERISA requirements, 17.3

**Defined Contribution Plans *See also Retirement Plans***

- generally, 17.4
- 401(k) plans, 17.7
- definition, 17.4
- money purchase plans, 17.6
- profit sharing plans, 8.9, 17.5
- target benefit plans, 17.8
- thrift and tax savings plans, 17.9

**Delegation Of Duties**

- by professionals, 15.9-11
- effect of delegation of LLC management, 2.6, 6.2, 6.16
- effect of on tax treatment of LLC, 6.2
- of ministerial tasks to managers while retaining management powers in members, 6.2
- statutory treatment of, 16.17

**Dentistry**

- practice in LLC form prohibited, 15.2
- statutory classification as profession, 15.2

**Dependent Care Assistance Plans**

generally, 17.18  
 defined, 17.18  
 discrimination among employees, availability, 17.18  
 tax treatment, 17.18

**Directors And Owners Of Corporation** *See also***Shareholders**

closely held corporations, personal holding company tax, 3.3  
 compared to LLC managers, 6.2  
 fiduciary duties, 6.4  
 good faith, 6.4  
 payment of tax on distributions received, 3.1, 3.8  
 payment of tax on undistributed earnings, 3.1  
 single shareholder ownership, C-corporation, 3.27  
 single shareholder ownership, S-corporation, 3.27  
 standards of conduct, 6.4  
 term in office, 6.2

**Disability Benefits**

discrimination among employees, availability, 17.16  
 wage continuation payments, tax treatment, 17.16

**Disability Insurance**

cafeteria plan purchase, 17.16, 17.17  
 deductibility of premiums, 17.16, 17.17  
 discrimination among employees, availability, 17.16, 17.17  
 tax treatment, 17.16, 17.17

**Disadvantages Of Business Form**

corporate form of business, tax treatment, 3.1, 3.27, 14.3  
 general partnerships, 3.21  
 limited partnerships, 3.21, 3.26, 8.1  
 limits on LLC member loss deductions, 8.6  
 LLC form of business, 1.11, 3.27, 8.6  
 RLLP form of business, 18.8  
 S-corporation, 3.11 -16, 3.26, 3.28, 8.1

**Disassociation** *See also* **Dissolution; Continuity Of Existence**

generally, 1.9, 6.22-23,  
 continuation vote requirements, 6.2  
 conversion as not event of disassociation, 7.6  
 events of, 1.9, 6.2, 6.23, 16.19  
 operating agreement providing for, 6.23,

**Discounts**

valuation discounts, 11.3, 11.4.3, 11.4.7, 11.4.12, 11.6

**Discrimination**

among classes of interests, 1.4

**Dissolution Of LLC**

generally, 1.9, 6.22, 6.24, 16.19  
 agency power after dissolution, 6.29,  
 articles of dissolution, 6.24, 6.29, 6.31

assignment of LLC interest, not grounds for, 6.18  
 avoidance of, 16.19  
 benefit derived during winding up held for LLC, 6.28

certificate of, 16.19

claims against dissolved LLC

-generally, 6.32  
 -notice requirements, 6.32

compared to partnership dissolution, 6.22

conversion as not event of dissolution, 7.6

date of referenced in articles or organization, 5.3

decree of judicial dissolution, 6.26, 6.29

dissolution rights, improper distributions, 6.14

effect of, 6.28

events triggering, 1.9, 6.23, 16.19

failure to file annual reports as grounds for, 5.18

judicial dissolution

-generally, 6.26  
 -decree of, 6.24, 6.26, 6.29  
 -venue, 6.26

statutory right to continue LLC upon, 6.2

voluntary dissolution, 6.25

winding up

-generally, 6.28  
 -appropriate actions during, 6.28  
 -by circuit court, 6.28  
 -by LLC management, 6.28  
 -distribution of assets during, 6.30

**Distributions**

generally, 1.11, 3.2, 15.10

assignee of member's interest right to receive, 1.8, 16.10

by C-corporation

-deductions for, 3.8  
 -recognition of income, 3.8  
 -taxation of, 3.8

classes of membership with differing rights to, 1.6

compelled distributions, C-corporations, 3.2

contribution rights upon wrongful distribution, 6.14

defined, 6.11

disproportionate distribution

-substantially appreciated inventory, 3.22, 8.7  
 -unrealized receivables, 3.22, 8.7

effecting basis in an LLC, 8.4

excessive distribution, 6.14, 15.10

failure to make, grounds for accumulated earnings tax, 3.3

failure to provide sufficient dividends, grounds for personal holding company tax, 3.3

impact of, measurement criteria, 6.14

in-kind distributions restricted in LLC, 6.13

-effects of restriction, 6.13

in redemption of shares, tax treatment, 3.8

increase in partner's share of partnership liabilities treated as distribution of cash, 3.19

liability upon wrongful distribution, 6.14

liquidating distributions, partnerships

-generally, 3.20  
 -recognition of loss, 3.22

- liquidating distributions, tax treatment, 3.2, 8.5
- liquidating distributions in accordance with capital accounts, 8.5
- member or manager liability for improper distribution, 6.14, 15.10
- non-taxable distributions as reducing shareholder basis, 3.7, 3.8
- other than in cash form, 1.6
- of cash and property to LLC member, 1.6
- of LLC assets during winding up
  - generally, 6.30,
  - priority of, 6.30,
- of LLC profits, 6.11
- on events of LLC disassociation
  - generally, 6.12,
  - entitlement to pre-disassociation distributions, 6.12
  - valuation of interest, 6.12
- owners of corporation, non-payment of tax on undistributed earnings, 3.1
- owners of corporation, payment of tax on distributions received, 3.1, 3.2
- periodic, taxation, capital or ordinary, 3.2
- pre-IPO distributions, 13.21
- prohibition of distribution of earnings to LLC members, loan documentation, 16.4
- qualified by articles of organization, 1.6, 1.8
- qualified by operating agreement, 1.6, 1.8, 6.11
- restrictions on LLC distributions
  - determining validity of distribution, 6.14
  - times prohibited, 6.14
- right to contribution from recipients of illegal distribution, 6.14, 15.10
- S-corporation shareholder decreased basis, non-taxable distributions, 3.7, 3.8
- statutory right of LLC member to receive, 6.2, 6.13
- statutory treatment as per capital, 1.6, 6.11
- taxation of S-corporation distributions
  - generally, 3.15, 6.11, 8.1
  - accumulated adjustment account, 3.15
  - determination of earnings and profits, 3.15
  - recognition of gain on, 3.15
- tax treatment
  - generally, 3.2, 3.22, 6.11, 8.7
  - recognition of gain or loss, 3.22, 8.7
  - tax basis, 3.22, 8.7
- to enable members to pay personal taxes, 16.4
- waiver of LLC's right of offset against distributions, 16.10

#### **Dividends**

- as personal holding company income, 3.3
- C-corporation distribution taxed as, 3.8
- dividends received deduction, 14.3
- failure to provide sufficient dividends, grounds for personal holding company tax, 3.3
- paid to shareholders, tax treatment, 3.3
- S-corporation distributions in excess of AAA treated as, 3.15

#### **Doctors Of Medicine See Physicians**

#### **Due Diligence**

- generally, 16.11
- items of concern in due diligence check, 16.12-.17
- LLC Act, lack of manager standard of conduct criteria, 6.4

#### **Earnings See also Compensation**

- accumulated earnings tax, C-corporation, 3.3
- allocation of income and gain by LLCs, 8.5
- allocation of income and gain by partnerships, 3.20, 3.28
- C-corporation, after tax earnings, 3.2
- creation by S-corporation, tax treatment, 3.15, 3.16
- distribution of, 6.11, 16.4
- excessive distribution of, 15.10
- increase and reduction of, 3.8
- non-payment of tax on undistributed corporate earnings, 3.1
- payment of personal tax on earnings by owners, 3.2
- payment of tax on distributed corporate earnings, 3.1
- pre-compensation earnings, PSC, 3.27
- retention of earnings, C-corporations, 3.2
- self-employment tax
  - generally, 8.9
  - application to LLC, 8.9
  - deduction of, 8.10
- tax treatment, generally, 3.1, 3.2

#### **Election Of LLC Managers**

- generally, 1.5, 6.2
- managers serving until successor duly elected, 6.2
- statutory right of members to vote on, 6.2
- vote requirements, 6.2

#### **Employee Benefits See also Disability Benefits; Fringe Benefits; Insurance; Profit Sharing; Retirement Plans**

- generally, 17.1
- C-corporation tax benefits from, 3.27
- cafeteria plans, 17.17
- funding of benefits by employer, 17.3, 17.4, 17.8
- health insurance premiums, corporate deductions, 3.27

#### **Employee-Owners**

- defined, Internal Revenue Code, 17.12
- shareholder-employees, salaries, 3.10, 3.27

#### **Employee Retirement Income Security Act of 1974 (ERISA)**

- nonqualified retirement plans, 17.11
- qualified retirement plan loans to self-employed "owner-employees", 17.12
- qualified retirement plans, 17.2, 17.10
- Tax Reform Act of 1986, 17.12, 17.14

#### **Employees**

- compensation of C-corp. shareholder employees, tax treatment, 3.10, 3.27

- compensation of S-corp. shareholder employees, tax treatment, 3.10
  - liability of, 12,13, 15.9-11, 18.3-4
  - LLC member's liability for acts of, 1.7
- Engineering**
  - practice in LLC form, 15.2
- Environmental Tax**
  - generally, 3.3
  - applied to corporations, 3.3
- Estate**
  - as shareholder in S-corporation, 3.11
  - avoiding ancillary probate, SMLLCs, 9.1, 9.8
  - membership in LLC, 1.4, 3.28, 6.2
  - of deceased member, rights of estate, 6.21
  - tax basis in entity, 8.23
- Estate Planning** *See* **Wealth Transfer Planning**
- Ethical Responsibilities**
  - non-attorney holding interest in LLC, 15.4
  - non-attorney right to direct professional judgment, 15.4
  - of corporate director, 6.4
  - of LLC manager, 6.4
- Execution**
  - articles of merger, 7.10
  - articles of organization, 5.3
  - execution authorization as part of due diligence check, 16.11
  - LLC property transfer documents, 6.16
  - of collateral assignment, 16.8
  - of financing statement, 16.6
  - of pledge agreement, 16.8
  - of RLLP statement, 18.6
  - of security agreements, 16.6
  - plan of merger, 7.10
  - resolutions regarding, 16.17
- Expenses**
  - copying of LLC records at member's own expense, 6.5
  - non-taxable expenses, effect on S-corporation shareholder basis, 3.12
- Expulsion**
  - of LLC member, 1.10, 6.23
  - effect of, 6.23
- Fair Market Value**
  - corporate earnings, fair market value effect, 3.8
  - corporate recognition of gain or loss upon liquidation, sale to shareholders at fair market value, 3.8
  - of LLC membership interest, 6.12
  - based on, 6.12
  - date of basis, 6.12
  - going concern value, 6.12
  - goodwill, 6.12
  - right to, withdrawal from LLC, 6.12, 6.22
  - relationship to S-corp. recognition of gain on distribution of property, 3.15
- Family Limited Liability Company** *See also* **Wealth Transfer Planning**
  - generally, 1.14
  - formation, 11.4.3
- Family Limited Partnership** *See also* **Wealth Transfer Planning**
  - generally, 1.14
  - formation, 11.4.3
- Family Partnership**
  - reallocation of income within, 3.20
- Family Wealth Transfers** *See* **Wealth Transfer Planning**
- Fees** *See also* **Costs; Expenses**
  - occupational fees, Louisville and Jefferson county, 11.8.11
- Fiduciary Duties**
  - duty of member to hold as trustee profit derived from use of LLC property, 6.4
  - of corporate director, 6.4, 13.13
  - of LLC manager, 6.4, 13.13
  - representative of incompetent LLC member, 6.21
  - tax-exempt organizations and LLCs, 10.8
- Files And Records**
  - financial statements, 6.14
  - inspection and copying of by LLC member, 6.5
  - required to be maintained, 6.5
  - written operating agreement retained as a record at principal office, 6.5, 6.14
- Financial Statements**
  - generally, 6.14
  - flexibility in preparation, 6.14
- Financing Arrangements** *See also* **Commercial Law And The LLC**
  - bankruptcy-remote entity, 9.5
  - due diligence of lender in loan transaction, 16.11
  - non-recourse financing, 3.19-21
  - "Qualified non-recourse financing", 3.21
  - recourse financing, 3.19, 3.20
  - single-asset entity, 9.6
- Fiscal Year** *See also* **Taxable Year**
  - approval by Internal Revenue Service, 3.27

business forms compared, 3.27  
election of by LLC, 3.27

#### **Flexible LLC Statute**

generally, 1.3  
defined, 1.3  
Kentucky LLC Act as, 6.1

#### **Flow Through Entity; Flow Through Taxation**

flow through entity, entity level tax, 3.1, 3.17, 4.1-22, 8.1  
general partnership as, 3.1, 3.17, 3.19, 8.1  
LLC as flow-through entity, 1.1, 1.10, 3.1, 3.28, 5.1, 8.1  
limited partnership as, 3.1, 3.17, 3.19, 8.1  
losses passed through to LLC member, 8.6  
owner reporting income, gain, loss on individual return, 3.1  
RLLP as, 3.1, 18.1  
S-corporation as, 3.1, 3.11, 3.13, 3.28, 8.1  
seeking federal partnership tax classification, 8.1  
use of to avoid IRS challenge of deductibility of shareholder salary, 3.10

