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Making the Obvious Choice Malpractice: LLPs and the Lawyer Liability Time Bomb in Kentucky's 2005 Tax Modernization

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I. INTRODUCTION

The treatment of limited liability partnerships (LLPs) under Kentucky's tax modernization of 2005 is interesting in several respects. First, by subjecting LLPs, limited liability companies (LLCs), and many other structures traditionally taxed on a flow-through basis to an entity-level tax as if they were corporations, Kentucky moved to block a "loop-hole" and recapture revenues "lost" since the creation of the new entities in 1994. In altering the tax treatment of these forms, Kentucky has gone against the national trend. Indeed, at the same time as the Kentucky legis-
lature was imposing corporate income taxes on LLPs, in effect imposing an entity-level tax as rent for limited liability, the legislature of North Carolina had before it a bill to extend limited liability to all partnerships without imposing entity-level taxation. We live in interesting times. This article will cover the shift in tax treatment in Part 2.

Second, by varying the tax treatment of general partnerships (GPs) and LLPs, Kentucky created a required point of analysis for lawyers forming a partnership entity where none previously existed. This, in turn, created a legal malpractice trap where none previously existed. This prospective trap will be discussed in Part 3.

Third, by making the tax treatment of LLPs retroactive to pre-existing LLPs, Kentucky turned the malpractice trap into a time bomb, potentially extending lawyer liability to entity-selection advice given prior to 2005 when there was but one correct decision. This time bomb may require Kentucky lawyers to revisit partnership form selection determinations made by clients based on advice given between the 1994 creation of the LLP form and the 2005 passage of tax modernization. This we discuss in Part 4.

Necessarily, some rather complicated tax provisions are simplified in the initial discussion. The tax modernization treatment of LLPs is more complicated than we discuss initially, and in Part 5 we develop a more comprehensive treatment of the tax analysis. To telegraph our conclusion: because partners in LLPs can obtain tax benefits at the individual level for taxes paid at the entity level, it is true that the choice between the LLP form and the GP form may be nearly netted out in some LLPs. But such equipoise is not always the case, and thus the need for the choice of form analysis—and the attendant malpractice trap—remains.

Having in Part 6 raised a range of legal malpractice exposures incident to an attorney's response to the tax modernization statute as it applies to LLPs, we close and offer our larger conclusions in Part 7.

Overview] ("In most states, the decision to conform to the Check-the-Box regulations for income tax purposes was not controversial. Almost all states that impose a corporate income tax, or its equivalent, have enacted legislation or announced in formal or informal guidance that they will classify an LLC in the same manner as it is classified for federal tax purposes."); Michael W. McLoughlin & Walter Hellerstein, State Tax Treatment of Foreign Corporate Partners and LLC Members After Check-the-Box, in 8 THE STATE AND LOCAL TAX LAWYER 1, 3 (2003) ("For the most part, states follow the federal tax treatment of partnerships and treat them as pass-through entities."); see also infra note 36.

8 H.B. 258, 2005 Gen. Assem., Reg. Sess. (N.C. 2005). The North Carolina bill was not enacted. Other efforts to extend limited liability without entity level taxation are being made throughout the country. In 2005, the Uniform Limited Partnership Act (ULPA) (2001) was submitted to a total of seven state legislatures. ULPA (2001) alters traditional limited partnership law by making the limited partner's limited liability more certain and by providing for an elective limited liability limited partnership (LLLP) status under which the general partners enjoy limited liability. See UNIF. LTD. P'SHIP ACT §§ 201(a)(4), 303, 404(c) (2001).
From the creation of the LLP form in Kentucky in 1994 until the effective date of the tax modernization legislation, a practitioner representing a client forming a Kentucky partnership had, for most purposes, two options but really only one choice. The first option was to form a general partnership under Kentucky's enactment of the Uniform Partnership Act. Partners in such a firm would have the benefit of flow-through taxation, as the firm was not taxed at the entity level, but would not have the benefit of limited liability.

The second option was to form a general partnership that then elected to be an LLP under Kentucky's add-on Limited Liability Partnership Act. We assume for the purposes of this analysis an informed decision to form a partnership, not an LLC or corporation. See generally J. William Callison & Maureen A. Sullivan, Partnership Law and Practice: General and Limited Partnerships ch. 2 (2004), and an informed decision to form that partnership in Kentucky and not in another jurisdiction. But see infra note 19. It should be recognized, however, that the discussion, which is presented in terms of the LLP, is equally applicable to the LLC, and there likely will be situations in which an LLC, for similar tax-driven reasons, will want to convert to a general partnership. In fact, each year there are many more LLCs founded in Kentucky (14,839 organizations in 2004, the last year for which figures are available) than there are LLPs (68 registrations in 2004); thus, it will be in the LLC that the need for analysis is at least quantitatively greatest. See Kentucky Secretary of State, Annual Business Filings Statistics (Sept. 7, 2005), http://sos.ky.gov/business/filings/statschart.htm. We assume, however, that the LLC has been typically used where statutory limited liability is more critical, and the conversion to a general partnership will be therefore less acceptable.


We acknowledge that as a theoretical matter there is no "entity" under the UPA, which adopted an "aggregate-based" approach to the partnership relationship. William Draper Lewis, The Uniform Partnership Act, 24 Yale L.J. 617, 640 (1915); see also Gary S. Rosin, The Entity-Aggregate Dispute: Conceptualism and Functionalism in Partnership Law, 42 Ark. L. Rev. 395 (1989). This, of course, follows through to the Kentucky LLP, which is simply a subform of the GP. See infra note 28. This is in contrast to RUPA, which adopts an entity-based, and not an aggregate-based, theory of the partnership relationship. See RUPA § 201(1) (1997); Robert W. Hillman, Allan W. Vestal & Donald J. Weidner, The Revised Uniform Partnership Act 67 (2004). While this presents an interesting theoretical impediment to the imposition of an entity-level tax, this conceptual impediment was easily overcome by the drafters of the tax modernization legislation: they simply ignored it.

