Choice of Entity

Course #5155H/QAS5155H

Course Material
Author’s Biography

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Chapter 1: Choosing a Business Form: Introduction and Overview

I. Introduction

Deciding to start a business is just the first in a series of important decisions. One of the most important questions the organizer or organizers must answer is “What is the best business form to choose?” The answer depends on a number of factors, including, but not limited to, the number of participants, concerns about taxes and exposure to personal liability. Some issues will be more or less important to each individual or group. Key issues in the choice of entity include the following:

- Taxation;
- State law treatment;
- Nature of the assets;
- Transferability of the business, both during life and upon death;
- Estate planning;
- Limited liability; and
- Retention of control.

Today, there are more choices than ever in selecting the appropriate business entity. Historically, there were three choices: the sole proprietorship, the partnership and the corporation. Now there are a number of hybrids that combine various characteristics of each traditional entity, such as the limited liability company that combines the limited liability of a corporation with the flexibility and tax advantages of a partnership. All states now offer limited liability companies as an option for most types of businesses. Other recent options include the limited liability partnership.

State law can also play an important role in determining the best entity. State law governs many important aspects of business entities, both tax and non-tax (i.e. in some states, an S Corporation is treated more favorably than in others).

It is important for a practitioner offering advice to clients to understand both the tax and non-tax consequences of each entity before opining on the best structure for any particular enterprise. This chapter will provide an overview of the major attributes of each type of entity. The subsequent chapters will provide a detailed look at a number of these issues, including formation, management, dissolution and taxation.

II. Sole Proprietorship

A sole proprietorship is an unincorporated business that is owned by one individual. It is the simplest form of business organization to start and maintain. The business has no separate legal existence apart from its owner. Its liabilities are the personal liabilities of
its owner. The income and losses of the business are included on the owner’s personal tax return.

Unlike partnerships and corporations – for which there are many, many statutory provisions – a sole proprietor is not subject to any separate set of laws. General business and tax laws apply, including those governing contracts and torts.

### MAJOR ATTRIBUTES: SOLE PRACTITIONER

- No requirements for formation; no franchise fee or license to obtain (unless local entity requires business license or fictitious name filing)
- No formalities required for operation, i.e. no meetings or corporate filings
- Sole proprietor has complete management authority, may or may not utilize agents
- Owner personally liable for all debts and obligations of the business
- All profits and losses are included in the owner’s personal tax return; the entity is not recognized for tax purposes
- Enterprise normally dies with the owner
- Business or assets thereof may be transferred or sold at the sole discretion of the owner
- Owner may decide to convert business to different type of entity, i.e. to form single-member LLC
- All judicial proceedings occur in the name of the owner

The major advantages and disadvantages of the sole proprietorship are based on its characteristics. The major advantage is probably its simplicity: there are no papers to file, and no meetings to hold. A sole proprietor may make decisions at any time about any matter. On the other side of the coin, the sole proprietor is personally liable for all the debts and obligations of the business. If a sole proprietor elects to engage agents in the operation of the business, including, but not limited to, employees, he or she is also vicariously liable for all of the agents’ actions committed in the scope of the business.

### III. Partnerships

A partnership is the relationship existing between two or more persons or entities that join to carry on a trade or business. Each person or entity contributes money, property, labor, or skill, and expects to share in the profits and losses of the business.
There are now a number of different types of partnerships recognized by state law. The three major types will be briefly described below. This overview provides a general understanding only; individual states may have different rules.

**A. GENERAL PARTNERSHIP**

At common law, this was the only type of partnership recognized. Aside from the sole proprietorship, the general partnership is the easiest business entity to form. There are no legal requirements aside from the agreement of two or more people or entities to operate a business for profit. Each general partner is entitled to manage the enterprise and is jointly and severally liable for the debts and obligations of the partnership.

There is no requirement that the partners execute a written partnership agreement or register with a state agency. There are no other formalities required. This makes the general partnership the simplest type of business entity where there is more than one owner.

A general partnership is a disregarded entity for purposes of federal income tax. Profits and losses flow through to the partners. The partnership files an informational return only with the IRS.

**MAJOR ATTRIBUTES: GENERAL PARTNERSHIP**

- Has some characteristics of a separate legal entity, i.e. can sue and be sued and hold property in its own name
- All general partners entitled to manage the enterprise
- Partnership profits, losses and distributions (including return of capital) are shared in proportion to the partners' contributions, unless the partnership agreement provides otherwise
- Each general partner is jointly and severally liable for the debts and other obligations of the partnership

**B. LIMITED PARTNERSHIP**

A limited partnership is comprised of one or more "general" partners and one or more "limited" partners. The general partner or partners are responsible for managing the partnership and, like partners in a general partnership, are jointly and severally liable for all partnership debts and obligations. The general partner or partners need not be a natural person; a corporation, for example, may serve as the general partner.

Limited partners are typically passive investors who are not involved in management of the partnership and who, as a result, are generally not personally liable for the debts and obligations of the partnership beyond their capital contributions.
Every state has a body of law governing limited partnerships, many modeled after the Uniform Limited Partnership Act.

While not involved in day-to-day operations of the enterprise, limited partners are entitled to receive information, including an accounting, regarding the partnership and likewise have a right to inspect various partnership records.

Limited partners who become involved in the management of the partnership or involved in other ways, including being employed by the partnership, risk losing their limited liability status. As with limited liability companies, discussed later in this chapter, a limited partnership may have different classes of partners as set forth in a partnership agreement.

### MAJOR ATTRIBUTES: LIMITED PARTNERSHIP

- Comprised of one or more general partners and one or more limited partners
- General partner can be corporation or other entity; need not be natural person
- Limited partners are “passive” investors
- Limited liability status can be lost through active involvement in the enterprise
- Must file certificate of limited partnership with appropriate state agency; normally no other formalities
- Limited partners entitled to accounting, inspection of records

Partnership profits, losses and distributions (including return of capital) are shared in proportion to the partners' contributions, unless the partnership agreement provides otherwise.

A limited partner has the right to assign his or her interest in whole or in part to a third person. However, such assignment merely transfers the right to receive distributions from the partnership; it does not entitle the transferee to become a partner unless provided in the partnership agreement or unless it is approved by all of the general partners.

Most states require a limited partnership to file a certificate of limited partnership with the appropriate state agency, normally the secretary of state. This formality is designed to give notice to prospective creditors of the limited liability status of the enterprise. The details of this process are set forth in Chapter 2. While a certificate is required, there is no legal requirement in most states that a limited partnership execute a written partnership agreement, although it is obviously advisable to do so.
The death, withdrawal, removal, incompetence, bankruptcy or dissolution of a general partner normally dissolves a limited partnership unless (1) the partnership agreement provides otherwise, or (2) all remaining general partners continue the business, or (3) where there is no remaining general partner, limited partners agree to continue the partnership according to the requirements of the applicable state law.

C. LIMITED LIABILITY PARTNERSHIP

A recent hybrid of the limited partnership, a limited liability partnership must be registered as a limited liability partnership under the laws of the state of organization. Every state has its own technical requirements for formation, which normally include the appointment of an agent for receipt of service of process.

All of the partners in a limited liability partnership are typically entitled to limited liability status for the acts or omissions of the partnership – though not generally for his or her own acts or omissions. Again, state law varies considerably on this topic.

Many states reserve limited liability partnership status for certain professional associations, for example, attorneys and certified public accountants.

IV. Corporations

The main characteristic of a corporation is that it is a separate legal entity with a life beyond that of its owners. A corporation is a creature of state law and is governed by the provisions of law in its state of organization (although it is obviously subject also to federal law, including the Internal Revenue Code).

Creating a corporation requires compliance with the corporate law of the state of organization. A corporation is the most complicated type of business to form and to operate due to the large number of formalities normally mandated. These include the filing of various documents with state agencies, the noticing and holding of meetings, and the maintenance of records. As a separate legal entity, a corporation may operate indefinitely. The death of a shareholder does not affect the legal status of a corporation.

Because a corporation is a separate legal entity, it is responsible for its own debts. Shareholders, directors and officers are normally not legally responsible for corporate liabilities, and can only be held personally liable under one of the following situations (which will be explained in detail in Chapter 5):

- Where the shareholder, officer or director has personally guaranteed a corporate debt;

- Where a court finds that the individual has acted as the "alter ego" of the corporation and should therefore be held personally liable for a debt or other obligation; or

- Where such an individual has been determined to have violated certain laws, such as by authorizing corporate wrongdoing.
MAJOR ATTRIBUTES: CORPORATION

- A legal entity separate and apart from its owners
- Has power to act in any way allowed by applicable state law and as provided in its Articles of Incorporation
- May only appear in court through a licensed attorney
- Management and control is vested in the board of directors, elected by the shareholders of the corporation
- Shareholders, directors or officers of the corporation are normally not legally responsible for corporate liabilities
- Profits of the corporation are taxable by the corporation as well as shareholders when distributed via dividends
- Has an unlimited lifespan; not affected by the death of shareholders

Management and control of a corporation is vested in its board of directors, which is elected by the shareholders of the corporation. The board of directors normally appoints officers to run the day-to-day business of the corporation. Such officers may or may not also be shareholders (although as a practical matter they usually are).

The profit of a corporation is taxed to both the corporation and to the shareholders when it is distributed as dividends. This so-called "double taxation" is often mentioned as a disadvantage of corporate status.

**V. S Corporation**

Originally created in 1958, an S corporation combines the limited liability of a classic C corporation with tax treatment similar to a partnership. S corporations are treated as corporations under state law. For purposes of federal income tax, however, S corporations are treated as partnerships. This means that the income, deductions, and tax credits of an S corporation flow through to the shareholders; income is taxed at the shareholder level and not at the corporate level. State taxation of S corporations varies. Some states, for example, treat an S corporation as a C corporation, and therefore impose an income or franchise tax.

The shareholders of a C corporation must “elect” to become an S corporation. There are a number of important restrictions placed on S corporations, including a cap on the number of shareholders (currently 100) and a requirement that there be only one class of stock. Failure to comply with the many IRS requirements will cause an S corporation to lose its status.
MAJOR ATTRIBUTES: S CORPORATION

- Shareholders enjoy same limited liability as shareholders of C corporation
- Treated as partnerships for purposes of federal taxation
- State taxation of S corporations varies
- Strict formalities for qualification and maintenance of tax status
- Maximum of 100 owners; only one class of stock allowed

A corporation will not be eligible to be an S corporation if it:

- Is not a domestic corporation;
- Has more than 100 shareholders;
- Has as a shareholder a person other than an individual, an estate, or certain trusts and tax-exempt organizations;
- Has a nonresident alien as a shareholder;
- Has more than one class of stock; or
- Is an “ineligible” corporation as defined in federal law

A corporation is also ineligible to be an S corporation if it is:

- A financial institution that uses the reserve method of accounting for bad debts;
- An insurance company;
- A corporation for which an election has been made to claim a possession tax credit; or
- A domestic international sales corporation ("DISC") or former DISC.

VI. Limited Liability Company

Limited liability companies have been a popular business form in European and other countries for decades. The first state in the United States to recognize limited liability companies was Wyoming, which allowed them beginning in 1977. Florida followed suit in 1982. It was not until the IRS agreed in a 1988 Revenue Ruling (Rev. Rul. 88-76) to treat LLCs as partnerships for tax purposes that many businesses decided to utilize this new form. This triggered legislative activity throughout the nation and each state sought to give its businesses the opportunity to utilize this new form. By 1996, all 50 states and the
District of Columbia had passed laws recognizing limited liability companies and creating statutory frameworks covering their formation, operation and dissolution.

Although recognized by the IRS for tax purposes, limited liability companies are purely creatures of state law. A limited liability company is an entity formed by following the procedures required in the state of operation. The owners of an LLC are generally referred to as “members”.

In most states, forming an LLC requires the preparation of only one document, the so-called Articles of Organization, which are filed with the Secretary of State or other designated state agency. This document, which is described in detail later in these materials, is usually brief and sets forth general information about the company, including its name, address, agent for service of process, term, and whether it will be run by the members or managers appointed by the members. Every state has detailed rules for what must be contained in this document and generally also offers a fill-in-the blank form that meets its statutory requirements.

<table>
<thead>
<tr>
<th>MAJOR ATTRIBUTES: LIMITED LIABILITY COMPANY</th>
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<tbody>
<tr>
<td>✓ Multi-member LLC may elect to be taxed as corporation or partnership</td>
</tr>
<tr>
<td>✓ Members normally have no personal liability for debts and obligations of the company</td>
</tr>
<tr>
<td>✓ All states allow single-member companies; there is no maximum number of owners</td>
</tr>
<tr>
<td>✓ More flexibility in management than corporation</td>
</tr>
<tr>
<td>✓ Few if any formalities required by state law</td>
</tr>
<tr>
<td>✓ Most states allow easy conversion to other business forms</td>
</tr>
<tr>
<td>✓ May not engage in certain businesses, including banking and insurance, in most states</td>
</tr>
<tr>
<td>✓ Most states expressly allow professional LLCs</td>
</tr>
</tbody>
</table>

In several states, LLCs are also required to file with the state an operating agreement, which, similar to a partnership agreement, provides a blueprint for how the LLC will be run, the financial obligations of the members, and how profits and losses will be divided. As a practical matter, almost every LLC will want to have a well-drafted operating agreement whether or not it is required. To the extent an operating agreement does not exist or is silent on a particular issue, courts will resolve disputes by referring to each state’s default statutory provisions governing operation of limited liability companies.
An LLC may be classified for Federal income tax purposes as either a partnership or a corporation. A domestic LLC with at least two members is automatically classified as a partnership for Federal income tax purposes unless it elects to be treated as a corporation. This is done by filing IRS Form 8832.

Unlike a partnership, none of the members of an LLC are personally liable for its debts. Practically, an LLC operates like a limited partnership without the requirement for a general partner. Unlike an S corporation, an LLC has no limits on the number of shareholders, classes of stock, or type of shareholders.

Because in most cases losses pass through to the members of an LLC, an LLC can be attractive to corporate investors and wealthy individuals. Other advantages to choosing this business form include:

- Limited liability for all owners;
- Flexibility in selecting a management structure; and
- Limited formalities, such as meetings and record-keeping.
CHAPTER 1 – REVIEW QUESTIONS

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter. They do not need to be submitted in order to receive CPE credit. They are included as an additional tool to enhance your learning experience.

We recommend that you answer each review question and then compare your response to the suggested solution before answering the final exam questions related to this chapter.

1. The easiest form of business organization to start and maintain is a sole proprietorship.
   a) true
   b) false

2. What is the major advantage of operating a business as a sole proprietorship:
   a) the owner enjoys protection from personal liability
   b) ease of formation and operation
   c) preferential tax treatment
   d) all of the above

3. Under a general partnership, there are no legal requirements aside from the agreement of two or more people to operate a business for profit.
   a) true
   b) false

4. How many limited partners can there be in a limited partnership:
   a) only one
   b) no more than the number of general partners
   c) at least one, but there is no maximum number
   d) at least one but no more than five

5. Limited partners who become involved in the management of the partnership risk losing their limited liability status.
   a) true
   b) false

6. The death of a general partner normally dissolves a limited partnership.
   a) true
   b) false
7. As a separate legal entity, a corporation may operate indefinitely.
   a) true  
   b) false

8. How does the federal government treat shareholders of an S corporation for tax purposes:
   a) as partners  
   b) the same as shareholders of a C corporation  
   c) according to state law  
   d) none of the above

9. Limited liability companies are limited to how many owners:
   a) 10  
   b) 25  
   c) 50  
   d) there is no limit
CHAPTER 1 – SOLUTIONS AND SUGGESTED RESPONSES

1. **A: True is correct.** The business has no separate legal existence apart from the owner, and the income and losses of the business are included on the owner’s personal tax return.

   B: False is incorrect. Unlike partnerships and corporations, a sole proprietor is not subject to any particular laws other than the general business and tax laws, including those governing contracts and torts.

   (See pages 1-1 to 1-2 of the course material.)

2. A: Incorrect. Sole proprietors enjoy no protection from personal liability because there is no separate entity to insulate them.

   B: Correct. There are literally no formalities to formation or operation.

   C: Incorrect. There is no such preference at the state or federal level.

   D: Incorrect. Neither A nor C are correct, therefore D cannot be correct either.

   (See page 1-2 of the course material.)

3. **A: True is correct.** The general partnership is the easiest business entity to form when there is more than one owner.

   B: False is incorrect. There are no requirements that the partners execute a written partnership agreement or register with a state agency. Each general partner is entitled to manage the enterprise and is jointly and severally liable for the debts and obligations of the partnership.

   (See page 1-3 of the course material.)

4. A: Incorrect. There must be at least one, but there can be an unlimited number.

   B: Incorrect. There must be at least one general and one limited partner but there does not have to be an equal amount of each.

   **C: Correct.** There must be one but there can be many more. There is no upper cap.

   D: Incorrect. There is no cap on the number of limited partners allowed.

   (See page 1-3 of the course material.)
5. **A: True is correct.** Limited partners cannot be involved in the day-to-day operations of the enterprise, but are entitled to receive information regarding the partnership and to inspect various partnership records.

   B: False is incorrect. Limited partners who become involved in the management or involved in other ways, including being employed by the partnership, risk losing their limited liability status.

   (See page 1-4 of the course material.)

6. **A: True is correct.** The limited partnership would generally be dissolved unless: 1) the partnership agreement provides otherwise; 2) all remaining general partners continue the business; or 3) where there is no remaining general partner, the limited partners agree to continue the partnership according to the requirements of the applicable state law.

   B: False is incorrect. Other causes of dissolution of the limited partnership include the withdrawal, removal, incompetence, bankruptcy, or dissolution of a general partner.

   (See page 1-5 of the course material.)

7. **A: True is correct.** The death of a shareholder does not affect the legal status of a corporation.

   B: False is incorrect. A corporation, unlike a sole proprietorship and many partnerships, has an unlimited life span.

   (See page 1-6 of the course material.)

8. **A: Correct.** Shareholders must elect S corporation status from the IRS, in which case they are treated for tax purposes as partners rather than shareholders.

   B: Incorrect. This would defeat the very purpose of electing S corporation status, namely to be treated as partners rather than as shareholders.

   C: Incorrect. They are treated as partners for federal tax purposes.

   D: Incorrect. Because A is correct, D cannot be correct.

   (See page 1-7 of the course material.)

B: Incorrect. The only type of entity that limits the number of owners is an S corporation.

C: Incorrect. There is no limit.

D: Correct. There can be an unlimited number of members of a limited liability company.

(See page 1-8 of the course material.)
Chapter 2: Formation of Business Entities

I. Introduction

The first step after choosing the desired business entity is its formation. The simplest business to form is obviously the sole proprietorship. It has no legal existence beyond that of the individual owner. There is no government license required to operate as a sole proprietor, no paperwork to file with the Secretary of State and no other special requirements beyond any local rules that might, for example, mandate that the owner obtain a business license.

The most complex business entity, both in terms of formation and operation, is the corporation. That is because the corporation literally has a life of its own, and, as such, its organizers must go through the necessary steps to "give birth" to that entity and then to nourish it. Formalities of formation include filing various documents with the appropriate state agency, normally the Secretary of State.

In between the sole proprietorship and the corporation lies the traditional partnership and several hybrids of the partnership – the limited partnership and the limited liability partnership. Finally, there is the limited liability company, a recent construct of American law that is a hybrid of the traditional partnership and a corporation in which the owners, called members, have the benefits of partnership tax treatment and the protection of limited liability traditionally reserved for corporate shareholders.

This chapter will provide an overview of the major requirements for business entity formation. Keep in mind that as with most other laws governing business entities, they are largely creatures of state law. This means that each state has its own statutes and common law governing everything from formation to dissolution. One common link between the laws of many states are the so-called Uniform Laws. Uniform laws are promulgated by the National Conference of Commissioners on Uniform State Laws, whose purpose is to compose sample, non-binding laws that the authors believe are the best treatment of a particular legal subject. They are often very persuasive in influencing state laws; over the years many have been adopted in whole by various states.

There are two uniform laws that govern general partnerships. The Uniform Partnership Act ("UPA") was initially promulgated in 1914; the Revised Uniform Partnership Act ("RUPA") was initially promulgated in 1992 and amended in 1993, 1994, 1996 and 1997. RUPA is the basis of the general partnership statutes in a majority of the states.

There are also two model acts governing limited partnerships: the Uniform Limited Partnership Act ("ULPA") initially promulgated in 1917; and the Revised Uniform Limited Partnership Act initially promulgated in 1976 and amended in 1985 and 2001.

The Uniform Limited Liability Company Act ("ULLCA") was promulgated in 1995. To date it has been used as the basis of state law in a handful of states.
Provisions from each of the above uniform laws will be mentioned from time-to-time as illustrative of state law treatment of various issues.

Table 2.1 Formalities of Business Formation

<table>
<thead>
<tr>
<th>ENTITY</th>
<th>FORMALITIES</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sole Proprietorship</td>
<td>No formal requirements; may require local business license or fictitious business name depending on nature of business</td>
</tr>
<tr>
<td>General Partnership</td>
<td>No formal requirements; written partnership agreement recommended</td>
</tr>
<tr>
<td>Limited Partnership</td>
<td>Must file written partnership agreement and certificate with Secretary of State¹</td>
</tr>
<tr>
<td>C Corporation</td>
<td>Must file Articles of Incorporation in state of incorporation</td>
</tr>
<tr>
<td>S Corporation</td>
<td>Same as C corporation, plus filing election of Subchapter S status with the Internal Revenue Service</td>
</tr>
<tr>
<td>Limited Liability Company</td>
<td>Must file Articles of Organization in state of origination</td>
</tr>
<tr>
<td>Limited Liability Partnership</td>
<td>Must file certificate of limited liability partnership with appropriate state agency</td>
</tr>
</tbody>
</table>

II. General Partnership

A. COMMON LAW FORMULATION

Aside from the sole proprietorship, the general partnership is the easiest business entity to form. There are no legal requirements aside from the agreement of two or more people or entities to operate a business for profit. Traditionally, this was done without so much as a piece of paper. The partners merely shared the work and divided the profits. If there were losses, those were shared as well. To determine whether a partnership exists, courts must simply ascertain the intention of the parties, and in the absence of a written agreement, the requisite intention is that which is deducible from the parties' actions. The agreement may be either expressed or implied.

The Revised Uniform Partnership Act ("RUPA") § 101 defines a partnership as "an association of two or more persons to carry on as co-owners of a business for profit." Pursuant to RUPA § 202, "the association of two or more persons to carry on as co-owners of a business for profit forms a partnership, whether or not the persons intend to form a partnership."

In determining whether a partnership is formed, RUPA further provides that the following rules apply:

¹ In most states, the proper agency will be the Secretary of State, but it may vary from jurisdiction to jurisdiction.
Joint tenancy, tenancy in common, tenancy by the entireties, joint property, common property, or part ownership does not by itself establish a partnership, even if the co-owners share profits made by the use of the property;

The sharing of gross returns does not by itself establish a partnership, even if the persons sharing them have a joint or common right or interest in property from which the returns are derived; and

A person who receives a share of the profits of a business is presumed to be a partner in the business, unless the profits were received in payment:

- of a debt by installments or otherwise;
- for services as an independent contractor or of wages or other compensation to an employee;
- of rent;
- of an annuity or other retirement or health benefit to a beneficiary, representative, or designee of a deceased or retired partner;
- of interest or other charge on a loan, even if the amount of payment varies with the profits of the business, including a direct or indirect present or future ownership of the collateral, or rights to income, proceeds, or increase in value derived from the collateral; or
- for the sale of the goodwill of a business or other property by installments or otherwise.

Relationships that are called "joint ventures" are partnerships if they otherwise fit the definition of a partnership. A joint venture is normally a business that is formed for the purpose of a particular transaction. A common use is for the development of real estate. When the real estate is developed, the joint venture is normally dissolved.

An association is not classified as a partnership, however, simply because it is called a "joint venture." An unincorporated nonprofit organization is not a partnership under RUPA, even if it qualifies as a business, because it is not a "for profit" organization.

Courts have commonly broken the concept of a partnership down into the following four elements: (1) community of interest in venture, (2) agreement to share profits, (3) agreement to share losses, and (4) mutual right of control or management of enterprise. As a result, the actual terminology used by the parties to describe their business relationship is of little import in determining whether a partnership exists.

By definition – and unless otherwise provided – a partnership is a general partnership and all partners are general partners. Compliance with various state laws is required to create a different type of partnership, including a limited partnership or a limited liability partnership. Those concepts are discussed later.

B. IRS CLASSIFICATION OF PARTNERSHIP

The fact that a business association is considered a partnership for state law purposes does not necessarily mean it will be recognized as such for IRS purposes. Due to the significance of partnership classification for purposes of federal income tax liabilities, it is important to understand how the IRS classifies business entities as partnerships.
An unincorporated organization with two or more members is generally classified as a partnership for federal tax purposes if its members carry on a trade, business, financial operation, or venture and divide its profits. However, a joint undertaking merely to share expenses is not a partnership. For example, co-ownership of property maintained and rented or leased is not a partnership unless the co-owners provide services to the tenants.

The rules used to determine whether an organization is classified as a partnership changed for organizations formed after 1996.

1. Organizations formed after 1996

An organization formed after 1996 is classified as a partnership for federal tax purposes if it has two or more members and it is none of the following:

- An organization formed under a federal or state law that refers to it as incorporated or as a corporation, body corporate, or body politic;
- An organization formed under a state law that refers to it as a joint-stock company or joint-stock association;
- An insurance company;
- Certain banks;
- An organization wholly owned by a state or local government;
- An organization specifically required to be taxed as a corporation by the Internal Revenue Code (for example, certain publicly traded partnerships);
- Certain foreign organizations;
- A tax-exempt organization;
- A real estate investment trust;
- An organization classified as a trust under section 301.7701-4 of the regulations or otherwise subject to special treatment under the Internal Revenue Code; or
- Any other organization that elects to be classified as a corporation by filing Form 8832.

2. Family Partnership

Members of a family can be partners. However, family members (or any other person) will be recognized as partners only if one of the following requirements are met:
If capital is a material income-producing factor, they acquired their capital interest in a bona fide transaction (even if by gift or purchase from another family member), actually own the partnership interest, and actually control the interest; or

If capital is not a material income-producing factor, they joined together in good faith to conduct a business. They agreed that contributions of each entitle them to a share in the profits, and some capital or service has been (or is) provided by each partner.

a. Capital Interest

A capital interest in a partnership is an interest in its assets that is distributable to the owner of the interest in either of the following situations:

- The owner withdraws from the partnership; or
- The partnership liquidates.

The mere right to share in earnings and profits is not a capital interest in the partnership.

b. Gift of Capital Interest

If a family member (or any other person) receives a gift of a capital interest in a partnership in which capital is a material income-producing factor, the donee's distributive share of partnership income is subject to both of the following restrictions.

- It must be figured by reducing the partnership income by reasonable compensation for services the donor renders to the partnership; and
- The donee's distributive share of partnership income attributable to donated capital must not be proportionately greater than the donor's distributive share attributable to the donor's capital.

For purposes of determining a partner's distributive share, an interest purchased by one family member from another family member is considered a gift from the seller. The fair market value of the purchased interest is considered donated capital. For this purpose, members of a family include only spouses, ancestors, and lineal descendants (or a trust for the primary benefit of those persons).

Example.

* A father sold 50% of his business to his son. The resulting partnership had a profit of $60,000. Capital is a material income-producing factor. The father performed services worth $24,000, which is reasonable compensation, and the son performed no services. The $24,000 must be allocated to the father as compensation. Of the remaining $36,000 of profit due to capital, at least 50%, or $18,000, must be allocated to the father since he owns a 50% capital interest. The son's share of partnership profit cannot be more than $18,000. 
3. Husband-wife Partnership

If spouses carry on a business together and share in the profits and losses, they may be partners whether or not they have a formal partnership agreement. If so, they should report income or loss from the business on Form 1065 rather than on Form 1040.

Each spouse should carry his or her share of the partnership income or loss from Schedule K-1 (Form 1065) to their joint or separate Form(s) 1040. Each spouse should include his or her respective share of self-employment income on a separate Schedule SE (Form 1040), Self-Employment Tax. This generally does not increase the total tax on the return, but it does give each spouse credit for social security earnings on which retirement benefits are based.

III. Limited Partnerships

The formation of a limited partnership is regulated by statute in each state. It normally requires more formality than a general partnership. The formation of a limited partnership must normally be evidenced by a written agreement. It also requires the filing of a certificate of limited partnership with the appropriate state agency. Many states also require formal public notice of the formation of the limited partnership as well as payment of a fee.

The procedure for formation of a partnership under the Uniform Limited Partnership Act entails the execution of a certificate containing certain prescribed information, and the filing and publication of such certificate in accordance with statutory requirements before the limited partnership begins to do business. Thus, a limited partnership cannot normally be created orally.

In order to form a limited partnership in California, for example, the general partners must execute, acknowledge, and file a Certificate of Limited Partnership (LP-1) with the Secretary of State. In addition, before or after the filing of a certificate, the partners must have entered into a partnership agreement. The filing fee for filing either a Certificate of Limited Partnership (LP-1) or an Application for Registration (LP-5) is $70.00.

Also note that RULPA and state statutes based on RULPA contain name requirements. Typically, the name of a limited partnership must contain the words "limited partnership" or some abbreviation thereof (and often times as the last words or letters in the name). Also, the name of a limited partnership may not be the same as, or deceptively similar to, the name of another entity organized or doing business in the state of formation. Texas, for example, requires the filing of the following certificate of formation of a limited partnership with the Secretary of State:
CERTIFICATE OF FORMATION OF A LIMITED PARTNERSHIP

Pursuant to the provisions of the Texas Revised Limited Partnership Act, V. A.T.S. art. 6132a-1, the undersigned persons certify that the statements hereinafter made are provisions of our agreement of limited partnership, which is to be effective when this certificate of limited partnership is filed by the Secretary of State of Texas [or on ______ after this certificate of limited partnership is filed by the Secretary of State of Texas].

A. Mandatory Statements
1. The name of the limited partnership is _______.
2. The address of the registered office of the limited partnership in Texas is _______ and the address of registered agent of the limited partnership for the service of process on the partnership is _______.
3. The address of the principal office of the limited partnership in the United States where records of the limited partnership are to be kept or made available under § 1.07 of the Act is _______.
4. The name, mailing address, and the street address of the business or residence of each general partner are:

<table>
<thead>
<tr>
<th>Name</th>
<th>Mailing Address</th>
<th>Street Address</th>
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B. Optional Statements
[Insert any additional statements desired. None are required.]

IN WITNESS WHEREOF this certificate has been duly executed by the following partners, who include all of the general partners of the limited partnership.

____________________________________________________________________

____________________________________________________________________

_____________

[Notarizations are not required.]

COMMENT

This form satisfies the limited requirements of TRLPA §2.01. The signed original and a copy should be delivered to the Secretary of State with the filing fee of $750 specified by TRPLA §12.01(1). Under TRLPA §2.07 the Secretary of State, if all is in order, will place his file mark on the original and the copy, file the original, and return the copy.