#### **Foreclosure**

of security interest, 16.8

#### **Foreign Businesses**

generally, 1.11, 16.16  
foreign LLC, 1.11, 4.13, 4.16-17, 5.10, 16.16  
-annual reports, 5.18  
-authority to transact business, 5.12  
-certificate of authority, effect, 5.14  
-defined, 5.10  
-law governing 5.11, 6.8  
-names of, 5.15  
-registered office and agent of, 6.15  
-transacting business without authority, 5.13  
-withdrawal of, 5.17  
foreign partnership conversion to LLC allowed, 7.4  
foreign RLLP, 18.7  
recognition of entity form by other jurisdictions, 1.11, 6.8, 16.16  
registration with Secretary of State, 1.11  
restrictions on, 1.11

#### **Foreign LLC**

generally, 1.11, 5.10, 6.8, 16.16  
annual reports, 5.18  
authority to transact business, 5.12  
certificate of authority, effect 5.14  
comity, 6.8  
commerce clause, 6.8  
conflicts of law, 1.11, 5.11, 6.8  
defined, 5.10  
full faith and credit clause, 6.8  
law governing, 5.11, 6.8  
liability issues concerning, 1.11, 5.13, 6.8  
merger with LLC, 7.8  
names of, 5.15

partnership tax classification, 4.16-17  
recognition of entity by other states, 1.11, 5.11, 6.8, 16.16  
registered office and agent, 5.16  
registration and distinguishability of name, 5.7  
registration of with Secretary of State, 1.11, 5.12  
restrictions on, 1.11  
state tax classification, 18.2  
transacting business without authority, 5.13  
withdrawal of, 5.17

#### **Formation Of LLC *See also Conversion; Merger***

generally, 5.1, 11.4.3, 15.8  
articles of organization, 1.4, 2.6, 2.8, 2.9, 5.3, 15.6, 16.12  
authorization for by professional licensing boards, 16.15  
by professionals, 5.7, 15.1-11  
capitalization, 6.9  
classification of Kentucky LLC, tax treatment, 4.1, 4.22  
contributions to capital, 6.9  
-acceptable forms, 6.9  
-basis in LLC, 8.4  
-enforceability, 6.9  
-tax treatment, 8.3  
conversion to, 5.3-4, 7.1-3, 7.5, 8.16-19, 15.8, 16.20  
county clerk filings, 1.4, 5.3  
date of, effective date of membership admissions, 6.17  
family LLC, 11.4.3  
family LLP, 11.4.3  
formation for any lawful purpose, 5.6  
formation to perform professional services, 5.6  
history of form, 4.4  
membership interest as security, 12.1-6  
merger, 7.1-2, 7.8-10, 16.20  
name requirements, 5.7, 15.6  
operating agreement, 2.9, 5.5, 16.13  
other states' treatment, 4.4  
partnership tax treatment as principal purpose, 3.1, 3.27, 4.1, 5.1, 6.1, 6.2, 8.1  
reservation of name, 5.7  
secretary of state filings, 1.4, 5.3, 5.7  
seeking partnership classification, procedures for, 4.11-22  
single member LLC, taxation, 3.27  
statutory basis, 5.1, 15.2  
structuring to avoid corporate taxation, 4.1, 6.1, 8.1  
tax issues, 1.10, 2.3-5, 3.28, 4.1, 8.1-2, 17.1, 15.7

#### **"Four-O-One k", 401(k) Plans *See Retirement Plans***

#### **Fraud Or Misrepresentation**

as grounds for personal liability of member, 1.7  
fraudulent conveyances, 11.7.3

#### **Free Transferability Of Membership Interest**

as a corporate characteristic, 1.10, 4.2, 6.19, 16.13

- assignment of ownership rights, 1.8, 6.18, 6.19, 16.8-9
  - assignee's liabilities upon, 6.19
  - assignee's rights upon, 6.18, 6.19
  - conflicts of interest arising under, 6.18
- avoiding, 6.1
- restriction on, 1.8, 6.2, 6.18
- statutory right of member to approve or disapprove, 6.2
- transfer to LLC member, requirement of contribution, 6.9, 6.19

### **Fringe Benefits**

- generally, 17.13
- cafeteria plans, 17.17
- Consolidated Omnibus Budget Reconciliation Act of 1986 (COBRA), 17.19
- dependent care assistance plans, 17.18
- disability insurance, 17.16
- funding of benefits by employer, methods, 17.3, 17.4, 17.8
- health and accident insurance, 17.14
- life insurance, 17.15
- S corporation fringe benefits, 17.14, 17.16-17
- tax treatment, 3.27, 17.13-18
- types of plans, 17.13

### **General Intangibles**

- pledge of LLC ownership interest, 16.8

### **General Partners; General Partnerships**

- allocation of income, gain, loss, deduction and credit
  - generally, 3.20, 3.28, 6.10, 6.11
  - restrictions on, 3.20, 3.28
  - "substantial economic effect" standard, 3.20, 3.28
- allocation of liabilities, tax treatment, 3.19, 3.21
- as flow-through entity, 3.1, 3.17, 8.1, 8.2
- authority of, 18.3
- basis in partnership
  - calculation of, 3.19, 3.21
  - decrease in, 3.19
  - effect of non-recourse liability, 3.19, 3.21
  - effect of recourse liability, 3.19
  - increase in, 3.19
- calendar or fiscal year, 3.27
- cancellation of assumed name upon conversion to LLC, 5.4, 7.5
- compared to LLC, tax treatment, 8.1, 8.2
- compared to RLLP, 18.3, 18.8
- compared to S-corporation, 3.11, 3.14, 3.17, 3.21, 3.28, 8.1
- contribution of property to, tax treatment
  - generally, 3.18-19, 3.21
  - partner tax basis, 3.18-19
  - partnership tax basis, 3.18
  - recognition of gain or loss, 3.18
  - conversion to LLC, 5.4, 7.3
  - tax treatment, 8.16
- contribution toward losses, 18.3

- conversion to RLLP, 8.20, 18.6
- corporate general partner in limited partnership, 3.17
  - qualifications for status, 3.17
- debts and obligations of, 3.19, 3.21, 6.7, 18.3
- deduction of losses by partner, 3.14, 3.20
- dissolution of, 6.22
- distribution of profits, 6.11
- granting a capital interest, 3.18
- granting a profit interest, 3.18-19
- health insurance premiums, deductions, 3.27
- interest in as security interest, 12.3
- joint liability of, 15.3
- joint and several liability of, 15.3, 6.7
- liability upon conversion to LLC form, 5.4, 7.6-7, 8.16, 16.20
- liability upon merger with LLC, 7.11, 7.12
- life insurance premiums, deductions, 3.27
- limitations on ability to deduct losses
  - generally, 3.21
  - at-risk rules, 3.21
  - passive activity rules, 3.21
- merger into LLC form, 7.2, 7.8-10, 16.20
- partnership agreement as similar to operating agreement, 5.5, 16.13
- partnership membership in LLC, 1.4, 6.2
- payment of personal tax on entity earnings, 3.2
- personal liability after conversion to LLC, 7.7
- reallocation of income within family partnership, 3.20
- requirement of more than one partner, 3.17
- tax treatment of, 1.10, 3.1-2, 3.17, 8.1-2
- taxation of partnership distributions
  - generally, 3.22, 6.11, 8.7
  - recognition of gain or loss, 3.22, 8.7
  - tax basis, 3.22
- TEFRA audit, 8.11
- termination of partnership, tax treatment, 3.23
- vicarious liability of, 15.3
- wrongful act or omission of, 6.7, 18.3

### **Gifts And Gifting See Wealth Transfer Planning**

### **Good Faith**

- corporate director's discharge of duties, 6.4

### **Goodwill**

- LLC use of goodwill of converted C-corporation, constructive dividends, 8.17
- relationship to tax treatment of payments to withdrawing partner, 8.8
  - application to LLC form, 8.8
- valuation of LLC interest, 6.12

### **Governing Bodies**

- generally, 2.3, 15.2, 15.5, 16.15
- ability to effect limits on vicarious liability, 15.5
- accountants, 16.15
- effect of LLC Act on authority of, 15.2, 15.5
- lawyers, 15.2-.5

physicians, 15.2  
professionals, 15.2, 15.5, 16.15  
prohibition of LLC form, 5.6, 15.2  
restriction of multiple services, 15.4

#### **Governing Law**

for security law purposes, 12.2, 12.4  
foreign LLC, 5.11, 6.8  
regarding financing statement filing, 16.7  
statutory treatment on LLC, 1.1, 5.1

#### **Graduated Tax Rates**

generally, 3.4

#### **GRAT See Trust**

#### **Hart-Scott-Rodino Act See Antitrust**

#### **Health And Accident Insurance**

generally, 17.14  
Consolidated Omnibus Budget Reconciliation Act  
of 1986 (COBRA), 17.19  
deductibility of premiums, 3.27, 8.14, 17.14  
employee-partners, tax treatment, 3.27  
former employees, continuation of coverage, 17.14,  
17.19  
gross income of employees, value of insurance  
excluded, 17.14  
S corporation shareholders, tax treatment, 3.27,  
17.14  
self insured reimbursement plans, tax treatment,  
17.14

#### **Historical Background Of LLC**

generally, 1.2, 4.1-4, 5.1, 18.2  
Kentucky LLC Act, bases, 5.1  
other states' treatment of the LLC, 1.2, 4.4, 5.1

#### **HR 10 Plans See Retirement Plans**

#### **Improper Distributions**

generally, 6.14, 15.10  
contribution rights upon, 6.14, 15.10  
liability for, 6.14, 15.10  
measurement of, 6.14

#### **In-Kind Distributions**

generally, 6.13  
effect of, 6.13  
LLC restriction on, 6.13, 6.15

#### **Indemnification**

generally, 6.4, 13.7, 15.9-11  
agents of LLC, 15.9-11  
obligation of non-negligent RLLP partners, 18.3  
obligation under KUPA, 18.3  
of LLC member or manager, 6.4  
operating agreement providing for, 6.4

statutory treatment, 18.3

#### **Individual Income Tax Rates**

table of, 3.4

#### **Inflation**

tax brackets adjusted for, 3.4

#### **Inspection And Copying Of LLC Records**

payment of expenses of, 6.5  
right to, 6.5  
special need or showing of purpose, 6.5

#### **Insurance See also Specific Entries**

adequacy of, 15.3  
companies, incorporation of, 2.3  
companies, S-corporation form prohibited, 3.11  
deductibility of premiums, 3.27, 17.14  
malpractice, 15.3  
mandates of insurance for qualifications as RLLP,  
18.6

#### **Inter-Entity Mergers**

generally, 7.8  
approval of, 7.9  
effects of, 7.11-12  
filing requirements, 7.10  
statutory authority, 7.8

#### **Interests See also Free Transferability Of Membership Interest; Transfers**

preferred FLP and FLLC interests, 11.4.9

#### **Interstate Activity By LLC See also Foreign LLC**

generally, 1.11, 6.8, 16.16  
authorization for, 5.12  
by RLLP, 18.7  
commerce clause arguments, 6.8  
governing law, 1.11, 5.2, 5.11, 6.8  
recognition of LLC form in states without LLC  
laws, 5.10-11, 6.8, 16.16  
state tax classification of LLCs, 4.22  
withdrawal from qualification to do business, 5.17

#### **Internal Revenue Code See also Taxation**

accumulated taxable income, 3.3  
allocation of income, gain, loss, deduction by LLC,  
8.5  
allocation of income, gain, loss, deduction by S-  
corp., 3.13-14, 3.28  
basis in LLC, 8.4  
calendar or fiscal year, 3.27  
cash method accounting, 3.28, 8.13, 15.7  
categories of taxpayers, 4.2  
contributions to LLC, 8.3  
contributions to S-corporations, 3.12  
corporate basis in assets, 3.6, 3.12  
corporate basis in stock, 3.6, 3.12  
corporate tax rates, LLC, 3.1, 3.3, 3.27