Act. Partners in such a firm would have the benefit of flow-through taxation and would enjoy the benefit of a partial limited liability shield. There being no significant marginal costs to forming as an LLP and not a GP, the choice was clear: maintain flow-through taxation and gain a shield on personal liability by forming as an LLP, not a GP. Indeed, it has been suggested that, given this set of options, it might be malpractice to not form as an LLP.

III. The Prospective Malpractice Trap

The pre-tax modernization choice set forth in Part 2 is simple. Given the options of the GP (flow-through taxation but personal liability) and the LLP (flow-through taxation and a shield on personal liability), no rational actor would choose the GP form. The choice following tax modernization is sometimes much more complicated. That is because tax modernization, in effect, sets up a potential trade-off between flow-through taxation and limited liability. After tax modernization, the issues of the GP choice remain the same: partners enjoy flow-through taxation and they continue to bear the burden of personal liability for firm liabilities.

Under tax modernization, it is the impact of the LLP choice that changes. The modernization expands the definition of what is, for tax purposes, a “corporation” subject to the “corporate” income tax, an expansion that encompasses the LLP. Partners in a LLP lose flow-through taxation


14 Ky. Rev. Stat. Ann. § 362.220(2). As shorthand, we refer to the LLP “shield on personal liability” in unqualified terms. We note here, but do not discuss in the broader treatment, the exceptions to the liability shield. It needs to be recognized that Kentucky LLPs are partial- and not full-shield LLPs. See generally Thomas E. Rutledge & Elizabeth G. Hester, Practical Guide to Limited Liability Partnerships, in 5 STATE LIMITED LIABILITY COMPANY & PARTNERSHIP LAWS § 2.1 (Supp. 4 (2004)). Regardless, the exceptions to the liability shield do not change with tax modernization and are a constant in the option sets we describe.

15 We assume for the purposes of this discussion that the burdens of preparing the initial filing, subsequent annual filings, and the $200 annual filing fee would only outweigh the benefits of the liability shield in the type of extraordinarily rare and grotesque firms one would find only on law-school examinations. See Ky. Rev. Stat. Ann. §§ 362.555(1), 362.555(5), 362.555(3) (West 2005). Thus we ignore the possibility here, without prejudice to their use in other settings on other days.


“Corporations” means:
(a) “Corporations” as defined in Section 7701(a)(3) of the Internal Revenue Code;
(b) S corporations as defined in Section 1361(a) of the Internal Revenue
through the imposition of entity-level income taxes on the firm.\textsuperscript{18} Still, they retain their shield on personal liability. Thus, under tax modernization, it becomes a theoretical possibility that a rational actor might choose to form as a GP and forego the benefits of LLP status. Consider two partnerships: Acme and Excelsior.

Acme is in a line of business with operations that are, absent catastrophic loss, neither economically stable nor predictable. Imagine a roadside bar and fireworks factory outlet. Acme has a constantly shifting unskilled workforce made up primarily of recently paroled drug dealers and arsonists, a number of whom are also now-disbarred attorneys. It has an enthusiastic clientele which could charitably be described as unstable, not prosperous, and litigious. As an LLP, Acme will pay $250,000 per annum in entity-level income taxes. Beyond the obvious risks of dram shop, explosion, and employee misconduct, Acme has an unpredictable set of liability risks. The company is constantly branching out into new, untried operations and has a constantly changing and growing set of employees. The constantly shifting galaxy of realistic sources of tort or contract liability for Acme is unknowable, much less insurable. The participants have no confidence that they can replicate the liability shield that would be available under the LLP form. The cost of the insurance that would be available to Acme as a GP to cover even some of the risk would be $300,000 per annum. Acme cannot replicate the benefits of the LLP form by paying less than the $250,000 the LLP form will cost in taxes. Clearly, it should adopt the LLP form.

Excelsior, by contrast, is in a line of business with operations that are economically stable and predictable. Imagine a real-estate partnership with

\begin{itemize}
\item[(c)] A foreign limited liability company as defined in KRS 275.015(6);
\item[(d)] A limited liability company as defined in KRS 275.015(8);
\item[(e)] A professional limited liability company as defined in KRS 275.015(19);
\item[(f)] A foreign limited partnership as defined in KRS 362.401(4);
\item[(g)] A limited partnership as defined in KRS 362.401(7);
\item[(h)] A registered limited liability partnership as defined in KRS 362.155(7);
\item[(i)] A real estate investment trust as defined in Section 856 of the Internal Revenue Code;
\item[(j)] A regulated investment company as defined in Section 851 of the Internal Revenue Code;
\item[(k)] A real estate mortgage investment conduit as defined in Section 860D of the Internal Revenue Code;
\item[(l)] A financial asset securitization investment trust as defined in Section 860L of the Internal Revenue Code; and
\item[(m)] Other similar entities created with limited liability for their partners, members, or shareholders.
\end{itemize}

\textsuperscript{18} Here we refer to Kentucky income taxation only. A LLP's tax classification for purposes of federal income taxation is not altered by Kentucky's tax modernization; while taxed at the entity-level for Kentucky purposes, barring a contrary election, the LLP is a flow-through for federal purposes.
a developed property on a long-term, favorable, triple-net lease with a stable, prosperous tenant. As an LLP, Excelsior will pay $250,000 per annum in entity-level income taxes. Assume further that Excelsior has a well-defined and predictable set of liability risks. It is the lessor under a triple-net lease with a reliable lessee that is required to maintain sufficient insurance. Excelsior has no other operations and has no employees. All realistic sources of tort or contract liability for Excelsior are insurable such that with a very high degree of confidence the participants believe that they can replicate the liability shield available under the LLP form. The cost of such insurance will be $200,000 per annum.\textsuperscript{19} As a GP, Excelsior can replicate the benefits of the LLP form by paying $200,000 in insurance premiums and avoid $250,000 in taxes, a net savings of $50,000. Clearly, it should not adopt the LLP form.