IV. Limited Liability Partnership

The limited liability partnership is a relatively new concept recognized by every state. Each state has its own version of this entity and its own requirements for formation, some of which, including Texas, refer to it as a registered limited liability partnership.
In Texas, for example, the law requires every proposed limited liability partnership to file an application with the Secretary of State stating its name, the address of its principal office, the number of partners and a brief statement of its business. The application must be signed by or on behalf of a majority in interest of its partners and must be accompanied by a fee of $200 for each partner. The registration by the Secretary of State is for one year, unless voluntarily withdrawn sooner, and may be renewed.

Texas law further requires the name of the registered limited liability partnership must end with the words "registered limited liability partnership" or "L.L.P." and under section 45-C the registered limited liability partnership must carry, if reasonably available, "at least $100,000 of liability insurance of a kind that is designed to cover the kinds of errors, omissions, negligence, incompetence, or malfeasance."

The object of the registered limited liability partnership is basically to provide that a partner in such partnership is not liable individually for partnership liabilities arising from errors, omissions, negligence, incompetence, or malfeasance in the course of the partnership business by another partner or a representative of the partnership not working under the supervision or direction of the first partner at the time, unless the first partner was directly involved in the specific activity or had notice or knowledge of the errors, omissions, negligence, incompetence or malfeasance. All partners remain jointly and severally liable for all other debts and obligations of the partnership, and the partnership assets are liable for all debts and obligations of the firm. These issues will be discussed in more detail in Chapter 5, Liability of Owners.

Most states require a registered limited liability partnership to renew its status annually. Many states require the registration to contain the name of each partner. Other states, including Alabama, do not require the name of each partner to be disclosed. At a minimum, however, every state requires the partnership to appoint an in-state agent for receipt of service of process.

In virtually all jurisdictions, the limited liability partnership is available only to so-called “professional” partnerships, e.g. accountants, attorneys and physicians. New York law, for example, § 121-1500, provides, in part:

(a) Notwithstanding the education law or any other provision of law, (i) a partnership without limited partners each of whose partners is a professional authorized by law to render a professional service within this state and who is or has been engaged in the practice of such profession in such partnership or a predecessor entity, or will engage in the practice of such profession in the registered limited liability partnership within thirty days of the date of the effectiveness of the registration provided for in this subdivision or a partnership without limited partners each of whose partners is a professional, at least one of whom is authorized by law to render a professional service within this state and who is or has been engaged in the practice of such profession in such partnership or a predecessor entity, or will engage in the practice of such profession in the registered limited liability partnership within thirty days of the date of the effectiveness of the registration provided for in this subdivision, (ii) a partnership without limited partners authorized by, or holding a license, certificate, registration or permit issued by the licensing authority pursuant to the education law to render a professional service within this state, which renders or intends to render professional services within this state, or (iii) a related limited
liability partnership may register as a registered limited liability partnership by filing with the department of state.

Each partner in a registered limited liability partnership must be duly licensed in the profession.

Many states require limited liability partnerships to maintain insurance to cover potential liabilities of the partnership. For example, California Corporations Code Section 16956 provides, in part:

(1) For claims based upon acts, errors, or omissions arising out of the practice of public accountancy, a registered limited liability partnership or foreign limited liability partnership providing accountancy services shall comply with one, or pursuant to subdivision (b) some combination, of the following:

(A) Maintaining a policy or policies of insurance against liability imposed on or against it by law for damages arising out of claims in an amount for each claim of at least one hundred thousand dollars ($100,000) multiplied by the number of licensed persons rendering professional services on behalf of the partnership; however, the total aggregate limit of liability under the policy or policies of insurance for partnerships with fewer than five licensed persons shall not be less than five hundred thousand dollars ($500,000), and for all other partnerships is not required to exceed five million dollars ($5,000,000) in any one designated period, less amounts paid in defending, settling, or discharging claims as set forth in this subparagraph. The policy or policies may be issued on a claims-made or occurrence basis, and shall cover: (i) in the case of a claims-made policy, claims initially asserted in the designated period, and (ii) in the case of an occurrence policy, occurrences during the designated period. For purposes of this subparagraph, "designated period" means a policy year or any other period designated in the policy that is not greater than 12 months. The impairment or exhaustion of the aggregate limit of liability by amounts paid under the policy in connection with the settlement, discharge, or defense of claims applicable to a designated period shall not require the partnership to acquire additional insurance coverage for that designated period. The policy or policies of insurance may be in a form reasonably available in the commercial insurance market and may be subject to those terms, conditions, exclusions, and endorsements that are typically contained in those policies. A policy or policies of insurance maintained pursuant to this subparagraph may be subject to a deductible or self-insured retention.

Upon the dissolution and winding up of the partnership, the partnership shall, with respect to any insurance policy or policies then maintained pursuant to this subparagraph, maintain or obtain an extended reporting period endorsement or equivalent provision in the maximum total aggregate limit of liability required to comply with this subparagraph for a minimum of three years if reasonably available from the insurer.

(B) Maintaining in trust or bank escrow, cash, bank certificates of deposit, United States Treasury obligations, bank letters of credit, or bonds of insurance or surety companies as security for payment of liabilities imposed by law for damages arising out of all claims in an amount of at least one hundred thousand
dollars ($100,000) multiplied by the number of licensed persons rendering professional services on behalf of the partnership; however, the maximum amount of security for partnerships with fewer than five licensed persons shall not be less than five hundred thousand dollars ($500,000), and for all other partnerships is not required to exceed five million dollars ($5,000,000). The partnership remains in compliance with this section during a calendar year notwithstanding amounts paid during that calendar year from the accounts, funds, Treasury obligations, letters of credit, or bonds in defending, settling, or discharging claims of the type described in this paragraph, provided that the amount of those accounts, funds, Treasury obligations, letters of credit, or bonds was at least the amount specified in the preceding sentence as of the first business day of that calendar year. Notwithstanding the pendency of other claims against the partnership, a registered limited liability partnership or foreign limited liability partnership shall be deemed to be in compliance with this subparagraph as to a claim if within 30 days after the time that a claim is initially asserted through service of a summons, complaint, or comparable pleading in a judicial or administrative proceeding, the partnership has provided the required amount of security by designating and segregating funds in compliance with the requirements of this subparagraph.

(C) Unless the partnership has satisfied subparagraph (D), each partner of a registered limited liability partnership or foreign limited liability partnership providing accountancy services, by virtue of that person’s status as a partner, thereby automatically guarantees payment of the difference between the maximum amount of security required for the partnership by this paragraph and the security otherwise provided in accordance with subparagraphs (A) and (B), provided that the aggregate amount paid by all partners under these guarantees shall not exceed the difference. Neither withdrawal by a partner nor the dissolution and winding up of the partnership shall affect the rights or obligations of a partner arising prior to withdrawal or dissolution and winding up, and the guarantee provided for in this subparagraph shall apply only to conduct that occurred prior to the withdrawal or dissolution and winding up. Nothing contained in this subparagraph shall affect or impair the rights or obligations of the partners among themselves, or the partnership, including, but not limited to, rights of contribution, subrogation, or indemnification.

(D) Confirming, pursuant to the procedure in subdivision (c), that, as of the most recently completed fiscal year of the partnership, it had a net worth equal to or exceeding ten million dollars ($10,000,000).

North Carolina, among other states, also requires a limited liability partnership to file an annual report with the Secretary of State (§ 59-84.4). The report must set forth the following:

- The name of the registered limited liability partnership or foreign limited liability partnership and the state or country under whose law it is formed;
The street address, and the mailing address if different from the street address, of the registered office, the county in which the registered office is located, and the name of its registered agent at that office in this State, and a statement of any change of the registered office or registered agent, or both;

The street address and telephone number of its principal office;

A brief description of the nature of its business; and

The fiscal year end of the partnership.

If the information contained in the most recently filed annual report has not changed, a certification to that effect may be made instead of setting forth the information required by subdivisions (2) through (4) of this subsection. The Secretary of State shall make available the form required to file an annual report.

V. Limited Liability Companies

The limited liability company, while recognized by the Internal Revenue Service for tax purposes, is still a product of applicable state law. Thus, in determining the mechanism required to form a limited liability company, organizers must examine the law of the state in which they wish to operate. All 50 states and the District of Columbia recognize limited liability companies and have statutory schemes governing their creation and operation. By way of illustration, we will examine the formation requirements in California and compare and contrast its requirements to other states where appropriate.

The first step in California and all other states is the filing of Articles of Organization with the Secretary of State (this is similar to the requirements for the formation of a corporation, which begin with the filing of Articles of Incorporation, also with the Secretary of State). Persons organizing the limited liability company may be, but are not required to be members of the entity. This is generally true of all states. In addition to Articles of Organization, California expressly requires limited liability companies to execute an Operating Agreement. Although most states do not have such a requirement, as a practical matter, almost all entities will need such a document to govern their affairs. The Operating Agreement and its importance will be discussed in connection with other topics.

While an LLC can be formed in many states solely through the filing of Articles of Organization, a few states, including Arizona and New York, require the extra step of public notice advertising. The purpose of public notice advertising is to alert members of the public who might engage in business with the entity that it will be operating as a limited liability company. In New York, for example, the advertisement must be published in two different newspapers in which the business will operate weekly for six successive weeks.

Public notice advertisements must be published in a newspaper of general circulation in the county in which the business will be operated. A newspaper of general circulation is one which has been adjudicated as such by the local courts. Since not all newspapers meet this requirement, organizers need to be careful that the newspaper they choose meets the legal requirements. As always, look to the statute of each state to determine what, if any, public notice advertisement is required.
Each state, including California, has specific requirements for the type of information that must be included in the Articles of Organization. Most, if not all, states make the process simple by providing fill-in-the-blank sample forms. Each state also spells out in statute the specific information that must be included in the Articles of Organization, as well as the information it has the option to include.

Pursuant to Code of Corporations Section 17051, California requires the articles to include all of the following:

- The name of the limited liability company;
- This following statement: “The purpose of the limited liability company is to engage in any lawful act or activity for which a limited liability company may be organized under the Beverly-Killea Limited Liability Company Act”;
- The name and address of the initial agent for service of process on the limited liability company who meets certain statutory qualifications or, in the alternative, a designated corporate agent;
- If the limited liability company is to be managed by one or more managers and not by all its members, the articles of organization must contain a statement to that effect. Neither the names nor numbers of the managers need to be included;
- If management is vested in only one manager, the articles of organization must include a statement to that effect; and
- If the limited liability company is to be managed by only one manager, the articles of organization shall contain a statement to that effect.

California, like many other states, does not require the articles to set forth any of specific powers of a limited liability company. California also provides that, at their election, organizers may include any other information not specifically prohibited by law, including the following:

- A provision limiting or restricting the business in which the limited liability company may engage or the powers that the limited liability company may exercise or both;
- Provisions governing the admission of members to the limited liability company;
- The time at which the limited liability company is to dissolve;
- Any events that will cause a dissolution of the limited liability company;
A statement of whether there are limitations on the authority of managers or members to bind the limited liability company, and, if so, what the limitations are; and

The names, numbers and qualification of the managers of the limited liability company.

Other information can be included, including provisions governing the admission of members into the limited liability company, at the election of the organizers.

Remember also that many states have different requirements, including different forms, that must be used for professional limited liability companies.

VI. Corporations

Like the other business entities discussed above, corporations are creatures of state law. This section will focus on California law as an example of how state law governs corporate creation.

The first step in creating a corporation is the filing of Articles of Incorporation with the Secretary of State. In addition, every domestic stock corporation in California is required to file a Statement of Information – Domestic Stock Corporation (Form SI-200 C or Form SI-200 N/C) with the Secretary of State, within 90 days after filing of its original Articles of Incorporation, and annually thereafter during the applicable filing period (statutory filing provisions are found in California Corporations Code § 1502).

The applicable filing period for a domestic stock corporation is the end of the calendar month during which its original Articles of Incorporation were filed and the immediately preceding five calendar months. If the name and/or address of the agent for service of process have changed, a corporation must file a complete statement. A corporation is required to file a statement even though it may not be actively engaged in business at the time this statement is due.

Every domestic stock corporation that is a "publicly traded company" must also file a Corporate Disclosure Statement with the required Statement of Information and a copy of the latest report prepared for the corporation by the independent auditor. "Publicly traded company" means a company with securities that are either listed or admitted to trading on a national or foreign exchange, or is the subject of two-way quotations, such as both bid and asked prices, that are regularly published by one or more broker-dealers in the National Daily Quotation Service or a similar service.

Changes to the information contained in the last filed Statement of Information or Corporate Disclosure Statement can be made any time outside of the applicable filing period by filing a complete Statement of Information and, if applicable, a complete Corporate Disclosure Statement. If the corporation is a publicly traded company and there has been any change to the last Statement of Information or Corporate Disclosure Statement filed with the Secretary of State, the Statement of Information and the Corporate Disclosure Statement must be completed in their entirety.
The fee for filing the initial or annual Statement of Information is $20.00. In addition, all domestic stock corporations must pay a $5.00 disclosure fee at the time of filing the initial or annual statement, for a total of $25.00. The filing fee and the disclosure fee may be included in a single check made payable to the Secretary of State. If a statement is filed outside the applicable filing period to amend any information on a previously filed statement, and is not an initial or annual filing, no fee is required.

A blank Statement of Information and a self-addressed envelope are provided to the corporation at the time of filing the original Articles of Incorporation. A preprinted Statement of Information and self-addressed envelope are mailed to each active corporation, to the last address of record, prior to the applicable due date. The corporation's failure to receive the form is not an excuse for failure to comply with the filing requirements.

If there has been no change in the information contained in the last Statement of Information and the last Corporate Disclosure Statement, if any, filed with the Secretary of State, the corporation may file a "no change" statement during the applicable filing period indicating that no changes in the required information have occurred.

Under California law, one or more persons, partnerships, associations or other corporations may form a corporation by first filing with the Secretary of State Articles of Incorporation.

A corporation is deemed to exist in perpetuity unless a termination provision is included in the Articles of Incorporation. A corporation is born when the articles are filed.

As with limited liability companies and certain partnerships, state law restricts the types of names that can be used by a corporation. For example, there are restrictions on the use of the words "bank" and "trust" and a general prohibition on the use of any name that is substantially similar to a preexisting corporation or the use of any name likely to mislead the public.

California and most other states have provisions allowing organizers to reserve a corporate name for up to 60 days prior to the filing of Articles of Incorporation.

California Corporations Code § 202 requires articles of incorporation to include the following:

- The name of the corporation, which generally must include the word "corporation", "incorporated" or "limited" or an abbreviation of one of such words; and

- The applicable one of the following statements:

  The purpose of the corporation is to engage in any lawful act or activity for which a corporation may be organized under the General Corporation Law of California other than the banking business, the trust company business or the practice of a profession permitted to be incorporated by the California Corporations Code; or
The purpose of the corporation is to engage in the profession of ____ (with the insertion of a profession permitted to be incorporated by the California Corporations Code) and any other lawful activities (other than the banking or trust company business) not prohibited to a corporation engaging in such profession by applicable laws and regulations.

- The name and address in this state of the corporation's initial agent for service of process;

- If the corporation is authorized to issue only one class of shares, the total number of shares which the corporation is authorized to issue. If the corporation is authorized to issue more than one class of shares, or if any class of shares is to have two or more series:
  - The total number of shares of each class the corporation is authorized to issue, and the total number of shares of each series which the corporation is authorized to issue or that the board is authorized to fix the number of shares of any such series;
  - The designation of each class, and the designation of each series or that the board may determine the designation of any such series; and
  - The rights, preferences, privileges and restrictions granted to or imposed upon the respective classes or series of shares or the holders thereof, or that the board, within any limits and restrictions stated, may determine or alter the rights, preferences, privileges and restrictions granted to or imposed upon any wholly unissued class of shares or any wholly unissued series of any class of shares. As to any series the number of shares of which is authorized to be fixed by the board, the articles may also authorize the board, within the limits and restrictions stated therein or stated in any resolution or resolutions of the board originally fixing the number of shares constituting any series, to increase or decrease (but not below the number of shares of such series then outstanding) the number of shares of any such series subsequent to the issue of shares of that series. In case the number of shares of any series shall be so decreased, the shares constituting such decrease shall resume the status which they had prior to the adoption of the resolution originally fixing the number of shares of such series.

- In case the corporation is a corporation subject to the Banking Law, the articles shall set forth a statement of purpose which is prescribed in the applicable provision of the Banking Law;

- In case the corporation is a corporation subject to the Insurance Code as an insurer, the articles shall additionally state that the business of the corporation is to be an insurer; and

- If the corporation is intended to be a "professional corporation" within the meaning of the Moscone-Knox Professional Corporation Act (Part 4 (commencing with Section 13400) of Division 3), the articles shall additionally contain the statement required by Section 13404.
Unless expressly prohibited in the Articles of Incorporation, a corporation will have the same powers and authority to carry on business as an individual. As a practical matter, most corporations include a broad provision in their Articles of Incorporation authorizing the company to engage in any lawful enterprise. This saves time later if the company elects to get into a new line of business.

If initial directors have not been named in the articles, the incorporator or incorporators, until the directors are elected, may, under California law, do whatever is necessary and proper to perfect the organization of the corporation, including the adoption and amendment of bylaws of the corporation and the election of directors and officers. The bylaws may be adopted, amended or repealed either by approval of the outstanding shares (Section 152) or by the approval of the board, except as provided in Section 212. Subject to subdivision (a)(5) of Section 204, the articles or bylaws may restrict or eliminate the power of the board to adopt, amend or repeal any or all bylaws. The bylaws set forth the rules for the daily operation of the corporation, including provisions governing:

- The time, place and manner of calling, conducting and giving notice of shareholders', directors' and committee meetings;
- The manner of execution, revocation and use of proxies;
- The qualifications, duties and compensation of directors; the time of their annual election; and the requirements of a quorum for directors' and committee meetings;
- The appointment and authority of committees of the board;
- The appointment, duties, compensation and tenure of officers;
- The mode of determination of holders of record of its shares; and
- The making of annual reports and financial statements to the shareholders.

California Corporations Code § 213 provides that “every corporation shall keep at its principal executive office in this state, or if its principal executive office is not in this state at its principal business office in this state, the original or a copy of its bylaws as amended to date, which shall be open to inspection by the shareholders at all reasonable times during office hours. If the principal executive office of the corporation is outside this state and the corporation has no principal business office in this state, it shall upon the written request of any shareholder furnish to such shareholder a copy of the bylaws as amended to date.”
VII. Subchapter S Corporation

S Corporations are created when a duly constituted and eligible corporation elects S Corporation status by filing Form 2553 with the Internal Revenue Service.

A corporation may elect S Corporation status only if it meets all of the following requirements:

- It is a domestic corporation;
- It has no more than 100 shareholders (Members of a family are treated as one shareholder for purposes of this requirement);
- Its only shareholders are individuals, estates, or certain exempt organizations;
- It has no nonresident alien shareholders;
- It has only one class of stock; and
- It is not one of the following ineligible corporations:
  - A bank or thrift institution that uses the reserve method of accounting for bad debts under section 585;
  - An insurance company subject to tax under the rules of subchapter L of the Code;
  - A corporation that has been treated as a possessions corporation under section 936, or
  - A domestic international sales corporation (DISC) or former DISC; or
  - It has a permitted tax year as required by section 1378 or makes a section 444 election to have a tax year other than a permitted year.

Each shareholder must consent to the election of subchapter S status.

A parent S corporation can elect to treat an eligible wholly-owned subsidiary as a qualified subchapter S subsidiary (Qsub). If the election is made, the assets, liabilities, and items of income, deduction, and credit of the Qsub are treated as those of the parent.
CHAPTER 2 – REVIEW QUESTIONS

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter. They do not need to be submitted in order to receive CPE credit. They are included as an additional tool to enhance your learning experience.

We recommend that you answer each review question and then compare your response to the suggested solution before answering the final exam questions related to this chapter.

1. Which of the following must file Articles of Organization in the state of origination:
   a) a sole proprietorship
   b) a general partnership
   c) a C corporation
   d) a limited liability company

2. The mere right to share in earnings and profits is a capital interest in a partnership.
   a) true
   b) false

3. Which of the following is the most important reason for forming a limited liability partnership:
   a) tax savings
   b) limit the liability of partners
   c) estate planning
   d) ease of formation

4. What is the first step involved in forming a limited liability company:
   a) requesting LLC designation from the Internal Revenue Service
   b) filing an Operating Agreement with the Secretary of State
   c) filing Articles of Organization with the Secretary of State
   d) Placing appropriate public notice advertisements in a newspaper of general circulation

5. Under California law, the first step in creating a corporation is the filing of a Corporate Disclosure Statement.
   a) true
   b) false
6. Which of the following is a requirement for a corporation to elect S corporation status:

   a) it must be a domestic corporation
   b) it must have less than 35 shareholders
   c) it can only have two classes of stock
   d) all of the above
CHAPTER 2 – SOLUTIONS AND SUGGESTED RESPONSES

1. A: Incorrect. No formal requirements. A local business license or a fictitious business name depending on the nature of the business may be required.

   B: Incorrect. No formal requirements although a written partnership agreement is recommended.

   C: Incorrect. C corporations must file Articles of Incorporation in the state of incorporation.

   D: Correct. A limited liability company must file Articles of Organization in the state of origination.

   (See page 2-2 of the course material.)

2. A: True is incorrect. The mere right to share in earnings and profits is not a capital interest in a partnership.

   B: False is correct. A capital interest in a partnership is an interest in assets that is distributable to the owner of the interest when the owner withdraws from the partnership or the partnership liquidates.

   (See page 2-5 of the course material.)

3. A: Incorrect. Tax savings is not a function of whether a partnership is a limited liability one or a different type.

   B: Correct. Providing the owners the protection of a corporation within a partnership context is the driving force behind the creation of a limited liability partnership.

   C: Incorrect. This is not typically a factor.

   D: Incorrect. This is not typically a factor because this type of entity is harder to form than a standard general partnership.

   (See page 2-8 of the course material.)
4. A: Incorrect. An LLC is actually not a tax designation. LLCs can either be taxed as partnerships or as corporations at the election of the members.

B: Incorrect. The Operating Agreement is not required to be filed with the Secretary of State in most states and is secondary to the Articles of Organization.

C: Correct. This is the first step in all states.

D: Incorrect. Public notice advertisements are mandated by some states but is not the first step in formation.

(See page 2-11 of the course material.)

5. A: True is incorrect. The first step would be to file the Articles of Incorporation.

B: False is correct. Only a domestic stock corporation that is a publicly traded company is required to file a Corporate Disclosure Statement.

(See page 2-13 of the course material.)

6. A: Correct. An S corporation is required to be a domestic corporation.

B: Incorrect. The limit for S corporations is currently 100 shareholders. Members of a family are treated as one shareholder for the purposes of this requirement.

C: Incorrect. An S corporation is only permitted one class of stock.

D: Incorrect. All of the listed requirements are not correct.

(See page 2-17 of the course material.)
Chapter 3: Rights and Duties of Business Owners

The person who chooses to go into business as a sole proprietor has few issues to worry about in this area. He or she must certainly comply with all applicable local, state and federal laws in conducting his business. He cannot, therefore, engage in proscribed anti-competitive practices in an effort to destroy a competitor. However, he has no partners and therefore may make decisions for the business that benefits him alone.

With businesses that have more than one owner, whether they be partners, members of a limited liability company or shareholders in a corporation, there are laws that govern the manner in which these co-owners can relate to one another and limit the bases upon which business decisions are made. This chapter discusses these areas, focusing on the rights as well as the obligations of owners in the following multi-owner businesses: partnerships, limited liability companies and corporations.

I. Partnerships

Both state law and written partnership agreements govern the conduct of partners, both as they relate to each other and to the partnership as a whole. State law often establishes default rules, which govern partnerships in the event the issue is not addressed in a partnership agreement. In some cases, those default rules are deemed so important that they cannot be changed through a written partnership agreement. Some of these rules deal with the rights or duties of partners.

A. RIGHTS OF PARTNERS

As set forth in § 401 of the Uniform Partnership Agreement (UPA) and provided for under every state law, each partner has the following basic rights (subject to modification in a written partnership agreement):

- The right to share in the profits (the default rule provides that partners share profits in equal amounts; this topic is discussed in detail in Chapter 6 – Distributions to Owners);
- The right to be reimbursed for an advance to the partnership beyond the amount of capital the partner agreed to contribute;
- The right to equal participation in the management of partnership business; and
- The right of access to the books and records of the partnership. This right may not be unreasonably restricted. Under the UPA, a partner’s right to inspect books and records may not be unreasonably limited in a written partnership agreement.

Partners do not have the right:

- To use partnership property for anything other than partnership business;
To demand remuneration for services performed for the partnership except as otherwise provided; or

To transfer his partnership to a third party without the consent of the other partners (the simple right to receive profits can be transferred without the consent of the other partners).

B. DUTY OF PARTNERS

The duties of partners can be broken down into two general categories:

- **Duty of Loyalty**: The duty of loyalty generally includes a duty to avoid self-dealing and a duty not to compete with the company.

- **Duty of Care**: This duty requires partners to make prudent, well-informed decisions regarding the partnership.

These twin duties have been codified in a number of ways. The provisions of Texas law are provided as illustrative of state law treatment on this subject:

**Texas Art. 6132b-4.04. General Standards of Partner's Conduct**

(a) Duties. A partner owes to the partnership and the other partners:
(1) a duty of loyalty; and
(2) a duty of care.

(b) Loyalty. A partner's duty of loyalty includes:
(1) accounting to the partnership and holding for it any property, profit, or benefit derived by the partner in the conduct and winding up of the partnership business or from use by the partner of partnership property;
(2) refraining from dealing with the partnership on behalf of a party having an interest adverse to the partnership; and
(3) refraining from competing with the partnership or dealing with the partnership in a manner adverse to the partnership.

(c) Care. A partner's duty of care to the partnership and the other partners is to act in the conduct and winding up of the partnership business with the care an ordinarily prudent person would exercise in similar circumstances. An error in judgment does not by itself constitute a breach of this duty of care. A partner is presumed to satisfy this duty if the partner acts on an informed basis and in compliance with Subsection (d).

(d) Method of Discharge. A partner shall discharge the partner's duties to the partnership and the other partners under this Act or under the partnership agreement, and exercise any rights and powers in the conduct or winding up of the partnership business:
(1) in good faith; and
(2) in a manner the partner reasonably believes to be in the best interest of the partnership.

(e) Effect of Partner Benefit. A partner does not violate a duty or obligation under this Act or under the partnership agreement merely because the partner's conduct furthers the partner's own interest.

(f) Trustee Standard Inapplicable. A partner, in that capacity, is not a trustee and is not held to the same standards as a trustee.
(g) Application to Nonpartner Winding Up. This section applies to a person winding up the partnership business as the personal or legal representative of the last surviving partner as if the person were a partner.

Subsection (b) provides three specific areas included in a partner's duty of loyalty:

- First, a partner is required to account to the partnership and hold for it any benefit derived by the partner in the conduct and winding up of the partnership business or from the use of partnership property. This requirement does not apply in the formation of the partnership. Negotiations for the formation of a partnership thus begin at arm's length. If they involve a special relationship, or if in the course of negotiations a special relationship may develop, that intensifies the obligation of good faith;
- Second, a partner is required to refrain from dealing with the partnership on behalf of a party having an interest adverse to the partnership; and
- Third, a partner must refrain from competing with the partnership or dealing with the partnership in a manner adverse to the partnership.

These rules are all designed, according to the official comment to the statute, to avoid a conflict of interest in the minds of a partner who has a duty of loyalty to the partnership and any of the partners. The first and third areas together cover "partnership opportunities."

Subsection (c) defines the partner's duty of care as that of negligence. This subsection, together with subsection (d), incorporates the so-called "business judgment rule," under which a partner is presumed to satisfy the duty of care if the partner acts on an informed basis, in good faith, and in the honest belief that the action is in the best interests of the partnership. The business judgment rule is described in greater detail in the portions of this chapter dealing with limited liability companies and corporations.

Subsection (d) requires that all duties of a partner to the partnership and the other partners, including the duties of loyalty and care, must be discharged in good faith and in a manner the partner reasonably believes to be in the best interest of the partnership. This requirement is not a separate duty; it is merely a statement of how any duty otherwise arising under Texas law or the partnership agreement must be discharged.

Subsection (e) provides that a partner's conduct is not deemed to be improper simply because it serves the partner's own individual interest. This provision underscores the partner's rights as an owner and principal in the enterprise, which must always be balanced against the partner's duties and obligations to the partnership and the other partners. This provision is consistent with another provision of Texas law which provides that a partner may transact business with the partnership and have the same rights and obligations with respect to those matters as a person who is not a partner.

Subsection (g) provides that the prescribed standards of conduct apply equally to a person engaged in winding up the partnership business as the personal or legal representative of the last surviving partner, as if the person were a partner.
Pursuant to Ann.Texas Civ.St. Art. 6132b-1.03, the duties set forth above may not be waived or eliminated entirely in a written partnership agreement.

**Art. 6132b-1.03. Effect of Partnership Agreement; Nonwaivable and Variable Provisions**

(a) Partnership Agreement Controls. Except as provided by Subsection (b), a partnership agreement governs the relations of the partners and between the partners and the partnership. To the extent that the partnership agreement does not otherwise provide, this Act governs the relations of the partners and between the partners and the partnership.

(b) Statutory Provisions that may not be Varied by Agreement. A partnership agreement or the partners may not:

1. unreasonably restrict a partner's right of access to books and records under Section 4.03(b);

2. eliminate the duty of loyalty under Section 4.04(b), but the partners may by agreement identify specific types or categories of activities that do not violate the duty of loyalty, if not manifestly unreasonable;

3. eliminate the duty of care under Section 4.04(c), but the partners may by agreement determine the standards by which the performance of the obligation is to be measured, if the standards are not manifestly unreasonable;

4. eliminate the obligation of good faith under Section 4.04(d), but the partners may by agreement determine the standards by which the performance of the obligation is to be measured, if the standards are not manifestly unreasonable;

According to the official comment, the above section is intended to ensure a fundamental core of partner responsibility. None of the duties of loyalty, care, and good faith under Section 4.04 may be eliminated entirely. Nevertheless, the partners may identify specific types or categories of activity that do not violate the duty of loyalty or may determine the standards by which the duty of care and the obligation of good faith are to be measured. These limitations or standards will be given effect if they are not manifestly unreasonable. Therefore, the partners can negotiate and draft specific contractual provisions favorably to their particular needs, but blanket waivers and those limitations or standards that a court finds to be manifestly unreasonable are not enforceable.

**C. PARTNERS’ LEGAL RIGHTS**

A partnership is normally authorized to bring legal action against a partner who has violated applicable rules of conduct, including a breach of loyalty. Under the Uniform Partnership Act, a partner may also bring a suit directly against another partner for almost any cause of action arising out of the conduct of the partnership business. In addition to a formal account, the court may grant any other appropriate legal or equitable remedy.
The Uniform Partnership Act also makes it clear that a partner may recover against the partnership and the other partners for personal injuries or damage to the property of the partner caused by another partner.