- criteria for payment in exchange for stock, 3.8
  - distributions from the LLC, 8.7
  - family partnership rules, 3.20
  - graduated tax rates, 3.4
  - health insurance premiums, deductions, 3.27
  - individual tax rates, 3.4
  - Kintner Regulations, 4.2
  - life insurance premiums, deductions, 3.27
  - limits on LLC member loss deductions, 8.6
  - loans from qualified pension and profit sharing plans prohibited, 8.14
  - net earnings from self-employment, 15.7
  - partnership tax treatment, generally, 3.17, 4.1-.22, 8.2
  - personal exemptions, 3.4
  - prohibition of cash method accounting for tax shelter, 15.7
  - PSC, uniform tax rates, 3.27
  - "qualified small business stock", 3.9
  - qualifying subchapter S trust (QSST), 3.11
  - recognition of gain and loss, 3.6, 3.12
  - restrictions on partner's ability to allocate income, gain, loss, deductions and credit, 3.20, 3.21, 8.2
  - "substantial economic effect" standard, 3.20
  - retirement and fringe benefit plans, treatment of, 3.27, 17.1
  - S-corporation multiple classes of stock prohibited, 3.11, 3.28
  - S-corporation safe harbors for non-convertible debt, 3.11
  - S-corporation shareholder qualifications, 3.11, 3.28
  - seeking partnership classification, procedures, 4.1-.22
  - shareholder basis in stock, 3.6, 3.12
  - shareholder contribution of property in exchange for stock, taxation, 3.6, 3.12
  - taxation of C-corporation shareholder compensation, 3.10
  - taxation of contributions to partnerships, 3.18
  - taxation of disposition of C-corporation stock, 3.9
  - taxation of partnership distributions, 3.22, 8.7
  - taxation of S-corporation shareholder compensation, 3.10
  - treatment of LLC members as limited partners, limited entrepreneurs, 15.7
- Internal Revenue Service (IRS)** *See also* **Taxation**
- abusive partnerships, 3.24
  - at-risk loss rules, 3.3, 3.14, 3.21, 8.6
  - challenge to deductibility of shareholder compensation, 3.10
  - clarification regarding income tax status of LLC, 1.2, 1.10, 4.1-.22, 8.2
  - classification criteria for partnership tax treatment, 1.10, 3.1-2, 4.1-2, 8.1
  - corporate characteristics, 3.27, 4.2, 8.1
  - passive loss rules, 3.3, 3.14, 3.21, 3.27, 8.6
  - policy relaxing S-corporation shareholder limitations, 3.11
  - reallocation of income in family S-corporation, 3.13
  - rulings on LLC, 1.2, 1.10, 4.1-.22, 8.2, 8.6
  - seeking partnership classification, procedures, 4.1-.22
  - tax rates, corporate income, 3.3
  - tax rates, individual income, 3.4
  - TEFRA audits, 8.11
  - appointment of tax matters partner, 8.11
  - view on receipt of partnership interest in exchange for services, 3.18
  - waiver of corporate taxation of S-corporation, 3.16
- Investment Contract**
- defined, 12.2
- Joinder**
- of LLC members in action against entity, 15.10
- Joint Liability**
- of general partners, 18.3
  - limitation of in RLLP, 18.3
- Joint And Several Liability**
- generally, 1.7, 15.1-.11
  - limitation of in RLLP, 18.3
  - of general partners, 1.1, 6.7, 18.3
  - of LLC member or manager for liabilities incurred without authority, 1.7
- Joint-Venture**
- LLCs as vehicle, generally, 14.1-.2
  - accounting treatment, 14.5
  - antitrust filing requirements, 14.6
  - comparison of entity choices, 14.3
  - joint venture agreements, 14.4
  - tax-exempt organizations, 10.3
- Judgment**
- charging a member's interest with payment of unsatisfied judgment, 6.20, 16.18
  - rights of judgment creditor against LLC, 6.20
  - security interest's priority over judgment creditor's charge, 16.18
- Judicial Decree**
- of dissolution
  - generally, 6.24, 6.26, 6.29
  - as presumptive notice, 6.29
  - delivery of, 6.26
  - venue, 6.26
  - of member bankruptcy, event of disassociation, 6.23
  - reasonably impractical to carry on LLC business, dissolution, 1.9
- Judicial Dissolution**
- grounds, 6.26
  - venue, 6.26
- Kentucky Bar Association**
- scope of regulation of, 15.3

**Kentucky Board Of Accountancy** *See* **Board Of Accountancy, Kentucky**

**Kentucky Board Of Medical Licensure** *See* **Board Of Medical Licensure**

**Kentucky Business Corporation Act**  
generally, 1.2, 1.16  
formation of LLC, 1.2, 1.16, 5.1, 5.3

**Kentucky Constitution**  
definition of corporation, 6.9  
foreign LLC governance, subject to, 5.11  
regulation of legal profession, 2.3, 15.3-5

**Kentucky License Tax**  
treatment of LLCs, 8.27

**Kentucky Medical Association**  
practice of medicine in LLC form, 15.2

**Kentucky Rules of Professional Conduct**  
non-attorney directing professional judgment, 15.4  
non-attorney holding interest in LLC, 15.4  
practice of law in LLC form, 15.3-5

**Kentucky Supreme Court**  
regulation of legal profession, 2.3, 15.3-5

**Kentucky Uniform Partnership Act**  
generally, 18.1  
amendments to effecting LLC, 18.3, 18.4  
relationship to LLC, 1.2, 5.3, 6.1  
relationship to RLLP, 18.1, 18.3-4

**Keogh Plans** *See* **Retirement Plans**

**Kintner Regulations** *See also* **Corporate Characteristics**  
generally, 4.2  
application to LLCs, 4.5  
bias in favor of partnership tax classifications, 4.3  
corporate characteristics, tax consequences, 4.2  
history, 4.3, 4.4  
presumption of partnership, 4.3

**Law** *See* **Legal profession**

**Lawyers** *See* **Attorneys**

**Legal Profession**  
conversion of practice to LLC form, 15.8  
ethical violations, liability for, 15.3-5  
Kentucky Bar Association, 15.3-5  
Kentucky Constitutional provisions, 2.3, 15.3-5  
Kentucky Rules of Professional Conduct, 15.3-5  
personal liability for professional acts, 6.7, 15.9-11

practice in LLC form, 15.2-11  
practice in PSC form, 15.3  
practice in RLLP form, 15.3  
regulation by Kentucky Supreme Court, 2.3, 15.3-5  
statutory professional classification, 15.2

## **Liabilities And Debts**

generally, 1.1, 1.7  
allocation to general partner of limited partnership, 3.19  
assumption of in incorporation, 3.6  
charging an LLC member interest, 16.18  
due diligence of lender in loan transaction, 16.11  
effect of conversion to LLC form, 7.6-7, 8.16  
effect of merger into LLC, 7.11-12  
environmental liabilities, 2.5  
increase of partner's share of, tax treatment, 3.19  
limitation from for LLC members, 3.26, 6.7  
loans to LLCs, 16.1  
member exposure to entity liabilities and debts, 1.7, 6.7, 18.3  
member, manager liability for due to acts without authority, 1.7, 6.7  
mortgages, 16.6-7  
non-recourse liability, 3.19-21, 8.4, 8.6  
personal guarantees, 1.7, 2.3, 3.19, 16.3  
personal liability for own acts or omissions, 6.7  
preorganization liabilities, 5.8  
promise to make LLC contribution, 6.9  
-assignee's liability for, 6.19  
-enforceability, 6.9  
-liability for, 6.9  
recourse liability, 3.19, 3.20, 7.7  
representations and warranties in loan transactions, 16.5  
responsibility for as a consequence of failure to maintain records, 6.5  
responsibility for upon conversion or merger to LLC form, 5.4, 7.6-7, 7.11-12, 16.20  
responsibility for upon dissolution of LLC, 6.28  
single-member LLCs, 9.2  
tax treatment, 3.19, 8.6  
use of in formula to determine improper distribution, 6.14

**License Revocation Or Suspension**  
professional regulatory boards, 15.2-5

**License Tax**  
Kentucky treatment of LLCs, 8.27

**Liens And Encumbrances**  
charging a member's interest, 6.20, 16.18  
due diligence of lender in loan transaction, 16.11  
effect of merger upon, 7.11-12  
not constituting assignment of LLC interest, 6.18  
pledge of ownership interest, 6.18, 16.8-9  
security interests, 6.18, 16.6-7

**Life Insurance**

- deductibility of premiums, 3.27, 17.15
- discrimination among employees, availability, 17.15
- non-discriminatory group term life insurance,
  - premiums excludable, C-corp., 3.27
  - applicability of exclusion to other business forms, 3.27
- tax treatment of premiums, 3.27, 8.14, 17.15
- use of family entities to hold, 11.4.8
- use of proceeds, tax treatment, 8.24

**Like-Kind Exchange**

- and the SMLLC, 9.4

**Limitation Of Activities Of LLC**

- in-kind distributions restricted, 6.13
- limitation of activities of RLLP, 18.6
- limits on LLC member loss deductions, 8.6
- multiple services by LLC, 15.4
- statutory treatment, 15.2

**Limited Liability Companies *See also Specific Entries***

- generally, issues involved, 1.1, 2.2-3, 3.28, 5.1, 6.1, 7.1, 8.1, 12.1, 15.1, 17.1
- ability of member to include entity liabilities in tax basis, 3.26
- admission of members, 6.17
- advantages of, 1.1, 3.26-28, 4.1, 5.1, 6.2, 6.10-11, 18.8
- agency authority, 6.2
- allocation of profit and losses, 6.10
- annual reports, 5.18
- appointment of "tax matters partner", 8.11
- articles of organization, 1.4, 2.8-9, 5.3, 15.6, 16.12
- assignment of LLC interests, 6.18-19
  - liabilities upon, 6.19
- authority to sue on behalf of, 6.34
- business corporation as alternative, 2.2-3, 2.6-7, 2.9
- C-corporation conversion to LLC, tax treatment, 8.17
- capital transactions, 2.3
- capitalization of, 2.3, 6.9
- cash method accounting, 3.28, 15.7
- centralized management, 4.2, 6.1
- compared to closely held corporation, 1.1
- compared to corporation, 1.4, 3.26-27, 6.1, 8.1
- compared to limited partnership, 3.26
- compared to partnership, 1.1, 3.26, 6.1, 8.2
- compared to RLLP, 18.1, 18.8
- compared to S-corporation, 3.28, 6.11, 8.1
- confidential information, protection of, 2.9, 6.5
- conflicts of interest, 6.4
- continuity of existence, 1.10, 2.7, 4.2, 16.13
- contributions to capital
  - generally, 6.9, 8.3
  - basis in LLC, 8.4
  - enforceability, 6.9
  - liability for, 6.9
  - taxation, 8.3
- conversion to LLC form, 5.4, 7.2-7
- death of member, 1.9, 2.7, 6.2, 6.12, 6.23, 16.19
- delegation of duties by professional, 15.10-11

- delegation of management, 1.5, 6.2
- differing classes of interests, 6.11
- differing tiers of ownership, 3.28
- disadvantages, 3.27
- dissolution, 1.9, 6.22-32
- distribution of profits, 6.11
- distributions from the LLC, taxation, 8.7
- distributions upon disassociation, 6.12
- economic rights under, 1.1, 1.8
- effective date of statute allowing for form, 1.1, 5.1
- eligibility for death benefit exclusion, 3.27
- entity veil, 1.7, 2.9, 15.1-11,
- equity interest by non-professional, 15.4
- events of disassociation, 6.23
- evidentiary admissions by an LLC, 6.6
- federal tax classification of Kentucky LLC, 4.1, 6.1
- flow-through taxation, 1.10, 2.4-5, 3.1, 3.26, 3.28, 4.1, 5.1, 8.1
- formalities concerning ownership and operation, 2.3, 6.1-2
- formation of as non-taxable event, 3.2
- formation requirements, 5.2, 5.3
- governing documents, 2.9, 5.3, 5.5, 16.12-13
- historical background, 1.2, 4.3-4, 5.1, 18.2
- improper distributions, liability for, 6.14
- in-kind distributions, 6.13
- interest in as personal property, 6.18
- interstate activity, 1.11, 5.10, 5.12, 6.8, 16.16
- lack of rules on issuance of ownership interests, 3.28
- liability issues, 1.7, 2.5, 3.26, 5.1, 6.7, 6.19, 7.6, 7.11-12, 15.9-11
- life insurance premiums, deductions, 3.27
- limitation on activities, 6.14, 8.6, 15.2
- limits on member's loss deductions, 8.6
- management authority, 6.2
- management of, 1.1, 1.5, 2.3, 6.2, 12.3
- management rights, 6.18
- manager management, 1.5, 6.2, 6.16, 12.3
- membership in, 3.27-28, 6.2, 6.17
- membership interest in, 6.9, 6.18-19, 12.1-6, 16.8-9
- membership management, 1.5, 6.2, 6.16, 12.3
- merger into business corporation, 7.8, 15.8
- merger into LLC form, 7.1-2, 7.8-12
- multiple professional services in single LLC, 15.4
- name of, 5.7, 15.6, 16.12
- notice to an LLC, 6.6
- operating agreement, 2.9, 5.5, 6.9, 16.13
- operation of subsidiary, 3.28
- operations controlled by statute, 6.2-3
- other states' treatment of, 1.2, 4.4, 5.1, 7.2-4
- ownership of LLC property, 6.15, 7.6
- participation in cafeteria plans, 3.27
- partnership classification for tax purposes, 1.10, 3.1-2, 3.26, 4.1-22, 5.1
- partnership conversion to, tax treatment, 8.16
- passive activities, 3.28, 8.6
- per capital basis voting, 6.3
- personal guarantees, 1.7, 2.5, 16.3
- personal liability of member, 1.7, 3.26, 6.7, 7.11-12, 15.9-11
- pre-organization activities, liability for, 5.8