If one accepts that there will be real-world partnerships that will fall toward the Excelsior end of the spectrum, then it becomes incumbent on each attorney organizing a partnership to make the analysis of whether the firm should or should not make the election to be an LLP.\textsuperscript{20} Thus, by differentiating the tax treatment of GPs and LLPs, Kentucky has created, where none previously existed, a required point of analysis for lawyers forming partnerships.

\textsuperscript{19} Of course, in the real world, it isn't an all-or-nothing calculus. Firms with the LLP liability shield maintain insurance to protect firm assets from judgment creditors. At issue here though is the excess insurance which could be obtained to protect the personal assets of firm participants in the absence of the LLP liability shield. Law firms with Kentucky-licensed attorneys organized as LLPs (as well as LLCs or PSCs) are obligated to maintain malpractice insurance or other means of satisfying client claims. Ky. Sup. Ct. R. 3.024. For these firms, the question is whether the cost of the marginal tax liability incurred by remaining an LLP is offset by protection from liabilities exceeding the insurance purchased (often in amounts exceeding the legal minimums) or retained in the form of retentions / deductibles. See infra text accompanying notes 34-36.

\textsuperscript{20} We put to the side, as beyond the scope of this discussion, the professional responsibility questions of whether a single attorney can purport to represent all the participants (or "the firm") in such a transaction. See generally Ky. Sup. Ct. R. 3.130(1.13) (organization as client); Ky. Sup. Ct. R. 3.130(1.7) (loyalty to client); Manion v. Nagin, No. 00-238 ADM-RLE, 2004 U.S. Dist. LEXIS 1776 (D. Minn. Feb. 4, 2004), aff'd, 394 F.3d 1062 (8th Cir. 2005) (explaining that while the organization of a corporation would not normally create attorney-client relationship with the corporation's constituents, an attorney-client relationship had arisen out of personal legal advice rendered to a constituent); Dean R. Dietrich, Representing a Partnership or Limited Liability Company, 72 Wis. LAW. 37 (Nov. 1999) (noting the difficulty in determining whether representation is of partnership/LLC or of the partners/members and the obligation of the attorney to clarify the situation in an engagement letter); RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 51 (2000) (discussing a lawyer's duty of care to certain nonclients); see also infra note 43. We suggest that the single attorney seeking to represent all of the constituents does so at great peril to her ability to satisfy her obligations of loyalty. See generally Robert R. Keatinge, Professional Responsibility and Liability in the Selection and Organization of Business Entities (ALI-ABA, March 25, 1999). We would note, however, that even if we are wrong and a single attorney may comfortably perform such a function, such a finding would only intensify, not change or ameliorate, the malpractice considerations in the post-tax-modernization world.
a partnership entity. This, in turn, creates a legal malpractice trap where none previously existed.

Some practitioners may be tempted to simply form the partnership in another jurisdiction to avoid the Kentucky statute-based problem. Although legislative debates and popular press reports frequently miss the point, as lawyers we all recognize that firms organized in other states are free to conduct business within the Commonwealth. The tax modernization statute frustrates this avoidance mechanism by taxing the Kentucky

21 Whether any LLPs should have been formed in Kentucky is open to dispute. One of the authors believes it to border on, if not be, malpractice per se for an attorney to form an LLP in Kentucky, a partial-shield jurisdiction, when the LLP could be formed in a full-shield jurisdiction, qualified to transact business in Kentucky, and takes the position that the full liability shield afforded by that foreign jurisdiction must be respected in Kentucky. See Ky. Rev. Stat. Ann. §§ 362.575(5), 362.585 (West 2005).

22 We are reminded of the 2002 debate over the proposed Constitutional amendments which consistently and without any basis in fact equated business formations under Kentucky law with business activity in the Commonwealth. See, e.g., Ken Berzof, Business Amendment Goes to Voters, Courier-Journal (Louisville), Nov. 5, 2002, at 1F (“Economic-development officials say the changes are long overdue and vital to the state’s future. Two-thirds of the states have taken similar steps, and supporters contend that if Kentucky holds on to its old constitutional provisions, companies would think twice about locating in the state.”); Al Cross, Constitutional Amendments; Measures on Corporations, Family-Law Courts Pass Easily, Courier-Journal (Louisville), Nov. 6, 2002, at 5X (“Supporters of the amendment, such as Associated Industries of Kentucky and the state Chamber of Commerce, said it would make Kentucky more attractive to new businesses by making it more favorable for them to incorporate in the state.”). This is not to say, however, that the 2002 amendments were without economic merit. See Thomas E. Rutledge, Amendment No. 2 Will Modernize Business Law, Lexington Herald-Leader, Oct. 21, 2002, at A8 (“Kentucky is one of only a handful of states that still retain archaic constitutional provisions governing corporations. The provisions drive Kentucky businesses to organize outside of our state, and to pay substantial fees to other state treasuries for that privilege, without providing any added protection to Kentucky citizens. Having these provisions is not worth the economic price we pay to keep them.”).

operations of foreign LLPs. This actually makes the analytic burden for the lawyer even more complicated.