II. Limited Liability Companies

A. RIGHTS OF MEMBERS

Similar to shareholders of a corporation, members of a limited liability company have certain rights, including rights to notice of meetings of the organization and rights to inspect the entity’s books and other financial records, including tax returns. Membership rights can be particularly crucial in situations where that member holds a minority interest in the company and is at odds with those holding majority ownership. Each state’s statutory schemes sets forth the specific rights of members, which generally includes the right to liquidate their investment.

Under the Uniform Limited Liability Company Act, members have the following rights to information:

ULLCA § 408. Member’s right to information.

(a) A limited liability company shall provide members and their agents and attorneys access to its records, if any, at the company's principal office or other reasonable locations specified in the operating agreement. The company shall provide former members and their agents and attorneys access for proper purposes to records pertaining to the period during which they were members. The right of access provides the opportunity to inspect and copy records during ordinary business hours. The company may impose a reasonable charge, limited to the costs of labor and material, for copies of records furnished.

(b) A limited liability company shall furnish to a member, and to the legal representative of a deceased member or member under legal disability:

(1) without demand, information concerning the company's business or affairs reasonably required for the proper exercise of the member's rights and performance of the member's duties under the operating agreement or this [Act]; and

(2) on demand, other information concerning the company's business or affairs, except to the extent the demand or the information demanded is unreasonable or otherwise improper under the circumstances.

(c) A member has the right upon written demand given to the limited liability company to obtain at the company's expense a copy of any written operating agreement.

One of the significant areas of the law of limited liability companies that has yet to be developed relates to the rights of minority members. This issue can arise in many ways, including situations where a minority member or members is being “squeezed out” of the company’s decision-making by those with a controlling interest in the entity. The law of corporations, which is much more developed, is often used to resolve disputes involving minority owners of limited liability companies in the absence of defined law governing these relatively new entities. Some states also allow members to seek judicial
dissolution of a limited liability company in certain situations where the interests of a minority owner are being harmed.

B. DUTIES OF MEMBERS

Under the common law, and as provided for in statute in many states, directors and officers of a corporation have a duty to the corporation and to the other shareholders to put personal interests aside and act in the best interests of the entity and its other owners. This is often referred to as a director's or officer's duty of loyalty. In addition, in executing their duties, directors and officers are likewise required to make well-informed decisions about the business. This is commonly referred to as a director's or officer's duty of care. Both of these common law principles of corporate law have been carried over to the limited liability company.

As corporate law is often used to resolve disputes in limited liability companies, its principles relating to a director's duty of loyalty and duty of care are commonly carried over in determining whether a member of a limited liability company has breached his duties to the other members or the company as a whole. As a result, a general understanding of these principles of corporate law can be important in understanding the responsibilities of a member of a limited liability company, particularly a member-managed company.

Remember, however, that one of the hallmarks of the limited liability company is its flexibility. As a result, a limited liability company's operating agreement can set forth specific rules governing the duties and obligations of its members in detail. Each state also generally provides specific rules in statute that set forth minimum standards of conduct by members. In some cases, standards will differ between member-managed and non-member-managed companies. As long as the standards set forth in an operating agreement do not violate state statute, courts will uphold them in the event of a litigated dispute.

Florida law is representative of the type of statutes adopted by many states governing the conduct of members of limited liability companies:

Florida §608.4225. General standards for managers and managing members

(1) Subject to Sections 608.4226 and 608.423, each manager and managing member shall owe a duty of loyalty and a duty of care to the limited liability company and all of the members of the limited liability company.

(a) The duty of loyalty includes, without limitation:

1. Accounting to the limited liability company and holding as trustee for the limited liability company any property, profit, or benefit derived by such manager or managing member in the conduct or winding up of the limited liability company business or derived from a use by such manager or managing member of limited liability company property, including the appropriation of a limited liability company opportunity.
2. Refraining from dealing with the limited liability company in the conduct or winding up of the limited liability company business as or on behalf of a party having an interest adverse to the limited liability company.

3. Refraining from competing with the limited liability company in the conduct of the limited liability company business before the dissolution of the limited liability company.

(b) The duty of care is limited to refraining from engaging in grossly negligent or reckless conduct, intentional misconduct, or a knowing violation of law.

(c) Each manager and managing member shall discharge the duties to the limited liability company and its members under this chapter or under the articles of organization or operating agreement and exercise any rights consistent with the obligation of good faith and fair dealing.

(d) A manager or managing member does not violate a duty or obligation under this chapter or under the articles of organization or operating agreement merely because the manager's or managing member's conduct furthers such manager's or managing member's own interest.

(e) A manager or managing member may lend money to and transact other business with the limited liability company. As to each loan or transaction, the rights and obligations of the manager or managing member are the same as those of a person who is not a member, subject to other applicable law.

(f) This section applies to a person winding up the limited liability company business as the personal or other legal representative of the last surviving member as if such person were a manager or managing member.

1. Duty of Loyalty

The duty of loyalty generally includes a duty to avoid self-dealing and a duty not to compete with the company. Thus, members are generally precluded by statute from competing with the limited liability company in the conduct of the company's business prior to its dissolution.

Remember, however, that the courts have given the members of limited liability companies broad discretion to fashion operating agreements and in the absence of a conflict with state law, will enforce those provisions even where they would seem to violate general principles of law.

Case-in-Point

In the case of McConnell v. Hunt Sports Ent., 725 N.E.2d 1193 (1999), an appellate court ruled that a member of a limited liability company did not violate his duty of loyalty to that entity when he created a separate company which successfully competed with the pre-existing LLC. The court ruled that since competition was not prohibited by the LLC's operating agreement, the member did not breach any fiduciary duties by creating the competing entity.
“In general terms, members of limited liability companies owe one another the duty of utmost trust and loyalty; however, such duty must be considered in the context of members’ ability, pursuant to operating agreement, to compete with the company,” the court wrote.

The limited liability company in McConnell was formed for the purpose of investing in and operating a professional hockey franchise in Columbus, Ohio. While the LLC was still trying to secure a team from the National Hockey League (NHL), the defendant member established a new company and was successful in landing an NHL franchise.

The LLC’s operating agreement provided, in part: "Members May Compete. Members shall not in any way be prohibited from or restricted in engaging or owning an interest in any other business venture of any nature, including any venture which might be competitive with the business of the Company." The court used this language in ruling in favor of the defendant member.

“The operating agreement constitutes the undertaking of the parties herein. In becoming members [of the limited liability company], appellant and appellees agreed to abide by the terms of the operating agreement, and such agreement specifically allowed competition with the company by its members,” the court wrote. “As such, the duties created pursuant to such undertaking did not include a duty not to compete. Therefore, there was no duty on the part of [the defendant member] to refrain from subjecting appellant to the injury complained of herein.”

Although courts do give great deference to the members of a limited liability company to create their own rules through operating agreements, states do impose some statutory limitations on some types of provisions that an operating agreement can contain. The rules normally distinguish between member-managed companies and manager-managed companies. For example, some states, including Vermont, expressly prohibit a member from a member-managed LLC from engaging in competitive behavior:

**Vermont § 3059 General standards of member's and manager's conduct**

(a) The only fiduciary duties a member owes to a member-managed limited liability company and its other members are the duty of loyalty and the duty of care imposed by subsections (b) and (c) of this section.

(b) A member's duty of loyalty to a member-managed limited liability company and its other members is limited to the following:

(1) to account to the company and to hold as trustee for it any property, profit or benefit derived by the member in the conduct or winding up of the company's business or derived from a use by the member of the company's property, including the appropriation of the company's opportunity;

(2) to refrain from dealing with the company in the conduct or winding up of the company's business as or on behalf of a party having an interest adverse to the company; and

(3) to refrain from competing with the company in the conduct of the company's business before the dissolution of the company.
In a non-member managed company, however, Vermont law provides that “a member who is not also a manager owes no duties to the company or to the other members solely by reason of being a member.” This treatment is consistent with that of most jurisdictions -- a member of a company who is not actively engaged in its management generally owes less duty than a member who is so involved. The reason for this distinction should be obvious – a member who is not actively managing an enterprise is not in as great a position to prejudice that enterprise through his other activities.

2. Duty of Care and the Business Judgment Rule

At common law, corporate officers and directors were required to not only be loyal in executing their jobs, but to be prudent and well-informed and believe that their decision would ultimately benefit the corporation when making decisions on behalf of their entity. This rule is generally referred to as “duty of care.”

Another common law rule, the so-called “business judgment rule,” provides that as long as an officer or director makes a decision on behalf of a corporation that is well-informed and based on advice from experts in their field, that officer or director will not be liable if the decision turns out to be a poor one. This means that the director will not be held to have violated his duty of care.

According to American Jurisprudence, Second Edition (2002) § 1703, “the cornerstone of the business judgment rule is the independence and disinterestedness of the directors charged with responsibility for decisions. The rule states that a corporate transaction that involves no self-dealing by, or other personal interest of, the directors who authorized the transaction will not be enjoined or set aside for the directors’ failure to satisfy the standards that govern a director’s performance of his or her duties, and directors who authorized the transaction will not be held personally liable for resultant damages, unless:

(1) The directors did not exercise due care to ascertain the relevant and available facts before voting to authorize the transaction; or

(2) The directors voted to authorize the transaction even though they did not reasonably believe or could not have reasonably believed the transaction to be for the best interest of the corporation; or

(3) In some other way, the directors’ authorization of the transaction was not in good faith.”

This rule was applied to directors, officers and majority shareholders of corporations at common law and, like many other aspects of corporate law, has become a foundation of rules governing limited liability companies.

Minnesota, like many other states, has enacted the business judgment rule into its statutes governing limited liability companies and provides, in part, that:

(a) A governor is entitled to rely on information, opinions, reports, or statements, including financial statements and other financial data, in each case prepared or presented by:
(1) one or more managers or employees of the limited liability company whom the governor reasonably believes to be reliable and competent in the matters presented;

(2) counsel, public accountants, or other persons as to matters that the governor reasonably believes are within the person's professional or expert competence; or

(3) a committee of the board of governors upon which the governor does not serve, duly established in accordance with section 322B.66, as to matters within its designated authority, if the governor reasonably believes the committee to merit confidence.

(b) Paragraph (a) does not apply to a governor who has knowledge concerning the matter in question that makes the reliance otherwise permitted by paragraph (a) unwarranted.

The business judgment rule is not a complete defense to an action for breach of fiduciary duty by a director or officer. Rather, it creates a presumption that is rebuttable by a showing of fraud or bad faith on the part of the officer or director.

**Case-in-Point**

A classic case involving breach of the duty to a limited liability company in which the defendant unsuccessfully asserted the business judgment defense was *Flippo v. CSC Associates, III, L.L.C.*, 547 S.E.2d 216, 262 Va. 48 (2001).

In Flippo, members of a family-owned LLC transferred the assets of the entity to a new entity, which they had created largely for estate planning purposes. Other members of the LLC sued, alleging breach of fiduciary duty, among other causes of actions. The trial court found that the defendant members had breached their fiduciary duties and had also violated the operating agreement of the LLC. Punitive and compensatory damages were awarded and the two defendant members were barred from serving as managers of the company.

The defendants argued they should not be held personally liable for their actions as they took the action pursuant to legal advice. In general, members of a limited liability company are not personally liable for their actions. Virginia, like most others has a specific provision of law stating that members are entitled to take action in reliance on expert advice, including that from an attorney. In this case, however, the court stressed that the action was not taken nor the advice solicited in the best interests of the company as a whole, but rather for the individual members who took the action. As such the protection afforded by the statute limiting personal liability did not apply.

To avail themselves of the protections of the statute, the court said, the legal advice must have been solicited and acted upon “in good faith for the benefit of the company.”

“Not only was the advice sought, delivered, and implemented for the personal benefit of the Flippines, Carter Flippo testified at trial that he thought the advice was not very good for FLTC,” the court concluded.

Part of the duty to make sound decisions on behalf of a corporation or limited liability company is the duty to be informed. A director or member who is not informed about the affairs of the entity is usually unable to assert the protections of the business judgment
rule. In other words, the business judgment rule assumes that officers, directors or members have executed their decisions on an informed basis. Thus, member-managers of an LLC, like a corporate officer or director, are obligated to keep well-informed about the affairs of the company. As a result, ignorance is generally not a defense to a poor decision.

Although the courts give great deference to companies to create their own rules and will generally attempt to resolve disputes with reference to the company’s articles of organization and operation, most states do bar certain limitations on the liability of managers where their actions violate their general duty of loyalty to the company. For example, Iowa law provides as follows:

**Iowa §490A.707. Limitation of liability of managers**

The articles of organization may contain a provision eliminating or limiting the personal liability of a manager to the limited liability company or to its members or of the members with whom the management of the limited liability company is vested pursuant to section 490A.702, to the limited liability company or to its members for monetary damages for breach of fiduciary duty as a manager or a member with whom management of the limited liability company is vested, if the provision does not eliminate or limit the liability of a manager or a member with whom management of the limited liability company is vested for any of the following:

1. Breach of the manager's or member's duty of loyalty to the limited liability company or to its members.

2. Acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law.

3. Transaction from which the manager or member derives an improper personal benefit or a wrongful distribution in violation of section 490A.807.

South Dakota expressly prohibits the operating agreement of a limited liability company from eliminating a member's general duty of loyalty to the company, although the operating agreement may identify specific activities which do not violate the duty of loyalty, so long as they are not so unreasonable so as to negate the effect of the duty of loyalty.

Likewise, South Dakota law says that an operating agreement may not unreasonably reduce the duty of care under or eliminate the obligation of good faith and fair dealing; “but the operating agreement may determine the standards by which the performance of the obligation is to be measured, if the standards are not manifestly unreasonable.”

**C. DISSOCIATION OF MEMBERS**

Every state has provisions that govern when and under what circumstances a member may resign, or “disassociate” from an LLC (the term “disassociate” is used whenever a member leaves an LLC, whether it be voluntarily or involuntarily). These can also be modified by the entity's operating agreement.
Some states provide a notice period before a member may withdraw, unless otherwise provided. For example, Alabama requires at least 30 days written notice prior to a resignation. A few require more, for example, Maryland requires six months notice.

§ 4A-605. Procedure for withdrawal

A member may withdraw by giving not less than 6 months' prior written notice to the other members at their respective addresses as shown on the books of the limited liability company, unless:

(1) The operating agreement provides that the member does not have the right or power to withdraw; or

(2) The operating agreement specifies another time for or other conditions of withdrawal.

Some states, including Alaska, expressly prohibit a member from resigning prior to dissolution unless provided for in the entity’s operating agreement.

A few states (including California and Arizona) allow a member to resign at any time; upon written notice Kentucky, for example, forbids a member from resigning without the consent of all other members unless the operating agreement provides otherwise.

An LLC may in some cases be entitled to damages from a member who resigns from an LLC prior to dissolution. Some states have provisions that provide express authority for the collection of damages, including Colorado:

Colorado Revenue Statute § 7-80-702: Resignation of member. Unless prohibited in a written operating agreement, a member may resign from a limited liability company at any time by giving written notice to the other members, but, if the resignation violates the operating agreement, the limited liability company may recover from the resigning member damages for breach of the operating agreement and offset the damages against the amount otherwise distributable to him.

North Dakota law, on the other hand, specifies that members always have the power, though not the right to withdraw, meaning they can do so but may be subject to damage.

Nebraska and Rhode Island totally fail to address the issue of resignation, leaving it totally within the discretion of the entity to so provide terms in its operating agreement. Remember that the ability of a member to withdraw from an LLC may be an important consideration when choosing a business entity. For some people, liquidity may be an important issue when deciding to create and invest in a business enterprise. Obviously, to the extent that an LLC is member-managed, the successful continuity of the enterprise would be frustrated without restrictions on resignation.

III. Corporations

Corporations are legal entities with a life of their own. They are, nevertheless, dependent on people to organize and run them. There are three main groups involved in the operation of a corporation: the shareholders, the directors and the officers. This section of the course will focus primarily on shareholders and directors of non-publicly traded for-profit companies. The rules involving publicly traded companies are so complex as to be beyond the scope of this course. However, many of the basic legal principles, including the duty of loyalty and duty of care, are the same.
A. RIGHTS AND DUTIES OF SHAREHOLDERS

1. Shareholders’ Rights

The basic statutory rights of shareholders of a corporation provided by state law include the following:

- The right to inspect certain corporate records and financial statements:
  - Specific rights spelled out in applicable state statute;
  - Shareholder generally required to show “proper purpose” prior to inspection, per statute;
  - Statutes generally broad in granting shareholders access to “records” and has been held to include any and all records reasonably necessary to inform the shareholder about corporate matters, including a list of other shareholders;

- The right to notice of meetings;

- The right to attend meetings; and

- The right to vote on various matters, including the election of directors.

2. Duty Of Shareholders

While individual shareholders normally do not owe a duty to the corporation or other shareholders, there are exceptions, particularly in the case of controlling shareholders who may owe, for example, a duty to a creditor of the corporation as well as to minority shareholders.

B. RIGHTS AND DUTIES OF BOARD OF DIRECTORS

1. Rights Of Directors

a. Informational Rights

Corporate directors have broad rights to access the records of the corporation they govern. This makes sense given the duty owed by each director to make informed decisions regarding the corporation. A director’s right to inspect records and financial statements is generally broader than the inspection rights of a shareholder. In the case of directors, the right is generally absolute in the absence of evidence that the director has an improper motivation.

The Pennsylvania statute governing access to records is a good example of state law treatment of this area:
§ 1512. Informational rights of a director

(a) General rule.—To the extent reasonably related to the performance of the duties of the director, including those arising from service as a member of a committee of the board of directors, a director of a business corporation is entitled:

(1) in person or by any attorney or other agent, at any reasonable time, to inspect and copy corporate books, records and documents and, in addition, to inspect and receive information regarding the assets, liabilities and operations of the corporation and any subsidiaries of the corporation incorporated or otherwise organized or created under the laws of this Commonwealth that are controlled directly or indirectly by the corporation; and

(2) to demand that the corporation exercise whatever rights it may have to obtain information regarding any other subsidiaries of the corporation.

The statute also gives directors the right to enforce their rights to access by bringing a legal action to compel inspection.

2. Duties Of Directors

Every director owes a general fiduciary duty to the corporation, which includes loyalty and fidelity (these principles are outlined in the section above dealing with limited liability companies). In most cases, these duties are owed to the corporation as a whole rather than to individual shareholders (although there may be an exception when a director takes action with respect to a single shareholder).

a. Duty of Care

Both common law and state statutes set forth specific rules and obligations governing the behavior of corporate directors. Pursuant to the Revised Model Business Corporation Act, §8.30, a director is required to discharge his or her duties:

- In good faith;
- With the care that an ordinary and prudent person in a like position would exercise under similar circumstances; and
- In a manner he or she reasonably believes to be in the best interest of the corporation.

The Georgia statute, Ga. Code Ann., § 14-3-830, is representative of state law in this area:

§ 14-3-830. Standards for directors

Unless a different standard is prescribed by law:
(1) A director shall discharge his or her duties as a director, including his or her duties as a member of a committee:
(A) In a manner the director believes in good faith to be in the best interests of the corporation; and
(B) With the care an ordinarily prudent person in a like position would exercise under similar circumstances;
(2) In discharging his or her duties, a director is entitled to rely on information, opinions, reports, or statements, including financial statements and other financial data, if prepared or presented by:
(A) One or more officers or employees of the corporation whom the director reasonably believes to be reliable and competent in the matters presented;
(B) Legal counsel, public accountants, or other persons as to matters the director reasonably believes are within the person’s professional or expert competence;
(C) A committee of the board of which the director is not a member, as to matters within its jurisdiction, if the director reasonably believes the committee merits confidence; or
(D) Religious authorities, ministers, priests, rabbis, or other persons whose positions or duties in the corporation the director believes justify reliance and confidence and whom the director believes to be reliable and competent in the matters presented;
(3) In the instances described in paragraph (2) of this Code section, a director is not entitled to rely if he has knowledge concerning the matter in question that makes reliance otherwise permitted by paragraph (2) of this Code section unwarranted;
(4) A director is not liable to the corporation, any member, or any other person for any action taken or not taken as a director if the director acted in compliance with this Code section; and
(5) A director shall not be deemed to be a trustee with respect to the corporation or with respect to any property held or administered by the corporation, including, without limit, property that may be subject to restrictions imposed by the donor or transferor of such property.

While courts generally do not like to second-guess the actions of directors, they do step in when actions are egregious. Such judicial action is often the product of a shareholder derivative suit.

**Example.**

Jerry is a majority shareholder and member of the Board of Directors of Fly-By-Night, Inc. Jerry has decided that he wants to retire, but needs the proceeds from the sale of his shares to do so comfortably. When an offer is made to purchase Fly-By-Night, Inc. by another corporation, Jerry votes in favor of the sale even though the terms of the agreement are not favorable to the remaining shareholders. Bill, one of the remaining shareholders, brings a suit against Fly-By-Night and Jerry on behalf of himself and the other minority shareholders. Jerry will be required to justify his decision by showing that it was not made purely in his owner interests, but that it was also in the best interests of the corporation as a whole, including the other shareholders.

Directors are also required to fulfill their duties using due care. However, to the extent that they reasonably rely on experts to make a decision that turns out to be wrong, they are normally insulated from liability under the “business judgment” rule that is discussed in detail earlier in this chapter.
b. Duty of Loyalty

Self-dealing is generally prohibited unless the director can show that the corporation is not being taken advantage of. This issue has arisen in a number of different factual scenarios, including the following:

- Transactions between a director and the corporation;
- Cases where a director has taken advantage of a business opportunity that should have gone to the corporation; and
- Cases in which the director directly competes with the corporation in its business.

In these situations, the director usually bears the burden of showing he or she did not violate his or her duty of loyalty to the corporation. Generally, if a transaction is fair to a corporation at the time it is authorized, approved, or ratified, the fact that a director of the corporation is directly or indirectly a party to the transaction is not grounds for invalidating the transaction or the director's vote regarding the transaction.

3. Legal Actions Against Directors

Directors who violate their duty of loyalty or duty of care to a corporation can, pursuant to applicable state law, be held personally liable for their breach of duty. Pennsylvania law, for example, provides the following:

§ 1713. Personal liability of directors

(a) General rule.--If a bylaw adopted by the shareholders of a business corporation so provides, a director shall not be personally liable, as such, for monetary damages for any action taken unless:
1. the director has breached or failed to perform the duties of his office under this subchapter; and
2. the breach or failure to perform constitutes self-dealing, willful misconduct or recklessness.

(b) Exceptions.--
Subsection (a) shall not apply to:
1. the responsibility or liability of a director pursuant to any criminal statute; or
2. the liability of a director for the payment of taxes pursuant to Federal, State or local law.

Good faith is the most common defense to actions brought against corporate directors and is often set forth in state law as an affirmative defense. For example, Massachusetts provides:
M.G.L.A. 156B § 65. Good faith and prudence as defense

A director, officer or incorporator of a corporation shall perform his duties as such, including, in the case of a director, his duties as a member of a committee of the board upon which he may serve, in good faith and in a manner he reasonably believes to be in the best interests of the corporation, and with such care as an ordinarily prudent person in a like position would use under similar circumstances.

In determining what he reasonably believes to be in the best interests of the corporation, a director may consider the interests of the corporation's employees, suppliers, creditors and customers, the economy of the state, region and nation, community and societal considerations, and the long-term and short-term interests of the corporation and its stockholders, including the possibility that these interests may be best served by the continued independence of the corporation.

In performing his duties, a director, officer or incorporator shall be entitled to rely on information, opinions, reports or records, including financial statements, books of account and other financial records, in each case presented by or prepared by or under the supervision of (1) one or more officers or employees of the corporation whom the director, officer or incorporator reasonably believes to be reliable and competent in the matters presented, or (2) counsel, public accountants or other persons as to matters which the director, officer or incorporator reasonably believes to be within such person's professional or expert competence, or (3) in the case of a director, a duly constituted committee of the board upon which he does not serve, as to matters within its delegated authority, which committee the director reasonably believes to merit confidence, but he shall not be considered to be acting in good faith if he has knowledge concerning the matter in question that would cause such reliance to be unwarranted.

The fact that a director, officer or incorporator so performed his duties shall be a complete defense to any claim asserted against him, whether under sections sixty to sixty-four, inclusive, or otherwise, except as expressly provided by statute, by reason of his being or having been a director, officer or incorporator of the corporation.

Some states have recently changed their laws to make it more difficult to hold a corporate director personally liable for action taken in the exercise of his authority as a director. These changes have been made in response to the increasing amount of litigation against directors, the increasing expense of defending such claims, and the increasing cost (and decreasing availability and scope) of director and officer liability insurance.
CHAPTER 3 – REVIEW QUESTIONS

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter. They do not need to be submitted in order to receive CPE credit. They are included as an additional tool to enhance your learning experience.

We recommend that you answer each review question and then compare your response to the suggested solution before answering the final exam questions related to this chapter.

1. Federal law governs the organization and operation of a partnership.
   a) true
   b) false

2. Which of the following is an example of a partner's Duty of Loyalty:
   a) investigating a business opportunity thoroughly before moving forward
   b) not opening or operating a competing business
   c) not having friends that own businesses that compete with the partnership
   d) conducting a thorough background check before hiring an employee

3. Under the Uniform Limited Liability Company Act, members of a limited liability company have which of the following rights:
   a) to receive notice of meetings
   b) to review certain company records
   c) to receive a percentage of the company’s profits on a weekly basis
   d) both a and b

4. Members are generally precluded by statute from competing with the limited liability company in the conduct of the company’s business prior to its dissolution.
   a) true
   b) false

5. What is the “business judgment rule”:
   a) an officer or director of a corporation is liable if they make a decision that does not bear financial fruit
   b) officers and directors are not liable for a decision that goes awry so long as they exercised due care and consideration in making that decision
   c) officers and directors of a corporation are strictly liable for all of their decisions
   d) officers and directors are never liable to a corporation for a bad decision because it is a hard job
6. The rights of shareholders of a corporation by state law include the right to receive a salary.

   a) true
   b) false

7. Under what circumstances is self-dealing by a corporate director allowed:

   a) when the director can show that the entity is not being taken advantage of
   b) never
   c) when the other directors agree with the deal
   d) whenever the deal involves less than $10,000

8. States have recently changed their laws to make it easier to hold a corporate director personally liable for action taken in the exercise of his authority as a director.

   a) true
   b) false
CHAPTER 3 – SOLUTIONS AND SUGGESTED RESPONSES

1. A: True is incorrect. Partnerships are governed by state law and written partnership agreements.

B: False is correct. State law often establishes default rules, which govern partnerships in the event the issue is not addressed in a partnership agreement. In some cases, state law cannot be changed through a written partnership agreement.

(See page 3-1 of the course material.)

2. A: Incorrect. This is a partner’s duty but falls under the Duty of Care rather than the Duty of Loyalty.

B: Correct. Partners are obligated, pursuant to the Duty of Loyalty, not to compete with the partnership.

C: Incorrect. Simply having friends in a competing business is not a violation of the Duty of Loyalty.

D: Incorrect. This is an example of a Duty of Care rather than a Duty of Loyalty.

(See page 3-2 of the course material.)

3. A: Incorrect. Members of a limited liability company are entitled to notice of members’ meetings so that they have an opportunity to provide input into decisions of the entity. However, this is not the best answer.

B: Incorrect. Members of a limited liability company must be given access at reasonable times and reasonable places to certain records of the entity, including tax returns. However, this is not the best answer.

C: Incorrect. The Uniform Limited Liability Company Act does not have such a provision and generally the distribution of income, if any, is governed by the entity’s articles of operation rather than by state law.

D: Correct. Because A and B are both rights of members, D is the best answer.

(See page 3-5 of the course material.)
4. **A: True is correct.** However, the courts have given the members of LLCs broad discretion to fashion operating statements, and in the absence of a conflict with state law, will enforce those provisions even when they would seem to violate general principles of law.

**B: False is incorrect.** The duty of loyalty generally includes the duty to avoid self-dealing and a duty not to compete with the company.

(See page 3-7 of the course material.)

5. **A: Incorrect.** Sometimes a decision does not work out but the decision maker is not automatically liable. This is, however, not the meaning of the Business Judgment Rule.

**B: Correct.** Under this theory, so long as the individual researched the issue and used prudence and good judgment, they will not be responsible if the decision does not work out well.

**C: Incorrect.** There is no strict liability and this is not the meaning of the Business Judgment Rule.

**D: Incorrect.** This is not the meaning of the Business Judgment Rule.

(See page 3-9 of the course material.)

6. **A: True is incorrect.** Shareholders do have some basic statutory rights, but receiving a salary is not one of them.

**B: False is correct.** Among the basic statutory rights of shareholders is the right to inspect certain corporate records and financial statements, the right to notice of meetings, the right to attend meetings, and the right to vote on various matters.

(See page 3-13 of the course material.)

7. **A: Correct.** The essence of the duty of loyalty imposed on corporate directors is that they are prohibited from engaging in any sort of self-dealing, such as a business dealing with the corporation, unless they can show it is fair to the corporation.

**B: Incorrect.** There is no flat prohibition.

**C: Incorrect.** Directors cannot ratify a deal that violates this rule.

**D: Incorrect.** There is no such dollar amount.

(See page 3-16 of the course material.)
8. A: True is incorrect. Some states have done just the opposite, making it more difficult to hold a corporate director personally liable in response to the increasing amount of litigation against directors, the increasing expense of defending such claims, and the increasing cost (and decreasing scope and availability) of director and officer liability insurance.

B: False is correct. States are changing their laws to make it more difficult, rather than easier, to hold a corporate director personally liable for action taken in the exercise of his authority as a director.

(See page 3-17 of the course material.)
Chapter 4: Management and Control of Business Entities

I. Single-Owner Entities

One of the key factors in choosing an appropriate business form when there are two or more owners is the level of desire each owner has for participating in the management of the enterprise.

Single-owner entities do have some flexibility in selecting a business structure: the traditional sole proprietorship, a corporation or a limited liability company. In each of these options, the owner retains ultimate responsibility for managing the enterprise whether or not they elect to engage employees or other agents in the running of their business. The only real differences for the single owner – other than tax issues – is whether he or she is subject to personal liability and the amount of formalities involved in the management of the enterprise.

Table 4.1 Options for the Single-Owner

<table>
<thead>
<tr>
<th>Issue</th>
<th>Sole Proprietor</th>
<th>Corporation</th>
<th>LLC</th>
</tr>
</thead>
<tbody>
<tr>
<td>Taxation</td>
<td>Income and losses flow through to the individual; there is no separate legal entity for the business</td>
<td>Income is taxed at the entity level and then again if distributions other than wages or other benefits are made</td>
<td>Single-member LLC has option of being taxed as a corporation or having income and losses passed through to member</td>
</tr>
<tr>
<td>Formalities</td>
<td>There are no legal formalities for either formation or operation of the business</td>
<td>Significant state law formalities for both formation and operation</td>
<td>State law formalities for formation, significantly less than corporation</td>
</tr>
<tr>
<td>Liability</td>
<td>The owner is personally liable for all the debts and obligations of the business</td>
<td>Shareholder not personally liable for the debts and obligations of the business*</td>
<td>Members not personally liable for debts and obligations of the business*</td>
</tr>
</tbody>
</table>

* This rule can be broken by legal doctrine called “piercing the corporate veil,” discussed in detail in Chapter 5.
For multi-owner businesses, the issue becomes more complex. The issue is not only whether or not a particular owner wants to be involved in the active management of the business, but also the degree of personal liability the owner is comfortable subjecting himself to. Table 4.2 below compares the potential personal liability of each owner with the level of participation each wants to have in management of the business.