- professional's use of form, 1.12, 5.6, 15.1-11, 16.15, 18.8
- professional regulatory boards, relationship to, 1.12, 5.6, 15.2-5, 16.15
- promoter, 5.3
- records of, 6.5
- registered agent, 5.9
- registered office, 5.9
- requirement of number of members, 6.2, 8.1
- S-corporation conversion to LLC, tax treatment, 8.18
- seeking partnership classification, procedures, 4.1-22
- self-employment tax, 3.28, 8.9-10
- sharing of fees within, 15.4
- single level taxation of, 3.1, 8.2
- single member LLC, taxation, 3.27
- standard of conduct of member/manager, 6.4
- state tax classification of LLC, 4.22
- statutory rights of members, 6.2
- structuring to avoid corporate taxation, 4.1, 8.1
- tax basis in LLC, 8.4
- tax benefits, retirement & fringe benefit plans, 17.1
- tax shelter, 8.13
- tax treatment, LLC form of organization, 1.10, 2.3-4, 3.1, 3.26-27, 4.1, 8.1
- taxable year, 8.12
- taxed as C-corporation if interests publicly traded, 3.28
- transfer of LLC property, 6.16
- transferability of ownership interests, 1.8, 2.8, 6.18-19, 12.1-6
- use in joint ventures, 14.1-6
- valuation of LLC interest upon disassociation, 6.12
- voting rights in, 1.5, 1.8, 6.3
- withdrawal of member, 1.9, 2.7, 6.12, 6.22-23, 16.19

#### **Limited Partnerships**

- calendar or fiscal year, 3.27
- cancellation of certificate of limited partnership upon conversion to LLC, 5.4
- compared to LLC, 1.14, 3.26
- compared to S-corporation, 3.17, 8.1
- conversion to LLC, 5.4, 7.3-4, 7.6-7, 16.20
  - effect on liabilities, 5.4, 7.6-7, 16.20
  - process for, 5.4, 7.3-4, 16.20
- corporate general partner in, 3.17
  - qualifications for status, 3.17
- disadvantages of, 3.26, 8.1-2, 8.6
- entity level taxation, avoidance or, 3.17, 8.2
- increase of tax basis, 3.26
- interest in, 12.1-6
- limited liability of, 3.26
- material participation by limited partners, tax treatment, 3.21, 8.1, 8.6
- membership in LLC, 1.4, 6.2
- merger with LLC, 7.8
- participation in management, 3.21, 3.26
- partner's payment of personal tax on entity earnings, 3.2

- pass through tax treatment, 1.10, 3.1, 3.17, 3.26, 8.1-2
- requirement of one general partner liable for debts, 1.1, 3.17, 8.1
- restrictions on limited partner's participation in operations, 1.1, 3.26, 8.1, 8.6
- termination, tax treatment, 3.23
- Uniform Limited Partnership Act, 5.13

#### **Liquidation Of LLC *See also* Dissolution Of LLC; Winding Up Of LLC**

- generally, 1.9
- as caused by LLC member bankruptcy, 16.19
- liquidation preference, 13.8.3
- tax treatment, 3.2

#### **Loans To LLCs *See* Commercial Law And The LLC**

#### **Maintenance Of LLC Records**

- generally, 6.5
- consequence of failure to maintain, 6.5, 6.7
- operating agreement providing for maintaining minutes, 6.3
- required records, 6.5
- responsible parties, 6.5

#### **Malpractice *See also* Professional Liability**

- generally, 15.10-11
- insurance, adequacy of, 15.3
- personal liability for own, 1.7, 2.5, 6.7, 15.10-11
- structuring insurance coverage for, 15.3

#### **Managers, Members And Owners Of LLC**

- generally, 1.5, 2.6
- admission as a member, 6.17
  - effective date, 6.17
- agency authority, generally, 6.2, 6.29
- agency power after dissolution, 6.29
- allocation of income, gain, loss, deduction and credit, 8.5, 8.6
  - limits on ability to deduct losses, 8.6
- allocation of profits or losses, 6.10
- assignment of membership interest, 6.18
  - liabilities upon, 6.19
- authority to sue on behalf of, 6.34
  - consequence of lack of authority, 6.35
- C-corporation membership in LLC, 3.28, 6.2
- classes of membership, 1.6, 3.28
- conflict of interests, 6.4
- consent to adoption of operating agreement, 5.5, 6.2
- consent to amendment of operating agreement, 5.5, 6.2
- continuation of entity upon event of disassociation, 6.2,
  - contribution from fellow members, 6.14, 6.18
- contributions to LLC, tax treatment, 8.3
- corporate membership in LLC, 1.4, 6.2
- death benefit exclusion, eligibility for, 3.27
- delegation of authority by, 1.5, 2.6, 6.2, 15.9-11
- distribution of profits, 6.11

distribution upon disassociation, 6.12  
 distributions authorized by, 6.14, 15.10  
 distributions of earnings to, 16.4  
 distributions, tax treatment, 8.6  
 economic rights of, 6.2, 6.18-19  
 election of manager, 1.5, 6.2  
 estate membership in LLC, 1.4, 3.28, 6.2  
 evidentiary admissions by, use against LLC, 6.6  
 fiduciary duties, 6.4  
 good faith, 6.4  
 improper distributions, 6.14  
 indemnification, 6.4, 15.9-11  
 inspection and copying of records, 6.5  
 keeping of minutes and documents, 6.3  
 LLC membership in another LLC, 3.28, 6.2  
 liability for acts without proper authority, 1.7, 6.2, 6.7  
 liability for own acts and omissions, 1.7, 3.26, 6.7  
 maintenance of records, 6.5  
 management authority, 6.2  
 management rights, 6.18  
 manager management, 1.5, 6.2, 6.16, 12.3  
 meetings of, 6.3  
 member's basis in LLC for tax purposes, 3.28, 8.4  
 membership interest, 6.12, 6.18, 6.19, 12.1-6  
 membership management, 1.5, 6.2, 6.16, 12.3  
 misconduct, 6.4  
 notice to, use against LLC, 6.6  
 number of members at time of filing articles, 1.4, 3.27, 6.2, 8.1  
 non-manager member in manager directed LLC, lack of duties, 6.2  
 non-professional's membership in law LLC, 15.4  
 operating agreement, 2.9, 5.5, 6.18, 16.13  
 organizer's membership in LLC, 5.3  
 owners denominated as "members", 6.2  
 ownership of LLC property, 6.15  
 participation in cafeteria plans, 3.27  
 partnership membership in LLC, 1.4, 3.28, 6.2  
 personal liability, limitation of, 1.1, 1.7, 3.26, 5.1, 6.7, 15.9-11  
 pledging of membership interest, 6.18, 16.8-9  
 qualifications of manager, 1.5  
 RLLP membership in LLC, 3.28  
 receipt of in-kind distributions restricted, 6.13  
 regulation of in professional capacity, 1.12, 15.2-5, 16.15  
 removal of manager, 1.5, 6.2  
 reporting of entity's income, gain, loss on individual return, 3.1-2, 8.2  
 right to receive distributions, 6.2, 6.13  
 self-employment tax, 8.9-10  
 separate acts by as creating liability, 15.9-11  
 single member LLC, tax treatment, 3.27  
 standards of conduct, 6.4  
 statement of management in articles, 1.4, 6.2  
 statutory rights of members, 6.2  
 term of office of LLC manager, 6.2  
 transfer of LLC property, 6.16  
 transfer of member's interest, 1.8, 4.2, 6.1-2, 6.18-19  
 trust membership in LLC, 1.4, 6.2  
 vacancy in LLC management offices, 1.5, 6.2

valuation of membership interest, 6.12  
 voting rights of, 1.5, 5.5, 6.2-.3

#### **Medical Profession *See also* Physicians**

Board of Medical Licensure, Kentucky, 15.2  
 classification as profession, 15.2  
 corporate practice of, 15.2  
 fee-splitting, 15.2  
 Kentucky Medical Association, 15.2  
 liability for professional services rendered, 6.7, 15.9-11  
 practice in LLC form, 15.2

#### **Membership In LLC *See also* Managers, Members And Owners Of LLC**

generally, 1.4, 3.28, 6.2, 12.1-6  
 admission to, 6.17  
   -effective date, 6.17  
   -means of, 6.17  
 assignment of membership interest, 6.18-19  
   -liabilities upon, 6.19  
 eligibility for, 6.2  
 interest as security, 12.1-6  
 management of entity, 1.5, 6.2, 12.3  
 owner denominated as "member", 6.2  
 pledge of membership interest, 6.18, 16.8-9  
 required number, 1.4, 6.2  
 statutory rights of members, 6.2  
 transferability of interest  
   -generally, 4.2, 6.18  
 valuation of interest upon disassociation, 6.12

#### **Mergers**

generally, 7.1, 7.8, 15.8, 16.20  
 approving the merger, 7.9  
 as alternative to other transactions, 7.2  
 benefit of statutory provisions on, 7.2  
 business corporation and LLC, 7.8  
 C-corporation merger into S-corporation, 3.15-16  
 C-corporation merger with LLC, tax treatment, 8.17  
 effect of upon liability, 7.11-12, 16.20  
 filing requirements, 7.10  
   -articles of merger, 7.10  
   -plan of merger, 7.10  
 inter-entity merger approved, 7.8  
 Kentucky limited partnerships, right to merge, 7.8  
 loan documents providing for, 16.20  
 personal liabilities, effect of merger, 7.12  
 RLLP with LLC, tax treatment, 8.19  
 S-corporation with LLC, tax treatment, 8.18  
 statutory treatment, 7.2, 7.8, 16.20  
 use of merger to effectuate practice conversion to LLC, 15.8

#### **Minimum Gain Chargeback Provision**

allocation of partnership non-recourse debt, 3.20

#### **Minutes Of Meetings**

obligation to maintain, provision in operating agreement, 6.3

**Misconduct**  
managers and members of LLC, 3.26, 6.4

**Model Code Of Professional Responsibility**  
personal liability, 15.3

**Model Rules Of Professional Conduct**  
ancillary services by law firm, 15.4

**Money Purchase Plan** *See* **Retirement Plans**

**Multiple Services**  
ability of professional LLC to provide, 15.4  
ability of RLLP to provide, 18.6

**Name Of LLC**  
generally, 1.4, 5.7, 15.6,  
ability to acquire, hold and convey property in,  
6.15, 16.6  
clear notice to third parties, 5.7  
failure to use approved name, 5.7  
foreign LLCs, 5.7, 5.15  
inclusion in articles of organization, 1.4, 5.3, 16.12  
name of professional LLC, 5.7  
name of RLLP, 18.5  
necessary words or abbreviations, 1.4, 1.12, 5.7, 15.6,  
16.12  
"real name" of LLC, 5.7  
reservation of, 5.7  
similarity with names of other LLCs, 5.7  
use of assumed names by LLC, 5.7

**Negligence**  
generally, 3.26, 15.9-11  
LLC liability for, 6.7, 15.9-11  
LLC manager, member, agent liability for, 1.7, 3.26,  
6.7, 15.9-11  
negligent supervision, 18.4  
RLLP partner liability for, 18.4

**Nonqualified Retirement Plans** *See* **Retirement Plans**

**Non-Recourse Liabilities**  
generally, 3.19  
tax treatment, 3.19-20, 8.4, 8.6

**Non-Tax Considerations In Choice Of LLC Form** *See*  
*also* **Specific Entries**  
generally, 2.1  
access to capital, 2.8  
analysis of the client's options, 2.3  
continuity of existence, 2.7  
estate planning, 2.10  
formality of operation, 2.9  
limited liability considerations, 2.5  
participation in management, considerations  
regarding, 2.6

roles of the business lawyer in formation, 2.2  
transferability of ownership interests, 2.8

**Notice To An LLC**  
generally, 6.6  
of grounds for administrative dissolution, 6.27

**Nurses**  
practice in LLC form, 15.2

**Occupational Fees**  
Louisville and Jefferson county, 11.8.11

**Occupational Therapists**  
practice in LLC form, 15.2

**Occupations**  
regulation of compared, 15.2, 15.5  
statutory treatment, professions, 15.2

**Operating Agreement**  
generally, 1.5, 2.9, 5.5  
addressing duty to maintain records, 6.5  
admission to membership, 6.17  
adoption of initial operating agreement, 5.5, 6.2-.3  
allocation of profits and losses, 6.10  
amendment of operating agreement, 5.5, 6.2-.3  
compared to corporate bylaws, 1.5, 16.13  
compared to partnership agreement, 1.5, 5.5, 16.13  
contents of, 1.5, 5.5  
distributions other than cash, 6.13  
existence of LLC without operating agreement, 5.5  
limiting right of withdrawal of member, 6.12, 6.22-.23  
maintaining minutes, 6.3  
meeting requirements, 6.3  
modification of default rules required to be  
pursuant to written operating agreement, 5.5,  
6.1-2, 6.19,  
notice requirements, 6.3  
providing for indemnification, 6.4  
recording of not required, 5.5  
retained as record at LLC principal office, 5.5  
structuring for dissolution, 1.9, 6.12, 6.23  
structuring for management rights, 1.5, 5.5  
structuring for personal liability issues, 6.4  
structuring for tax purposes, 4.1  
use of in loan transaction due diligence check, 16.13  
written or oral, 1.5, 5.5, 16.13

**Operations Of LLC**  
generally, 2.6, 2.9  
admission to membership, 6.17  
-effective date, 6.17  
-means of, 6.17  
agency authority, 6.2, 15.9-11  
allocation of losses, 3.28, 6.2, 6.10, 8.5  
allocation of profits, 6.10  
annual reports, 1.9, 2.9, 5.18, 16.5, 16.14