If avoidance will not work, doing the extra work will. Lawyers involved in the organization of partnerships are simply going to have to lead their clients through the analysis required to determine if the firm at issue is one of those in which it makes economic sense to abandon the personal liability shield. The characteristics of the firms in which it might now make sense to organize as GPs are clear: predictable and fully insurable potential liabilities; predictable insurance costs; and predictable Kentucky income-tax liability. Even where the insurance cost turns out to be less than the additional income tax liability, participants may still elect to give up the savings and assume the cost of the LLP formation if they are unusually risk averse (which, as one might imagine, would not be unusual in people who form firms that have such predictable liabilities and costs).

IV. TURNING THE TRAP INTO A TIME BOMB: IT'S RETROACTIVE

So, as it turns out, our parents were right. The way to avoid liability is to do the required work. Good enough. The problem is that the legal malpractice trap in the tax modernization treatment of LLPs is not just a trap. It is a time bomb because it implicates decisions lawyers made on firm-entity selection for the past eleven years and may require that lawyers go back and test—and possibly change—determinations that were beyond question when made.

Take our Excelsior partnership as an example. Post tax-modernization, because the cost of insuring against Excelsior’s potential participant liabilities as a GP is lower than Excelsior's tax liability as an LLP, it is possible that Excelsior should be formed as a GP. How would the same Excelsior have properly been formed pre tax-modernization? Since there was no cost—in terms of tax liability—from taking advantage of the LLP liability shield, Excelsior should have been formed as an LLP.

24 See Ky. Rev. Stat. Ann. § 141.010(24) (West 2005) (as amended by H.B. 272 § 3, 2005 Gen. Assem., Reg. Sess. (Ky. 2005)) (including within the definition of “corporation” a foreign limited liability partnership as defined in § 362.155(7)). A foreign limited liability company as defined in § 275.015(6), and a foreign limited partnership, as defined in § 362.401(4), are similarly reached by tax modernization. See supra note 17.

25 Consider a partnership such as Excelsior that owns properties in several states. Does the cost of an LLP election in any state justify the additional costs in Kentucky?

26 See, e.g., Stanley L. Blend & Barbara S. deMarigny, Lone Star State Tax Problem: Five Star Federal Tax Creativity, 4 Bus. Entities 22 (May/June 2002) (describing how, over twenty-seven months, more than 1,600 corporations or LLCs in Texas converted to the partnership form in response to the classification by Texas of LLCs as corporations).
So assume that Excelsior was properly formed as an LLP in 1999. Tax modernization is retroactive.27 Excelsior should now be a GP—or at the very least, the analysis needs to be done to make sure that Excelsior should not be changed from an LLP into a GP.28 What obligation does a lawyer have to go back and revisit past transactions to see if a change in the law requires new attention to the file?

We acknowledge there to be a dearth of reported decisions on choice-of-entity malpractice.29 There are a variety of explanations. First, the level of competence expected in the area may be so low that lawsuits generally are not viable. Second, prior to the rise of the LLC and LLP, the available options were, generally speaking, the simplified menu of the corporation (taxed as either a C corp. or an S corp.), the limited partnership, and the general partnership.30 Each had clear and unambiguous distinctions as to organizational structure and tax consequences so choices were more clear cut and less subject to post hoc review and criticism. Third, major developments in recent years, including the abandonment of the Kintner classification regulations,31 the adoption of “Check-the-Box,”32 and the expanded availability of the S corporation,33 have liberalized the availability of pass-through taxation treatment.


28 An existing LLP election may be allowed to expire or may be withdrawn. See Ky. Rev. Stat. Ann. §§ 362.555(4), (5). In that instance the partnership continues, just without the partial limited liability afforded by section 362.220(2). In this respect, it is always helpful to remember the oft-repeated wisdom of Dean Donald Weidner, the reporter for RUPA, that LLPs and GPs are not two different entity forms; rather the LLP is simply a subtype of the GP. See Robert W. Hillman, Allan W. Vestal & Donald J Weidner, The Revised Uniform Partnership Act 363 (2004). See also Revised Unif. P’ship Act § 201(b) (1997); Rutledge & Booth, supra note 6, at 97 (“The limited liability partnership (‘LLP’) is in all respects a general partnership, save for a revision in the rule of joint and several liability of all partners for the debts and obligations of the LLP.”).

29 For example, the authors have searched in vain for a case discussing the liability of an attorney or accountant who purportedly organized an S corporation with an impermissible shareholder, resulting in a C corporation and perhaps vastly different tax consequences to the shareholders. For a review of malpractice claims against tax attorneys and accountants see Jacob L. Todres, Malpractice and the Tax Practitioners: An Analysis of the Areas in Which Malpractice Occurs, 48 EMORY L.J. 547 (1999).

30 Obviously, here we are discussing “run of the mill” businesses and therefore exclude more “exotic” structures such as the business trust and special tax classifications such as the REIT, REMIC, RIC, FSC, DISC, and FASIT.

31 See generally Rutledge and Booth, supra note 6, at 54–85.


33 For example, originally an S corporation was limited to ten shareholders (former I.R.C. § 1371(a)(1) (1958)), a threshold increased to fifteen with conditions in 1976 and fifteen generally in 1978. In 1981 the limit was raised to twenty-five, and in 1982 to thirty-five. In 1996 that limit was increased to seventy-five. In 2004 the limit was raised to one hundred
Another issue is that proving "malpractice" in choice of entity will typically involve challenging the sufficiency of the organizational documents. Deals of any sophistication turn not on the entity itself but rather on the documents that effectuate the agreement of the owners. Challenges to these documents are essentially never seen, perhaps in part because sophisticated parties employ their personal counsel to represent their personal interests in the deal. But that does not mean that such suits cannot be brought, and counsel to Excelsior is going to have a hard time explaining why she did not discuss with Excelsior's partners why they should abandon their LLP status.