Table 4.2 Level of Participation in Management and Personal Liability of Various Multi-Owner Business Entities

<table>
<thead>
<tr>
<th>Business Entity</th>
<th>Management Rules</th>
<th>Liability of Owners</th>
</tr>
</thead>
<tbody>
<tr>
<td>General Partnership</td>
<td>Each general partner has an equal right to manage the enterprise</td>
<td>Each general partner is jointly and severally liable for the debts and obligations of the partnership</td>
</tr>
<tr>
<td>Limited Partnership</td>
<td>Each general partner has equal right to manage the enterprise; limited partners risk losing limited liability status by participating in management and are usually “passive” investors</td>
<td>Each general partner is jointly and severally liable for the debts and obligations of the partnership; limited partners are not personally liable so long as they remain &quot;passive&quot; investors</td>
</tr>
<tr>
<td>Limited Liability Partnership</td>
<td>All general partners have equal right to participate in management of the enterprise</td>
<td>All general partners are jointly and severally liable for the debts and obligations of the partnership; limited partners not personally liable so long as they are not actively involved</td>
</tr>
<tr>
<td>Limited Liability Company</td>
<td>Right to manage is vested in all of its members unless provided otherwise in articles of organization</td>
<td>Every member retains limited liability regardless of whether they actively participate in management of the company</td>
</tr>
<tr>
<td>Corporation</td>
<td>Management and control normally vested in the board of directors, elected by the shareholders of the corporation</td>
<td>Shareholders retain limited liability in the absence of special facts; directors can be personally liable for certain breaches of duty</td>
</tr>
</tbody>
</table>

II. Partnerships

A. GENERAL PARTNERSHIPS

The general rule of law is that, absent a contrary provision in a written partnership agreement, all partners in a general partnership have an equal right to manage the enterprise. Texas law, for example, Art. 6132b-4.01(d), provides: “Each partner has
equal rights in the management and conduct of the business of a partnership. A partner's right to participate in the management and conduct of the business is not community property."

Absent a contrary agreement, each partner has a continuing right to participate in the management of the partnership and to be informed about the partnership business, even if his assent to partnership business decisions is not required.

1. Resolving Disputes

Every state has a default rule that governs partners in the event of a dispute when resolution is not governed by a written partnership agreement. Most states provide when there are differences between partners in the ordinary course of business, the matter is to be decided by a majority of the partners. If the dispute concerns a matter that is beyond the scope of the partnership's normal business affairs, e.g. whether to dissolve, most courts have held that the matter must receive the consent of all of the partners. In general, each partner has a single vote regardless of the contribution provided at the time of formation.

2. Voting Classes

Under most circumstances, partners are free to establish classes of partners which can, for example, give preferential voting rights to certain partners.

Texas law, for example, Art. 6132b-4.01(l), provides:

(l) Classes or Groups of Partners. A written partnership agreement may establish classes or groups of one or more partners having certain expressed relative rights, powers, and duties, including voting rights, and may provide for the future creation of additional classes or groups of partners having certain relative rights, powers, and duties, including voting rights, expressed in the partnership agreement or at the time of creation of the class or group. The rights, powers, or duties of a class or group may be senior to those of one or more existing classes or groups of partners.

(m) Voting Rights. A written partnership agreement that grants or provides for granting to a partner a right to vote may contain provisions relating to:

1. giving notice of the time, place, or purposes of a meeting at which a matter is to be voted on by the partners;
2. waiver of notice;
3. action by consent without a meeting;
4. the establishment of a record date;
5. quorum requirements;
6. voting in person or by proxy; or
7. any other matter relating to the exercise of the right to vote.

B. LIMITED PARTNERSHIPS

The general rule of law is that limited partners do not have a right to actively participate in the management of the partnership. Under the Maine Revised Limited Partnership Act, for example, 31 M.R.S.A. § 433, "Except as provided in the partnership agreement
or applicable law, a limited partner may not participate in the management of the partnership's business."

Limited partners are, by their nature, passive investors. As a practical matter, a limited partner does not generally want to participate in the management of the company, because to do so normally results in the loss of their limited liability status. Although not generally entitled to manage, state laws generally have provisions that protect the interests of limited partners, including the right to access the books and other records of the partnership.

According to the Revised Uniform Limited Partnership Act, a general partner of a limited partnership has the same rights and powers as a partner in a general partnership, absent an express provision to the contrary in a partnership agreement. This means the general partners of a limited partnership likewise have equal rights in the management of the enterprise.

Other than the limits on limited partnership participation, the partnership as a whole is fairly flexible with respect to the allocation of management authority. State law generally gives general partners freedom in selecting a management structure and, as noted above, in even creating classes of partnership interests. The draw-back, of course, is that general partners remain personally liable for the obligations of the partnership.

### III. Limited Liability Companies

#### A. DESIGNATING MANAGEMENT OF A LIMITED LIABILITY COMPANY

One of the many advantages of a limited liability company over other business forms is the flexibility in deciding who will manage the enterprise. For example, in a limited liability partnership, limited partners are precluded from participating in the active management of the business if they want to maintain their limited liability status. A limited liability company, on the other hand, can be managed by some, all or none of the members of the company, yet in all of those scenarios ALL members maintain their limited liability status. See Table 4.3, below.

#### Table 4.3 Comparison of Management Options in Different Business Forms: Who is Able to Manage?

<table>
<thead>
<tr>
<th>Business Form</th>
<th>Management Authority</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sole Proprietorship</td>
<td>Sole proprietor, anyone designated by him</td>
</tr>
<tr>
<td>General Partnership</td>
<td>All general partners</td>
</tr>
<tr>
<td>Limited Partnership</td>
<td>General partners only</td>
</tr>
<tr>
<td>C Corporation</td>
<td>Board of Directors, officers designated by board</td>
</tr>
<tr>
<td>S Corporation</td>
<td>Board of Directors, officers designated by board</td>
</tr>
<tr>
<td>LLC</td>
<td>Some or all members or managers as designated by members</td>
</tr>
</tbody>
</table>
There are two types of limited liability companies when it comes to management: those that are manager-managed and those that are member-managed. The Articles of Organization generally define the entity's management structure; indeed, some states require the articles to do so. Most states presume that in the absence of a provision to the contrary, all members will act as managers of the company.

Some states, including Tennessee, also provide that a limited liability company can be managed by a board of governors, similar to the concept of a board of directors of a corporation:


(a)(1) MANAGEMENT. If the LLC is member-managed, all powers shall be exercised by or under the authority of, and the business and affairs of the LLC shall be managed by or under the direction of its members.

(2) If the LLC is board-managed, all powers shall be exercised by or under the authority of, and the business and affairs of the LLC shall be managed by or under the direction of the board of governors, subject to the provisions of subsection (b) and any limitations set forth in the articles or operating agreement. An LLC shall be either member-managed or board-managed, as designated in its articles. Unless otherwise provided in the articles or operating agreement, each governor shall have equal voting power per capita with each other governor.

Some limited liability companies will also designate titles, including that of “officer”, which are normally associated with corporations. Since limited liability companies are free – subject to certain constraints in state law – to fashion their own management structure, they are likewise free to create job titles and vest authority as they deem appropriate.

In a member-managed limited liability company, each member has equal rights in the management and conduct of the company's business unless otherwise provided in its operating agreement. The company is free to allocate voting rights based on any formula it wishes, in the absence of a specific state law to the contrary. Limited liability companies usually allocate voting rights either on a per capita basis – where each member has one vote – or based on capital contribution – where stakeholders are given votes proportional to their ownership interest in the company.

For most decisions, a majority vote of the members is sufficient. Certain decisions, however, pursuant to either state law or the company's operating agreement, must be unanimous.

In a manager-managed company, the members have no right to participate in the management of the company unless they also serve as managers (subject, of course, to a different rule in a company's operating agreement). In most cases, managers are not required to be members of the company (see discussion of professional limited liability companies later in this chapter). Companies are free to set forth criteria for managers in their articles of organization or operation.
B. MANAGERS AS AGENTS OF A LIMITED LIABILITY COMPANY

Common law rules of agency law typically apply to managers of a limited liability company. This means that a manager has the authority to bind the company or otherwise create legal obligations on behalf of the entity, e.g. in executing a lease on a building or purchasing a piece of equipment to be used by the business.

Most states have the specific statutory provisions detailing the authority of a manager to act as an agent of a limited liability company which take effect to the extent other provisions are not set forth in either the company’s articles of organization or articles of operation. For example, Alabama law provides, pursuant to Title 10, §12-21, as follows:

(a) Except as provided in subsection (b), every member is 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 binds 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 of the fact that the member has no such authority.

(b) If the articles of organization provide that management of the limited liability company is vested in a manager or managers, both of the following conditions apply:

(1) No member, acting solely in the capacity as member, is an agent for the limited liability company.

(2) Every manager is 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 binds 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 of the fact that the manager has no such authority.

(c) An act of a manager or a member which is not apparently for the carrying on in the usual way the business of the limited liability company does not bind the limited liability company unless authorized in accordance with the operating agreement at the time of the transaction or at any other time.

(d) No act of a manager or member in contravention of a restriction on authority shall bind the limited liability company to persons having knowledge of the restriction.

(e) In a limited liability company managed by its members under subsection (a) of Section 10-12-22, the only fiduciary duties a member owes to the company or to its other members are the duty of loyalty and the duty of care imposed by subsections (f) through (g).
A basic overview of the common law principles, set forth in the American Law Institute’s Restatement of Agency, Second, is helpful in understanding the statutes or contract provisions that affect this area of management. There are generally three types of authority recognized as common law: express, implied and apparent.

1. **Express Authority**

Express authority is the easiest to see and define. A principal, whether it is a limited liability company, corporation or any other entity, specifically gives to an agent the authority to engage in specified activities. Because the power or authority is spelled out both for the agent and principal to see and for third parties, there is little opportunity for confusion over the authority of the agent.

2. **Implied Authority**

Implied authority is that authority which is implicit in the position of the agent. For example, it can easily be implied that the president of a company has authority to hire and fire subordinates. The fact that the authority was not expressly granted by the owners of the company does not negate the existence of the authority.

3. **Apparent Authority**

Apparent authority exists under certain circumstances when a third party believes the purported agent has authority to bind the principal, whether he does or not. Apparent authority is defined in the Restatement of the Law of Agency, Second, as “the power to affect the legal relations of another person by transactions with third persons, professedly as agent for the other, arising from and in accordance with the other’s manifestations to such third persons.”

Under these circumstances, the principal has taken some action that would reasonably cause a third party to believe that the individual in question is in fact an agent of the principal. When a third party acts in reliance on the apparent authority of the agent, the principal is bound by the actions to the same extent as he would if the agent had express authority.

“Apparent authority exists only with regard to those who believe and have reason to believe that there is authority; there can be no apparent authority created by an undisclosed principal,” according to the Comment to the Restatement.

**Example.**

*Company A places an advertisement in the local newspaper offering a parcel of land for sale and directing interested buyers to contact Real Estate Agent X for more information. Agent X has authority to sell the property. Agent X also has apparent authority with respect to anyone who reads the newspaper advertisement.*

The Restatement says that “manifestation of the principal may be made directly to a third person, or may be made to the community, by signs, by advertising, by authorizing the agent to state that he is authorized, or by continuously employing the agent.”
4. Uniform Limited Liability Company Act

Under the Uniform Limited Liability Company Act, adopted by the National Conference of Commissioners on Uniform State Laws, the principles of agency that govern general partnerships also apply to limited liability companies.

a. Member-managed company

Each member of a member-managed company is an agent of the company and therefore has authority to bind the company when acting in the ordinary course of the company's business. The only exception is where the member had no authority to take the action in question and this fact was known to the person with whom the member was acting. Unless specifically authorized by other members, a member of a member-managed company generally does not have authority to bind the company in a matter not within the normal scope of its business.

b. Manager-managed company

Members generally do not have authority to bind a company unless they also serve as managers. The rules governing managers are the same as those that apply to members of member-managed companies, as described above: managers will bind the company when acting in the normal scope of business unless the manager lacked the authority and this fact was known to the third party. Additionally, unless specifically authorized by the company, a manager does not have authority to bind the company in an action that is not within the normal scope of the business. For example, the manager of an LLC organized to operate a restaurant will not have authority to lease an airplane on behalf of the company, unless specifically authorized to do so.

The specific provision of the ULLCA governing agency is §301, which reads:

ULLCA § 301. Agency of members and managers.

(a) Subject to subsections (b) and (c):

(1) Each member is an agent of the limited liability company for the purpose of its business, and an act of a member, including the signing of an instrument in the company's name, for apparently carrying on in the ordinary course the company's business or business of the kind carried on by the company binds the company, unless the member had no authority to act for the company in the particular matter and the person with whom the member was dealing knew or had notice that the member lacked authority.

(2) An act of a member which is not apparently for carrying on in the ordinary course the company's business or business of the kind carried on by the company binds the company only if the act was authorized by the other members.

(b) Subject to subsection (c), in a manager-managed company:
(1) A member is not an agent of the company for the purpose of its business solely by reason of being a member. Each manager is an agent of the company for the purpose of its business, and an act of a manager, including the signing of an instrument in the company's name, for apparently carrying on in the ordinary course the company's business or business of the kind carried on by the company binds the company, unless the manager had no authority to act for the company in the particular matter and the person with whom the manager was dealing knew or had notice that the manager lacked authority.

(2) An act of a manager which is not apparently for carrying on in the ordinary course the company's business or business of the kind carried on by the company binds the company only if the act was authorized under Section 404.

c) Unless the articles of organization limit their authority, any member of a member-managed company or manager of a manager-managed company may sign and deliver any instrument transferring or affecting the company's interest in real property. The instrument is conclusive in favor of a person who gives value without knowledge of the lack of the authority of the person signing and delivering the instrument.

**Cases-in-Point**

Unless there is a conflict with a specific state statute, courts will generally apply common law agency rules to limited liability companies and their agents. That is exactly what happened in *Water, Waste & Land v. Lanham* (955 P.2d 997, 1998), a decision by the Colorado Supreme Court. The plaintiff in the case, Water, Waste & Land (referred to as “Westec”), entered into a verbal contract to perform engineering services for Lanham, a member and manager of the limited liability company called Preferred Income Investors (“PII”). Westec did not know. However, that Lanham was an agent for PII. Clark, another member-manager of LLC, originally contacted Westec about performing engineering work for PII, but did not disclose the existence of PII. He provided Westec with a business card containing Lanham's address. The letters “P.I.I.” appeared on the card, but no other information was provided that would have identified PII as the real principal.

The lawsuit arose when Westec completed the engineering work and sent a bill to Lanham. No payment was ever made. Westec sued Lanham individually as well as PII, which by now the plaintiff had discovered was the principal. Both PII and Lanham individually were held liable for the debt. Lanham appealed, arguing he should not be held personally liable for the debt of an LLC.

Under general agency law, an agent will be personally liable for the debt of his principal if he fails to disclose the identity of the principal to the third party with whom he is contracting. The court dismissed the notion that the state’s requirement that LLCs register with the state put Westec on “constructive notice” that Lanham was merely an agent for PII. The court said that the mere presence of the initials “P.I.I.” on Lanham’s business card was not sufficient to cause Westec to know they were really dealing with an LLC. Thus, even though members of an LLC are normally immune from personal liability for the debts of the company, the common law rules of agency still apply, the court said.
“Under the common law of agency, an agent is liable on a contract entered on behalf of a principal if the principal is not fully disclosed,” the court wrote. “In other words, an agent who negotiates a contract with a third party can be sued for any breach of the contract unless the agent discloses both the fact that he or she is acting on behalf of a principal and the identity of the principal.”

Lanham could have avoided liability if he had simply notified Westec that they were really contracting with PII. Having failed to do so, Westec was justified in believing that it was contracting with Lanham: “The duty of disclosure clearly lies with the agent alone; the third party with whom the agent deals has no duty to discover the existence of an agency or ... the identity of the principal,” the court added. Thus, Lanham was held liable not for his status as a member of the LLC, but rather based on his role as an agent of the company.

In *Taghipour v. Jerez* (26 P.3d 885, 2001), two members of a limited liability company and the LLC brought action against third member and lender, seeking declaration that loan agreement entered into by lender and third member was invalid, claiming damages for lender's negligence, and seeking partition of LLC property that secured loan.

The LLC in question was formed by three members, including the defendant, Jerez, for the purpose of developing a piece of real estate. The LLC's Articles of Organization listed Jerez as an LLC member and a manager, while its Operating Agreement provided that no loan could be contracted on behalf of the LLC without a resolution approved by its members.

Three years after acquiring the disputed property, Jerez, unbeknownst to the LLC's other members or managers, unilaterally entered into a loan agreement for $25,000 with Mt. Olympus on behalf of the LLC. To secure the loan, Jerez executed and delivered a trust deed on the property to Mt. Olympus. Subsequently, Mt. Olympus dispersed $20,000 of the funds to Jerez and kept the remaining $5,000 for various fees. Jerez apparently misappropriated the $20,000. The LLC, unaware of the loan, ultimately defaulted on it and Mt. Olympus foreclosed on the property.

The two other members of the LLC then sued Mt. Olympus and Jerez. In their claim against Mt. Olympus, the plaintiffs asked the court to return the property.

The plaintiffs argued that Jerez, as a manager of the LLC, could not unilaterally bind the company when the company's operating agreement required unanimous consent before securing a loan on the property. Further, the plaintiffs argued that Mt. Olympus had an obligation to determine that Jerez was merely an agent for the LLC, and therefore lacked authority to enter into the contract.

Under Utah's law governing LLCs, “if the management of the limited liability company is vested in a manager or managers, any manager has authority to bind the limited liability company, unless otherwise provided in the articles of organization or operating agreement.”

Another provision of Utah law provides, however, that "instruments and documents providing for the acquisition, mortgage, or disposition of property of the limited liability company shall be valid and binding upon the limited liability company if they are executed by one or more managers."
The court ruled that the more specific provision giving a manager the authority to bind the company in executing a mortgage is controlling over the more general provision limiting the authority of a manager. Further, the court said that Mt. Olympus had no obligation to inquire into the specific authority of Jerez once it determined that he was in fact an agent for the LLC. Accordingly, the LLC, while it certainly has a cause of action against Jerez for, among other things, breach of fiduciary duty, had no way to compel Mt. Olympus to return the property.

IV. Corporations

The essence of a corporation is centralized management. In the simplest terms, the shareholders of a corporation elect a Board of Directors, in which overall responsibility for the corporation is vested. The Board of Directors then selects the officers of the corporation, who are responsible for the day-to-day operation of the enterprise. The Board is therefore the policy-making arm of the entity. If the shareholders are unhappy with the policies of the Board, they have the option of changing the Board pursuant to the applicable Articles of Incorporation and Bylaws.

While the incorporators are free to impose any lawful restrictions on the authority of the Board of Directors in the Articles of Incorporation, directors normally possess full discretionary power over the corporation. The Articles of Incorporation or Bylaws may give the Board authority to delegate certain functions to committees. While the Board may obviously delegate certain responsibilities to officers or to various committees, it is the Board which has overall responsibility for the management of the corporation and its assets.

Georgia is illustrative of state law treatment:

§ 14-2-801. Requirement for and duties of board of directors

(a) Each corporation must have a board of directors, except as provided in Article 9 of this chapter or in a written agreement meeting the requirements of Code Section 14-2-732.

(b) All corporate powers shall be exercised by or under the authority of, and the business and affairs of the corporation managed under the direction of, its board of directors, subject to any limitation set forth in the articles of incorporation, in rights, options, or warrants permitted by paragraph (2) of subsection (d) of Code Section 14-2-624, or in an agreement among the shareholders meeting the requirements of Code Section 14-2-732.

(c) No limitation upon the authority of the directors, whether contained in the articles of incorporation or an agreement among the shareholders meeting the requirements of Code Section 14-2-732, shall be effective against persons, other than shareholders and directors, who are without actual knowledge of the limitation.

Likewise, the Articles of Incorporation may provide that, in the case of a close corporation, the enterprise will be managed directly by the shareholders rather than by a Board of Directors. This is more akin to the management of a member-managed limited liability company.
In exercising their management function, the Board has some limitations. The members of the Board owe a fiduciary duty to the corporation and therefore are prohibited from engaging in self-dealing. This and other issues relating to this topic are discussed in Chapter 3, Rights and Duties of Business Owners.

The centralized management structure of a corporation is less flexible than a limited liability company, in which the business may be managed by all of the members, some of the members only or even by professional managers. The powers of the board of directors may be limited by express provisions in the Articles of Incorporation or by a shareholder agreement.

A. SHAREHOLDER PARTICIPATION IN MANAGEMENT

Participation in management by shareholders is normally limited to voting for the Board of Directors and, in some circumstances, through the execution of proxies. However, shareholders of a C corporation may generally participate in its management through positions as officers and directors without affecting their limited liability status.

Sole stockholders in close corporations, which often includes Subchapter S corporations, often choose to play a more active role in management of the corporation.

B. COMMITTEES

It is a common practice for the board of directors of a corporation to delegate certain responsibilities to various committees. The larger the corporation, the more common this practice seems to be. The use of committees can be prohibited through the corporation’s Articles of Incorporation, but is generally authorized by state law in the absence of such a provision.

For example, South Carolina, § 33-8-250, provides:

(a) Unless the articles of incorporation or bylaws provide otherwise, a board of directors may create one or more committees and appoint members of the board of directors to serve on them. Each committee must have two or more members who serve at the pleasure of the board of directors.

(b) The creation of a committee and appointment of members to it must be approved by the greater of (1) a majority of all the directors in office when the action is taken or (2) the number of directors required by the articles of incorporation or bylaws to take action under Section 33-8-240.

(c) Sections 33-8-200 through 33-8-240, which govern meetings, action without meetings, notice and waiver of notice, and quorum and voting requirements of the board of directors, apply to committees and their members as well.

(d) To the extent specified by the board of directors or in the articles of incorporation or bylaws, each committee may exercise the authority of the board of directors under Section 33-8-101.
(e) A committee, however, may not:
(1) authorize distributions;
(2) approve or propose to shareholders action that Chapters 1 through 20 of this Title requires be approved by shareholders;
(3) fill vacancies on the board of directors or on any of its committees;
(4) amend articles of incorporation pursuant to Section 33-10-102;
(5) adopt, amend, or repeal bylaws;
(6) approve a plan of merger not requiring shareholder approval;
(7) authorize or approve reacquisition of shares, except according to a formula or method prescribed by the board of directors; or
(8) authorize or approve the issuance or sale or contract for sale of shares, or determine the designation and relative rights, preferences, and limitations of a class or series of shares, except that the board of directors may authorize a committee (or a senior executive officer of the corporation) to do so within limits specifically prescribed by the board of directors.

(f) The creation of, delegation of authority to, or action by a committee does not alone constitute compliance by a director with the standards of conduct described in Section 33-8-300.

The statutes of several states make nondelegable certain powers not listed in section 8.25(e) - for example, the power to change the principal corporate office, to appoint or remove officers, to fix director compensation, or to remove agents. These are not prohibited by section 8.25(e) since the whole board of directors may reverse or rescind the committee action taken, if it should wish to do so, without undue risk that implementation of the committee action might be irrevocable or irreversible.
<table>
<thead>
<tr>
<th><strong>Table 4.4 Components of Corporation Management</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Shareholders</strong></td>
</tr>
<tr>
<td><strong>Board of Directors</strong></td>
</tr>
<tr>
<td><strong>Officers</strong></td>
</tr>
<tr>
<td><strong>Proxies</strong></td>
</tr>
<tr>
<td><strong>Articles of Incorporation and Bylaws</strong></td>
</tr>
<tr>
<td><strong>State law</strong></td>
</tr>
</tbody>
</table>
CHAPTER 4 – REVIEW QUESTIONS

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter. They do not need to be submitted in order to receive CPE credit. They are included as an additional tool to enhance your learning experience.

We recommend that you answer each review question and then compare your response to the suggested solution before answering the final exam questions related to this chapter.

1. Which of the following entities cannot be composed of a single owner:
   a) limited liability company
   b) general partnership
   c) sole proprietorship
   d) corporation

2. Which of the following statements about the rights of limited partners is most correct:
   a) limited partners generally have a right to actively participate in the management of the partnership
   b) limited partners generally do not have a right to actively participate in the management of the business
   c) limited partners are required to be actively engaged in the management of the partnership
   d) limited partners have no rights other than to a portion of the proceeds when the business is sold

3. There are two types of limited liability companies: active and passive.
   a) true
   b) false

4. Under common law, the easiest type of authority to see and define is apparent authority.
   a) true
   b) false

5. In a manager-managed company, members of an LLC generally do not have the authority to bind the company unless they also serve as managers.
   a) true
   b) false
6. In a corporation, who is generally responsible for the day-to-day operations of the business:

   a) shareholders  
   b) board of directors  
   c) officers  
   d) all of the above

7. Shareholders of a C corporation may generally participate in its management through positions as officers and directors without affecting their limited liability status.

   a) true  
   b) false
CHAPTER 4 – SOLUTIONS AND SUGGESTED RESPONSES

1. A: Incorrect. A limited liability company can be composed of a single person or of multiple persons or entities.

   **B: Correct.** By definition, a partnership requires two or more individuals or entities to be partners.

   C: Incorrect. A sole proprietorship, by definition, is a business owned by a single individual without the benefit of any separate legal entity.

   D: Incorrect. A corporation can be made up of as few as a single shareholder.

   (See page 4-1 of the course material.)

2. A: Incorrect. The general rule is just the opposite.

   **B: Correct.** Limited partners are, by their nature, passive investors. As a practical matter, a limited partner does not generally want to participate in the management of the company because to do so normally results in the loss of their limited liability status.

   C: Incorrect. To the contrary, limited partners will lose their limited partner status if they become actively engaged in the operations of the partnership.

   D: Incorrect. Limited partners have a number of rights as specified in the partnership agreement and as provided by applicable state law.

   (See pages 4-3 to 4-4 of the course material.)

3. A: True is incorrect. There are two types of limited liability companies, but they are manager-managed and member-managed.

   **B: False is correct.** The two types are manager-managed and member-managed. The Articles of Organization generally define the entity’s management structure.

   (See page 4-5 of the course material.)

4. A: True is incorrect. There are three types of authority under common law: express, implied, and apparent. The easiest to see and define is express authority because the authority is spelled out both for the agent and principal to see and for third parties; there is little opportunity for confusion over the authority of the agent.

   **B: False is correct.** Apparent authority exists under certain circumstances when a third party believes the purported agent has authority to bind the principal, whether he does or not.

   (See page 4-7 of the course material.)
5. **A: True is correct.** The rules governing managers are the same as those that apply to members of member-managed companies.

   B: False is incorrect. A member of a member-managed company is an agent of the company and therefore has the authority to bind the company when acting in the ordinary course of the company’s business.

   (See page 4-8 of the course material.)

6. A: Incorrect. Shareholders typically have little involvement in day-to-day operations unless they happen to also be officers.

   B: Incorrect. The shareholders elect a Board of Directors, who then select the officers of the corporation. The officers are responsible for the day-to-day operation of the enterprise.

   **C: Correct.** Officers, as selected by the Board of Directors, have day-to-day responsibility for the management of corporations.

   D: Incorrect. Since A and B are incorrect, D cannot be correct.

   (See page 4-11 of the course material.)

7. **A: True is correct.** Participation in management by shareholders is normally limited to voting for the Board of Directors and, in some circumstances, through the execution of proxies or as employees.

   B: False is incorrect. A C corporation shareholder does not lose their limited liability status due to management through positions as officers and directors.

   (See page 4-12 of the course material.)
Chapter 5: Liability of Owners

Like taxes, ease of dissolution or conversion, and control, limited liability is one of the key issues that must be considered when determining what type of business entity to adopt. No business owner wants any personal liability, if possible. There are a variety of business forms that make limited liability possible: a corporation, whether S or C, or a limited liability company, each offer limited liability to their owners. A limited partner in a limited partnership will also have limited liability unless he or she takes an “active” role in the management of the limited partnership.

Table 5.1 Comparison of Liability of Owners of Different Entities

<table>
<thead>
<tr>
<th>Entity</th>
<th>Liability of Owners</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sole Proprietorship</td>
<td>A sole proprietor is always personally liable for any of the debts, obligations or liabilities of the business</td>
</tr>
<tr>
<td>General Partnership</td>
<td>General partners are jointly and severally liable for the debts, obligations and liabilities of the partnership</td>
</tr>
<tr>
<td>Limited Partnership</td>
<td>A limited partner has limited liability unless he or she takes an active role in the management of the limited partnership; general partner(s) remain personally liable</td>
</tr>
<tr>
<td>Corporation (C or S)</td>
<td>Shareholders not personally liable for debts, obligations or liabilities of the business</td>
</tr>
<tr>
<td>Limited Liability Company</td>
<td>Members not personally liable for debts, obligations or liabilities of the business</td>
</tr>
</tbody>
</table>

The liability exposure of a general partner in a general partnership or a general partner or limited partner in a limited partnership can be eliminated partially or entirely, depending upon state law, if the partnership registers as a limited liability partnership or limited liability company.

Only the sole proprietorship and the general or limited partnership (in the case of the general partners) leave owners without protection for their personal assets. This chapter defines the circumstances under which these traditional business models as well as newer ones – namely the limited liability partnership and the limited liability company – act to protect owners from personal liability.

Remember, however, that regardless of the choice of entity used, an individual will always be held personally liable for any damages caused by his or her own acts or omissions as well as for any liabilities he or she has personally guaranteed. There are also circumstances under which the veil of protection offered by corporations or limited liability companies can be pierced. This issue is also discussed in detail below.
I. Partnerships

At common law, a partnership was not considered to be a separate legal entity, and therefore could not sue or be sued in the firm name. Most States now have statutes or rules authorizing partnerships to sue or be sued in the partnership name.

A. GENERAL PARTNERSHIPS

The general partnership is essentially the only remaining multi-owner business entity in which all owners are subject to personal liability for all of the debts and obligations of the partnership. State law normally provides that each general partner is jointly and severally liable for the debts of the partnership. This means a creditor is free to sue the partnership as a whole, or any or all individual partners, in an effort to collect a debt or to otherwise enforce a legal right.

The Uniform Partnership Act, § 306, provides as follows:

Section 306. Partner's Liability

(a) Except as otherwise provided in subsections (b) and (c), all partners are liable jointly and severally for all obligations of the partnership unless otherwise agreed by the claimant or provided by law.

(b) A person admitted as a partner into an existing partnership is not personally liable for any partnership obligation incurred before the person's admission as a partner.

Under some statutory formulations, a creditor is required to first attempt to collect from the partnership before commencing an action against an individual partner. Some states also differentiate between liability for contracts as opposed to liability for the commission of torts (i.e. assault, defamation). As usual, refer to the laws of each state for specific guidance.