- applicability of form to professionals, 1.12, 2.9, 15.2, 18.8
  - appointment of "tax matters partner", 8.11
  - assignment of membership interest
    - conflicts of interest arising from, 6.18
    - liabilities upon, 6.19
    - rights upon, 6.18-19
  - authority to sue on behalf of LLC, 6.34
  - centralized management, 1.10, 4.2
  - compared to close corporation, 1.1
  - compared to limited partnership, 3.26, 8.1
  - compared to partnership, 1.1, 3.28, 8.2
  - compared to S-corporation, 3.26, 8.1
  - contribution to capital
    - generally, 6.9, 8.3
    - enforceability, 6.9
    - liability for, 6.9
    - taxation, 8.3
  - dissolution and winding up, 6.22-29, 6.30-32
  - distribution of profits, 6.11
  - distribution upon disassociation, 6.12
  - financial statements, preparation, 6.14
  - flexibility of, 1.1, 3.28, 5.1, 6.1-2
  - formed for "any lawful purpose", 5.7
  - governing law, 6.8
  - improper distributions, 6.14
  - in-kind distributions, 6.13
  - interstate operations, 1.11, 2.9, 5.10-11, 6.8, 16.16
  - losses deductible by members, 8.5-6
  - operating agreement, 2.9, 5.5, 6.10, 16.13
  - operative provisions of the LLC Act, 6.1
  - ownership of LLC property, 6.15
  - maintaining records at principal office, 2.9, 5.5, 6.3, 6.5
    - failure to maintain, 6.5
    - right to inspect, 6.5
  - management authority, 1.5, 6.2, 12.3
  - membership eligibility, 6.2
  - membership number requirements, 3.27, 6.2, 8.1
  - parties to actions by or against LLC, 6.33
  - privacy of records, 2.9, 6.2, 6.5, 16.12
  - professional's use of form, 15.2, 16.15
  - single member LLC, taxation, 3.27
  - statutory rights of members, 6.2
    - direct management rights, 1.5, 6.2
    - election of managers, 1.5, 6.2
    - receipt of distributions, 6.2, 6.13
    - to continue entity, 6.2
    - vote on operating agreement, 6.2
    - vote on transfers of interests, 6.2
  - taxable year, 8.12
  - transfer of LLC property, 6.16
  - valuation of membership interest, 6.12
- Oral Agreements**
- oral operating agreements, 1.5, 5.5, 16.13
- Ordinary Course**
- authority of LLC manager to bind entity in, 6.2
  - authority of LLC member to bind entity in, 6.2
- inability to pay debts in, improper distributions, 6.14
  - of partnership business, 18.3
- Owners See Managers, Members And Owners**
- Paralegals**
- professional's liability for acts of, 15.9-11
- Partnerships See also General Partners, Limited Partnerships, Registered Limited Liability Partnerships**
- abusive partnership
    - generally, 3.24
    - applicability to LLC, 3.24
    - use of doctrine, 3.24
  - allocation of income, gain, loss, deduction and credit
    - generally, 3.20, 3.28, 6.10, 8.2
    - restrictions on, 3.20, 3.28
    - "substantial economic effect" standard, 3.20, 3.28, 6.10
  - assumption of liabilities, tax treatment, 3.18
  - authority of partners, 18.3
  - calendar or fiscal year, 3.27
  - cancellation of assumed name upon conversion to LLC, 5.4
  - capital interest, 3.18
  - compared to LLC, 1.1, 1.2, 3.26, 6.1, 8.2
  - compared to RLLP, 18.3, 18.8
  - compared to S-corporation, 3.11, 3.14, 3.17, 8.1
  - contribution among, 18.3
  - contribution of property to, tax treatment
    - generally, 3.18
    - recognition of gain or loss, 3.18
    - partner tax basis, 3.18
    - partnership tax basis, 3.18
  - conversion to LLC form, 5.4, 7.2-4, 7.7, 8.16, 16.20
  - conversion to RLLP form, tax treatment, 8.20
  - corporate general partner in limited partnership, 3.17
    - qualifications for, 3.17
  - debts and obligations of, 5.4, 7.7, 18.3
  - deductions of losses by partners, 3.14, 8.2
  - dissolution, 6.22
  - distribution of profits, 6.11
  - entity-level taxation, avoidance of, 3.17, 8.2
  - family partnership, reallocation of income, 3.20
  - flow through taxation, 3.1, 3.17, 8.2
  - formation of law partnership with non-lawyers, 15.4
  - formation under KUPA as prerequisite for RLLP election, 18.6
  - health insurance premiums, deductions, 3.27
  - informality of, 2.3
  - interest in as security, 12.1-6, 16.8
  - liability of partners, 1.1, 6.7, 7.7, 16.20, 18.3
  - liability upon conversion to LLC form, 5.4, 7.7, 8.16, 16.20
  - liability upon merger with LLC, 7.11-12

- limitations on partner's ability to deduct
  - partnership losses
  - at-risk loss rules, 3.21
  - passive activity rules, 3.21
- limited partnership, one general partner, 3.17, 8.1
- membership in LLC, 1.4, 6.2
- merger into LLC form, 7.2, 7.8-9, 8.19, 16.20
- partner personal tax on entity earnings, 3.2
- practice of accounting through, 15.2
- practice of law through, 15.3
- profit interest, 3.18
- receipt of net distributions by, 16.10
- registered limited liability partnerships, 2.5, 15.3
- requirement of more than one partner, 3.17
- tax basis in
  - calculation of, 3.19
  - decrease of, 3.19
  - increase of, 3.19
  - non-recourse liability, effect, 3.19-20
  - recourse liability, effect, 3.19-20
- tax classification, 3.1, 3.17, 4.1-22, 8.2
- tax consequences of conversion to LLC form, 8.16
- taxation of partnership distributions
  - generally, 3.22, 6.11
  - recognition of gain or loss, 3.22
  - tax basis, 3.22
- TEFRA audit, 8.11
  - appointment of "tax matters partner", 8.11
- termination of, tax treatment, 3.23

**Partnership Tax Classification** *See also* Kintner Regulations

- generally, 1.1, 1.10, 3.1, 3.26, 4.1, 8.1, 16.4, 16.13
- classification of Kentucky LLC, 4.1-22
- corporate characteristics, 1.10, 3.1, 4.2, 8.1
  - centralized management, 1.3, 1.10, 4.2
  - continuity of life, 1.3, 1.10, 4.2
  - free transferability of interests, 1.3, 1.10, 4.2
- limited liability, 1.3
- flow-through tax treatment of LLC, 1.3, 1.10, 3.1, 3.26, 5.1, 8.2
- IRS rulings on, 1.10, 4.1-22, 8.2, 8.6
- procedures for obtaining, 4.1-22
- S-corporation application, 3.2, 3.11, 3.12, 8.1

**Passive Activities**

- defined, 3.14, 3.21
- application to LLC, 8.6
- application to partnerships, 3.21
- application to S-corporations, 3.14
- effect on S-corporation shareholder ability to deduct losses, 3.13
- LLC no passive income limits, 3.28
- material participation standard, 3.14, 3.21
- passive loss rules, IRS, 3.3, 3.14, 3.21, 3.27, 8.6
- portfolio income as not qualifying as, 3.14
- rental activities as, 3.14, 3.21
- S-corporation termination, 3.11

**Passive Income**

- calculation formula of tax, 3.16

- IRS waiver of tax, 3.16
- LLC, no passive income limits, 3.28
- S-corporation payment of tax at normal rates, 3.16

**Pass Through Taxation** *See* Flow Through Taxation

**Patient Relationships** *See* Client Relationships

**Penalties** *See* Statutory Violations And Penalties

**Per Capital**

- allocation of profits and losses
  - generally, 6.10
- distribution of profits
  - generally, 6.11
  - taxation, 6.11
- voting, generally, 6.3
  - advantages of, 6.3
  - use by LLC, 6.3

**Personal Exemptions**

- generally, 3.4
- filing status, effect of, 3.4

**Personal Guarantees**

- generally, 2.3
- allocation of LLC debts among members in absence of personal guarantee, 8.4
- allocation of tax basis to guarantor, partnership, 3.19, 3.21
- in loan transactions, 16.3
- LLC member personal liability for, 1.7

**Personal Holding Company** *See also* Taxation

- defined, 3.3

**Personal Holding Company Tax** *See also* Taxation

- generally, 3.3
- applied to closely held corporation, 3.3
- when applied, 3.3

**Personal Liability** *See also* Professional Liability

- generally, 1.1, 3.26, 6.7, 15.9-11, 16.3
- allocation to general partner of limited partnership, 3.19
- charging a member's interest, 16.18
- contracts of LLC, 6.2, 6.7, 16.3
- effect of assignment of membership interest, 6.18-19
- effect of conversion upon, 5.4, 7.6-7, 8.16, 16.20
- effect of failure to maintain LLC records, 6.5, 6.7
- effect of failure to qualify as foreign LLC, 5.13
- effect of merger upon, 7.11-12, 16.20
- for additional capital contributions committed to, 1.4, 6.19
- for capital contribution to LLC, 1.7
- for improper distribution, 6.14, 15.10
- for personal guarantee, 1.7



- governing board effect upon, 15.2, 15.5
  - improper distributions, 6.14
  - increase in partner's share, tax treatment, 3.19
  - joint and several liability, 15.9-11, 18.3
  - limitation of for LLC owners, 1.1, 1.7, 3.26, 5.1, 6.7
  - of general partner, 6.7, 18.1-4
  - of LLC member for acts of others, 1.7, 3.26, 6.7
  - of LLC member for own acts or omissions, 1.7, 3.26, 6.7
  - of LLC member or manager acting under improper authority, 1.7, 6.2, 6.7
  - of partner in RLLP, 2.5, 18.2-3, 18.6
  - operating agreement effecting, 6.19
  - piercing entity veil, 1.7, 2.5, 6.7, 15.9-11
  - professionals, 6.7, 15.1-11
  - relationship to IRS at-risk loss rules, 3.14
  - shielding from, 3.26, 5.1, 6.7, 15.9-11
  - statutory treatment for LLC in Kentucky, 5.1, 6.7, 15.10
- Personal Property**
- effect of merger upon, 7.11
  - granting of security interest in, 16.6
  - LLC membership interest as, 16.8
  - of partnership vesting in LLC upon conversion, 5.4, 7.6
  - ownership of LLC personal property, 6.15
  - ownership of LLC real property, 6.16
  - perfection of security interest in, 16.7
  - pledge of ownership interest, 6.18, 16.8-9
- Petition For Reinstatement**
- application for, contents of, 6.27
  - relation back of reinstatement, 6.27
- Pharmacists**
- practice in LLC form, 15.2
- Phase-Out**
- generally, 3.14, 3.21
  - tax payer's deductions subject to, 3.14, 3.21
- Physical Therapy**
- practice in LLC form, 15.2
- Physicians *See also* Medical Profession**
- practice of medicine in LLC form, 15.2
- Piercing The Entity Veil**
- generally, 1.7, 2.9, 6.7, 15.9-11
  - alter ego theory as basis for, 1.7
  - application to LLC, 1.7, 2.9, 6.7, 9.1, 9.10, 15.9-11
- Plan Of Merger**
- approval of, 7.10
  - contents of, 7.10
- Pledge**
- generally, 16.8-9
  - as not constituting assignment of LLC membership interest, 6.18
  - effect of, 6.18, 16.9
  - interest as personal property, 6.18, 16.8
  - of property as "at-risk", tax treatment, 3.14, 3.21
  - pledge agreement, 16.8
- Portfolio Income**
- as not passive, 3.14
- Preemptive Rights**
- S-corporation, multiple classes of stock prohibited, 3.11
- Preferences**
- liquidation preference, 13.8.3
  - preferred FLP and FLLC interests, 11.4.9
  - voting rights, 13.8.4
- Preorganization Liabilities**
- generally, 5.8
- Presumptions**
- lack of presumption of one year term of office for LLC manager, 6.2
  - of notice upon dissolution, 6.29
  - under Kintner regulations, tax classification, 4.3
  - under securities laws, 12.3
- Principal**
- statutory liability of, 15.9-11
- Private Letter Rulings**
- tax consequences of conversion from partnership to LLC, 8.16
  - on LLC tax classification, 4.1-22, 8.2
  - on passive activity loss rules to LLC, 8.6
  - on tax shelter status of LLC, 8.13
  - self-employment taxation, 8.9
- Probate**
- ancillary probate, SMLLCs, 9.8
- Professional Corporations**
- calendar or fiscal year, 3.27
  - compared to LLC, 3.27
  - merger with LLC, tax treatment, 8.17
  - payment of pre-compensation earnings as compensation, 3.27
  - tax treatment, generally, 3.1, 3.27
  - uniform tax rate, 3.27
  - use of form by accountants, 15.2
  - use of form by dentists, restriction to, 15.2
- Professional Liability**
- acts of non-professional LLC employees, 15.9-11

duty of supervision, 15.9-11  
legal profession, 15.3, 15.9-11  
liability for own acts, 3.26, 6.7, 15.9-11  
negligent supervision, 15.9-11, 18.4

**Professional Licenses** *See also* **License Revocation Or Suspension**

licensure, revocation or suspension, 15.2  
professional regulatory boards, 15.2-.2, 16.15

**Professional Limited Liability Company**

generally, 1.12, 15.1  
claims against after dissolution, 6.32  
contractual liability, 15.3  
formation, 1.12, 15.8  
malpractice liability, 6.7, 15.10-11  
multiple services, 15.4  
name of, 15.6  
personal liability, 1.12, 6.7  
practice conversions, 15.8  
professional liability, 1.12, 15.11  
statutory framework, 1.12, 6.7, 15.10  
tax issues for, 15.7  
tort liability, 6.7, 15.10-11  
use of the PLLC, 15.2  
-by lawyers, 15.3  
-governing boards, 15.5