V. The Second Order Analysis: Of Course, Nothing Is THAT Simple—Except When It Is

By now, those tax attorneys who have followed the occasionally somewhat unobvious provisions of the tax modernization act as to LLPs will be grumbling that it is not quite as simple as we have laid out in Part 2. And they are right. Because of the provisions which give partners a nonrefundable credit at the individual level for income taxes paid at the entity-level, it can be the case that the partners, on an individual basis, are nearly unaffected by the choice between an entity-taxed LLP and a non-entity-taxed GP. But such near equipoise is not always the case. That means that the analysis is still required and the malpractice trap remains.

Defining a domestic or foreign LLP as a corporation subjects the LLP to income tax liability at rates ranging from four to seven percent.\(^\text{34}\) Also applicable is an alternative minimum tax (AMT) system, with the AMT

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<td>5.00</td>
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<td>100,000.01 TO 250,000.00</td>
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<td>8.25</td>
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calculated in one of two ways. The entity’s tax liability will be equal to the largest of the three numbers.

Kentucky’s tax modernization, in addition to expanding the reach of the “corporate” income tax, radically alters its manner of calculation by adopting an AMT (referred to as the “alternative minimum calculation”) providing that for taxable years beginning on or after January 1, 2005, corporations must pay the greater of the corporate income tax or the AMT. See Ky. Rev. Stat. Ann. § 141.040(5). The AMT is calculated in two manners:

**AMT1:** AMT1 is equal to the lesser of a gross receipts or a gross profit tax calculated as follows:

- **Gross receipts tax:** $0.095 per $100 of “gross receipts” (defined at Ky. Rev. Stat. Ann. § 141.040(5)(b)(1) (created by H.B. 272, § 7)).
- **Gross profits tax:** $0.75 per $100 of “Kentucky gross profits” (defined at Ky. Rev. Stat. Ann. § 141.010(27) (created by H.B. 272, § 3)).

**AMT2:** $175.00 (equivalent to $184,211.00 in gross receipts under the AMT1 gross receipts tax and $23,333.00 in gross profits under the AMT1 gross profits tax).


Although not an issue for LLPs (or LLCs), the pre-tax-modernization corporate “license tax,” was imposed at a rate of $2.10 for every $1,000 of capital employed in the state. See Ky. Rev. Stat. Ann. §§ 136.070, 136.071 (prior to H.B. 272, 2005 Gen. Assem., Reg. Sess. (Ky. 2005)). The tax was beset by issues including the proper manner of its application to foreign corporations and its negative impact upon economic development. See Ill. Tool Works v. Ky. Revenue Cabinet, No. 00-CI-00623 (Franklin Cir. Ct., Ky. 2003). See, e.g., Robert Schoenberger, *Tax Plan’s Economic Effect Debated, Fletcher Cities Better Climate for Business; Doubts Raised,* Courier-Journal (Louisville), Feb. 22, 2004, at 1E ("[T]he license tax discourages businesses from building bigger facilities in Kentucky because that means putting more capital in a state where it is taxed."). The license tax was not applicable to LLPs or any other business structure that was not incorporated. See Shanks v. Ky. Ind. Oil Co., 8 S.W.2d 383, 384 (Ky. 1928). Under tax modernization, the license tax is repealed for tax periods ending on or after December 31, 2005. See H.B. 272 § 1, 2005 Gen. Assem., Reg. Sess. (Ky. 2005)

Other states imposing an entity-level tax on business structures that, for federal tax purposes, are pass-through entities include: Alabama (net worth based “business privilege” tax imposed on LLCs; Ala. Code § 40-14A-22(a) (1975)); California (entity-level franchise tax; Cal. Rev. & Tax. Code §§ 17941, 17942 (West 2004)); Illinois (1.5% personal property replacement tax based on net income; 35 Ill. Comp. Stat. Ann. §§ 5/205(b), 5/201(d) (West 2005)); Michigan (Michigan Single Business Tax; Mich. Dept. of Treasury Revenue Admin. Bulletin 1999-9, available at http://www.michigan.gov/documents/rab99-9_109073_7.pdf); New Hampshire (LLCs doing business in the state are subject to a 5% tax on dividends and interest, an 8.5% business profits tax, and the 0.75% business enterprise tax; N.H. Rev. Stat. Ann. §§ 77:1, 77-A:2, 77-E:2 (2005)); New Jersey (partnerships obligated to pay 6.37% of New Jersey net income allocated to nonresident, noncorporate partners and 9.05% for all nonresident corporate partners; N.J. Stat. Ann. § 54:10A-15.11 (West 2002)); Ohio (8.5% entity-level tax imposed except where all owners give written consent to state tax jurisdiction; Ohio Rev. Code Ann. §§ 5733.06, 5733.40, 5733.41 (West 1997)); Pennsylvania (LLCs except certain professional LLCs subject to 0.699% capital stock and franchise taxes; 15 Pa. Cons. Stat. § 8925 (1995)); Tennessee (excise tax of 6.5% of net earnings and franchise tax of $0.25 per $100 of net worth applied to LLCs, LLPs and LPs; Tenn. Code Ann. §§ 67-4-2007, 67-4-2105(a), 67-4-2106(a)) (West 2005); Texas (LLCs, but not LLPs, LPs, or LLLPs, taxed as
Now the partners of the LLP will be entitled to take a "nonrefundable credit" equal, in the aggregate, to the corporate income tax paid that exceeds the AMT2 of $175 paid by each entity. Therefore, the LLP's partners are always in at least a tax-due position (net loss) of $175, in the aggregate, and true equipoise is not attainable. This $175 extraction may be characterized as the "rent" for the benefits of limited liability, and is assessed even if the LLP has no operations or income.