1. Protection for Incoming Partners

Under UPA § 306(a), above, an incoming partner becomes jointly and severally liable, as a partner, for all partnership obligations, except as otherwise provided in subsection (b). That subsection eliminates an incoming partner's personal liability for partnership obligations incurred before his admission as a partner. In effect, a new partner has no personal liability to existing creditors of the partnership, and only his investment in the firm is at risk for the satisfaction of existing partnership debts.

2. Liability of Purported Partners

Persons who hold themselves out as a partner when they are not in fact partners can also make themselves liable for the debts of the partnership. This normally occurs when someone holds themselves out as a partner and a third party, in reliance on that representation, takes some action. The third party is thereafter able to enforce the obligation against the purported partner. To the extent the partnership had knowledge of the actions of the purported partner, they too can be bound under general agency principles.
3. A Note on Agency

The principles of agency law were discussed in detail in Chapter 3. These same principles apply with respect to determining individual liability. Thus, a person who holds himself out as a partner to a third party who relies on that representation can indeed find himself liable as a partner even if that is technically not true.

An actual partner can also bind the partnership even in cases where he lacks actual authority, so long as he has apparent authority for the actions in question.

**Example.**

*Bill, John and Jack are general partners in a local car rental agency. The partnership agreement specifies that all partners must agree before cars can be purchased. John, without the knowledge of Bill and Jack, enters into a contract with a car distributor for the purchase of 10 new cars. John tells the distributor that he has authority to enter into the contract. When the partnership fails to make payment on the cars, the distributor, relying on John’s apparent authority, can hold the partnership liable for the amount due.*

These agency principles apply to all types of partnerships. The statutes of most states expressly recognize the application of agency principles to partnerships. Other states recognize the principle through case law.

**B. LIMITED PARTNERSHIPS**

A limited partnership is composed of at least one general partner and at least one limited partner. The general partner or partners remain subject to personal liability to the same extent as partners in a general partnership. Limited partners, on the other hand, remain immune from personal liability for the debts and obligations so long as they remain relatively “limited” in their involvement in the partnership. Every state has a specific law that details the amount of involvement that can subject a limited partner to personal liability.

California, for example, provides as follows:

**Corporations Code § 15507.**

(a) A limited partner shall not become liable as a general partner unless, in addition to the exercise of his rights and powers as a limited partner, he takes part in the control of the business.

(b) A limited partner shall not be deemed to take part in the control of the business by virtue of his possessing or exercising a power, specified in the certificate, to vote upon matters affecting the basic structure of the partnership, including the following matters or others of a similar nature:

(1) Election or removal of general partners.
(2) Termination of the partnership.
(3) Amendment of the partnership agreement.
What conduct by a limited partner is sufficient for a court to consider that person to be a general partner for purposes of imposing personal liability?

The general rule of thumb is that minimal involvement in the day-to-day business of the partnership will not subject a limited partner to personal liability. In each case it is a question of fact for a court to decide. The following examples should help to understand what type of circumstances influence a court’s decision.

### Table 5.2 Facts causing personal liability for limited partner.\(^1\)

<table>
<thead>
<tr>
<th>Facts</th>
<th>Personal Liability</th>
<th>No Personal Liability</th>
</tr>
</thead>
<tbody>
<tr>
<td>Limited partner attends regular partnership meetings.</td>
<td></td>
<td>X</td>
</tr>
<tr>
<td>Limited partner votes for or against the sale of partnership assets where the vote was conducted in accordance with the terms of the partnership agreement.</td>
<td></td>
<td>X</td>
</tr>
<tr>
<td>Limited partner was an officer, director, or shareholder of a corporation which was the sole business operated by the partnership and limited partner managed the day-to-day business of the corporation.</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Limited partner promoted the business of the partnership but was not involved in managerial decisions of the partnership, such as accounting or financial decisions.</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Limited partner provided advice and counsel to the general partner with respect to the day-to-day business of the partnership but the ultimate decisionmaking authority remained with the general partner.</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Acts of the general partner with respect to the conduct of the day-to-day business of the partnership were subject to the direction and control of the limited partners.</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Limited partner provided advice and counsel to general partner during time of financial crisis and guaranteed a line of credit for the partnership.</td>
<td></td>
<td>X</td>
</tr>
</tbody>
</table>

\(^1\) These are examples only. As every case has its own unique set of facts and nuances, this chart should not be relied upon as legal advice.
<table>
<thead>
<tr>
<th><strong>Limited partner exercises control over the distribution of the profits of the partnership.</strong></th>
<th>X</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Limited partner who was also an employee of the partnership but did not have ultimate decision-making authority with respect to such matters as hiring and firing, purchasing, price-setting, extensions of credit, and the like, and was subject to the direction and control of a general partner.</strong></td>
<td>X</td>
</tr>
<tr>
<td><strong>Limited partner was employed by the partnership and he or she possessed ultimate decision-making authority which was not subject to check by a general partner.</strong></td>
<td>X</td>
</tr>
<tr>
<td><strong>Limited partner who was also employee of the partnership was subject to the direction and control of a general partner, and the ultimate decision-making authority with respect to substantive matters of partnership business rested with a general partner.</strong></td>
<td>X</td>
</tr>
<tr>
<td><strong>Limited partners maintained final “say so” on all major decisions concerning partnership business even where general partner controlled day-to-day decisions.</strong></td>
<td>X</td>
</tr>
<tr>
<td><strong>Limited partner engaged in certain activities to publicize the business of the partnership.</strong></td>
<td>X</td>
</tr>
<tr>
<td><strong>Corporation is general partner of the partnership and the limited partner is also an officer, director, or shareholder of the corporate general partner, where the separate identities of the corporation and the partnership are maintained, such as where the corporation was not formed solely to operate the partnership and the partnership was not the sole business of the corporation.</strong></td>
<td>X</td>
</tr>
<tr>
<td><strong>Limited partner executes a guaranty agreement on a loan made to the partnership where guarantor is not considered personally liable for the amounts guaranteed since the guarantor is entitled to reimbursement from the primary obligor.</strong></td>
<td>X</td>
</tr>
</tbody>
</table>
Limited partners agreed at time they became partners that they would have unlimited liability for debts of partnership. | X |

Limited partner was an officer or shareholder of a corporate general partner and performed acts on behalf of the corporation in the conduct of partnership business, where limited partner maintained his or her identity as an agent of the corporation and creditors had knowledge that the limited partner was acting in his or her capacity as an agent of the corporate general partner. | X |

Limited partners were hired as independent contractor consultants of partnership and oversaw several projects of the partnership but did not have final authority over the project and held themselves out to third parties as consultants and not as limited partners. | X |

Limited partner brings a lawsuit on behalf of the partnership. | X |

C. LIMITED LIABILITY PARTNERSHIPS

In essence, a limited liability partnership (referred to in some states as a “registered limited liability company,”) is a partnership in which, for purposes of liability, all partners are considered limited partners. Keep in mind that limited liability partnerships are currently reserved for only a select group of professionals (e.g. attorneys and physicians) under the laws of most states. Public policy has dictated that as such, partners generally remain liable for their own acts or for other acts where certain conditions are met.

As these partnerships are creatures of statute, the statute of each specific state needs to be consulted. Texas law, for example, provides the following:

Art. 6132b-3.08. Liability in and Registration of Registered Limited Liability Partnership

(2) A partner in a registered limited liability partnership is not individually liable, directly or indirectly, by contribution, indemnity, or otherwise, for debts and obligations of the partnership arising from errors, omissions, negligence, incompetence, or malfeasance committed while the partnership is a registered limited liability partnership and in the course of the partnership business by another partner or a representative of the partnership not working under the supervision or direction of the first partner unless the first partner:
(A) was directly involved in the specific activity in which the errors, omissions, negligence, incompetence, or malfeasance were committed by the other partner or representative; or

(B) had notice or knowledge of the errors, omissions, negligence, incompetence, or malfeasance by the other partner or representative at the time of occurrence and then failed to take reasonable steps to prevent or cure the errors, omissions, negligence, incompetence, or malfeasance.

Pennsylvania law, § 8204, provides:

(a) General rule. – Except as provided in subsection (b), a partner in a registered limited liability partnership shall not be individually liable directly or indirectly, whether by way of indemnification, contribution or otherwise, for debts and obligations of, or chargeable to, the partnership, whether sounding in contract or tort or otherwise, that arise from any negligent or wrongful acts or misconduct committed by another partner or other representative of the partnership while the registration of the partnership under this subchapter is in effect.

(b) Exceptions.--
(2) Subsection (a) shall not affect the liability of a partner:
(i) Individually for any negligent or wrongful acts or misconduct committed by him or by any person under his direct supervision and control.
(ii) For any debts or obligations of the partnership:
(A) arising from any cause other than those specified in subsection (a); or
(B) as to which the partner has agreed in writing to be liable.
(iii) To the extent expressly undertaken in the partnership agreement or the certificate of limited partnership.
(3) Subsection (a) shall not affect in any way:
(i) the liability of the partnership itself for all its debts and obligations;
(ii) the availability of the entire assets of the partnership to satisfy its debts and obligations; or
(iii) any obligation undertaken by a partner in writing to individually indemnify another partner of the partnership or to individually contribute toward a liability of another partner.

(c) Continuation of limited liability. – Neither the termination of the registration of a partnership under this subchapter nor the dissolution of the partnership shall affect the limitation on the liability of a partner in the partnership under this section with respect to negligent or wrongful acts or misconduct occurring while the registration under this subchapter was in effect.

A partner who participates in the management of a partnership will ordinarily not have the type of direct supervision and control by reason of that position that will make the partner individually liable under subsection (b)(2)(i) of the Pennsylvania law. The direct supervision and control must be with respect to the acts giving rise to the liability. That type of supervision and control will usually exist in the case of a partner who has the ongoing assignment of supervising generally all of the work of an employee of the partnership. However, where a partner exercises supervision and control over an employee just with respect to discrete matters, the partner will be liable under subsection (b)(2)(i) only with respect to those matters.
Subsection (b)(3)(i) makes clear that this section will not have any effect on the liability of the partnership itself, which will continue to be liable for the conduct of its partners and other representatives. This means that an innocent partner cannot argue that his or her proportionate interest in the partnership (and thus indirectly a similar proportion of the partnership's assets) should be exempt from being available to satisfy a debt or obligation of the partnership for which the innocent partner is not liable. Likewise, this section also does not affect the liability of a partner for his or her own acts which may create a partnership obligation.

States also require registered limited liability partnerships to maintain insurance policies in specified amounts to cover potential claims arising against the partnership as a whole. Once again, while the law can vary significantly from one state to another, the following principles generally apply to limited liability partnerships:

- Partners are personally liable for their own acts or omissions, including professional malpractice;
- Participation in management of the partnership does not make the partner liable for the acts or omissions of the other members of the partnership in the absence of actual knowledge;
- Partners are liable for the acts or omissions of those who they directly supervise;
- The partnership as a whole remains liable for all its debts and obligations; and
- Applicable rules of professional conduct must be complied with regardless of state law.

II. Limited Liability Companies

One of the key benefits of a limited liability company compared with other entities, notably sole proprietorships, is that individual members are generally NOT liable for the debts or acts of the entity. This includes obligations created by contract as well as other acts or omissions, including torts.

However, as with corporations, there are circumstances under which members can be held personally liable. The legal theory that has historically applied to corporations in this area is referred to as “piercing the corporate veil,” although the term “alter ego” is also sometimes used. In general, this theory says that if a corporation fails to act like a corporation in key respects, the veil of protection provided to its shareholders can be pierced, making the shareholders individually liable for the debts and obligations of the corporation. The types of practices that have traditionally led to a piercing of the corporate veil include commingling of funds or other actions in which one or more shareholders disregard the corporate structure of the business, undercapitalization, and a failure to follow corporate formalities, including holding regular meetings.
In determining the circumstances under which a limited liability member may be held personally liable for the acts or omissions of the entity, the law of the state in which it was organized must be examined. Many states have no express statutory provisions governing piercing of the corporate veil of a limited liability company; in such cases, one should look to the rules governing corporations for guidance, both statutory and case law.

Some states do provide specific guidance. Below are a few examples of the types of statutory schemes widely used:

1. **Washington**

   Wash. Rev. Code §25.15.060. *Members of a limited liability company shall be personally liable for any act, debt, obligation, or liability of the limited liability company to the extent that shareholders of a Washington business corporation would be liable in analogous circumstances. In this regard, the court may consider the factors and policies set forth in established case law with regard to piercing the corporate veil, except that the failure to hold meetings of members or managers or the failure to observe formalities pertaining to the calling or conduct of meetings shall not be considered a factor tending to establish that the members have personal liability for any act, debt, obligation, or liability of the limited liability company if the certificate of formation and limited liability company agreement do not expressly require the holding of meetings of members or managers.*

2. **Wisconsin**

   W.S.A. §183.0304. (1) *The debts, obligations and liabilities of a limited liability company, whether arising in contract, tort or otherwise, shall be solely the debts, obligations and liabilities of the limited liability company. Except as provided in ss. 183.0502 and 183.0608, a member or manager of a limited liability company is not personally liable for any debt, obligation or liability of the limited liability company, except that a member or manager may become personally liable by his or her acts or conduct other than as a member or manager.*

   (2) *Notwithstanding sub. (1), nothing in this chapter shall preclude a court from ignoring the limited liability company entity under principles of common law of this state that are similar to those applicable to business corporations and shareholders in this state and under circumstances that are not inconsistent with the purposes of this chapter.*

3. **Colorado**

   C.R.S.A. § 7-80-107. (1) *In any case in which a party seeks to hold the members of a limited liability company personally responsible for the alleged improper actions of the limited liability company, the court shall apply the case law which interprets the conditions and circumstances under which the corporate veil of a corporation may be pierced under Colorado law.*

   (2) *For purposes of this section, the failure of a limited liability company to observe the formalities or requirements relating to the management of its business and affairs is not in itself a ground for imposing personal liability on the members for liabilities of the limited liability company.*
4. California

Code of Corporations § 17101. (a) Except as otherwise provided in Section 17254 or in subdivision (e), no member of a limited liability company shall be personally liable under any judgment of a court, or in any other manner, for any debt, obligation, or liability of the limited liability company, whether that liability or obligation arises in contract, tort, or otherwise, solely by reason of being a member of the limited liability company.

(b) A member of a limited liability company shall be subject to liability under the common law governing alter ego liability, and shall also be personally liable under a judgment of a court or for any debt, obligation, or liability of the limited liability company, whether that liability or obligation arises in contract, tort, or otherwise, under the same or similar circumstances and to the same extent as a shareholder of a corporation may be personally liable for any debt, obligation, or liability of the corporation; except that the failure to hold meetings of members or managers or the failure to observe formalities pertaining to the calling or conduct of meetings shall not be considered a factor tending to establish that a member or the members have alter ego or personal liability for any debt, obligation, or liability of the limited liability company where the articles of organization or operating agreement do not expressly require the holding of meetings of members or managers.

(c) Nothing in this section shall be construed to affect the liability of a member of a limited liability company (1) to third parties for the member's participation in tortious conduct, or (2) pursuant to the terms of a written guarantee or other contractual obligation entered into by the member, other than an operating agreement.

(d) A limited liability company or foreign limited liability company shall carry insurance or provide an undertaking to the same extent and in the same amount as is required by any law, rule, or regulation of this state that would be applicable to the limited liability company or foreign limited liability company were it a corporation organized and existing or duly qualified for the transaction of intrastate business under the General Corporation Law.

(e) Notwithstanding subdivision (a), a member of a limited liability company may agree to be obligated personally for any or all of the debts, obligations, and liabilities of the limited liability company as long as the agreement to be so obligated is set forth in the articles of organization or in a written operating agreement that specifically references this subdivision.

Note that in most of these statutory schemes, limited liability will not be lost merely for failing to abide by formalities involving meetings of the entity. This is different than corporations, which can have their veil pierced for failing to follow these types of formalities. The distinction is largely based upon the more flexible management character of limited liability companies. In general, however, these statutory schemes look to the rules governing corporations to determine when members of a limited liability company will be held personally liable for the debts or other obligations of the entity.

A look at how a few courts have responded to specific claims that the veil of a limited liability company should be pierced is important in more fully understanding the types of facts that can give rise to personal liability.
Cases-in-Point

Although it is an unpublished decision (and therefore technically cannot serve as a precedent in future cases), *Stone v. Frederick L. Hobby Associated II* serves as an excellent example of the type of analysis and facts involved in piercing the veil of a limited liability company. The case, decided in 2001, involved an action alleging breach of a home construction warranty. The plaintiffs, the buyers of the home, sought to attach the assets of the defendants as individuals. In order to do so, the court first had to determine if the plaintiff had facts sufficient to pierce the veil of the limited liability company.

Frederick L. Hobby, III and Sally Leiendecker were the sole members of Frederick Hobby Associates II, LLC. The plaintiffs purchased the $3.3 million home in Greenwich, Connecticut from Hobby II. At the time of the execution of the purchase agreement, the home was not complete. Hobby made warranties in the sales agreement about the condition the home would be in at the time of closing.

The essence of the lawsuit is that the work on the home was not completed as promised in the sales agreement, and included a number of material defects.

Shortly before the closing date, the LLC transferred most of its assets to certain individuals, including its two members. The plaintiffs alleged a number of causes of action against the individual members and the LLC, including breach of contract and fraud.

The court rejected all of the defendant’s defenses and turned to the question of whether the members of the LLC could be held individually liable and therefore could be required to show proof of assets sufficient to satisfy a judgment. The LLC had virtually no assets, making the plaintiffs ability to reach the assets of the individual members critical.

The plaintiffs argued that Hobby II’s veil may be pierced by this court under the instrumentality theory or the identity theory, or both.

Hobby II was formed as a Connecticut limited liability company in February of 1998.

Connecticut General Statutes Section 34-133(a) provides, with certain exceptions, that: "a person who is a member or manager of a limited liability company is not liable, solely by reason of being a member or manager, under a judgment, decree or order of a court, or in any other manner, for a debt, obligation or liability of the limited liability company, whether arising in contract, tort or otherwise or for the acts or omissions of any other member, manager, agent or employee of the limited liability company."

Courts will, however, disregard the corporate or limited liability structure under certain circumstances, especially when, as the court stated: “the corporate entity, has been so controlled and dominated that justice requires liability to be imposed on the real actor. The rationale behind [piercing the corporate veil] is that if the shareholders themselves, or the corporations themselves, disregard the legal separation, distinct properties, or proper formalities of the different corporate enterprises, then the law will likewise disregard them so far as is necessary to protect individual and corporate creditors.”

“The same rationale applies in the case of a limited liability company,” the court said.
The instrumentality rule, the court said, requires proof of three elements: (1) that the defendant member or members totally controlled the business entity to the point that the entity failed to have its own identity; (2) that the defendant(s) exercised this control in order to perpetrate a fraud or other wrong; and (3) that such action resulted in injury to a third party.

The identity rule, on the other hand, is generally used when two allegedly separate business entities with the same owner or owners are effectively run as one. This includes the failure to follow corporate or other business formalities.

In analyzing the facts of this case, the court found the following:

- Frederick L. Hobby, III and Sally M. Leiendecker are the members of Hobby II;
- Each member has a 50 percent ownership interest in Hobby II, as well as full authority to manage and control the company's business;
- Hobby II's office is located in Frederick L. Hobby, III's private home, owned by him in his individual capacity, and Hobby II pays no rent and has no lease with him; and
- Hobby II currently has no assets and it never had any assets other than the premises now owned by the plaintiffs.

In addition, evidence showed that the limited liability company was established for the sole purpose of avoiding personal liability on the part of the members. Evidence also showed that the individual defendants held themselves out as the owners of the business in a number of key respects and in executing at least one document denies the existence of a limited liability company. Evidence also showed the following: Hobby failed to refer to itself as an LLC in some of its advertising; that Hobby signed documents ostensibly for the company in his individual capacity; the members use of the term “partner” when referring to their interests in the company; and the failure to use the term LLC on certain correspondence sent by defendants to plaintiffs.

The court found all requirements of the instrumentality rule to have been met, namely that the defendant exercised complete control over the business entity, that they did so in order to commit illegal or dishonest acts and that these acts resulted in losses suffered by the plaintiffs.

"The plaintiffs have demonstrated that Frederick L. Hobby, III and Sally M. Leiendecker exercised such domination over Hobby II that in essence, the limited liability company had no mind, will or existence of its own," the court concluded.

"Moreover, the evidence described above, when viewed in the aggregate, provides probable cause for this court to apply the identity rule," the court continued. "The plaintiffs have demonstrated that Frederick L. Hobby, III and Sally M. Leiendecker used Hobby II interchangeably with their own personal identities and with identities of other entities under their control, and failed to observe formalities for the limited liability company. The names of these other entities, whether real or fictitious, represent entities which are, in reality, controlled as one entity because of common owners or members and because of a lack of observance of formalities between the entities. Furthermore,
when viewed in the aggregate, the evidence shows such a unity of interest and ownership that Hobby II’s independence as a limited liability company had in effect ceased or had never begun, and an adherence to the fiction of Hobby II’s separate identity would serve only to defeat justice and equity by permitting the individual defendants to escape liability arising out of a "shell" operation conducted for their benefit. This situation is characteristically appropriate for implementation of the identity rule. Thus, the plaintiffs have sustained their burden of demonstrating that there is probable cause to sustain the validity of their claim to pierce Hobby II’s corporate veil under both the instrumentality and the identity rules.”

Another recent yet classic example of piercing the veil of a limited liability company occurred in *Hamilton v. All Ventures, LLC*. The defendant company was created for the single purpose of obtaining a contract for asbestos removal from a New Orleans casino. The member with the largest interest was ISS, a wholly-owned subsidiary of R-Square Investments, a corporation.

All entered into a contract with the plaintiff Hamilton to manage the asbestos-removal contract. After work was complete, Hamilton sued both ISS and All ventures for failure to pay a bonus due under the terms of the contract.

In holding both ISS and All liable for the bonus payment, the court on appeal accepted the finding of the trial court that All was but a “shell corporation with no employees nor capital.” The court noted that Louisiana has historically allowed piercing of the corporate veil when shareholders have “disregarded the corporate entity to such extent that they and it become indistinguishable.”

“The legal fiction of a distinct corporate entity may be disregarded,” the court added, “when a corporation is so organized and controlled as to make it merely an instrumentality or adjunct of another corporation.” The courts have allowed this same theory to apply to limited liability companies.

In this case, the court found that All was totally controlled by ISS; indeed it had no employees of its own. All was formed for the sole purpose of performing one job. Further, the court found that All failed to follow business formalities and persons associated with the project were unsure whether they were dealing with All or ISS. Indeed, the court added, All’s accounting was done by ISS employees.

Another issue closely related to piercing the veil of a limited liability company is the degree to which such an entity has the authority to hold harmless a member who would otherwise be held personally liable for some sort of act or omission perpetrated as an agent of the company. A number of states have statutes which limit the right of a company to protect a member from personal liability under certain circumstances. These laws are generally based on public policy. These provisions usually deal with holding a member liable for violating obligations and duties towards the company, such as the duty of loyalty.
IIII. Corporations

A corporation is a legal entity that exists separate and apart from its owners. The actions and obligations of a corporation are therefore considered to be separate from those of its shareholders.

The corporate structure is intended to protect shareholders from liability arising from the operation of the corporation. Because a corporation possesses legal existence separate and apart from that of its shareholders, the mere operation of a corporation does not render a shareholder personally liable for corporate acts.

But there are circumstances under which a shareholder can be held personally liable for acts which would normally make only the corporation itself liable. In general, these circumstances are grouped together into a legal concept referred to as “piercing the corporate veil,” which was introduced in Part II, Limited Liability Companies, above. The term grew out of the very protective nature of the corporate form.

In general terms, the concept of piercing the corporate veil is applied to remedy injustices which arise where a shareholder has overextended his privilege in use of the corporate entity in order to defeat justice, to perpetrate a fraud, or to evade a contractual or tort responsibility. An attempt by a third party to pierce the corporate veil does not constitute an independent cause of action against the corporation; rather it is an assertion of facts and circumstances which will persuade the court to impose the corporate obligation on its owners based on another, underlying cause of action.

To pierce the corporate veil, there must be evidence of abuse of the corporate form. Because limited liability is one of the great hallmarks of corporate status, courts exercise caution in disregarding the corporate identity in order to hold a shareholder personally liable. Though all grouped together under the heading of “piercing the corporate veil,” there are a few sets of circumstances that most often give rise to such an action:

- Failure to follow corporate formalities;
- Commingling of corporate and personal assets;
- Undercapitalization of a corporation; and
- Use of the corporate form to perpetuate fraud.

A. COMMON THEORIES FOR PIERCING THE CORPORATE VEIL

1. Failure to Follow Corporate Formalities

Another term commonly used in legal circles for “piercing the corporate veil” is “alter ego.” This can probably best be understood in looking at failure to follow corporate formalities as a basis for holding shareholders personally liable.

One of the characteristics of corporate status is the necessity to comply with various statutory requirements governing the day-to-day operation of the entity, including the noticing and holding of meetings and the maintenance of various records. Since a
corporation is a separate legal entity, these requirements are intended to govern the life of the corporation and to protect the interests of individual shareholders. When the shareholders of a corporation ignore these various requirements and operate the corporation as an “alter ego” of themselves, they risk losing the limited liability status of the corporation.

Failure to observe corporate formalities includes such activities as commencement of business without the issuance of shares, lack of shareholders’ or directors’ meetings, lack of signing of consents, and the making of decisions by shareholders as if they were partners. A plaintiff seeking to pierce the corporate veil must show that the defendant disregarded the separateness of the corporation as a legal entity.

Example.

Joe, the CEO of ABC, Inc., ignores the requirements of the corporation’s bylaws and makes all decisions unilaterally, without the consent of the Board of Directors. He fails to hold regular shareholders meetings as required by the bylaws and by state law and fails to inform other shareholders about the operations of the corporation. John, a former ABC, Inc. supplier who is owed $10,000 for various merchandise, sues both ABC, Inc. and Joe personally for payment. Based on the way Joe ran the corporation, he is probably personally liable for the debt.

2. Commingling

Another classic basis for piercing the corporate veil is when the shareholder or shareholders commingles personal and corporate funds. This is another way in which courts have found that the shareholders are using the corporate entity as an “alter ego.” As with the failure to follow corporate formalities or any other basis of piercing the corporate veil, the amount of commingling must be fairly significant and must evidence the fact that the shareholder(s) themselves are disregarding the corporate entity.

Example.

Bill is the CEO of a closely-held corporation, XYZ, Inc. The other shareholders are not directly involved in the running of the business. Bill, who is in the process of purchasing a new home, decides to “borrow” $100,000 from a corporate account as a down payment. He repays the money when he receives his annual bonus the next month. In addition, Bill regularly has XYZ, Inc. make payments on his personal credit card. He also used the company American Express card to charge a $5,000 necklace for his girlfriend. He never repaid the corporation for the expenditure. Margaret, a customer of the XYZ Corporation, is hurt when an XYZ employee negligently drops a box on her head. Margaret sues XYZ, Inc. as well as Bill for compensation for her injuries. Based on the way Bill has operated the corporation as his "alter ego" by the commingling of funds, he risks being held personally liable in Margaret's tort action.
3. **Undercapitalization**

A corporation that fails to provide enough assets to cover its liabilities also runs the risk of having its veil of limited liability pierced. An inability to pay debts is an insufficient basis for piercing the corporate veil; courts generally require a finding that the shareholders purposefully undercapitalized the business to avoid paying certain debts.

For purposes of piercing the corporate veil, "inadequate capitalization" means capitalization that is very small in relation to the nature of the business of the corporation and the risks attendant to such a business. The adequacy of capital is normally measured as of the time of a corporation's formation.

If an adequately capitalized corporation later substantially expands the size or nature of the business with an attendant substantial increase in business hazards, the corporation might be deemed inadequately capitalized unless there is an infusion of additional risk capital by shareholders.

The policy behind this theory is to discourage investors from inadequately capitalizing relatively risky businesses, thereby putting potential creditors rather than themselves at risk for certain losses.

Although each case is different, courts are generally more reluctant to pierce the corporate veil under this theory for the benefit of a voluntary creditor, especially one that is sophisticated. For example, if a bank extends a loan to an undercapitalized corporation which defaults on the payment, most courts would find that it was a risk that the bank assumed on its own. On the other hand, an involuntary creditor, such as a third party who is injured as the result of a tort committed by an agent of the corporation, is more likely to find the court receptive to their claim against the shareholders in the event the corporation is unable to pay the debt.

4. **Fraud**

Use of the corporation to promote fraud, injustice, or illegal activities is also a common basis for piercing the corporate veil. Again, the plaintiff in such a case bears the burden of proving that the shareholders used the corporate entity in an inappropriate way for their personal benefit.

A party seeking to pierce the corporate veil bears the burden of establishing that the corporation was so ignored, controlled or manipulated that it was merely the instrumentality of another, and that the misuse of the corporate form would constitute a fraud or promote injustice.

**B. EFFECT OF SOLE OWNERSHIP**

Sole ownership of a corporation by one person or another corporation is normally not a factor in determining whether to pierce corporate veil. Limited liability will ordinarily exist, even though a corporation is closely held or has a single shareholder; however, a court may disregard a corporate entity and pierce the veil of limited liability where the corporation is merely the "alter ego" or business conduit of another person or entity.
C. EFFECT OF PIERCING ON OTHER SHAREHOLDERS

The fact that a plaintiff is able to pierce the corporate veil and hold one or more shareholders personally liable does not mean that the veil will be pierced as to other shareholders of the corporation.

Case-in-Point

In *Gilbert v. James Russell Motors, Inc.*, 812 So.2d 1269 (Ala.Civ.App.,2001), the defendants John and Lori Gilbert, husband and wife, were shareholders of G & W Auto Sales, Inc. ("G & W"). James Russell Motors, Inc. ("JRM") sued G & W and sought to have John and Lori as well as shareholder Lee Wood held personally liable. The defendants John and Lori Gilbert along with Wood formed the corporation in 1997 for the purpose of buying and selling automobiles. Wood contributed his experience in the business while the Gilberts contributed capital.

Wood, who handled the day-to-day operations of the business, entered into a contract with the plaintiff for the purchase of several automobiles. He did not tell the plaintiff that the business was incorporated. Further, Wood failed to pay for the automobiles, which he later sold. He then deposited the proceeds from the sale into his personal account rather than the business account. On more than one occasion, Wood also took money from the corporation for personal use. Wood also admitted that he lied to the Gilberts about transactions that did not actually take place. When the plaintiff sued for the purchase price of the cars, he sued the corporation as well as each of the shareholders individually. The court held shareholder Wood personally liable. He did not appeal that finding.

However, the court said that the fact that corporate identity is disregarded as far as Wood is concerned does not mean it also has to be disregarded as to the other shareholders. “Our review of the documents presented in this case suggest that G & W substantially met the requirements of a corporate entity,” the court wrote. “No evidence indicates that the Gilberts knew of Wood's inappropriate activities with regard to the business or that they condoned those activities. The evidence in the record does not support a conclusion that the Gilberts had complete control of G & W, that they misused any control that they did have, or that any misuse they allegedly exerted proximately caused harm to JRM. We cannot say that the record contains evidence that would support a piercing of G & W's corporate veil for that reason.”