**Professional Regulatory Boards** *See also* **License Revocation Or Suspension**

authority over choice of business form, 1.12, 5.6, 15.2-5, 16.15  
prohibition of LLC form, 1.12, 3.11, 5.6, 15.2  
relation to professional in LLC, 5.6, 15.2, 15.2-5, 16.15  
restriction of multiple services, 15.4

**Professional Services**

generally, 15.2  
architecture, 15.2  
attorneys, 15.2-.5  
certified public accountants, 15.2  
chiropractors, 15.2  
defined, 15.2  
dentists, 15.2  
engineering, 15.2  
landscape architects, 15.2  
liability for, 3.26, 6.7, 15.9-11  
multiple services, 15.4  
nurses, 15.2  
occupational therapists, 15.2  
optometrists, 15.2  
osteopaths, 15.2  
pharmacists, 15.2  
physical therapists, 15.2  
physicians, 15.2  
practiced in LLC form, 5.3, 5.6, 15.2-5, 18.8  
podiatrists, 15.2  
psychologists, 15.2  
scope of, 15.3

statement of services in articles of organization, 5.3  
statutory coverage, Kentucky, 15.2  
veterinarians, 15.2

**Professions** *See also* **Specific Entries**

financial institutions, S-corporation form prohibited, 3.11, 3.28  
insurance company, S-corporation form prohibited, 3.11, 3.28  
multiple professions practiced in single LLC, 15.4  
occupations contrasted, 15.2  
use of RLLP form, 2.5, 15.3, 18.8

**Profit**

allocations of, 1.6, 3.19, 6.10  
allocation of non-recourse liabilities in accordance with partner's profits interest, 3.19, 8.4  
determination of for S-corporation shareholder taxation, 3.15  
effect of upon taxation of corporate distributions, 3.8  
expectation of as requirement for election of RLLP form, 18.6  
expectation of in investment contract, 12.2  
granting a profits interest in partnership, tax treatment, 3.18  
increase and reduction of profit upon distribution of property, 3.8  
LLC distributions of profit, 6.11  
member/manager duty to hold in trust for benefit of LLC, 6.4  
S-corporation profits, situations where occurring, 3.15  
-payment of tax at corporate level, 3.16  
sale or exchange of, partnership termination, 3.23  
undistributed profits, AAA reflection of, 3.15

**Profit Sharing**

as issue of allocation, 6.11  
profit sharing plans, retirement, 8.9, 17.5

**Profit Sharing Plans** *See* **Profit Sharing; Retirement Plans**

**Promissory Notes**

as capital contribution to LLC, 1.4

**Promoter; Organizer**

duty to file articles of organization, 1.4  
requirements as to membership in LLC, 5.3

**Proper Party**

generally, 6.33  
authority to sue on behalf of LLC, 6.34  
-consequence of lack of authority to bring suit, 6.35  
-voting requirements, 6.34  
joinder of LLC member, 6.33  
statutory treatment, 6.33

- to a conversion to LLC form, 7.4
- Prototype Limited Liability Company Act**
  - generally, 5.1, 5.13, 7.2
- Proxies**
  - inability of LLC interest assignee to obtain, 16.9
  - provision for in operating agreement, 6.3
  - use of in corporate share pledge agreements, 16.9
- Psychologists**
  - practice in corporate form, 15.2
  - statutory treatment, 15.2
- Public Accountants** *See* **Accountants**
- Purchase Of The LLC** *See* **Sale Or Purchase Of The LLC**
  - generally, 13.8.5
- Qualified Income Offset Provision**
  - LLC, 8.5
  - partnership, 3.20
- Qualified Limited Liability Company**
  - generally, 5.2-.3, 5.12
  - annual reports, 5.18
  - effect of failure to qualify, 5.13
  - qualified RLLP, 18.7
  - withdrawal of qualification to do business, 5.17
- Qualified Non-Recourse Financing**
  - defined, 3.14
  - relationship to at-risk status, 3.14, 8.6
- Qualified Retirement Plans** *See* **Retirement Plans**
- Qualified Small Business Stock**
  - defined, 3.9
  - exclusion of gain from sale of, 3.9
- Qualified Subchapter- S Trust (QSST)**
  - S-corporation shareholder qualifications, 3.11
- Real Estate And Real Property**
  - ability of LLC to acquire, hold and convey in entity name, 6.15, 16.6
  - contribution of property to S-corporation, tax treatment, 3.12
  - effect of merger with LLC upon, 7.11
  - granting of security interest in, 16.6
  - mortgages on, 16.6-.7
  - of partnership vesting in LLC upon conversion, 5.4, 7.6
  - ownership of LLC real property, 6.15
  - perfection of security interest in, 16.7
  - qualified non-recourse financing
    - defined, 3.14, 3.21
    - relationship to IRS at-risk loss rules, 3.14, 3.21
  - taxation of C-corporation's distribution of, 3.8
  - transfer of LLC real property, 6.16
  - use of family entity to hold, 11.4.6
- Records Of The LLC**
  - consequences of failure to maintain, 6.5, 6.7
  - division into classes, 6.5
  - inspection and copying by members, 6.5
  - records required to be maintained, 6.5
  - responsible parties for maintenance, 6.5
- Recourse Liabilities**
  - generally, 3.19
  - effect of conversion, 7.7
  - limited partnership, tax treatment, 8.4
  - tax treatment, 3.19-.20
- Redemption Of LLC Stock**
  - applicability of attribution rules, 3.8
  - corporate distribution in redemption of shares, tax treatment, 3.8
  - corporate distribution, treatment as payment in exchange for stock, 3.8
- Registered Agent**
  - generally, 1.4, 5.3, 5.9, 16.7
  - failure to maintain as grounds for administrative dissolution, 5.9, 6.27
  - failure to maintain as grounds to revoke certificate of authority, 5.16
  - in determination of office to file financing statement, 16.7
  - information regarding in articles of organization, 1.4, 5.3, 16.12
  - of foreign LLC, 5.16
  - service of process through, 5.9
  - statement consenting to serve as agent, 5.3
- Registered Limited Liability Partnerships**
  - generally, 2.5, 18.1
  - as flow through entity, tax treatment, 3.1
  - changes affecting status, 18.6
  - compared to LLC, 18.8
  - contribution and indemnification duties of RLLP partner, 18.3
  - conversion of partnership into RLLP, tax treatment, 8.20
  - election of RLLP status, 18.1, 18.6
  - entity liability, 18.4
  - engagement in multiple services, 18.6
  - filing requirements, 18.1
  - filings with Secretary of State, 18.6
  - foreign RLLP, 18.7
  - formation of, 18.6
  - historical background, 18.2
  - inability to practice as LLC as reason for choice of, 18.2

- insurance or financial condition for qualification, 18.6
  - Kentucky Uniform Partnership Act (KUPA), 18.1, 18.3, 18.4, 18.6
  - liability for acts of co-partners, employees, agents, 18.3
  - liability for contracts in the ordinary course, 2.5, 18.4
  - liability for partner's own acts, 18.4
  - limitation of liability, 2.5, 18.3, 18.6
  - limitation of joint liability, 18.1, 18.2
  - membership in LLC, 3.28, 6.2
  - merger with LLC, tax treatment, 8.19
  - name of, 18.5
  - other states' treatment, 18.3, 18.6
  - owner's personal tax on entity earnings, 3.2
  - relationship to general partnership, 18.1, 18.8
  - registration of, 18.6
  - renewal statements, 18.6
  - statutory authorization for, 2.5, 18.1, 18.2
  - use by professionals, 2.5, 15.2-3, 18.8
  - withdrawal and admission of new partner in, 18.6
- Registered Office**
- generally, 1.4, 5.3, 5.9, 16.7
  - failure to maintain as grounds for administrative dissolution, 5.9, 6.27
  - failure to maintain as grounds for revocation of certificate of authority, 5.16
  - in determination of office to file financing statement, 16.7
  - information regarding in articles of organization, 1.4, 5.3, 16.12
  - of foreign LLC, 5.16
  - service of process through, 5.9
- Registration**
- of foreign LLC name with Secretary of State, 5.7, 5.15
  - of RLLP, 18.6
  - of securities, 12.1-6
  - renewal statement, 18.6
- Regulatory Boards** *See Professional Regulatory Boards*
- Reliance**
- creditor reliance upon promise to contribute capital to LLC, 6.9
  - of creditor on commitment to LLC capital contribution, 1.4
  - of third party on apparent authority of LLC member or manager, 6.2
  - on personal credit of partner, conversion to LLC, 7.7
- Removal Of Managers**
- generally, 1.5
- Renewal Statement**
- expiration of, 18.6
- for RLLP, 18.6
- Rent**
- rental activity as passive, 3.14, 3.21
  - material participation standard, 3.14, 3.21
- Reorganizations** *See also Mergers*
- C-corporation conversion to S-corporation, tax treatment, 3.15, 3.16
  - conversion to LLC form, 5.4, 7.2-3, 7.5, 15.8, 16.20, 18.8
  - tax treatment, 8.16
  - effect of mergers, 7.11-12
  - merger of LLC, 7.1-2, 7.8-10
  - recognition of gain, S-corporation distribution, 3.15
  - tax free reorganizations, 3.9
- Representations And Warranties**
- in loan transactions, 16.5
  - promise to make contribution to LLC, 6.9
- Representative Of Deceased LLC Member**
- rights of, 6.21
- Res Judicata**
- use against LLC, 6.35
- Residency Of Entity**
- perfection of security interest, 16.7
- Retirement And Fringe Benefit Plans**
- generally, 17.1
- Retirement Of Member** *See Withdrawal Of LLC Member*
- Retirement Plans** *See also Specific Entries*
- generally, 17.1
  - 401(k) plans, 17.7, 17.9
  - cafeteria plans, 17.17
  - Consolidated Omnibus Budget Reconciliation Act of 1986 (COBRA), 17.9
  - defined benefit plans, 17.3, 17.8, 17.12
  - defined contribution plans, 17.3, 17.4, 17.7
  - dependent care assistance plans, 17.17-18
  - disability insurance, 17.13, 17.16-17
  - Employee Retirement Income Security Act (ERISA), 17.2-3, 17.10, 17.12
  - HR 10 plans, 17.2, 17.12
  - health and accident insurance, 17.14, 17.17
  - Keogh plans, 17.2, 17.12
  - life insurance, 17.15, 17.17
  - loan from qualified pension and profit sharing plan prohibited, 8.14
  - money purchase plans, 17.5-6
  - multiple entity plans, 17.12
  - nonqualified plans, 17.11
  - profit sharing plans, 3.27, 8.9, 17.5, 17.9

- qualification and administration 17.2, 17.10, 17.12
  - qualified retirement plans, 3.27, 17.2-5, 17.7, 17.10, 17.12
  - self-employed, 17.7, 17.12, 17.14, 17.16-17
  - target benefit plans, 17.8
  - Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), 17.12
  - tax qualification of plans, criteria, 17.2, 17.10
  - Tax Reform Act of 1986, 17.12, 17.14
  - thrift and tax savings plans, 17.9
  - welfare benefit plans, 17.13, 17.17
- Revenue Reconciliation Act Of 1993**
- tax treatment of payments to retiring or deceased partner, 8.8
  - application to LLCs, 8.8
- Revised Uniform Limited Partnership Act**
- generally, 1.2, 5.2
  - transfer of membership interest under, 1.8
- Rules Of Professional Responsibility**
- utilization of PSC and LLC form by attorneys, 15.3
- S Corporation**
- generally, 2.3, 3.11, 3.28
  - at-risk loss rules, 3.14, 3.21
  - allocation of income, gain, loss, 3.13, 3.26, 3.28
  - as member of affiliated group prohibited, 3.11
  - C-corporation merger into S-corporation, 3.15
  - calendar or fiscal year, 3.27
  - classes of stock, multiple, 2.3, 6.11
  - compared to LLC, 3.26, 6.2, 6.11, 8.1
  - compared to partnership, 3.11, 3.14, 3.21, 3.28, 8.1
  - compensation of shareholder, taxation, 3.10
  - continuation of status, 2.3
  - contribution by shareholder, tax treatment, 3.12
  - conversion to LLC form, 8.18
  - corporate level taxation of, 3.11, 3.16, 3.28, 8.1
  - corporate tax basis, contributions, 3.12
  - creation of earnings and profits, 3.15
  - debt reclassified as equity, 3.11
  - deduction of losses by shareholder
    - generally, 3.13-14, 3.21
    - limitations on, 3.13-14, 3.21
  - disadvantages of form, 3.11, 3.13, 3.26, 3.28, 6.11, 8.1
  - distribution of cash and property, tax treatment, 3.10
  - dividend policies, 2.3
  - election of status, 3.11
  - family S-corporation, tax treatment, 3.13
  - financial institutions prohibited from using form, 3.11
  - formation of, tax treatment, 3.2
  - health insurance premiums, deductions, 3.27
  - husband and wife shareholders, 3.11
  - IRS policy on shareholder number limits, 3.11
  - income reporting by shareholders, 3.13, 3.28
  - insurance companies prohibited from using form, 3.11
  - investment tax credit recapture, 3.16
  - limitations, tax treatment, 3.11, 3.26, 3.28, 6.11, 8.1
  - mandate of domestic corporation status, 3.11
  - membership in LLC, 3.28, 6.2
  - multiple classes of stock prohibited, 3.11, 3.28
  - net built-in gains tax, 3.16
  - non-resident alien as shareholder, 3.11, 3.28
  - number of shareholders, 3.11, 3.26, 3.28, 6.2
  - organizational and operational requirements, 1.1, 3.11, 3.28
  - outside investors, 2.3
  - owner's personal tax on entity earnings, 3.2
  - ownership of another corporation, 3.11
  - pass through entity tax treatment, 1.1, 3.1, 3.11, 3.13, 3.28, 8.1
  - passive activity loss rules, 3.14, 3.21
  - payment of tax on net passive income, 3.16
    - calculation formula, 3.16
    - waiver of tax by IRS, 3.16
  - previously a C-corporation, 3.15, 3.16
    - tax treatment, 3.16
  - qualifying subchapter S trust "QSST", 3.11, 3.28
  - safe harbor, non-convertible debt, 3.11
  - sale or exchange of S corporation stock, 3.12
  - self-employment tax, 3.10, 8.9
  - shareholder basis in corporation, tax purposes, 3.2, 3.12
  - shareholder consent to election of status, 3.11
  - shareholder income tax on distributive share, 3.10
  - shareholder individual tax returns, 3.10, 3.13
  - shareholder qualification, 3.11, 3.28, 6.2
  - shareholder salary, social security tax, 3.10
  - single-level taxation, 1.1, 3.11, 3.28, 8.1
  - special allocations prohibited, 3.11
  - statutory restrictions, 3.11, 3.28, 8.1
  - tax benefits unavailable, 2.3
  - tax exemptions, 2.3, 3.16
  - taxation of contributions to, 3.12
    - recognition of gain or loss, 3.12
    - tax basis, shareholder and corporation, 3.12
  - taxation of distributions, 3.15
    - accumulated adjustment account, 3.15
    - earnings and profits, 3.15
    - recognition of gain, 3.15
  - termination of status, failure to maintain eligibility, 3.11
  - trust as shareholder, 3.11
  - unreasonable compensation, 3.10
  - venture capital investors, 2.3
  - voting rights, differing, 3.11
- Safe Harbor Provisions**
- allocation of non-recourse debt
    - generally, 3.20
    - minimum gain chargeback provision, 3.20
    - "substantial economic effect" standard, 3.20
  - IRS classification rules, 4.17-18
  - in financing arrangements, 16.7
  - no more than 500 partners, 3.28
  - non-convertible debt with non-contingent interest, S-corporation, 3.11