In addition to the issue of the taxation of a single LLP (or other entity previously taxed as a partnership), there are important issues in the taxation of multiple entities with a common owner. For example, assume that Amy has no 2005 income other than the following allocations from the following LLPs:

<table>
<thead>
<tr>
<th>LLP</th>
<th>Net Income</th>
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<tbody>
<tr>
<td>LLP1</td>
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<tr>
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<td><strong>Total</strong></td>
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On a net basis, Amy has no taxable income and, prior to tax modernization, would have no Kentucky income tax liability. But tax modernization does not operate on a net basis. Rather, the tax is applied entity-by-entity.

<table>
<thead>
<tr>
<th>LLP</th>
<th>6% Corporate Tax Liability</th>
<th>AMT2 Liability</th>
</tr>
</thead>
<tbody>
<tr>
<td>LLP1</td>
<td>$100,000</td>
<td>6,000</td>
</tr>
<tr>
<td>LLP2</td>
<td>(75,000)</td>
<td>0</td>
</tr>
<tr>
<td>LLP3</td>
<td>(65,000)</td>
<td>0</td>
</tr>
<tr>
<td>LLP4</td>
<td>25,000</td>
<td>1,500</td>
</tr>
<tr>
<td>LLP5</td>
<td>78,000</td>
<td>4,680</td>
</tr>
<tr>
<td>LLP6</td>
<td>(63,000)</td>
<td>0</td>
</tr>
<tr>
<td><strong>Total Tax</strong></td>
<td><strong>$12,705</strong></td>
<td></td>
</tr>
</tbody>
</table>

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Thanks to tax modernization, Amy’s tax liability has gone from $0.00 to $12,705.00. Obviously Amy is not happy. And obviously her counsel has some in-depth analysis to undertake to see whether or not her unhappiness can be eliminated, reduced, or at a minimum explained.

Further potential exists for a failure of equipoise at the individual partner level, again making the analysis required and— you have to love the way this works— introducing yet another (and far more complicated) trap for the attorneys who form the entity and, perhaps, for the attorney who represents the entity post formation. Consider the GP/LLP decision from the standpoint of two partners with different individual tax situations.

Able and Baker are the partners in Excelsior. Excelsior is the only partnership with which Able is involved. Excelsior will pay corporate taxes of $250,000 in 2005, and Able and Baker will each have a credit of half of this amount less half of $175 on their personal tax returns. But Baker is involved in a number of partnerships with Kentucky activities, some of which are profitable in any one year and some of which are not. Furthermore, Baker lives in a state other than Kentucky, and it is not clear that his home state will afford him a credit on his state income tax filing for the entity-level taxes paid by Excelsior. So while the application of the corporate income taxes to Excelsior may be nearly transparent to Able, it is not, or at least may not be, to Baker. Able is liability phobic, and for that reason Excelsior is organized in Delaware, a full-shield jurisdiction. Counselor, how do you recommend dealing with this problem?

VI. COUNSEL’S OBLIGATION TO ADVISE CURRENT AND PRIOR CLIENTS OF THE IMPACT OF TAX MODERNIZATION

This brings us to our central question: does the attorney who represented Able and Baker in the formation of Excelsior have an obligation to revisit the structure with them and analyze their situation under tax modernization? This question will in part turn on whether the representation ter-

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38 This example assumes the AMT2 liability is less than either of the AMT1 calculations; at $185,000 in gross receipts AMT1 exceeds AMT2 liability.

39 We may assume that Amy feels like Arthur Godfrey, who observed, “I’m proud to be paying taxes in the United States. The only thing is—I could be just as proud for half the money.” Quotable Online, http://www.quotableonline.com/ArthurGodfrey.html (last visited Oct. 18, 2005).


42 See supra note 21.

43 It is worth noting that presumably Able and Baker consulted an attorney, that she represented one or both of them in the organization of Excelsior, and that upon its formation
minated at some point in the distant past, if the representation was recent and never formally closed, or if it is rather ongoing. If the representation of the partnership is ongoing, counsel would be hard pressed to argue that she is not under an obligation to keep abreast of changes in law affecting her client, and one of those changes is certainly tax modernization. But what about representation completed some time in the past? This somewhat begs the question of whether the representation was truly closed. Was the relationship initiated with an engagement letter that defined its scope? Was there a letter advising the client of the completion of the engagement and of the return of all client property? Do the partners still think of the attorney as the lawyer for the partnership? Whether the attorney-client relationship, and with it a cessation of some, but not all, of the attorney's obligations to the client, has been terminated is a question of fact, and "the mere completion of a particular matter may not terminate the relationship, particularly if the client does not understand that the matter is concluded." Keeping in mind that the advice to qualify Excelsior as an LLP was proper counsel at the time rendered, we are here concerned with her attorney-client responsibilities shifted to Excelsior. See, e.g., Manion v. Nagin, No. 00-238 ADM/RLE, 2004 U.S. Dist. LEXIS 1776 (D. Minn. Feb. 5, 2004), aff'd, 394 F.3d 1062 (8th Cir. 2005). But see Pucci v. Santi, 711 F. Supp. 916, 927 n.4 (N.D. Ill. 1989) (stating that an attorney for a partnership also represents each general partner); Schwartz v. Broadcast Music, Inc., 16 F.R.D. 31, 32 (S.D.N.Y. 1954) (stating that each member of unincorporated association is a client of the association's attorney); New York City Bar Ass'n Comm. on Prof'l and Judicial Ethics, Formal Opinion 1986-2 (1986).