D. LIABILITY OF SUCCESSOR CORPORATION

The general rule of successor corporation liability is that a new corporation is not liable for the debts of the prior corporation, unless:

- The buyer expressly or implicitly agrees to assume such liability;
- The transaction amounts to a de facto consolidation or merger;
- The buyer corporation is merely a continuation of the seller corporation; or
- The transaction is entered into fraudulently for the purpose of escaping liability."
The key inquiry is whether the successor corporation is merely a reincarnation of its predecessor, the old corporation in a new form.

**Case-in-Point**

In *Lopez v. TDI Services, Inc.*, 631 So.2d 679, La.App. 3 Cir. (1994), the court of appeals held it was appropriate to pierce the corporate veil and hold the majority shareholder in a corporation personally liable for past due wages of a former employee.

Thomas DesOrmeaux was the majority shareholder of Thermal Dynamics as well as various successor corporations for which the plaintiff was employed, including TDI Services, Inc.

The court noted that corporate formalities were observed by Thermal Dynamics insofar as meetings being held. However, the facts showed all the "earmarks of a transaction between persons dealing with themselves". Thomas DesOrmeaux had incorporated at least six different companies in less than ten years. Each new company was clearly formed in order to escape the liabilities and creditors of its predecessor. The business of each company exclusively involved the DesOrmeaux patented technology for waste disposal, the license for use for which was granted and withdrawn at the whim of the patentholders. The sole patentholder since June 1988 has been Thomas DesOrmeaux. Each successor corporation used the personnel and equipment of its predecessor. The operational management of each corporation remained in the hands of Thomas DesOrmeaux.

"We see no policy reason not to hold Thomas DesOrmeaux personally liable for the judgment owed to Lopez by Thermal Dynamics," the court concluded. "The purpose of limited liability, to encourage investments in high risk businesses by enabling investors who use the corporate form to make capital contributions while insulating their personal wealth from the business risks, is not served in this case. Thomas DesOrmeaux essentially risked nothing; his creditors risked all."

**E. LIABILITY OF PARENT FOR DEBTS OF SUBSIDIARY**

Another way in which the corporate veil can be pierced is to hold a parent company liable for the debts and obligations of a subsidiary. A classic example of piercing the veil of the parent corporation was *Sabine Towing & Transportation Co., Inc. v. Merit Ventures*, 575 F.Supp. 1442 (1983), in which the parent company created the subsidiary for the express purpose of engaging in a new line of business. When the new business began to fail, it sold the subsidiary. The buyers opted to close down the company. Creditors then sued the parent for money still owed by the defunct subsidiary. The court found the parent liable as the "alter ego" of the subsidiary corporation. Facts included the following:

- The parent company owned 100 percent of the stock of the subsidiary;
- The two companies had overlapping officers and directors;
- The two companies shared the same offices;
Incoming phone calls to the subsidiary were handled by a receptionist who gave the name of the parent;

Initial capitalization was inadequate;

The parent guaranteed a large loan made to the subsidiary;

The subsidiary was "directed" by the parent to make loans to other sister companies; and

The parent advanced money to the subsidiary throughout the life of the company.

The court concluded that in this case there was a pattern of control and domination of the subsidiary by the parent to such a degree that the subsidiary was nothing more than a “corporate fiction”. As such, it would be an injustice to third party creditors of the subsidiary not to allow them to seek payment from the parent.

"The Merit Venture owners reaped substantial benefit by structuring their subsidiaries in the manner they did; including substantial tax benefits and increased control of the subsidiaries. Having gained the benefit, they should have accepted the burden of adhering to the standards cited above. Clearly, they did not, and must be thus held primarily liable for Merit Transportation's debts. Otherwise, Merit Ventures will profit at the expense of innocent third parties," the court wrote.

In general, the factors used by the courts in determining whether to hold the parent liable for the debts and obligations of the subsidiary are the following:

Common or overlapping stock ownership between the parent and the subsidiary;

Common or overlapping directors and officers;

Use of same corporate office;

Inadequate capitalization of the subsidiary;

Financing of the subsidiary corporation by the parent;

Whether the parent existed solely as a holding company for its subsidiaries;

The parent's use of the subsidiary's property and assets as its own;

The nature of intercorporate loan transactions;

Incorporation of the subsidiary being caused by the parent;

Whether the parent and the subsidiary file consolidated income tax returns;

Decision-making for the subsidiary made by the parent and its principals;

Whether the directors of the subsidiary act independently in the interest of the subsidiary or in the interest of the parent;
- The making of contracts between the parent and the subsidiary that are more favorable to the parent;
- Observance of formal legal requirements; and
- Existence of fraud, wrong-doing or injustice to third parties.

None of the above factors alone would be determinative. Many relate to routine business practices followed by many companies. Under § 501 of the Internal Revenue Code, for example, a corporation may file a joint return with its subsidiaries when the parent owns at least eighty percent of the subsidiary. This practice was followed by Merit Ventures with all its subsidiaries. It allows a parent corporation to shelter taxable income from a profitable subsidiary by offsetting it against losses from an unprofitable subsidiary. Courts therefore inquire into the totality of the circumstances before imposing liability on the parent for the debts of the subsidiary.
CHAPTER 5 – REVIEW QUESTIONS

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter. They do not need to be submitted in order to receive CPE credit. They are included as an additional tool to enhance your learning experience.

We recommend that you answer each review question and then compare your response to the suggested solution before answering the final exam questions related to this chapter.

1. In which of the following entities are the owners automatically personally liable for the debts and obligations of the enterprise:
   a) limited liability company
   b) general partnership
   c) corporation
   d) all of the above

2. What is the minimum number of each type of partner required to form a limited partnership:
   a) at least one limited and one general partner
   b) at least two limited partners
   c) at least two general partners
   d) at least two general and two limited partners

3. Limited liability partnerships are currently reserved for only a select group of professionals under the laws of most states.
   a) true
   b) false

4. One of the advantages of a limited liability partnership is that the partners are only liable for their own acts or omissions and not those of the individuals they directly supervise.
   a) true
   b) false

5. When a shareholder is held personally liable for the acts or omissions of the entity, it is called:
   a) standard procedure
   b) piercing the corporate veil
   c) implied authority
   d) none of the above
6. To pierce the corporate veil of a corporation, there must be evidence of abuse of the corporate form.

   a) true
   b) false
CHAPTER 5 – SOLUTIONS AND SUGGESTED RESPONSES

1. A: Incorrect. A limited liability company gives its members the personal liability protection of a corporation. While members can become liable under certain circumstances, it is the exception rather than the rule.

   B: Correct. This is the only type of multi-owner entity that does not automatically afford personal liability protection to all of its owners. In a general partnership, each partner is personally liable for the debts and obligations of the business.

   C: Incorrect. A corporation gives the shareholders protection from personal liability in most cases.

   D: Incorrect. Because A and C are wrong, D cannot be correct.

   (See page 5-2 of the course material.)

2. A: Correct. There must be at least one general and one limited partner to constitute a limited partnership. The general partner is in charge of day to day management of the enterprise.

   B: Incorrect. There need be only one limited partner but there must also be at least one general partner to constitute a limited partnership.

   C: Incorrect. There need be only one general partner but there must also be at least one limited partner to constitute a limited partnership.

   D: Incorrect. A limited partnership can be comprised of only one general and one limited partner.

   (See page 5-3 of the course material.)

3. A: True is correct. Public policy has dictated that, as such, partners generally remain liable for their own acts or for other acts where certain conditions are met.

   B: False is incorrect. A limited liability partnership is a partnership in which, for purposes of liability, all partners are considered limited partners. They are generally reserved for professionals such as accountants, attorneys, and physicians.

   (See page 5-6 of the course material.)
4. A: True is incorrect. Partners of limited liability partnerships are liable for the acts or omissions of those they directly supervise.

**B: False is correct.** An advantage of a limited liability partnership does not make the partner liable for the acts or omissions of the other members of the partnership in the absence of actual knowledge.

(See page 5-8 of the course material.)

5. A: Incorrect. It is not standard procedure for a limited liability company to be held personally liable for acts or omissions.

**B: Correct.** This is also known as the “alter ego.” If the corporation fails to act like a corporation in key respects, the veil of protection provided to the shareholders is removed.

C: Incorrect. Apparent authority relates to binding of a principal, not to being held personally liable.

D: Incorrect. One of the items listed is the correct answer. Therefore, “none of the above” is not correct.

(See page 5-8 of the course material.)

6. **A: True is correct.** Because limited liability is one of the great hallmarks of corporate status, courts exercise caution in disregarding the corporate identity in order to hold a shareholder personally liable.

B: False is incorrect. The few sets of circumstances that most often give rise to an action of “piercing the corporate veil” are: 1) failure to follow corporate formalities; 2) commingling of corporate and personal assets; 3) undercapitalization of a corporation; and 4) use of the corporate form to perpetuate fraud.

(See page 5-14 of the course material.)
Chapter 6: Distributions to Owners

This chapter focuses on the manner in which profits are distributed to the owners of various entities – be they partners in a general partnership or shareholders in a classic C corporation – and the manner in which they are taxed.

I. Single-Owner Entities

When an individual elects to go into business for himself, there are three choices available when selecting a type of entity: (1) the classic sole proprietorship; (2) a corporation; or (3) a limited liability company. The tax treatment of distributions will be different with each form, as shown in Table 6.1, below:

Table 6.1 Taxation of Single-Member Entities

<table>
<thead>
<tr>
<th>ENTITY TYPE</th>
<th>TAX EFFECT OF DISTRIBUTION</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sole Proprietor</td>
<td>All profits and losses flow directly to the owner and are taxed at his/her individual rate</td>
</tr>
<tr>
<td>Corporation</td>
<td>In a traditional C corporation, profits are taxed at the corporate level; dividends paid to shareholders are then taxed again at the rate of the individual rate of the shareholder</td>
</tr>
<tr>
<td>Limited Liability Company</td>
<td>Member can elect to have distributions taxed as a corporation or flow through to the owner and have the entity “disregarded” for federal tax purposes</td>
</tr>
</tbody>
</table>

The limited liability company is often the best option for the single-owner in that it provides the limited liability offered by a corporation, as well as the option to avoid the double-taxation of a corporation on distributions. Other considerations discussed in this course obviously also affect the ultimate choice of entity.

II. Partnerships

A. DISTRIBUTIONS: ALLOCATING PROFITS AND LOSSES

The general default rule of most states, as provided in the Uniform Partnership Act (UPA) § 401, is that each partner is entitled to an equal share of the profits and is likewise responsible for an equal share of the losses. As with most default rules, of course, the partners are free to agree to a different arrangement in their written partnership agreement.
U.P.A. Section 401. Partner’s Rights and Duties

(a) Each partner is deemed to have an account that is:
(1) credited with an amount equal to the money plus the value of any other property, net of the amount of any liabilities, the partner contributes to the partnership and the partner’s share of the partnership profits; and
(2) charged with an amount equal to the money plus the value of any other property, net of the amount of any liabilities, distributed by the partnership to the partner and the partner’s share of the partnership losses.

(b) Each partner is entitled to an equal share of the partnership profits and is chargeable with a share of the partnership losses in proportion to the partner’s share of the profits.

(c) A partnership shall reimburse a partner for payments made and indemnify a partner for liabilities incurred by the partner in the ordinary course of the business of the partnership or for the preservation of its business or property.

(d) A partnership shall reimburse a partner for an advance to the partnership beyond the amount of capital the partner agreed to contribute.

(e) A payment or advance made by a partner which gives rise to a partnership obligation under subsection (c) or (d) constitutes a loan to the partnership which accrues interest from the date of the payment or advance.

Subsection (a) provides that each partner is deemed to have an account that is credited with the partner’s contributions and share of the partnership profits and charged with distributions to the partner and the partner’s share of partnership losses. In the absence of another system of partnership accounts, these rules establish a basic system of accounts for the partnership.

Under the default rule, partners share profits per capita and not in proportion to capital contribution as do corporate shareholders or partners in limited partnerships. If partners agree to share profits other than equally, losses will be shared similarly to profits, absent agreement to do otherwise. Of course, by agreement, they may share losses on a different basis from profits. The default rules apply even where one or more of the partners contribute no capital.

The Revised Uniform Limited Partnership Act (RULPA) has no specific provision allocating profits and losses among the partners. Instead, the Act directly apportions the right to receive distributions. Nearly all limited partnerships will choose to allocate profits and losses in order to comply with applicable tax, accounting and other regulatory requirements. Those requirements, rather than this Act, are the proper source of guidance for that profit and loss allocation.

Section 503. Sharing Of Distributions

A distribution by a limited partnership must be shared among the partners on the basis of the value, as stated in the required records when the limited partnership decides to make the distribution, of the contributions the limited partnership has received from each partner.
B. INTERIM DISTRIBUTIONS

Under RULPA § 504, a partner does not have a right to any distribution before the dissolution and winding up of the limited partnership unless the limited partnership decides to make an interim distribution. Likewise, RULPA § 505 provides that a partner does not have a general right to receive a distribution on account of dissociation. However, RULPA Sections 603 and 604 permitted a limited partner to withdraw on six months notice and receive the fair value of the limited partnership interest, unless the partnership agreement provided the limited partner with some exit right or stated a definite duration for the limited partnership.

C. DISTRIBUTIONS IN-KIND

Both the UPA and the RULPA provide that a partner does not have the right to receive and may not be required to accept in-kind distributions. This rule is complemented in the UPA by a provision which provides that, in winding up the partnership business upon dissolution, any surplus after the payment of partnership obligations must be applied to pay in cash the net amount distributable to each partner.

D. TRANSFER OF DISTRIBUTIONAL RIGHTS

While both the UPA and the RULPA prohibit a partner from transferring his partnership interest without the consent of the other partners, a partner is almost always free to transfer his or her right to receive distributions.

For example, UPA § 507 provides: “When a partner or transferee becomes entitled to receive a distribution, the partner or transferee has the status of, and is entitled to all remedies available to, a creditor of the limited partnership with respect to the distribution. However, the limited partnership's obligation to make a distribution is subject to offset for any amount owed to the limited partnership by the partner or dissociated partner on whose account the distribution is made.”

E. LIMITATIONS ON DISTRIBUTIONS

Even when authorized by default provisions or by a specific provision of a partnership agreement, there are circumstances in which making a distribution is wrongful. RULPA § 508 is illustrative of a common state law treatment of this issue:

Section 508. Limitations On Distribution

(a) A limited partnership may not make a distribution in violation of the partnership agreement.

(b) A limited partnership may not make a distribution if after the distribution:
(1) the limited partnership would not be able to pay its debts as they become due in the ordinary course of the limited partnership's activities; or
(2) the limited partnership's total assets would be less than the sum of its total liabilities plus the amount that would be needed, if the limited partnership were to be dissolved, wound up, and terminated at the time of the distribution, to satisfy the preferential rights upon dissolution, winding up, and termination of partners whose preferential rights are superior to those of persons receiving the distribution.

(c) A limited partnership may base a determination that a distribution is not prohibited under subsection (b) on financial statements prepared on the basis of accounting practices and principles that are reasonable in the circumstances or on a fair valuation or other method that is reasonable in the circumstances.

(d) Except as otherwise provided in subsection (g), the effect of a distribution under subsection (b) is measured:
(1) in the case of distribution by purchase, redemption, or other acquisition of a transferable interest in the limited partnership, as of the date money or other property is transferred or debt incurred by the limited partnership; and
(2) in all other cases, as of the date:
(A) the distribution is authorized, if the payment occurs within 120 days after that date; or
(B) the payment is made, if payment occurs more than 120 days after the distribution is authorized.

(e) A limited partnership's indebtedness to a partner incurred by reason of a distribution made in accordance with this section is at parity with the limited partnership's indebtedness to its general, unsecured creditors.

(f) A limited partnership's indebtedness, including indebtedness issued in connection with or as part of a distribution, is not considered a liability for purposes of subsection (b) if the terms of the indebtedness provide that payment of principal and interest are made only to the extent that a distribution could then be made to partners under this section.

(g) If indebtedness is issued as a distribution, each payment of principal or interest on the indebtedness is treated as a distribution, the effect of which is measured on the date the payment is made.

RULPA § 509 imposes liability on partners for making improper distributions under certain circumstances:

**Section 509. Liability for Improper Distributions**

(a) A general partner that consents to a distribution made in violation of Section 508 is personally liable to the limited partnership for the amount of the distribution which exceeds the amount that could have been distributed without the violation if it is established that in consenting to the distribution the general partner failed to comply with Section 408.

(b) A partner or transferee that received a distribution knowing that the distribution to that partner or transferee was made in violation of Section 508 is personally liable to the limited partnership but only to the extent that the distribution received by the partner or transferee exceeded the amount that could have been properly paid under Section 508.
(c) A general partner against which an action is commenced under subsection (a) may:
(1) implead in the action any other person that is liable under subsection (a) and compel contribution from the person; and
(2) implead in the action any person that received a distribution in violation of subsection (b) and compel contribution from the person in the amount the person received in violation of subsection (b).

(d) An action under this section is barred if it is not commenced within two years after the distribution.

A limited partnership's failure to meet the standard of § 508(c) cannot by itself cause a general partner to be liable under § 509(a). Both of the following would have to occur before a failure to satisfy § 508(c) could result in personal liability for a general partner under § 509(a):

- The limited partnership "base[s] a determination that a distribution is not prohibited . . . on financial statements prepared on the basis of accounting practices and principles that are [not] reasonable in the circumstances or on a [not] fair valuation or other method that is [not] reasonable in the circumstances" [§ 508(c)]; and
- The general partner's decision to rely on the improper methodology in consenting to the distribution constitutes "grossly negligent or reckless conduct, intentional misconduct, or a knowing violation of law" [§ 408(c)] or breaches some other duty under § 408.

To serve the protective purpose of §§ 508 and 509, in this subsection "consent" must be understood as encompassing any form of approval, assent or acquiescence, whether formal or informal, express or tacit.

III. Taxation of Partnership Distributions

A. DEFINING “DISTRIBUTION”

The various types of partnerships discussed earlier in this course generally do not affect taxation issues. This section will therefore deal with partnerships as a whole. For purposes of taxation, partnership distributions include the following:

- A withdrawal by a partner in anticipation of the current year's earnings;
- A distribution of the current year's or prior years' earnings not needed for working capital;
- A complete or partial liquidation of a partner's interest; and
- A distribution to all partners in a complete liquidation of the partnership.

A partnership distribution is not taken into account in determining the partner's distributive share of partnership income or loss. If any gain or loss from the distribution is recognized by the partner, it must be reported on his or her return for the tax year in which the distribution is received. Money or property withdrawn by a partner in
anticipation of the current year's earnings is treated as a distribution received on the last day of the partnership's tax year.

A partner's adjusted basis in his or her partnership interest is decreased (but not below zero) by the money and adjusted basis of property distributed to the partner. A partnership generally does not recognize any gain or loss because of distributions it makes to partners. The partnership may be able to elect to adjust the basis of its undistributed property.

B. DISTRIBUTIONS TREATED AS SALE OR EXCHANGE

When a partnership distributes the following items, the distribution may be treated as a sale or exchange of property rather than a distribution:

- Unrealized receivables or substantially appreciated inventory items distributed in exchange for any part of the partner's interest in other partnership property, including money; or

- Other property (including money) distributed in exchange for any part of a partner's interest in unrealized receivables or substantially appreciated inventory items.

This treatment does not apply to the following distributions:

- A distribution of property to the partner who contributed the property to the partnership; and

- Payments made to a retiring partner or successor in interest of a deceased partner that are the partner's distributive share of partnership income or guaranteed payments.

C. SUBSTANTIALLY APPRECIATED INVENTORY

Inventory items of the partnership are considered to have appreciated substantially in value if, at the time of the distribution, their total fair market value is more than 120% of the partnership's adjusted basis for the property. However, if a principal purpose for acquiring inventory property is to avoid ordinary income treatment by reducing the appreciation to less than 120%, that property is excluded.

D. PARTNER'S GAIN OR LOSS

A partner generally recognizes gain on a partnership distribution only to the extent any money (and marketable securities treated as money) included in the distribution exceeds the adjusted basis of the partner's interest in the partnership. Any gain recognized is generally treated as capital gain from the sale of the partnership interest on the date of the distribution. If partnership property (other than marketable securities treated as money) is distributed to a partner, he or she generally does not recognize any gain until the sale or other disposition of the property.
Example.

The adjusted basis of Jo's partnership interest is $14,000. She receives a distribution of $8,000 cash and land that has an adjusted basis of $2,000 and a fair market value of $3,000. Because the cash received does not exceed the basis of her partnership interest, Jo does not recognize any gain on the distribution. Any gain on the land will be recognized when she sells or otherwise disposes of it. The distribution decreases the adjusted basis of Jo's partnership interest to $4,000 [$14,000 - ($8,000 + $2,000)].

1. Marketable Securities Treated as Money

Generally, a marketable security distributed to a partner is treated as money in determining whether gain is recognized on the distribution. This treatment, however, does not generally apply if that partner contributed the security to the partnership or an investment partnership made the distribution to an eligible partner.

The amount treated as money is the security's fair market value when distributed, reduced (but not below zero) by the excess (if any) of:

- The partner's distributive share of the gain that would be recognized had the partnership sold all its marketable securities at their fair market value immediately before the transaction resulting in the distribution, over

- The partner's distributive share of the gain that would be recognized had the partnership sold all such securities it still held after the distribution at the fair market value as described immediately above.

More information on this issue, including the definition of marketable securities, can be found by reviewing § 731(c) of the Internal Revenue Code.

2. Loss on Distribution

Subject to a few exceptions, a partner does not recognize loss on a partnership distribution unless all of the following requirements are met:

- The adjusted basis of the partner's interest in the partnership exceeds the distribution;

- The partner's entire interest in the partnership is liquidated; and

- The distribution is in money, unrealized receivables, or inventory items.

3. Distribution of Partner's Debt

If a partnership acquires a partner's debt and extinguishes the debt by distributing it to the partner, the partner will recognize capital gain or loss to the extent the fair market value of the debt differs from the basis of the debt.
The partner is treated as having satisfied the debt for its fair market value. If the issue price (adjusted for any premium or discount) of the debt exceeds its fair market value when distributed, the partner may have to include the excess amount in income as canceled debt. Similarly, a deduction may be available to a corporate partner if the fair market value of the debt at the time of distribution exceeds its adjusted issue price.

4. Net Pre- Contribution Gain

A partner generally must recognize gain on the distribution of property (other than money) if the partner contributed appreciated property to the partnership during the 7-year period before the distribution. A 5-year period applies to property contributed before June 9, 1997, or under a written binding contract:

- That was in effect on June 8, 1997, and at all times thereafter before the contribution, and
- That provides for the contribution of a fixed amount of property.

The gain recognized is the lesser of the following amounts:

- The excess of:
  - The fair market value of the property received in the distribution, over
  - The adjusted basis of the partner's interest in the partnership immediately before the distribution, reduced (but not below zero) by any money received in the distribution.

- The "net pre-contribution gain" of the partner. This is the net gain the partner would recognize if all the property contributed by the partner within seven years (five years for property contributed before June 9, 1997) of the distribution, and held by the partnership immediately before the distribution, were distributed to another partner, other than a partner who owns more than 50% of the partnership.

The character of the gain is determined by reference to the character of the net pre-contribution gain. This gain is in addition to any gain the partner must recognize if the money distributed is more than his or her basis in the partnership. For these rules, the term "money" includes marketable securities treated as money.

5. Effect on Basis

The adjusted basis of the partner's interest in the partnership is increased by any net pre-contribution gain recognized by the partner. Other than for purposes of determining the gain, the increase is treated as occurring immediately before the distribution.

The partnership must adjust its basis in any property the partner contributed within seven years (five years for property contributed before June 9, 1997) of the distribution to reflect any gain that partner recognizes under this rule.
Any part of a distribution that is property the partner previously contributed to the partnership is not taken into account in determining the amount of the excess distribution or the partner's net pre-contribution gain. For this purpose, the partner's previously contributed property does not include a contributed interest in an entity to the extent its value is due to property contributed to the entity after the interest was contributed to the partnership.

Recognition of gain under this rule also does not apply to a distribution of unrealized receivables or substantially appreciated inventory items if the distribution is treated as a sale or exchange, as discussed earlier.

6. Partner's Basis for Distributed Property

Unless there is a complete liquidation of a partner's interest, the basis of property (other than money) distributed to the partner by a partnership is its adjusted basis to the partnership immediately before the distribution. However, the basis of the property to the partner cannot be more than the adjusted basis of his or her interest in the partnership reduced by any money received in the same transaction.

**Example 1.**

The adjusted basis of Beth's partnership interest is $30,000. She receives a distribution of property that has an adjusted basis of $20,000 to the partnership and $4,000 in cash. Her basis for the property is $20,000.

**Example 2.**

The adjusted basis of Mike's partnership interest is $10,000. He receives a distribution of $4,000 cash and property that has an adjusted basis to the partnership of $8,000. His basis for the distributed property is limited to $6,000 ($10,000 - $4,000, the cash he receives).

a. Complete liquidation of partner's interest

The basis of property received in complete liquidation of a partner's interest is the adjusted basis of the partner's interest in the partnership reduced by any money distributed to the partner in the same transaction.

b. Partner's holding period

A partner's holding period for property distributed to the partner includes the period the property was held by the partnership. If the property was contributed to the partnership by a partner, then the period it was held by that partner is also included.

c. Basis divided among properties

If the basis of property received is the adjusted basis of the partner's interest in the partnership (reduced by money received in the same transaction), it must be divided among the properties distributed to the partner. For property distributed after August 5, 1997, allocate the basis using the following rules.
Allocate the basis first to unrealized receivables and inventory items included in the distribution by assigning a basis to each item equal to the partnership's adjusted basis in the item immediately before the distribution. If the total of these assigned bases exceeds the allocable basis, decrease the assigned bases by the amount of the excess.

Allocate any remaining basis to properties other than unrealized receivables and inventory items by assigning a basis to each property equal to the partnership's adjusted basis in the property immediately before the distribution. If the allocable basis exceeds the total of these assigned bases, increase the assigned bases by the amount of the excess. If the total of these assigned bases exceeds the allocable basis, decrease the assigned bases by the amount of the excess.

d. Allocating a basis increase

Allocate any basis increase required in rule (2), above, first to properties with unrealized appreciation to the extent of the unrealized appreciation. (If the basis increase is less than the total unrealized appreciation, allocate it among those properties in proportion to their respective amounts of unrealized appreciation.) Allocate any remaining basis increase among all the properties in proportion to their respective fair market values.

Example.

Julie’s basis in her partnership interest is $55,000. In a distribution in liquidation of her entire interest, she receives properties A and B, neither of which is inventory or unrealized receivables. Property A has an adjusted basis to the partnership of $5,000 and a fair market value of $40,000. Property B has an adjusted basis to the partnership of $10,000 and a fair market value of $10,000.

To figure her basis in each property, Julie first assigns bases of $5,000 to property A and $10,000 to property B (their adjusted bases to the partnership). This leaves a $40,000 basis increase (the $55,000 allocable basis minus the $15,000 total of the assigned bases). She first allocates $35,000 to property A (its unrealized appreciation). The remaining $5,000 is allocated between the properties based on their fair market values. $4,000 ($40,000/$50,000) is allocated to property A and $1,000 ($10,000/$50,000) is allocated to property B. Julie’s basis in property A is $44,000 ($5,000 + $35,000 + $4,000) and her basis in property B is $11,000 ($10,000 + $1,000).

e. Allocating a basis decrease

Use the following rules to allocate any basis decrease required in rule (1) or rule (2), earlier.

Allocate the basis decrease first to items with unrealized depreciation to the extent of the unrealized depreciation. (If the basis decrease is less than the total unrealized depreciation, allocate it among those items in proportion to their respective amounts of unrealized depreciation.)
Allocate any remaining basis decrease among all the items in proportion to their respective assigned basis amounts (as decreased in (1)).

Example.

Tom's basis in his partnership interest is $20,000. In a distribution in liquidation of his entire interest, he receives properties C and D, neither of which is inventory or unrealized receivables. Property C has an adjusted basis to the partnership of $15,000 and a fair market value of $15,000. Property D has an adjusted basis to the partnership of $15,000 and a fair market value of $5,000.

To figure his basis in each property, Tom first assigns bases of $15,000 to property C and $15,000 to property D (their adjusted bases to the partnership). This leaves a $10,000 basis decrease (the $30,000 total of the assigned bases minus the $20,000 allocable basis). He allocates the entire $10,000 to property D (its unrealized depreciation). Tom's basis in property C is $15,000 and his basis in property D is $5,000 ($15,000 - $10,000).

f. Distributions before August 6, 1997

For property distributed before August 6, 1997, allocate the basis using the following rules:

- Allocate the basis first to unrealized receivables and inventory items included in the distribution to the extent of the partnership's adjusted basis in those items. If the partnership's adjusted basis in those items exceeded the allocable basis, allocate the basis among the items in proportion to their adjusted bases to the partnership; and

- Allocate any remaining basis to other distributed properties in proportion to their adjusted bases to the partnership.

g. Partner's interest more than partnership basis

If the basis of a partner's interest to be divided in a complete liquidation of the partner's interest is more than the partnership's adjusted basis for the unrealized receivables and inventory items distributed, and if no other property is distributed to which the partner can apply the remaining basis, the partner has a capital loss to the extent of the remaining basis of the partnership interest.

h. Special adjustment to basis

A partner who acquired any part of his or her partnership interest in a sale or exchange or upon the death of another partner may be able to choose a special basis adjustment for property distributed by the partnership. To choose the special adjustment, the partner must have received the distribution within 2 years after acquiring the partnership interest. Also, the partnership must not have chosen the optional adjustment to basis, discussed later.
If a partner chooses this special basis adjustment, the partner's basis for the property distributed is the same as it would have been if the partnership had chosen the optional adjustment to basis. However, this assigned basis is not reduced by any depletion or depreciation that would have been allowed or allowable if the partnership had previously chosen the optional adjustment.

The choice must be made with the partner's tax return for the year of the distribution if the distribution includes any property subject to depreciation, depletion, or amortization. If the choice does not have to be made for the distribution year, it must be made with the return for the first year in which the basis of the distributed property is pertinent in determining the partner's income tax.

A partner choosing this special basis adjustment must attach a statement to his or her tax return that the partner chooses under § 732(d) of the Internal Revenue Code to adjust the basis of property received in a distribution. The statement must show the computation of the special basis adjustment for the property distributed and list the properties to which the adjustment has been allocated.