### **Sale Or Purchase Of The LLC**

- challenging transfer of LLC property, 6.16
- conversion and merger as alternatives, 7.2
- sale of membership interest as security, 12.1-.6
- sale or transfer of LLC property, 6.16
- winding-up of LLC, 6.28

### **Secretary Of State, Commonwealth Of Kentucky**

- administrative dissolution by, 5.7, 5.9, 6.27, 16.5
- annual report filings, contents, 1.9, 2.9, 5.18, 16.14
- articles of organization filings, 1.4, 5.3, 16.12
- application for certificate of authorization of foreign LLC, 5.12, 5.14, 16.14
- application for certificate of existence, 16.14
- articles of merger, 7.10
- assumed name statement by LLC, 5.7
- cancellation of certificate of dissolution, 6.27
- cancellation of certificate of limited partnership upon conversion, 7.5
- certificate of cancellation of assumed name upon conversion, 7.5
- county clerk's delivery of decree of dissolution to, 6.26
- failure to meet annual filing requirements, administrative dissolution, 5.18, 16.5
- foreign LLCs, filings, 1.11, 5.7, 5.12, 5.14, 5.18
- foreign RLLP filings, 18.7
- name of LLC approval, 5.7
- name of RLLP approval, 18.5
- notice of change of principal place of business, 5.3
- petition for reinstatement filed with, 6.27
- RLLP filings, contents, 18.6
- role of in conversion to LLC form, 7.5, 16.20

### **Securities Act Of 1933**

- definition of security, 12.2

### **Securities Law Issues**

- generally, 12.1
- consequences of issuing a security, 12.5
- exemptions from registration, 12.6
- federal securities laws, 12.2
- holding period, 13.22
- member-managed versus manager-managed LLC, 12.3
- state securities laws, 12.4

### **Security Interest *See also Commercial Law And The LLC***

- generally, 16.6
- granting of, 16.6
  - not constituting an assignment of LLC interest, 6.18
- in personal property, 16.7
- in real property, 3.14, 3.21,
- perfection of, 16.7
- qualified non-recourse financing, 3.14, 3.21

### **Self-Employment Tax**

- generally, 8.9

- application to LLC, 8.9, 13.5.1
- deduction of, 8.10

### **Service Of Process**

- on domestic LLC, 5.9
- on foreign LLC, 5.16

### **Shares Of Stock *See Stock***

### **Shareholders**

- accumulated earnings tax, avoidance of tax at shareholder level, 3.3
- basis in S-corporation stock, 3.12
- compensation of C-corporation shareholder
  - compensation caps, 3.10
  - deductibility by corporation, 3.10
  - IRS challenges, 3.10
  - two-level taxation, avoidance of, 3.10
- compensation of S-corporation shareholder, tax treatment, 3.10
- contributions by, gain or loss, 3.6
- corporate distribution in redemption of shares, taxation, 3.8
- deduction of losses by S-corporation shareholder
  - generally, 3.13, 3.28
  - at-risk loss rules, 3.14
  - limitations on, 3.13-.14, 3.28
  - passive activity loss rules, 3.14
- double taxation of, 1.1
- exclusion of gain from sale of qualified small business stock, 3.9
- law practice LLC, 15.3-.5
- liability, 1.1, 15.1-.11
- minority shareholder protections, 2.3
- ownership of C-corporation, single shareholder, 3.27
- ownership of S-corporation, single shareholder, 3.27
- qualified persons, 3.11, 3.28
- receipt tax-free stock upon reorganization, 3.9
- recognition of losses, 3.9
- S-corporation shareholder qualifications, 3.11, 3.28
- S-corporation shareholder report of income, 3.13, 3.28
- S corporation status, effect, 2.3
- S-corporation status, shareholder consent, 3.11
- shareholder contribution of property in exchange for stock, tax treatment, 3.6
- shareholder individual return, exclusion of corporate income or loss, 3.5
- shareholder tax basis in money loaned to corporation, 3.7
- shareholder tax basis in stock, 3.6, 3.7
  - effect of non-taxable distributions, 3.7
  - effect of operating income or loss, 3.7
- shareholder tax, distributions received, 3.1, 3.2
- shareholder tax on undistributed earnings, 3.1
- shielding from professional liability, 15.1-.11
- taxation of distribution as dividend, 3.8

**Sharing Of Fees** *See also Profit Sharing*  
within LLC, 15.4

**Sharing Of Profits** *See Profit Sharing*

**Single-Member Limited Liability Company**

generally, 1.4, 1.13, 9.1  
articles of organization, 5.3  
as alternative to corporate subsidiary, 9.7  
avoiding ancillary probate, 9.8  
bankruptcy-remote SMLLC, 9.5  
conversion of single-member LLC to multi-member LLC, 8.21, 9.11  
conversion of multi-member LLC to single-member LLC, 8.22, 9.12  
federal income taxation of, 1.10, 1.13  
financing flexibility with single-asset entities, 9.6  
formation, 9.9  
liability shield, 9.2, 9.10  
like-kind exchanges, 9.4  
operating agreement, 5.5, 9.10  
planning opportunities with, 9.1  
transfer tax avoidance, 9.3  
uses for, 1.13

**"Small Business Stock"**

qualification under Internal Revenue Code, 3.9  
Small Business Investment Act of 1958, 3.9

**Sole Proprietorship**

compared to LLC, 3.27  
merger with LLC, 7.8  
taxation, 3.27

**Solo Professional Practice**

operation of LLC as, 15.2-.3

**State Bar Of Kentucky**

relationship with Supreme Court of Kentucky, 15.3  
regulation of, 15.3

**State Taxation, Kentucky**

generally, 2.4, 3.1, 4.22 8.26  
license tax, 8.27  
state tax classification, 4.22

**Statutory Basis For Limited Liability Companies**

generally, 1.1-.3, 2.5, 18.1  
history, 4.3, 4.4, 5.1  
statutory rights of members, 6.2  
use by professionals, 15.1

**Statutory Liability Of LLC Members**

generally, 1.7, 6.7, 15.9-.11

**Statutory Rights Of LLC Members**

generally, 6.2  
rights upon withdrawal, 6.12

voting, 6.3

**Statutory Transactions Of LLC**

conversion, 7.1-.7  
dissolution, 6.22-.32  
merger, 7.1-.2, 7.8-.12

**Statutory Violations And Penalties**

abusive partnership doctrine, 3.24  
administrative dissolution by Secretary of State, 5.9, 16.5  
failure to maintain required records, 6.5  
false statement in articles of incorporation, revocation of certificate of authority, 5.16

**Stock** *See also Shareholders*

allocation of in proportion to ownership S-corporation, 3.11, 3.28  
basis in, S-corporation shareholder, 3.12, 3.14  
capital losses, 3.9  
deferred gain on sale of publicly traded stock, 3.9  
disposition of, tax treatment, 3.9  
gain on sale of stock, tax, 3.9  
loss sustained by shareholder, tax treatment, 3.9, 3.12  
multiple classes of in S-corporation, 3.11, 3.28  
non-voting stock, 2.3, 3.11, 3.28  
passive activities, 3.14  
preferred stock in S-corporation, 3.11  
qualified small business stock, 3.9  
receipt of upon reorganization, 3.9  
redemption of shares, 3.8  
S corporation issues, 3.11, 3.12, 3.28  
S-corporation ownership of stock of another corporation, limitations, 3.11  
single class mandate, S-corporation, 3.11, 3.28  
shareholder basis in stock, 3.12  
worthless stock, 3.9

**Stockholders** *See Shareholders*

**Stock Restriction Agreements** *See Buy-sell Agreements*

**Strategic Alliances** *See Joint Venture*

**Subsidiaries**

SMLLC as alternative to corporate subsidiary, 9.7

**Substantially Appreciated Inventory**

disproportionate distribution of as source of gain or loss, 3.22, 8.7

**Successor Liability**

assignment of membership interest, 6.18-.19  
by partnership, tax treatment, 3.18  
upon conversion, 5.4, 7.6, 16.20  
upon merger, 7.11-.12, 16.20

**Support Staff**

professional's liability for, 15.9-.11

**Target Benefit Plans** *See* **Retirement Plans****Taxable Year**

generally, 8.12  
carrying over of unused losses, 3.21  
partner's inability to deduct losses in excess of  
basis at end of, 3.21

**Taxation** *See also* **Internal Revenue Code; Specific Entries**

generally, 1.1, 1.10, 2.4, 3.1-2, 4.1, 8.1, 18.8  
ability of LLC member to include entity liabilities  
in tax basis, 3.26  
accumulated earnings tax, 3.3  
advantages for LLC form, 1.1-2, 1.10, 2.4-5, 3.1,  
3.27-28, 8.1, 14.3  
allocation of income among LLC and its  
employees, 3.28, 8.5  
allocation of income, gain, loss, deduction and  
credit, S-corporation, 3.13  
-at-risk loss rules, 3.14  
-limitations, 3.14  
-passive activity loss rules, 3.14  
allocation of liabilities, 3.19  
allocation of losses, LLC, 1.6, 3.28, 6.10, 8.2, 8.5-6  
alternative minimum tax, 3.3  
application of attribution rules, 3.8  
at-risk loss rules, 3.3, 8.6  
avoiding transfer taxes, SMLLCs, 9.3  
basis in partnership  
-generally, 3.19, 8.4  
-calculation of, 3.19  
-decrease of, 3.19  
-effect of non-recourse liability, 3.19  
-effect of recourse liability, 3.19  
-increase of, 3.19  
basis of LLC membership for tax purposes, 3.2,  
3.26, 3.28, 8.4  
C-corporation, double taxation, 1.1, 3.27, 8.1, 14.3  
calendar or fiscal year, comparison of business  
forms, 3.27  
capital gains tax, C-corporation, 3.3  
classification of Kentucky LLC, 4.1-22  
compelled distributions, 3.2  
compensation of C-corporation shareholder, 3.10  
compensation of S-corporation shareholder, 3.10  
consolidated return, corporation as member of  
affiliated group, 3.5  
contributions to business entity, 3.2, 3.18, 8.3  
contributions to C-corporations, 3.6, 14.3  
contributions to S-corporations, 3.12  
-basis in stock, 3.12  
-recognition of gain and loss, 3.12  
conversion to LLC, 8.15  
-C-corporation, 8.17  
-partnership, 8.16  
-RLLP, 8.19  
-S-corporation, 8.18