44 One of us had the experience of lecturing in a state that had just adopted RUPA. While addressing the just-passed effective date of the new law, a participant leapt to his feet and ran from the room. Later, it was learned that only that morning he had closed a deal and issued his opinion based on the old (and now repealed) partnership act.

45 See Robert R. Keatinge & David C. Little, The Former and Quiescent Client, 33 Colo. Law. 79, 79 (Aug. 2004) ("If the relationship continues, even though the matter has been concluded, the attorney will still have duties, which may include the duty to monitor changes in the law as they affect the transactions in which the attorney has been involved.").


48 See Lovell v. Winchester, 941 S.W.2d 466, 468 (Ky. 1997) ("Courts have found that the [attorney-client] relationship is created as a result of the client's reasonable belief or expectation that the lawyer is undertaking the representation."); see also In re Bordelon, 894 So. 2d 315, 322 (La. 2005) ("[I]t is true as a general principle that the existence of an attorney/client relationship 'turns largely on the client's subjective belief that it exists ....'") (quoting Louisiana State Bar Ass'n v. Bosworth, 481 So. 2d 567, 571 (La. 1986)); Lawrence Sav. Bank v. Levenson, 797 N.E.2d 485, 492 (Mass. App. Ct. 2003) (indicating that "[t]he existence of an attorney-client relationship is a question to be resolved by the trier of fact ....").

49 Keatinge & Little, supra note 45, at 80.
a lawyer's obligation to go back to someone she perceives to be a former client and advise them anew.

While there is little law on a lawyer's continuing obligations to a former client, the decision rendered in *Hargett v. Holland* is instructive. Therein the question was raised as to an attorney's obligation "to fulfill a continuing duty to prepare a will properly reflecting the testator's testamentary intent." Beneficiaries of the will had brought an action against decedent's attorney asserting counsel, *sua sponte*, should have seen to the updating of the instrument. This assertion was rejected. Absent allegations of an ongoing attorney-client relationship between testator and defendant with regard to the will from which such a continuing duty might arise, or allegations of facts from which such a relationship may be inferred, the allegations which are contained in the complaint are insufficient to place any continuing duty on defendant to review or correct the prepared will, or to draft another will.

... An attorney who is employed to draft a will and supervise its execution and who has no further contractual relationship with the testator with regard to the will has no continuing duty to the testator regarding the will after the will has been executed.

The Restatement (Third) of the Law Governing Lawyers, at Section 33, comment h, provides in part:

A lawyer has no general continuing obligation to pass on to a former client information relating to the former representation. The lawyer might, however, have such an obligation if the lawyer continues to represent the client in other matters or under any continuing relationship. Whether such an obligation exists regarding particular information depends on such factors as the client's reasonable expectations; the scope, magnitude, and duration of the client/lawyer relationship; the evident significance of the information to the client; the burden on the lawyer making disclosure; and the likelihood that the client will receive the information from another source.

Especially telling with respect to this aspect of the restatement is the reporter's note on comment h, which provides in part: "No authority on point has been found on post-representation duties to inform a present

51 *Id.* at 788.
52 *Id.* at 787.
53 *Id.* at 789.
54 *Id.* at 788 (emphasis added).
client about material developments relating to a formerly completed and different matter. The rule stated is believed to follow from the fiduciary duties inherent in the ongoing client-lawyer relationship."

Given the above, perhaps counsel can avoid any exposure if she does not advise the partnership she organized as an LLP years ago, that has not had contact with her for several years, and for which she knows that new counsel, experienced in partnership law, both organizational and tax, is serving as attorney. But the absence of exposure is not assured. And it will not be frequent that prior counsel will be in such an optimum position.

More frequently, the engagement will never have been properly closed. In the meantime, the firm may have mailed the partnership holiday cards or firm newsletters/marketing materials, and there may indeed be a basis for the partners to reasonably believe that she was at least "a," if not "the," lawyer for the partnership. Especially disturbing would be if the attorney off-handedly said "I'll let you know if anything changes." She may not recall making the statement, but Able and/or Baker will remember it, and it alone may have raised her standard of care sufficiently to make her responsible for not advising the partners of the implications of tax modernization. Conversely, if the attorney was prescient enough to tell Able and

56 Id.; see also 2005 ALAS Loss Prevention Manual § IVC. § 4-7:
Because a significant passage of time often occurs between creation of an estate plan and the client's death, changes can occur in the law or facts relevant to the estate plan after the client's will has been executed. The question presented is whether the lawyer has a legal or ethical duty to seek out and advise the client, at least where the changes clearly require the client to reconsider the plan and the lawyer has no reason to believe that the client understands the significance of the changes.

Firms may sometimes be willing to assume such an obligation where, for example, the client is a regular client of the firm and is consulted regularly. In most cases, on the other hand, an open-ended obligation to advise a one-time client about the implications of all changes in the client's circumstances, or even all changes in the law, could create substantial potential malpractice exposure.


58 Consider in this context the possible distinctions between "To Friends of this Firm" and "To Clients of This Firm." See, e.g., Shearing v. Allergan, Inc., No. CV-5-93-866 DWH (LRL), 1994 U.S. Dist. LEXIS 21680, at *2 n.1 (D. Nev. Apr. 4, 1994) (finding an ongoing relationship based on a quote from the firm to the "former" client: "We... value our relationship with you and look forward to responding to your legal needs for many years to come."); SWS Fin. Fund v. Salomon Bros. Inc., 790 E Supp. 1392, 1396 (N.D. Ill. 1992) (finding an ongoing relationship based on a firm letter stating, "I appreciate the opportunity to provide legal services to you, as do others within our firm.... Please do not hesitate to contact me if you have any questions regarding the enclosed.").