**Example.**

*Bob purchased a 25% interest in X partnership for $17,000 cash. At the time of the purchase, the partnership owned inventory having a basis to the partnership of $14,000 and a fair market value of $16,000. Thus, $4,000 of the $17,000 he paid was attributable to his share of inventory with a basis to the partnership of $3,500.*

*Within 2 years after acquiring his interest, Bob withdrew from the partnership and for his entire interest received cash of $1,500, inventory with a basis to the partnership of $3,500, and other property with a basis of $6,000. The value of the inventory received was 25% of the value of all partnership inventory. (It is immaterial whether the inventory he received was on hand when he acquired his interest.)*

*Since the partnership from which Bob withdrew did not make the optional adjustment to basis, he chose to adjust the basis of the inventory received. His share of the partnership's basis for the inventory is increased by $500 (25% of the $2,000 difference between the $16,000 fair market value of the inventory and its $14,000 basis to the partnership at the time he acquired his interest). The adjustment applies only for purposes of determining his new basis in the inventory, and not for purposes of partnership gain or loss on disposition.*

*The total to be allocated among the properties Bob received in the distribution is $15,500 ($17,000 basis of his interest - $1,500 cash received). His basis in the inventory items is $4,000 ($3,500 partnership basis + $500 special adjustment). The remaining $11,500 is allocated to his new basis for the other property he received.*
7. Mandatory adjustment

A partner does not always have a choice of making this special adjustment to basis. The special adjustment to basis must be made for a distribution of property, (whether or not within 2 years after the partnership interest was acquired) if all the following conditions existed when the partner received the partnership interest.

- The fair market value of all partnership property (other than money) was more than 110% of its adjusted basis to the partnership;

- If there had been a liquidation of the partner’s interest immediately after it was acquired, an allocation of the basis of that interest under the general rules (discussed earlier under Basis divided among properties) would have decreased the basis of property that could not be depreciated, depleted, or amortized and increased the basis of property that could be; or

- The optional basis adjustment, if it had been chosen by the partnership, would have changed the partner’s basis for the property actually distributed.

a. Required statement

Generally, if a partner chooses a special basis adjustment and notifies the partnership, or if the partnership makes a distribution for which the special basis adjustment is mandatory, the partnership must provide a statement to the partner. The statement must provide information necessary for the partner to compute the special basis adjustment.

IV. Limited Liability Companies

A. DISTRIBUTIONS

1. Pre-Dissolution Distributions

Pre-dissolution distributions (also known as “interim distributions”) are governed by a company’s own operating agreement. Arizona law, for example, § 29-703, provides that “a limited liability company shall make distributions of cash or other property to its members before the dissolution and winding up of the limited liability company to the extent and at the times or on the occurrence of the events specified in an operating agreement.”
Table 6.2 Summary of LLC Member’s Rights to Distributions

<table>
<thead>
<tr>
<th>Member Interest</th>
<th>Rule</th>
</tr>
</thead>
<tbody>
<tr>
<td>Timing of Distributions</td>
<td>Made at times provided in the entity’s operating agreement</td>
</tr>
<tr>
<td>Amount of Distributions</td>
<td>Determined by formula set forth in company’s operating agreement or, in the absence thereof, applicable state default provisions</td>
</tr>
<tr>
<td>Type of Distributions</td>
<td>Normally cash only; no right to demand “in-kind” distributions unless expressly provided in operating agreement</td>
</tr>
<tr>
<td>Transferability of Rights to Distributions</td>
<td>Members are free to transfer or assign their right to distributions without consent of other members unless expressly prohibited</td>
</tr>
</tbody>
</table>

a. Formula for calculating amount of distributions

Members of a limited liability company are free to split profits based on any formula they select. A company that has its own formula for profit-sharing will generally include it as part of their written Articles of Organization or operating agreement. As with most other aspects of limited liability companies, however, each state has a "default" rule that governs how profits are distributed to members in the absence of a specific provision in the company's operating agreement. States generally take one of two approaches in their default rule:

- Members receive distributions in proportion to the contribution they made to the company; or
- Members share equally in the profits of the company, regardless of the specific financial contribution of each member.

The latter is the approach taken by the Uniform Limited Liability Company Act, § 405, which provides, in part, that "any distributions made by a limited liability company before its dissolution and winding up must be in equal shares.” This is the same approach that is taken in default rules governing distributions of a partnership.

The drafters of the ULLCA explain the rationale for their default provision in the Comment to § 405, which provides:

“Recognizing the informality of many limited liability companies, this section creates a simple default rule regarding interim distributions. Any interim distributions made must be in equal shares and approved by all members. The rule assumes that: profits will be shared equally; some distributions will constitute a return of contributions that should be shared equally rather than a distribution of profits; and property contributors should have the right to veto any distribution that threatens their return of contributions on liquidation. In the simple case where the members make
equal contributions of property or equal contributions of services, those assumptions avoid the necessity of maintaining a complex capital account or determining profits. Where some members contribute services and others property, the unanimous vote necessary to approve interim distributions protects against unwanted distributions of contributions to service contributors. Consistently, Section 408(a) does not require the company to maintain a separate account for each member, the Act does not contain a default rule for allocating profits and losses, and Section 806(b) requires that liquidating distributions to members be made in equal shares after the return of contributions not previously returned.”

When a contribution is made in cash, valuation is not an issue. When a contribution is made in some other form, however, such as real property, there can sometimes be an issue as to the distributive share that a member should receive. In such cases, if the company’s operating agreement fails to provide guidance, look to see whether the state of organization provides some formula for determining value.

The following general rules should be applied to non-cash contributions in the absence of any other statutory guidance:

- The value of a capital contribution of services is the fair market value of the services at the time they are rendered;
- The value of a capital contribution of property other than cash is the fair market value of the property at the time of its transfer to the limited liability company; and
- The value of a capital contribution of the use of property is the fair market value of the use of the property during the period that the limited liability company enjoyed possession or use of the property.

b. Limitations on distributions

ULLCA § 406 governs distributions declared or made when the company is insolvent. It provides that distributions may NOT be made in the following circumstances:

- The limited liability company would not be able to pay its debts as they become due in the ordinary course of business; or
- The company's total assets would be less than the sum of its total liabilities plus the amount that would be needed, if the company were to be dissolved, wound up, and terminated at the time of the distribution, to satisfy the preferential rights upon dissolution, winding up, and termination of members whose preferential rights are superior to those receiving the distribution.

ULLCA § 406 further provides the methods that can be used to determine financial insolvency, stating that the company can base its findings "on financial statements prepared on the basis of accounting practices and principles that are reasonable in the circumstances or on a fair valuation or other method that is reasonable in the circumstances."
The Comment to ULLCA § 406 recognizes special accounting problems that can be associated with the timing of a distribution, and provides, in part, as follows:

“The application of the equity insolvency and balance sheet tests present special problems in the context of the purchase, redemption, or other acquisition of a company’s distributional interests. Special rules establish the time of measurement of such transfers. Under Section 406(c)(1), the time for measuring the effect of a distribution to purchase a distributional interest is the date of payment. The company may make payment either by transferring property or incurring a debt to transfer property in the future. In the latter case, subsection (c)(1) establishes a clear rule that the legality of the distribution is tested when the debt is actually incurred, not later when the debt is actually paid. Under Section 406(e), indebtedness is not considered a liability for purposes of subsection (a) if the terms of the indebtedness itself provide that payments can be made only if and to the extent that a payment of a distribution could then be made under this section. The effect makes the holder of the indebtedness junior to all other creditors but senior to members in their capacity as members.”

In determining whether a company was able to make a distribution, the effect of the distribution is normally measured as of the date on which the money or other property is transferred, or indebtedness payable in installments or otherwise is incurred, by the limited liability company. Other, more specific formulas may be provided in applicable state law.

c. Effect of wrongful distributions

The personal liability of members of a limited liability company was discussed in detail in Chapter 5. The general rule is that a member of a limited liability company is not personally liable for the debts of the company except in certain limited circumstances. One circumstance, however, in which a member can face personal liability is in the event he or she participates in an unlawful distribution of company assets. In such a case, the member becomes liable to the company as a whole rather than a third party.

As usual, refer to the specific laws of each state to determine the precise circumstances under which a member will be personally liable. Under Michigan law, for example, a member or manager who assents to or votes for a wrongful distribution is personally liable to the company for the amount of any distribution that exceeds that which could have been made lawfully under their state law or the company’s own operating agreement (M.C.L.A. §450.4308).

Michigan law assumes that any member or manager who participates in a decision to approve a distribution has knowledge that the distribution is wrongful. This legal presumption can only be overcome if the member or manager files a written dissent with the limited liability company within a reasonable period of time. Members who accept a distribution with knowledge that it was improper are also liable for the amount that exceeds the amount they were legally entitled to receive.
The rules under the Uniform Limited Liability Company Act, § 407, are similar. The Comment to § 407 provides that only the company itself, not its creditors, have a right to recovery in the event of a wrongful dissolution. This section also provides that members who both vote for or assent to an unlawful distribution and receive a portion or all of the distribution will be liable, at the election of the company, under either but not both subsections.

A member who is held liable for an unlawful distribution will normally be able, under applicable state law, to seek a contribution from other offending members. Florida law, for example, F.S.A. § 608.426, provides:

(1) The limited liability company may make distributions to its members in accordance with the provisions contained in the operating agreement, except that no distribution may be made if after the distribution the limited liability company would be insolvent. If the operating agreement does not provide for the payment of distributions to members, the distributions shall be made on the basis of the agreed value, as stated in the records of the limited liability company, of the contributions made by each member to the extent they have been received by the limited liability company and have not been returned.

(2) The managers or managing members of a limited liability company may base a determination that a distribution is not prohibited under subsection (1) either on financial statements prepared on the basis of accounting practices and principles that are reasonable in the circumstances or on a fair valuation or other method that is reasonable in the circumstances. In the case of any distribution based upon such financial statement or such a valuation, each such distribution shall be identified as a distribution based upon such financial statements or a fair valuation of assets, and the amount distributed shall be disclosed to the receiving members concurrent with their receipt of the distribution.

(3) A manager or managing member who votes for or assents to a distribution made in violation of this section, the articles of incorporation, or the operating agreement, is personally liable to the limited liability company for the amount of the distribution that exceeds what could have been distributed without such violation if it is established that the manager or managing member did not perform the manager's or managing member's duties in compliance with s. 608.4225. In any proceeding commenced under this section, a manager or managing member has all of the defenses ordinarily available to a manager or managing member.

(4) A manager or managing member held liable under subsection (3) for an unlawful distribution is entitled to contribution:

(a) From every other manager or managing member who is also liable under subsection (3) for the unlawful distribution; and

(b) From each member to the extent of the amount the member accepted knowing the distribution was made in violation of this section, the articles of incorporation, or the operating agreement.

(5) A proceeding under this section is barred unless it is commenced within 2 years after the date on which the distribution was made. In the case of a distribution in the form of indebtedness, each payment of principal or interest is treated as a distribution.
Case-in-Point

A recent case dealing with liability for an improper distribution was *Imperial Trading Co., Inc. v. Uter*, 837 So.2d 663 (2002), in which a member of an LLC was found personally liable for the return of improper distributions to his wife.

In 1992, Wayne Bunch and Thomas Harmon were operating several Tobacco Mart stores in Louisiana. Each of their stores was a separately organized legal entity, but seemingly all worked under the guise of Tobacco Mart, Inc. Many of the products sold by these Tobacco Mart stores were supplied by the plaintiff, Imperial Trading Company, Inc. In dealing with Imperial, Bunch and Harmon were required to personally guarantee amounts owed on open account. Attorney Michael J. Uter (Uter) represented Bunch and Harmon in the organization of their Tobacco Mart entities.

Being intrigued by the opportunity for success in operating additional tobacco stores, in 1992, Uter contacted Jack Menzie, whom he had represented in several real estate transactions in the past, about the idea of opening additional Tobacco Mart locations in Louisiana and other states. Menzie and his wife, Connie S. Menzie, agreed to inject money into the proposed venture. Later that year, Ms. Menzie contributed $113,244.71 to the venture.

On advice of their accountant, Uter organized the ownership of these stores through limited liability companies, rather than individual corporations. Articles of organization and an initial report were prepared by Uter and filed with the secretary of state's office. Each of the articles of organization indicated that a written operating agreement was executed contemporaneously with it. In the initial reports for these organizations, Uter was listed as the registered agent for service of process and the initial manager. Tax returns disclosed ownership of Vidalia L.L.C. and Mississippi L.L.C. in Bunch (12.5 percent), Harmon (12.5 percent), Ms. Menzie (36.5 percent), Brennan Uter (36.5 percent), Menzie (1 percent), and Uter (1 percent).

Subsequently, Uter and Menzie were introduced to Imperial's president by Bunch and Harmon. In light of Bunch and Harmon's recommendation that Imperial do business with Uter and Menzie and considering the potential for profit, Imperial established a line of credit in the amount of $50,000 for the purchase of products for several Tobacco Mart stores.

The indebtedness associated with these lines of credit was evidenced by separate promissory notes signed by Uter and Menzie, in a dual capacity, individually and on behalf of the specified store. Security was given for the payment of these notes by a general security agreement also executed by Uter and Menzie in a dual capacity. Imperial supplied tobacco to 14 different stores in Louisiana, Mississippi and Tennessee.

In the summer of 1994, Uter was contacted by an Imperial representative regarding the payment on their open accounts and the possible termination of delivery of products. Around that same time, Menzie and Ms. Menzie decided they would withdraw from the businesses because of the financial status of the businesses. In June 1994, Ms. Menzie withdrew $263,852.48 from various Tobacco Mart checking accounts, which she asserted was a return of her investment and/or repayment of the loans she had made to the venture, with eight percent interest.
The assets of some of the stores were sold later that year to help pay the debt to Imperial. Imperial began making deliveries on a C.O.D. basis only until the parties were able to reach an agreement on repayment.

Imperial eventually filed suit seeking recovery for unpaid balances on their account. In addition to finding the company liable for the open book account, the court found that the payments in 1994 to Ms. Menzie left the company unable to meet its financial obligations and therefore constituted a violation of state law. It therefore ordered a return of the money.

Relative to interim distributions, LSA-R.S. 12:1324 provides:

A. Except as provided in this Chapter, a member is entitled to receive distributions from a limited liability company before the withdrawal of the member from the limited liability company and before the dissolution and winding up of the limited liability company to the extent and at the times or upon the occurrence of the events provided in an operating agreement or as authorized by the members.

B. Interim distribution 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 a written operating agreement. To the extent such operating agreement does not so provide in writing, distributions shall be made equally to the members.

However, restrictions are placed on the making of any distributions by LSA-R.S. 12:1327(A), which provides:

No distribution shall be made if, after giving effect to the distribution:

(1) The limited liability company would not be able to pay its debts as they become due in the usual course of business.

(2) The limited liability company's total assets would be less than the sum of its total liabilities plus, unless the articles of organization or a written operating agreement provides otherwise, 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.

The court therefore found the distribution to be in violation of state law. The court also found Mr. Menzie to be jointly liable for the return of the illegal distribution based on LSA-R.S. 12:1328, which imposes joint and several liability on the members or managers of a limited liability company who knowingly, or without the exercise of reasonable care and inquiry, vote for or assent to a distribution in violation of LSA-R.S. 12:1327. Such liability falls on each member, if management is reserved to the members, or each manager, if management is vested in one or more managers.

Although the record does not reveal a knowing violation of the statute, the court said it reasonably supports a finding that such distributions were made without the exercise of reasonable care and inquiry as to whether they were wrongful, as defined by the statute.
d. Transferability of distributional interest

While members of a limited liability company do not have an interest in any of the specific assets of the company, they do have an interest in the distributions to which they are entitled as members. This interest is the personal property of the member and therefore is freely transferable – absent a contrary provision in the company’s articles of organization or operating agreement – under the ULLCA, § 501, as well as the laws of all states.

Remember that while a member normally enjoys the right to transfer, assign or otherwise dispose of their right to the distributions of a limited liability company in which they are a member, they normally do not have such liberal rights to transfer their actual membership in the company.

Florida law, for example, F.S.A. § 608.432, provides, in part:

(1) A limited liability company interest is assignable in whole or in part except as provided in the articles of organization or operating agreement. The assignee of a member's interest shall have no right to participate in the management of the business and affairs of a limited liability company except as provided in the articles of organization or operating agreement and upon:

(a) The approval of all of the members of the limited liability company other than the member assigning the limited liability company interest; or

(b) Compliance with any procedure provided for in the articles of organization or operating agreement.

(2) Unless otherwise provided in the articles of organization or operating agreement:

(a) An assignment of a membership interest does not entitle the assignee to become or to exercise any rights or powers of a member;

(b) An assignment of a membership interest entitles the assignee to share in such profits and losses, to receive such distribution or distributions, and to receive such allocation of income, gain, loss, deduction, or credit or similar item to which the assignor was entitled, to the extent assigned.

e. In kind distributions

States normally do not allow a member of a limited liability company to demand an in kind distribution unless expressly provided in the company’s operating agreement. This is consistent with the concept of a limited liability company as an entity. This is also consistent with the rules for limited partnerships.

The limitation on the right to demand in kind distributions applies normally regardless of what type of contribution was made by a member to the company (e.g. Pennsylvania Statutes § 8934, provides: “A member, regardless of the nature of the contribution of the member, has no right to demand and receive any distribution from a limited liability company in any form other than cash.”)
2. Treatment Of Excess Contributions

In the event a member of a limited liability company provides an advance to the company in an amount greater than the amount of contribution agreed upon, the company is liable to the member for the difference. This amount is often treated as a loan, and therefore requires the company to pay the member interest accruing from the date the payment was made.

On the other hand, members are normally not entitled to compensation for their personal services performed for the benefit of the company, other than those performed in winding up the company's business, except as otherwise provided in the entity's operating agreement.

3. Post-Dissolution Distributions

When a limited liability company either chooses to or is forced to dissolve, e.g. through judicial or administrative action, the assets of the company must be disposed of. The issue of dissolution will be discussed in more detail in Chapter 10. This discussion focuses on the distribution of assets only.

When a limited liability company winds up its business, all creditors – including members who are creditors – must be paid before distributions can be made to members. Any remaining assets are then distributed according to each member's general rights to distributions as provided in the company's operating agreement or the applicable state's default provisions.

B. FEDERAL TAX TREATMENT OF DISTRIBUTIONS

For federal tax purposes, a limited liability company can be treated either as a sole proprietorship, a partnership or a corporation. In order to elect treatment as a partnership, a limited liability company must have at least two members. Those with only one can elect to be treated either as a sole proprietorship or a corporation.

Consequently, the applicable tax payment requirements of a limited liability company – as discussed above – depend on the tax treatment elected by the company. To the extent that a limited liability company elects to be treated as a partnership for purposes of federal taxation, normal rules governing taxation of partnerships discussed earlier in this chapter apply. To the extent a limited liability company elects to be treated as a corporation for purposes of federal taxation, normal rules governing taxation of corporations likewise generally apply.

Each LLC member's share of profits and losses, called a distributive share, is set out in the LLC operating agreement. Most operating agreements provide that a member's distributive share is in proportion to his percentage interest in the business. For instance, if Bill owns 70% of the LLC, and John owns the other 30%, Bill will be entitled to 70% of the LLC's profits and losses, and John will be entitled to the other 30%. If the members want to divide profits and losses in a manner that is not proportionate to the members' percentage interests in the business, it is called a "special allocation," and must comply with specific IRS rules.
Distributions to equity owners of businesses taxed as partnerships are normally not subject to income tax pursuant to IRC § 731, which provides, in part, that “gain shall not be recognized . . . except to the extent that any money distributed exceeds the adjusted basis of such partner’s interest in the partnership immediately before the distribution.”

Any gain recognized is generally treated as capital gain from the sale of the partnership interest on the date of the distribution. If partnership property (other than marketable securities treated as money) is distributed to a partner, he or she generally does not recognize any gain until the sale or other disposition of the property.

**Example.**

The adjusted basis of Jo's partnership interest is $14,000. She receives a distribution of $8,000 cash and land that has an adjusted basis of $2,000 and a fair market value of $3,000. Because the cash received does not exceed the basis of her partnership interest, Jo does not recognize any gain on the distribution. Any gain on the land will be recognized when she sells or otherwise disposes of it. The distribution decreases the adjusted basis of Jo’s partnership interest to $4,000 [$14,000 - ($8,000 + $2,000)].

Likewise, I.R.C. §731 provides that a member of a limited liability company may not declare a loss “except that upon a distribution in liquidation of a partner's interest in a partnership where no property other than that described in subparagraph (A) or (B) is distributed to such partner, loss shall be recognized to the extent of the excess of the adjusted basis of such partner's interest in the partnership over the sum of: (A) any money distributed; and (B) the basis to the distributee.”

In addition, passive activity limitations and at-risk rules that apply to partnerships generally may restrict the amount a member of a limited liability company may deduct.

1. **At-Risk Rules**

The at risk rules of I.R.C. § 465 provide that the members are allowed to deduct their shares of LLC losses to the extent they have an adequate amount at risk in the relevant activity. Generally, nonrecourse debt is not included in the amount at risk, but an exception exists for "qualified nonrecourse financing," which typically exists when a commercial lender makes a nonrecourse loan secured by real property.

Unlike a limited partnership in which the general partner is fully liable for partnership obligations, in an LLC no member may be liable for the LLC's obligations (except to the extent a member has separately agreed to assume them). Accordingly, even if the debt of an LLC is nominally recourse at the entity level, it may be nonrecourse to the members, thereby making it easier for LLC debt secured by real property to constitute "qualified nonrecourse financing."
Case-in-Point

In a case of first impression, a federal district court in Gregg v. U.S., 186 F.Supp.2d 1123 (2000) ruled that a member of a limited liability company was entitled to be treated like a general rather than a limited partner for purposes of determining whether he was an active participant in the business and therefore not subject to passive income limits.

The case arose in response to an I.R.S. audit of plaintiff’s income tax return. It disallowed his characterization of flow-through loss from the limited liability company of which he was a member as an ordinary loss and re-characterized that loss as a passive activity loss. The issue was whether plaintiff’s ratable share of the flow-through operating loss from the LLC should be characterized as ordinary loss or passive activity loss in plaintiffs’ joint tax return.

Ordinary losses can be applied against any income; however, passive activity losses can be applied only against passive activity income. Passive activity losses that are not currently deductible are carried forward to the next taxable year. The IRS characterized plaintiff’s flow-through loss from the limited liability company of which he was a member as a passive activity loss, thus limiting any deductions to applicable passive gains.

In general, a “passive activity” is one in which the taxpayer does not “materially participate.” The IRS has specific regulations which govern whether a taxpayer has materially participated in the business. Those regulations differentiate between general and limited partners, making it much more difficult for a limited partner to be considered an active participant in the business than a general partner.

The IRS argued that a member of a limited liability company should be treated as a limited partner because members of an LLC, like limited partners, are not personally liable for the debts and obligations of the entity.

The plaintiff, on the other hand, said existing IRS regulations governing partnerships were obsolete as applied to limited liability companies because of the unique characteristics of the relatively new type of business entity. The court agreed with the plaintiff, writing:

A limited partnership must have at least one general partner who is personally liable for the obligation of the limited partnership. If, for federal tax purposes, an LLC is treated as a limited partnership, and all members of the LLC are treated as limited partners because of their limited liability, the consequence of such a treatment does not satisfy the requirement of ‘at least one general partner.’ In addition, LLC members retain their limited liability regardless of their level of participation in the management of the LLC. But a limited partner in a limited partnership cannot, by definition, participate in the management.
“Furthermore, the legislative history clearly shows that Congress enacted the limited partnership test for the purpose of the passive activity loss rules to thwart the deduction by investors, such as limited partners in a limited partnership, of ‘passive’ losses from ‘tax shelter’ investments against other non-passive income, since ‘a limited partner generally is precluded from participating in the partnership’s business if he is to retain his limited liability status.’”

The limited partnership test is not applicable to all LLC members. Because LLCs are designed to permit active involvement by LLC members in the management of the business, the court concluded that the limited partnership test is not applicable to all LLC members. Further, the court said, LLC members – unlike limited partners – may materially participate in the LLC without losing their limited liability protection. “In the absence of any regulation asserting that an LLC member should be treated as a limited partner of a limited partnership,” the court said, “defendant's conclusion is inappropriate. Therefore, the higher standard of material participation test for limited partners should not be applied to plaintiff.”

2. Retained Earnings

The benefits of pass-through taxation available to most limited liability companies are obvious. However, there are certain circumstances under which an LLC might benefit from corporate tax status, depending on the nature of the business. One situation where this might be true is when a company has a large amount of retained earnings, that is when a company elects to keep a substantial amount of profits in the company rather than distributing it to its members.

Unlike an LLC, a corporation is responsible for paying taxes on corporate profits left or retained in the business. An LLC that elects corporate tax status, therefore, means that the company will pay tax on the earnings based on the income tax rates that apply to corporations. The members do not have to pay personal income taxes on those profits which are left in the company. And, because the corporate income tax rates for the first $75,000 of corporate taxable income are lower than the individual income tax rates that apply to most LLC owners, this can save you and your co-owners money in overall taxes.

Example.

*If your LLC needs to purchase expensive equipment at the beginning of each year, it may decide to leave $50,000 in the business at the end of the year. With the regular pass-through taxation of an LLC, these retained profits would probably be taxed at the member’s individual tax rate, which is probably over 27%. But with corporate taxation, that $50,000 is taxed at the lower 15% corporate rate.*

A limited liability company that elects corporate tax status by filing Form 8832 is precluded from switching back to partnership status for five years.
V. Corporations

Unlike some of the other business entities this course has discussed, a corporation is a legal entity separate and apart from its shareholders. As such – with the exception of subchapter S corporations, which will be discussed below – the profits of a corporation are taxed to the corporation at the applicable tax level. On the other hand, when profits are distributed to shareholders – normally through the issuance of a dividend – shareholders become individually liable for the income they receive. This section will first discuss shareholders’ “right” to receive dividends and then discuss issues affecting the taxation of dividends and salaries of shareholder-employees.

A. SHAREHOLDERS’ RIGHT TO DIVIDENDS

Even assuming that a corporation is profitable, the owners are not necessarily entitled to personally share in the profits. The general rule of law is that shareholders are not entitled to a dividend. The discretion to grant a dividend lies solely with the corporation’s Board of Directors. Only in a few very limited situations – normally involving closely-held corporations – have shareholders been successful in compelling dividends.

However, it is also important to note here that while it cannot normally be compelled, the failure of a closely-held corporation to pay a dividend can, in some circumstances, lead to tax penalties when the failure is the result of a desire to avoid federal taxation pursuant to IRC § 531, below:

I.R.C. § 531. Imposition of accumulated earnings tax

In addition to other taxes imposed by this chapter, there is hereby imposed for each taxable year on the accumulated taxable income (as defined in § 535) of each corporation described in section 532, an accumulated earnings tax equal to 15 percent of the accumulated taxable income.

I.R.C. § 532 provides that the penalty set forth in § 531 applies to any corporation formed for the purpose of avoiding income taxation of its shareholders with the following exceptions:

- Certain holding companies (as defined in § 542);
- A corporation exempt from tax under subchapter F (§ 501 and following);
- A foreign personal holding company (as defined in § 552);
- A passive foreign investment company (as defined in §1297).

The number of shareholders in a corporation is not a factor in determining applicability of the tax in § 531. However, § 533, below, sets forth rules regarding the type of evidence that is sufficient to prove a purpose to avoid income tax. The test focuses on the “reasonable” need of the corporation for the retained earnings (§ 537 sets forth criteria for determining the reasonable needs of the business).
Section 533. Evidence of purpose to avoid income tax

(a) For purposes of section 532, the fact that the earnings and profits of a corporation are permitted to accumulate beyond the reasonable needs of the business shall be determinative of the purpose to avoid the income tax with respect to shareholders, unless the corporation by the preponderance of the evidence shall prove to the contrary.

(b) The fact that any corporation is a mere holding or investment company shall be prima facie evidence of the purpose to avoid the income tax with respect to shareholders.

B. LIMITATIONS ON DIVIDENDS

As we saw with partnerships and limited liability companies, there are circumstances in which a corporation is prohibited from issuing a dividend, even if approved by its Board of Directors. These limitations almost always involve protecting the solvency of the corporation.

C. CORPORATE SALARIES

One way corporations avoid the double-taxation of dividends is by making shareholders employees and paying them a salary. The employee is of course taxed on his or her income as is any other employee, but the corporation is entitled to deduct the salary as an ordinary business expense. This is an option most used in small, closely-held corporations where the shareholders are also employees.

There are, however, limitations on this practice. The main limitation is that corporations are not entitled to deduct as a business expense so-called “excessive” salaries. This rule is in place to prohibit shareholders from avoiding paying tax on dividends by passing profits through as salary or other compensation, such as bonuses.

I.R.C. § 162 provides the general right of a corporation to deduct the salaries of employees as an ordinary expense:

(a) In general – There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including--

(1) a reasonable allowance for salaries or other compensation for personal services actually rendered;

(m) Certain excessive employee remuneration.—

(1) In general – In the case of any publicly held corporation, no deduction shall be allowed under this chapter for applicable employee remuneration with respect to any covered employee to the extent that the amount of such remuneration for the taxable year with respect to such employee exceeds $1,000,000.

With respect to non-publicly traded corporations, the excessiveness of a corporate salary or other remuneration is measured from the perspective of the independent investor, as provided in the following treasury regulation:
§ 1.162-7 Compensation for personal services

(a) There may be included among the ordinary and necessary expenses paid or incurred in carrying on any trade or business a reasonable allowance for salaries or other compensation for personal services actually rendered. The test of deductibility in the case of compensation payments is whether they are reasonable and are in fact payments purely for services.

(b) The test set forth in paragraph (a) of this section and its practical application may be further stated and illustrated as follows:

(1) Any amount paid in the form of compensation, but not in fact as the purchase price of services, is not deductible. An ostensible salary paid by a corporation may be a distribution of a dividend on stock. This is likely to occur in the case of a corporation having few shareholders, practically all of whom draw salaries. If in such a case the salaries are in excess of those ordinarily paid for similar services and the excessive payments correspond or bear a close relationship to the stockholdings of the officers or employees, it would seem likely that the salaries are not paid wholly for services rendered, but that the excessive payments are a distribution of earnings upon the stock. An ostensible salary may be in part payment for property. This may occur, for example, where a partnership sells out to a corporation, the former partners agreeing to continue in the service of the corporation. In such a case it may be found that the salaries of the former partners are not merely for services, but in part constitute payment for the transfer of their business.

(2) The form or method of fixing compensation is not decisive as to deductibility. While any form of contingent compensation invites scrutiny as a possible distribution of earnings of the enterprise, it does not follow that payments on a contingent basis are to be treated fundamentally on any basis different from that applying to compensation at a flat rate. Generally speaking, if contingent compensation is paid pursuant to a free bargain between the employer and the individual made before the services are rendered, not influenced by any consideration on the part of the employer other than that of securing on fair and advantageous terms the services of the individual, it should be allowed as a deduction even though in the actual working out of the contract it may prove to be greater than the amount which would ordinarily be paid.

(3) In any event the allowance for the compensation paid may not exceed what is reasonable under all the circumstances. It is, in general, just to assume that reasonable and true compensation is only such amount as would ordinarily be paid for like services by like enterprises under like circumstances. The circumstances to be taken into consideration are those existing at the date when the contract for services was made, not those existing at the date when the contract is questioned.

(4) For disallowance of deduction in the case of certain transfers of stock pursuant to employees stock options, see section 421 and the regulations thereunder.

In 1993 and 1994, Exacto Spring Corporation, a closely held corporation engaged in the manufacture of precision springs, paid its cofounder, chief executive, and principal owner, William Heitz, $1.3 and $1.0 million, respectively, in salary. The Internal Revenue Service ruled that the compensation was excessive, finding that Heitz should not have been paid more than $381,000 in 1993 or $400,000 in 1994.