-single-member/multi-member LLC, 8.21-22  
corporate basis in assets received, 3.6  
corporate basis in stock, 3.6-7  
corporate characteristics as determination factors  
in providing partnership tax treatment, 1.10,  
3.1, 3.27-28, 4.1-2, 8.1  
corporate estimated tax payments, 3.16  
corporate level tax, 1.1, 3.1, 3.3, 8.1, 14.3  
corporate shareholder tax on distributed earnings,  
3.1-2  
corporate shareholder tax on undistributed  
earnings, 3.1  
deductions of losses by LLC members, 8.3, 8.6  
deductions of losses from passive activities,  
limitations, 3.3, 3.14, 8.6  
deferred gain on sale of public stock, 3.9  
disability insurance, 17.16  
disadvantages for LLC form, 3.2, 3.27, 8.6  
disposition of C-corporation stock  
-deductions for worthless stock, 3.9  
-gain on sale of stock, 3.9  
-recognition of loss, 3.9  
distribution of cash or appreciated property, 3.2  
distributions from the LLC, 8.6  
double taxation of corporate form, 1.1, 3.27, 14.3  
entity level tax, LLC, 1.1, 3.1-2, 3.17, 3.26, 8.2, 14.3  
environmental tax, 3.3  
expense deductions for LLC, 3.28  
family partnerships, reallocation of income rules,  
3.20, 11.8.5  
federal taxation of LLC, 1.1, 1.10, 3.1, 3.28, 4.1, 5.1,  
8.1  
flow-through taxation, 1.1, 1.10, 2.4, 3.1, 3.11, 3.17,  
3.26, 3.28, 5.1, 8.2  
gift tax annual exclusion, 11.8.6  
health and accident insurance reimbursement,  
17.14  
IRS challenges to corporate deduction for salaries,  
3.10  
insurance premium deductibility, 17.13-17  
investment tax credit recapture, 3.16  
Kentucky license tax, 8.27  
Kintner Regulations, 4.2-4  
LLC taxed as C-corporation if publicly traded, 3.28  
liabilities assumed by the corporation in  
incorporation, tax treatment, 3.6  
life insurance, 17.15  
like-kind exchanges, SMLLC, 9.4  
limitations on ability to deduct partnership losses  
-generally, 3.21, 8.6  
-at-risk loss rules, 3.21, 8.6  
-passive activity rules, 3.21, 8.6  
liquidation of LLC, 3.2  
multi-entity structures, 2.4, 3.27  
nonqualified retirement plans, 17.11  
of contributions to partnerships  
-generally, 3.18-19  
-IRS analysis of partner's receipt of interest in  
exchange for services, 3.18  
-partner tax basis, 3.18-19  
-partnership tax basis, 3.18  
-recognition of gain or loss, 3.18



- of partnerships, general and limited, 3.17
  - organizational tax, 3.2
  - owner reporting pass-through entity income, gain, loss on individual return, 3.1-2
  - partnership allocation of income, gain, loss, deduction and credit
    - generally, 3.20
    - restrictions on, 3.20
    - "substantial economic effect" standard, 3.20
  - partnership classification of LLC, 4.1-22, 8.1-2
  - partnership termination, 3.23
  - partnership treatment for federal tax purposes, 1.1, 1.10, 3.1, 3.17, 3.26, 4.1-22, 5.1, 8.1, 8.2
  - passive activities loss rules, 3.3, 3.13-14, 3.27-28
  - periodic distributions, 3.2
  - personal holding company tax, 3.3
  - professional LLCs, 15.7
  - qualified retirement plans, requirements, 17.2, 17.10
  - rates, federal corporate, 3.3, 3.27
  - rates, individual vs corporate, 3.27
  - recognized gain and loss, C-corporation, 3.6
  - seeking partnership classification, procedures, 4.1-22
  - self-employment tax, 3.10, 3.28, 8.9-10, 13.5.1
  - shareholder basis in money loaned to corporation, 3.7
  - shareholder basis in stock, 3.6-7
  - single-level taxation of LLC, 1.1-2, 3.1, 3.28, 4.1, 8.2
  - social security tax, S-corporation shareholder, 3.10
  - state taxation of LLC, 1.1, 3.1, 8.26
  - step-up basis to fair market value upon death, 3.2
  - taxable income of LLC, 3.28, 15.7
  - taxable year, 8.12
  - taxation of partnership distributions
    - generally, 3.22, 8.2
    - recognition of gain or loss, 3.22, 8.6
    - tax basis, 3.22, 8.6
  - tax free reorganizations, 3.9
  - tax shelters, 8.13, 15.7
  - transfer tax, 11.8.7
  - treatment of LLC income as net earnings from self-employment, 8.9-10, 15.7
  - treatment of LLC member as limited partner or limited entrepreneur, 8.2, 8.6, 15.7
- Tax Equity And Fiscal Responsibility Act Of 1982 (TEFRA)**
  - retirement plans of LLC, affect on, 17.12
  - TEFRA audits, 8.11
  - appointment of tax matters partner, 8.11
- Tax-Exempt Organizations** *See also Charitable Organizations*
  - and the LLC, generally, 10.2
  - charitability, 10.5
  - fiduciary duties, 10.8
  - LLCs as joint-venture vehicles, 10.3
  - LLCs as tax-exempt corporations, 10.12
  - prior history, the LP model, 10.4
  - qualifying LLC for exemption, 10.14
  - Revenue Ruling 98-15, 10.7, 10.9
  - state law questions, 10.13
  - structure, 10.6
- Tax Reform Act Of 1986**
  - cash method accounting, 8.13
  - Employee Retirement Income Security Act (ERISA), 17.2-3, 17.10, 17.12, 17.14
  - health and accident insurance premiums, deductibility, 17.14
  - retirement plans of LLC, affect on, 17.12
  - taxation of the liquidating corporation, 3.8
- Tax Shelter**
  - generally, 8.13, 15.7
  - cash method accounting, 8.13, 15.7
  - defined, 8.13, 15.7
  - LLC as, 8.13
  - private letter rulings on LLC as, 8.13
  - special rules applicable to forming, 8.13
  - syndicate defined, 8.13
  - tests to determine if tax shelter, 8.13
- Termination**
  - partnership, tax treatment, 3.23
- Thrift And Tax Savings Plans** *See Retirement Plans*
- Torts**
  - LLC liability for, 6.7, 15.9-11
  - LLC member, manager, agent liability for, 1.7, 6.7, 15.9-11
  - partner liability for, 6.7, 18.3-4
  - RLLP liability for, 18.3-4
- Transfers** *See also Commercial Law And The LLC*
  - assignability of membership interest, 1.8, 4.2, 6.2, 6.18-19
  - assignee's rights upon, 1.8, 6.18-19
  - of LLC ownership interest to member, requirement of contribution, 6.9
  - of LLC property, 6.16
  - of membership interests, 1.8, 4.2, 6.2, 6.18-19
  - restriction on, 6.2, 6.18
  - S-corporation shareholder gain or loss on stock transfer, 3.12
  - transfer tax, 11.8.7
- Trust**
  - grantor retained annuity trust combined with FLPs and FLLCs, 11.4.10
  - membership in LLC, 1.4, 6.2
  - membership in S-corporation, 3.11
  - merger with LLC, 7.8
  - responsibility of LLC member/manager to hold profit in trust for entity, 6.4
- Uniform Commercial Code**
  - generally, 16.7, 16.8

**Uniform Limited Liability Company Act**  
generally, 5.1, 7.2

**Unrealized Receivables**

definition, 8.7  
disproportionate distribution of as source of gain or loss, 3.22, 8.7  
relationship to payments to withdrawing member, 8.7

**Unreasonable Compensation** *See Compensation*

**Unrelated Business Taxable Income**  
generally, 13.5.4

**Vacancy In LLC Management Office**  
generally, 1.5

**Valuation**

manipulative valuations, distributions in-kind, 6.13  
of member's interest upon disassociation, 6.12,  
-going concern value, 6.12  
-goodwill, 6.12

**Valuation Discounts** *See Discounts*

**Venture Capital**

use of LLCs in venture capital transactions, 13.1  
-access to company records, 13.15  
-advantages of the LLC, 13.4  
-distribution of appreciated property, 13.4.3  
-pass-through taxation, 13.4.1  
-special tax allocations, 13.4.2  
-state tax issue, 13.4.4  
-structural flexibility, 13.4.5  
-capital structure, 13.8  
-conversion rights, 13.8.2  
-dividends, 13.8.1  
-liquidation preference, 13.8.3  
-put rights, 13.8.5  
-tax treatment, 13.8.6  
-voting rights, 13.8.4  
-comparison to S corporations, 13.6  
-conversion to C corporation, 13.20  
-description of venture capital transactions, 13.3  
-disadvantages, 13.5  
-self-employment taxes, 13.5.1  
-stock options and benefits, 13.5.3  
-tax-free mergers, 13.5.2  
-unrelated business taxable income, 13.5.4  
-indemnification and limitation of liability, 13.17  
-management structure, 13.9  
-board of directors, 13.10  
-designation of manager or member managed, 13.12  
-fiduciary duties, 13.13

-officers, 13.11  
-pre IPO distributions, 13.21  
-related party transactions, 13.18  
-securities laws holding period, 13.22  
-shareholder meetings, 13.16

**Vesting Of LLC Management Rights**

generally, 1.5, 16.12  
assignment of membership interest, 6.18-.19  
-centralized management, 4.2

**Veterinarians**

practice in LLC form, 15.2

**Vicarious Liability**

generally, 6.7, 15.9-.11  
based upon separate act of LLC member or agent, 6.7, 15.9-.11  
based upon status as LLC member, manager or agent, 6.7, 15.9-.11  
failure to supervise distinguished, 15.9-.11  
for contractual obligations, 15.9-.11  
statutory treatment of, 6.7, 15.9-.11

**Violation Of Statutory Duties** *See Statutory Violations And Penalties*

**Voluntary Dissolution**

generally, 6.25,  
requirements for, 6.25

**Voting**

admission of member, 6.17  
approval of merger, 7.9  
approval procedures for conversion to LLC, 7.4  
authority to sue on behalf of LLC, voting, 6.34  
consent to adoption of operating agreement, 5.5, 6.2  
consent to amendment of operating agreement, 5.5, 6.2  
continuation of entity, vote requirements, 6.2  
election of managers, 6.2  
improper distributions, liability, 6.14  
per capital basis voting, LLC, 6.3  
requirements upon partnership conversion to LLC, 5.4  
rights of assignee of membership interest, 1.8, 16.9  
rights of members, 1.1, 1.5, 6.2

**Waiver**

of corporate taxation of S-corporation by IRS, 3.16  
of meeting notice, provision in operating agreement, 6.3  
of right to offset against distributions, 16.10

**Warranties** *See Representations And Warranties*

**Wealth Transfer Planning**

- with family LLCs and LPS, generally, 1.14, 11.1-2
  - advantages of, 11.3
  - appraisals, 11.4.4, 11.8.1
  - asset protection planning, 11.7, 11.7.2
    - fraudulent conveyance, 11.7.3
    - liability shield of family entity, 11.7.1
  - business succession planning vehicle, 11.4.7
  - charitable FLPs and FLLCs, 11.4.11
  - combining with GRATs, 11.4.10
  - comparing FLPs and FLLCs, 11.4.13
  - conversion of family corporations into FLLC, 11.4.12
  - discount planning, 11.6
  - dissolution events, 1.14
  - estate planning fundamentals, 11.5
    - life-time gifting, 11.5
  - federal and state tax classification, 11.4.2
  - formation process, 11.4.3
  - holding life insurance, 11.4.8
  - holding real estate, 11.4.6
  - liability shield, 11.7.1
  - preferred FLP and FLLC interests, 1.4.9
  - state of formation, 11.4.1
  - types of assets held by family entities, 11.4.5
  - tax issues, 11.8
    - appraisals, 11.8.1
    - business purposes for FLPs and FLLCs, 11.8.9
    - death bed gifting, 11.9.5
    - family partnership rules, 11.8.5
    - gift tax annual exclusion, 11.8.6
    - gift tax return, 11.9.1
    - IRC secs. 2036 and 2038, 11.8.4
    - IRC sec. 2701, 11.8.8
    - IRC sec. 2703, 11.8.3
    - IRC sec. 2704(a), 11.8.7
    - IRC sec. 2704(b), 11.8.2
    - IRS challenges, 11.9-11.9.8
    - occupational fees, 11.8.11
    - partnership investment company rules, 11.8.10

#### **Welfare Plans *See* Fringe Benefits**

#### **Winding Up Of LLC**

- generally, 6.24,
- agency power during, 6.29
- appropriate actions during, 6.28
- by circuit court, 6.28
  - venue, 6.28
- by management, 6.28,
- distribution of assets during, 6.30
- handling claims, known and unknown, against the LLC, 6.32
  - notice, 6.32,
  - time barring, 6.32,

#### **Withdrawal Of LLC Member**

- as event of disassociation, 1.9, 6.12, 6.23, 16.19
- distributions upon, 6.12
- entitlement to pre-withdrawal distributions, 6.12

- in-kind distributions restricted, 6.13
- of partner in RLLP, 18.6
- provided for in operating agreement, 1.9, 6.23
- relationship to continuity of life factor, 7.2
- restricting in operating agreement, 6.12
- statutory treatment, 16.19
- tax treatment of payments to withdrawing member, 8.8
- valuation of member's interest in LLC, 6.12-13
- withdrawal events, 1.9, 6.12, 6.23

#### **Withdrawal Of Qualification**

- certificate of withdrawal, 5.17
- content of application for certificate of withdrawal, 5.17

#### **Worthless Stock**

- tax treatment, 3.9

#### **Wrongful Acts And Omissions**

- LLC member liability for, 1.7, 3.26, 6.4, 6.7, 15.9-11, 18.3-4
- of general partner, 6.7, 18.3
- of RLLP partner, 18.4
- standard of conduct of LLC member/manager, 6.4
- statutory treatment, 6.7