59 See, e.g., Lama Holding Co. v. Shearman & Sterling, 758 F. Supp. 1392, 1396 (S.D.N.Y. 1991) (indicating that "[i]n attorney-client agreements there may be liability 'when there is
Baker that "[t]here have been press reports that the governor's office might change the tax treatment of these new structures; check back with me from time to time and we can redo the analysis," then it will be difficult to argue that she has not met her standard of care.60

Another question is whether the attorney wants to forego the positive prospect of reinitiating a relationship and the opportunity to provide counsel (and collect a well earned fee)? But that is a different issue.

VII. CONCLUSION

One of us thinks that the tax-modernization treatment of LLPs is actually theoretically correct; that the availability of limited liability should be tied to entity-level taxation.61 Of course, even he would not have supported it as a stand-alone measure, one state essentially alone. And he would have favored it as part of a clearly articulated sweeping overhaul of business entity regulation which would have included the elimination of LLCs and Subchapter S corporations.

The other one of us has some significant doubts about the substantive merits of the 2005 tax modernization treatment of LLPs and other traditionally pass-through structures in light of the burdens imposed on small and medium-sized businesses in increased compliance costs62 and

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60 See Harrison v. Guenther, Guenther & Gillane, 98-979 (La. App. 5 Cir. 1/26/99), 726 So. 2d 508, 511.


The Business License Tax could be viewed as the price a business pays to receive the protection granted by government. A business owner could get this kind of protection from an insurance company. They would pay for the protection. Limited liability has a value to a business owner. The government that grants that value should receive some of it.

62 As observed by one accounting firm, "Kentucky will now be viewed by out-of-state businesses as having a state filing requirement for flow-through entities that is the most complicated of any state in the Union."

New Kentucky Tax Law, Fin. News & Views (Strothman & Co., Louisville, Ky.), Mar. 22, 2005. Another accounting firm observed "Effective for fiscal years beginning on or after January 1, 2005, Kentucky's corporate tax base has been expanded to include all entities that have the legal benefit of limited liability, which makes this state's laws very different from the federal law and the law in most other states." Summary of Major Provisions of Tax Modernization (Chilton & Medley PLC, Louisville, Ky.), Mar. 28, 2005 (on file with the Kentucky Law Journal).
absolute increases in tax liability, questions the rent extraction inherent in linking entity-level taxation to limited liability, is rather fond of LLCs and would not want to see them eliminated, and believes that a fairly substantial clean-up of the tax modernization provisions generally is going to be required before we are finished.

But whether you think the tax-modernization treatment of LLPs is a good thing or a bad thing, it is clear that it raises some disturbing potential malpractice concerns for Kentucky practitioners. And it is further clear that these concerns are compounded by the retroactive application of the tax modernization provisions. That these malpractice concerns are raised by tax modernization is particularly troubling because of the nature of the provisions that give rise to the malpractice liability. The decision to form an LLP and not a GP was virtually automatic under the now-abandoned tax treatment of LLPs. To make that decision, which the prior regime in effect said was not worthy of critical thought, the basis for a retroactive claim seems fundamentally unfair and ill advised.

The bigger problem is the dilemma now faced by the business community, which rushed to adopt the LLP and LLC forms. In a very short period of time, we have created two new forms of business entities and labeled them as “good for business.” Only a few years later, what was heralded as a business boosting, revenue-neutral innovation was recharacterized as a “tax loophole.” We proceed to reverse the most basic rules of taxation and liability for these new entities, and then make those reversals retroactive. Again, the result is heralded as being “good for business.” We have sent Kentucky’s business community remarkably incompatible signals.

Perhaps the worst feature of all is that these fundamental changes—both the creation of the business forms and the change in their tax status—have been accomplished with essentially no public debate or thoughtful

63 As characterized by Chilton & Medley PLC:
   Individual partners, members, or shareholders of pass-through entities will continue to include in their income their distributive share of flow-through income. They will also receive a Kentucky tax credit for their share of the tax paid on net income at the entity-level. Unfortunately, excess credits are neither refundable nor can they be used to reduce tax on other income. Thus, since in many situations the entity-level tax will exceed individual taxes, this provision results in an increase in Kentucky income tax on many business activities.


64 See Admin. of Governor Paul E. Patton, supra note 61.


66 See, e.g., Jordan, supra note 5.

67 See Admin. of Governor Paul E. Patton, supra note 5.
consideration of the public policy consequences of the moves. One could view the lurching path of these developments as being driven entirely by short-term revenue considerations. In a period of perceived surplus we were willing to give the business community a huge, if publicly unacknowledged, windfall through the creation of LLPs and LLCs, enabling limited liability and flow-through taxation in a manner previously unseen. With the economy softened, we recoup the "lost" revenue by changing the tax treatment of the new forms.

Willie Sutton would be proud, but it is hardly the stuff of which good public policy is made. To be truly "good for business," Kentucky needs, first, to base tax policy on good basic public policy analysis and realistic long-term revenue projections. Second, we need not change tax policy without a good justification, looking further than a short-term revenue shortfall. Third, we need to recognize the value of uniformity with other states and deviate from business-center states only when there is a compelling justification to do so.

Regardless of whether one agrees with the outcome or not, tax modernization's treatment of LLPs is not a step to be celebrated. It raises a variety of malpractice concerns for Kentucky's attorneys. It ought to raise serious concerns of process and outcome for Kentucky's business community. Neither is a desired result.

68 Steve Cocheo, *The Bank Robber, the Quote, and the Final Irony*, 89 A.B.A. BANKING J. 71 (March 1997) (presenting evidence that Sutton did not make the comment attributed to him, namely that he robbed banks "because that's where the money is," but subsequently adopted it as his own).

69 See supra note 62 and accompanying text.