Exacto challenged the IRS’s determination in the Tax Court. That court found that the maximum reasonable compensation for Heitz would have been $900,000 in the earlier year and $700,000 in the later one. Exacto appealed.

In reaching its conclusion, the Tax Court applied a test that requires the consideration of seven factors, none entitled to any specified weight relative to another. The factors are, in the court's words, "(1) the type and extent of the services rendered; (2) the scarcity of qualified employees; (3) the qualifications and prior earning capacity of the employee; (4) the contributions of the employee to the business venture; (5) the net earnings of the employer; (6) the prevailing compensation paid to employees with comparable jobs; and (7) the peculiar characteristics of the employer's business."

The appeals court noted that the test does not give any indication of how the factors are to be weighed and that some are also vague. The court said in determining whether executive compensation is excessive, it should be evaluated from the perspective of the “independent investor.”

"A corporation can be conceptualized as a contract in which the owner of assets hires a person to manage them. The owner pays the manager a salary and in exchange the manager works to increase the value of the assets that have been entrusted to his management; that increase can be expressed as a rate of return to the owner's investment," the court wrote. "The higher the rate of return (adjusted for risk) that a manager can generate, the greater the salary he can command. If the rate of return is extremely high, it will be difficult to prove that the manager is being overpaid, for it will be implausible that if he quit if his salary was cut, and he was replaced by a lower-paid manager, the owner would be better off; it would be killing the goose that lays the golden egg."

In this case, the court found that the expected return for an investor in a firm such as Exacto would be 13 percent. Since the actual return was 20 percent, the court said the salary was “presumptively” reasonable:

"We say ‘presumptively,’” the court wrote, “because we can imagine cases in which the return, though very high, is not due to the CEO’s exertions. Suppose Exacto had been an unprofitable company that suddenly learned that its factory was sitting on an oil field, and when oil revenues started to pour in its owner raised his salary from $50,000 a year to $1.3 million. The presumption of reasonableness would be rebutted. There is no suggestion of anything of that sort here and likewise no suggestion that Mr. Heitz was merely the titular chief executive and the company was actually run by someone else, which would be another basis for rebuttal.”
The court did go on to say that the IRS could still have won its case if it had been able to show that the company did not in fact intend to pay Heitz that amount as salary, that his salary really did include a concealed dividend though it need not have. “This is material (and the "independent investor" test, like the multi-factor test that it replaces, thus incomplete, though invaluable),” the court said, “because any business expense to be deductible must be, as we noted earlier, a bona fide expense as well as reasonable in amount. The fact that Heitz's salary was approved by the other owners of the corporation, who had no incentive to disguise a dividend as salary, goes far to rebut any inference of bad faith here, which in any event the Tax Court did not draw and the government does not ask us to draw.”

VI. Subchapter S Corporations

The essence of the subchapter S corporation is that profits are “passed through” to shareholders directly, just as distributions in a partnership. Thus, by making the election under subchapter S, the corporation retains all the advantages of operating in corporate form, without suffering the form's greatest disadvantage: double taxation. The subchapter S corporation is a pass- through entity, similar in its tax treatment to partnerships.

A. ELECTING S CORPORATION STATUS

Timing of the election can be critical in limiting one’s tax liability. The rules for timing of an election are set forth in I.R.C. § 1362, below:

I.R.C. § 1362 Election; revocation; termination

(a) Election.—
(1) In general.--Except as provided in subsection (g), a small business corporation may elect, in accordance with the provisions of this section, to be an S corporation.
(2) All shareholders must consent to election.--An election under this subsection shall be valid only if all persons who are shareholders in such corporation on the day on which such election is made consent to such election.
(b) When made.—
(1) In general.--An election under subsection (a) may be made by a small business corporation for any taxable year--
(A) at any time during the preceding taxable year, or
(B) at any time during the taxable year and on or before the 15th day of the 3d month of the taxable year.
(2) Certain elections made during 1st 2 1/2 months treated as made for next taxable year.--If--
(A) an election under subsection (a) is made for any taxable year during such year and on or before the 15th day of the 3d month of such year, but

(B) either--

(i) on 1 or more days in such taxable year before the day on which the election was made the corporation did not meet the requirements of subsection (b) of section 1361, or

(ii) 1 or more of the persons who held stock in the corporation during such taxable year and before the election was made did not consent to the election, then such election shall be treated as made for the following taxable year.

(3) Election made after 1st 2 1/2 months treated as made for following taxable year.--If--

(A) a small business corporation makes an election under subsection (a) for any taxable year, and

(B) such election is made after the 15th day of the 3d month of the taxable year and on or before the 15th day of the 3rd month of the following taxable year, then such election shall be treated as made for the following taxable year.

(4) Taxable years of 2 1/2 months or less.--For purposes of this subsection, an election for a taxable year made not later than 2 months and 15 days after the first day of the taxable year shall be treated as timely made during such year.

(5) Authority to treat late elections, etc., as timely.--If--

(A) an election under subsection (a) is made for any taxable year (determined without regard to paragraph (3)) after the date prescribed by this subsection for making such election for such taxable year or no such election is made for any taxable year, and

(B) the Secretary determines that there was reasonable cause for the failure to timely make such election, the Secretary may treat such an election as timely made for such taxable year (and paragraph (3) shall not apply).

(c) Years for which effective.--An election under subsection (a) shall be effective for the taxable year of the corporation for which it is made and for all succeeding taxable years of the corporation, until such election is terminated under subsection (d).

B. TAX TREATMENT OF DISTRIBUTIONS / APPLICATION OF AT-RISK RULES

Once a corporation elects subchapter S status, its income and losses pass through to its shareholders in the same fashion as a partnership. However, the special allocations permitted in partnerships – discussed above – are not allowable in the case of S corporations. This means that a shareholder in an S corporation is not able to increase his or her basis through allocation of the corporation’s liabilities.

Losses are also treated the same as with partnerships, although they are limited by a shareholder’s basis in stock of the S corporation. These rules are detailed in I.R.C. § 1366 below:
§ 1366. Pass-thru of items to shareholders

(a) Determination of shareholder's tax liability.--

(1) In general.--In determining the tax under this chapter of a shareholder for the shareholder's taxable year in which the taxable year of the S corporation ends (or for the final taxable year of a shareholder who dies, or of a trust or estate which terminates, before the end of the corporation's taxable year), there shall be taken into account the shareholder's pro rata share of the corporation's--

(A) items of income (including tax-exempt income), loss, deduction, or credit the separate treatment of which could affect the liability for tax of any shareholder, and

(B) nonseparately computed income or loss.

For purposes of the preceding sentence, the items referred to in subparagraph (A) shall include amounts described in paragraph (4) or (6) of section 702(a).

(2) Nonseparately computed income or loss defined.--For purposes of this subchapter, the term "nonseparately computed income or loss" means gross income minus the deductions allowed to the corporation under this chapter, determined by excluding all items described in paragraph (1)(A).

(b) Character passed thru.--The character of any item included in a shareholder's pro rata share under paragraph (1) of subsection (a) shall be determined as if such item were realized directly from the source from which realized by the corporation, or incurred in the same manner as incurred by the corporation.

(c) Gross income of a shareholder.--In any case where it is necessary to determine the gross income of a shareholder for purposes of this title, such gross income shall include the shareholder's pro rata share of the gross income of the corporation.

(d) Special rules for losses and deductions.--

(1) Cannot exceed shareholder's basis in stock and debt.--The aggregate amount of losses and deductions taken into account by a shareholder under subsection (a) for any taxable year shall not exceed the sum of--

(A) the adjusted basis of the shareholder's stock in the S corporation (determined with regard to paragraphs (1) and (2)(A) of section 1367(a) for the taxable year), and

(B) the shareholder's adjusted basis of any indebtedness of the S corporation to the shareholder (determined without regard to any adjustment under paragraph (2) of section 1367(b) for the taxable year).

(2) Indefinite carryover of disallowed losses and deductions.--
(A) In general.--Except as provided in subparagraph (B), any loss or deduction which is disallowed for any taxable year by reason of paragraph (1) shall be treated as incurred by the corporation in the succeeding taxable year with respect to that shareholder.

(B) Transfers of stock between spouses or incident to divorce.--In the case of any transfer described in section 1041(a) of stock of an S corporation, any loss or deduction described in subparagraph (A) with respect such stock shall be treated as incurred by the corporation in the succeeding taxable year with respect to the transferee.

(3) Carryover of disallowed losses and deductions to post-termination transition period.-

(A) In general.--If for the last taxable year of a corporation for which it was an S corporation a loss or deduction was disallowed by reason of paragraph (1), such loss or deduction shall be treated as incurred by the shareholder on the last day of any post-termination transition period.

(B) Cannot exceed shareholder’s basis in stock.--The aggregate amount of losses and deductions taken into account by a shareholder under subparagraph (A) shall not exceed the adjusted basis of the shareholder’s stock in the corporation (determined at the close of the last day of the post-termination transition period and without regard to this paragraph).

(C) Adjustment in basis of stock.--The shareholder’s basis in the stock of the corporation shall be reduced by the amount allowed as a deduction by reason of this paragraph.

(D) At-risk limitations.--To the extent that any increase in adjusted basis described in subparagraph (B) would have increased the shareholder's amount at risk under section 465 if such increase had occurred on the day preceding the commencement of the post-termination transition period, rules similar to the rules described in subparagraphs (A) through (C) shall apply to any losses disallowed by reason of section 465(a).

(e) Treatment of family group.--If an individual who is a member of the family (within the meaning of section 704(e)(3) ) of one or more shareholders of an S corporation renders services for the corporation or furnishes capital to the corporation without receiving reasonable compensation therefor, the Secretary shall make such adjustments in the items taken into account by such individual and such shareholders as may be necessary in order to reflect the value of such services or capital.

(f) Special rules.--

(1) Subsection (a) not to apply to credit allowable under section 34.--
Subsection (a) shall not apply with respect to any credit allowable under section 34 (relating to certain uses of gasoline and special fuels).

(2) Treatment of tax imposed on built-in gains.--If any tax is imposed under section 1374 for any taxable year on an S corporation, for purposes of subsection (a), the amount so imposed shall be treated as a loss sustained by the S corporation during such taxable year. The character of such loss shall be determined by allocating the loss proportionately among the recognized built-in gains giving rise to such tax.
(3) Reduction in pass-thru for tax imposed on excess net passive income.--If any tax is imposed under section 1375 for any taxable year on an S corporation, for purposes of subsection (a), each item of passive investment income shall be reduced by an amount which bears the same ratio to the amount of such tax as--

(A) the amount of such item, bears to

(B) the total passive investment income for the taxable year.

A shareholder in a subchapter S corporation must also carry forward to future taxable years any loss that exceeds the basis limitation, and likewise can deduct only the disallowed loss when and to the extent the owner acquires additional outside basis. The issue was detailed by the IRS in Treas. Reg. §1.133602(a)(2), below:

§ 1.1366-2 Limitations on deduction of passthrough items of an S corporation to its shareholders

(a) In general--(1) Limitation on losses and deductions. The aggregate amount of losses and deductions taken into account by a shareholder under §1.1366-1(a)(2), (3), and (4) for any taxable year of an S corporation cannot exceed the sum of—

(i) The adjusted basis of the shareholder's stock in the corporation (as determined under paragraph (a)(3)(i) of this section); and

(ii) The adjusted basis of any indebtedness of the corporation to the shareholder (as determined under paragraph (a)(3)(ii) of this section).

(2) Carryover of disallowance. A shareholder's aggregate amount of losses and deductions for a taxable year in excess of the sum of the adjusted basis of the shareholder's stock in an S corporation and of any indebtedness of the S corporation to the shareholder is not allowed for the taxable year. However, any disallowed loss or deduction retains its character and is treated as incurred by the corporation in the corporation's first succeeding taxable year, and subsequent taxable years, with respect to the shareholder. For rules on determining the adjusted bases of stock of an S corporation and indebtedness of the corporation to the shareholder, see paragraphs (a)(3)(i) and (ii) of this section.
(3) Basis limitation amount--(i) Stock portion. A shareholder generally determines the adjusted basis of stock for purposes of paragraphs (a)(1)(i) and (2) of this section (limiting losses and deductions) by taking into account only increases in basis under section 1367(a)(1) for the taxable year and decreases in basis under section 1367(a)(2)(A), (D) and (E) (relating to distributions, noncapital, nondeductible expenses, and certain oil and gas depletion deductions) for the taxable year. In so determining this loss limitation amount, the shareholder disregards decreases in basis under section 1367(a)(2)(B) and (C) (for losses and deductions, including losses and deductions previously disallowed) for the taxable year. However, if the shareholder has in effect for the taxable year an election under § 1.1367-1(g) to decrease basis by items of loss and deduction prior to decreasing basis by noncapital, nondeductible expenses and certain oil and gas depletion deductions, the shareholder also disregards decreases in basis under section 1367(a)(2)(D) and (E). This basis limitation amount for stock is determined at the time prescribed under § 1.1367-1(d)(1) for adjustments to the basis of stock.

(ii) Indebtedness portion. A shareholder determines the shareholder's adjusted basis in indebtedness of the corporation for purposes of paragraphs (a)(1)(ii) and (2) of this section (limiting losses and deductions) without regard to any adjustment under section 1367(b)(2)(A) for the taxable year. This basis limitation amount for indebtedness is determined at the time prescribed under § 1.1367-2(d)(1) for adjustments to the basis of indebtedness.

(4) Limitation on losses and deductions allocated to each item. If a shareholder's pro rata share of the aggregate amount of losses and deductions specified in § 1.1366-1(a)(2), (3), and (4) exceeds the sum of the adjusted basis of the shareholder's stock in the corporation (determined in accordance with paragraph (a)(3)(i) of this section) and the adjusted basis of any indebtedness of the corporation to the shareholder (determined in accordance with paragraph (a)(3)(ii) of this section), then the limitation on losses and deductions under section 1366(d)(1) must be allocated among the shareholder's pro rata share of each loss or deduction. The amount of the limitation allocated to any loss or deduction is an amount that bears the same ratio to the amount of the limitation as the loss or deduction bears to the total of the losses and deductions. For this purpose, the total of losses and deductions for the taxable year is the sum of the shareholder's pro rata share of losses and deductions for the taxable year, and the losses and deductions disallowed and carried forward from prior years pursuant to section 1366(d)(2).

(5) Nontransferability of losses and deductions. Any loss or deduction disallowed under paragraph (a)(1) of this section is personal to the shareholder and cannot in any manner be transferred to another person. If a shareholder transfers some but not all of the shareholder's stock in the corporation, the amount of any disallowed loss or deduction under this section is not reduced and the transferee does not acquire any portion of the disallowed loss or deduction. If a shareholder transfers all of the shareholder's stock in the corporation, any disallowed loss or deduction is permanently disallowed.

(6) Basis of stock acquired by gift. For purposes of section 1366(d)(1)(A) and paragraphs (a)(1)(i) and (2) of this section, the basis of stock in a corporation acquired by gift is the basis of the stock that is used for purposes of determining loss under section 1015(a).

(b) Special rules for carryover of disallowed losses and deductions to post-termination transition period described in section 1377(b)--(1) In general. If, for the last taxable year of a corporation for which it was an S corporation, a loss or deduction was disallowed to
a shareholder by reason of the limitation in paragraph (a) of this section, the loss or
deduction is treated under section 1366(d)(3) as incurred by that shareholder on the last
day of any post-termination transition period (within the meaning of section 1377(b)).

(2) Limitation on losses and deductions. The aggregate amount of losses and
deductions taken into account by a shareholder under paragraph (b)(1) of this section
cannot exceed the adjusted basis of the shareholder’s stock in the corporation
determined at the close of the last day of the post-termination transition period. For this
purpose, the adjusted basis of a shareholder’s stock in the corporation is determined at
the close of the last day of the post-termination transition period without regard to any
reduction required under paragraph (b)(4) of this section. If a shareholder disposes of a
share of stock prior to the close of the last day of the post-termination transition period,
the adjusted basis of that share is its basis as of the close of the day of disposition. Any
losses and deductions in excess of a shareholder’s adjusted stock basis are
permanently disallowed. For purposes of section 1366(d)(3)(B) and this paragraph
(b)(2), the basis of stock in a corporation acquired by gift is the basis of the stock that is
used for purposes of determining loss under section 1015(a).

(3) Limitation on losses and deductions allocated to each item. If the aggregate amount
of losses and deductions treated as incurred by the shareholder under paragraph (b)(1)
of this section exceeds the adjusted basis of the shareholder’s stock determined under
paragraph (b)(2) of this section, the limitation on losses and deductions under section
1366(d)(3)(B) must be allocated among each loss or deduction. The amount of the
limitation allocated to each loss or deduction is an amount that bears the same ratio to
the amount of the limitation as the amount of each loss or deduction bears to the total of
all the losses and deductions.

(4) Adjustment to the basis of stock. The shareholder’s basis in the stock of the
corporation is reduced by the amount allowed as a deduction by reason of this
paragraph (b). For rules regarding adjustments to the basis of a shareholder’s stock in
an S corporation, see § 1.1367-1.

(c) Carryover of disallowed losses and deductions in the case of liquidations,
reorganizations, and divisions--(1)Liquidations and reorganizations. If a corporation
acquires the assets of an S corporation in a transaction to which section 381(a) applies,
any loss or deduction disallowed under paragraph (a) of this section with respect to a
shareholder of the distributor or transferor S corporation is available to that shareholder
as a shareholder of the acquiring corporation. Thus, where the acquiring corporation
is an S corporation, a loss or deduction of a shareholder of the distributor or transferor S
corporation disallowed prior to or during the taxable year of the transaction is treated as
incurred by the acquiring S corporation with respect to that shareholder if the
shareholder is a shareholder of the acquiring S corporation after the transaction. Where
the acquiring corporation is a C corporation, a post- termination transition period arises
the day after the last day that an S corporation was in existence and the rules provided
in paragraph (b) of this section apply with respect to any shareholder of the acquired S
corporation that is also a shareholder of the acquiring C corporation after the transaction.
See the special rules under section 1377 for the availability of the post-termination
transition period if the acquiring corporation is a C corporation.
(2) Corporate separations to which section 368(a)(1)(D) applies. If an S corporation transfers a portion of its assets constituting an active trade or business to another corporation in a transaction to which section 368(a)(1)(D) applies, and immediately thereafter the stock and securities of the controlled corporation are distributed in a distribution or exchange to which section 355 (or so much of section 356 as relates to section 355) applies, any loss or deduction disallowed under paragraph (a) of this section with respect to a shareholder of the distributing S corporation immediately before the transaction is allocated between the distributing corporation and the controlled corporation with respect to the shareholder. Such allocation shall be made according to any reasonable method, including a method based on the relative fair market value of the shareholder's stock in the distributing and controlled corporations immediately after the distribution, a method based on the relative adjusted basis of the assets in the distributing and controlled corporations immediately after the distribution, or, in the case of losses and deductions clearly attributable to either the distributing or controlled corporation, any method that allocates such losses and deductions accordingly.

C. ACCUMULATED PROFITS

An S corporation is likely to accumulate earnings in only one of two ways: (1) where the S corporation acquires the assets of a C corporation; or (2) where the S corporation was formerly a C corporation. If a subchapter S corporation has accumulated earnings and profits, then the tax treatment of distributions is governed by §1368(c):

§ 1.1368-1 Distributions by S Corporations.

(a) In general. This section provides rules for distributions made by an S corporation with respect to its stock which, but for section 1368(a) and this section, would be subject to section 301(c) and other rules of the Internal Revenue Code that characterize a distribution as a dividend.

(b) Date distribution made. For purposes of section 1368, a distribution is taken into account on the date the corporation makes the distribution, regardless of when the distribution is treated as received by the shareholder.

(c) S corporation with no earnings and profits. A distribution made by an S corporation that has no accumulated earnings and profits as of the end of the taxable year of the S corporation in which the distribution is made is treated in the manner provided in section 1368(b).

(d) S corporation with earnings and profits--(1) General treatment of distribution. Except as provided in paragraph (d)(2) of this section, a distribution made with respect to its stock by an S corporation that has accumulated earnings and profits as of the end of the taxable year of the S corporation in which the distribution is made is treated in the manner provided in section 1368(c). See section 316 and § 1.316-2 for provisions relating to the allocation of earnings and profits among distributions.

(2) Previously taxed income. This paragraph (d)(2) applies to distributions by a corporation that has both accumulated earnings and profits and previously taxed income (within the meaning of section 1375(d)(2), as in effect prior to its amendment by the Subchapter S Revision Act of 1982, and the regulations thereunder) with respect to one or more shareholders. In the case of such a distribution, that portion remaining after the
application of section 1368(c)(1) (relating to distributions from the accumulated adjustments account (AAA) as defined in § 1.1368-2(a)) is treated in the manner provided in section 1368(b) (relating to S corporations without earnings and profits) to the extent that portion is a distribution of money and does not exceed the shareholder’s net share immediately before the distribution of the corporation’s previously taxed income. The AAA and the earnings and profits of the corporation are not decreased by that portion of the distribution. Any distribution remaining after the application of this paragraph (d)(2) is treated in the manner provided in section 1368(c)(2) and (3).

Table 6.3, below, provides an overview of the differences in tax treatment of distributions of various entities.

### Table 6.3 Tax Treatment of Profits and Losses of Various Entities

<table>
<thead>
<tr>
<th>ISSUE</th>
<th>C CORPORATION</th>
<th>S CORPORATION</th>
<th>DISREGARDED ENTITIES¹</th>
</tr>
</thead>
<tbody>
<tr>
<td>Distributions to equity owners</td>
<td>Ordinary income to the extent of E&amp;P, § 301, unless treated as an exchange</td>
<td>Passed through to shareholders per IRC § 1368</td>
<td>Generally not taxed per IRC § 731</td>
</tr>
<tr>
<td>Losses</td>
<td>Not passed through to shareholders; must be used at corporate level to offset earnings</td>
<td>Passed through to shareholders per IRC § 1366(a)(1)</td>
<td>Passed through to partners or members per IRC §§ 702 and 704(a)</td>
</tr>
<tr>
<td>At Risk Rule</td>
<td>Normally applies only to closely-held corporations</td>
<td>Shareholders subject to at-risk rule at shareholder level</td>
<td>Partners and members subject to rule at the partner or member level</td>
</tr>
<tr>
<td>Passive activity loss</td>
<td>Applies to closely-held corporations</td>
<td>Applies at the shareholder level</td>
<td>Applies at the partner or member level</td>
</tr>
<tr>
<td>Accumulated earnings</td>
<td>May accumulate income for business reasons, but unreasonable accumulations subject to tax</td>
<td>All income is passed through to shareholders</td>
<td>All income is passed through to partners and members</td>
</tr>
</tbody>
</table>

¹ These include partnerships and limited liability companies that elect to be taxed as a partnership.
CHAPTER 6 – REVIEW QUESTIONS

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter. They do not need to be submitted in order to receive CPE credit. They are included as an additional tool to enhance your learning experience.

We recommend that you answer each review question and then compare your response to the suggested solution before answering the final exam questions related to this chapter.

1. The sole proprietorship is often the best option for the single-owner in that it provides the limited liability offered by a corporation, as well as the option to avoid the double-taxation of a corporation on distributions.
   
   a) true
   b) false

2. Under the default rule of the Uniform Partnership Act (UPA), partners share profits:

   a) on a per capita basis
   b) in proportion to their capital contribution
   c) on whatever basis is the most advantageous for that fiscal year
   d) none of the above

3. Which of the following statements about the UPA and RULPA’s treatment of in-kind distributions is correct:

   a) both the UPA and RULPA specify that partners have the right to receive in-kind distributions
   b) only the UPA specifies that partners have the right to receive in-kind distributions
   c) only the RULPA specifies that partners have the right to receive in-kind distributions
   d) both the UPA and the RULPA specify that partners do not have the right to receive in-kind distributions

4. In regards to the taxation of partnership income, a partnership distribution is not taken into account in determining the partner’s distributive share of partnership income or loss.

   a) true
   b) false

5. A partner generally recognizes gain on a partnership distribution only to the extent any money included in the distribution exceeds the adjusted basis of the partner’s interest in the partnership.

   a) true
   b) false
6. A partner does not recognize loss on a partnership distribution unless:
   a) the adjusted basis of the partner’s interest in the partnership exceeds the distribution  
   b) the partner’s entire interest in the partnership is liquidated  
   c) the distribution is in money, unrealized receivables, or inventory items  
   d) all of the above must be met

7. How do members of a limited liability company split profits:
   a) they are required to split profits based on capital contributions  
   b) they are allowed to split profits any way they choose  
   c) they are required by most states to split profits evenly regardless of each member’s capital contribution  
   d) profits in an LLC must be retained and can only be split upon dissolution

8. According to ULLCA §406, a limited liability company cannot make distributions if the LLC would not be able to pay its debts as they become due in the ordinary course of business.
   a) true  
   b) false

9. Do members of a limited liability company have a right to transfer their interests in the entity:
   a) generally, members of an LLC have the right to freely transfer their interest in the profits of the entity but not their interest itself without the consent of the other members  
   b) all states forbid the transfer of both their interest and their right to receive profits from the entity without the written consent of all other members  
   c) generally, members of an LLC can transfer their interest in the entity freely but not their right to receive the profits of the entity  
   d) none of the above

10. How are limited liability companies treated for federal income tax purposes:
    a) as a corporation only  
    b) as a sole proprietorship only  
    c) as a partnership only  
    d) as either a corporation, partnership, or sole proprietorship

11. Corporate income tax rates are less than the individual income tax rates that apply to most LLC owners for the first $1,000,000.
    a) true  
    b) false
12. Even if a corporation is profitable, the owners are not necessarily entitled to a dividend.

   a) true
   b) false

13. For purposes of the Internal Revenue Code, public company salaries in excess of ______ are considered “excessive” and therefore not deductible as a business expense.

   a) $100,000
   b) $250,000
   c) $750,000
   d) $1,000,000

14. Losses of a C corporation are passed through to the shareholders.

   a) true
   b) false
CHAPTER 6 – SOLUTIONS AND SUGGESTED RESPONSES

1. A: True is incorrect. A sole proprietorship is the easiest to form, but does not provide limited liability. In addition, all profits and losses flow directly to the owner, and are taxed at the higher individual rate.

   **B: False is correct.** The limited liability company is the business entity form that is often the best option for the reasons stated.

   (See page 6-1 of the course material.)

2. **A: Correct.** According to the default rule, profits and losses are shared on a per capita basis. By agreement of the partners, another basis can be used.

   B: Incorrect. Corporate shareholders share in profits based on their capital contributions.

   C: Incorrect. The UPA default rule is to share profits on a per capita basis. By agreement, the partners may share profits and losses on another basis.

   D: Incorrect. Since one of the answers listed is correct, “none of the above” cannot be the correct answer.

   (See page 6-2 of the course material.)

3. A: Incorrect. Both provide that partners do not have the right to receive in-kind distributions.

   B: Incorrect. Both provide that partners do not have the right to receive in-kind distributions.

   C: Incorrect. Both provide that partners do not have the right to receive in-kind distributions.

   **D: Correct.** Both provide that partners do not have the right to receive in-kind contributions and cannot be required to accept in-kind contributions.

   (See page 6-3 of the course material.)

4. **A: True is correct.** If any gain or loss from the distribution is recognized by the partner, it must be reported on his or her return for the tax year in which the distribution is received.

   B: False is incorrect. A partner’s adjusted basis in his or her partnership interest is decreased (but not below zero) by the money and adjusted basis of property distributed to the partner.

   (See pages 6-5 to 6-6 of the course material.)
5. **A: True is correct.** Any gain recognized is generally treated as capital gain from the sale of the partnership interest on the date of the distribution.

   B: False is incorrect. If partnership property is distributed to a partner, he or she generally does not recognize gain until the sale or other disposition of the property.

   (See page 6-6 of the course material.)

6. A: Incorrect. This is only one of three requirements that must be met. Also, the partner’s entire interest in the partnership must be liquidated, and the distribution must be in money, unrealized receivables, or inventory items.

   B: Incorrect. This is only one of three requirements that must be met. The adjusted basis of the partner’s interest in the partnership must exceed the distribution, and the distribution must be in money, unrealized receivables, or inventory items.

   C: Incorrect. This is only one of three requirements that must be met. The adjusted basis of the partner’s interest in the partnership must exceed the distribution, and the partner’s entire interest in the partnership must be liquidated.

   **D: Correct.** All of the three requirements must be met.

   (See page 6-7 of the course material.)

7. A: Incorrect. There is no such requirement. Members may fashion whatever formula they wish for distribution of profits.

   **B: Correct.** Generally speaking, members of an LLC can devise any plan they wish for distribution of profits.

   C: Incorrect. There is no such requirement.

   D: Incorrect. There is no such requirement.

   (See page 6-14 of the course material.)

8. **A: True is correct.** An LLC also may not make distributions if the company’s total assets would be less than the sum of its total liabilities plus the amount that would be needed if the company were to be dissolved, wound up, and terminated at the time of the distribution to satisfy the preferential rights.

   B: False is incorrect. ULLCA §406 also provides the methods that can be used to determine financial insolvency, stating that the company can base its findings “on financial statements prepared on the basis of accounting practices and principles that are reasonable in the circumstances or on a fair valuation or other method that is reasonable in the circumstances.”

   (See page 6-15 of the course material.)
9. **A: Correct.** Members can generally freely transfer their right to the profits of the entity but are typically precluded from transferring their actual ownership interest without the consent of the other members unless their operating agreement provides otherwise.

**B: Incorrect.** This is not the case with either the right to receive profits or the member's interest in the entity.

**C: Incorrect.** Just the opposite is true. Other members have more of a say in who the owners of the entity are than who has a right to profits.

**D: Incorrect.** Because A is true, this cannot be correct.

(See page 6-20 of the course material.)

10. **A: Incorrect.** Being treated as a corporation for tax purposes is only one of the options available to limited liability companies.

**B: Incorrect.** Being treated as a sole proprietorship is only one of the options available for a limited liability company.

**C: Incorrect.** Being treated as a partnership is an option but is not the only option limited liability companies have when selecting tax treatment.

**D: Correct.** One of the benefits of a limited liability company is the flexibility in tax treatment. The members can elect any of the above tax treatments based on their individualized needs.

(See page 6-21 of the course material.)

11. **A: True is incorrect.** The corporate income tax rates are favorable for the first $75,000, rather than $1,000,000. To elect corporate status, the LLC must file Form 8832.

**B: False is correct.** A limited liability company that elects corporate tax status may not have to switch back to partnership status for five years.

(See page 6-24 of the course material.)

12. **A: True is correct.** The general rule of law is that shareholders are not entitled to a dividend. The discretion to grant a dividend lies solely with the corporation’s Board of Directors.

**B: False is incorrect.** Only in a few very limited situations, normally involving closely-held corporations, have shareholders been successful in compelling dividends.

(See page 6-25 of the course material.)
13. A: Incorrect. The actual amount is much higher.

B: Incorrect. The actual amount is much higher.

C: Incorrect. The actual amount is much higher.

D: Correct. Publicly traded companies may not deduct as a business expense salaries in excess of $1,000,000 as those are considered “excessive” pursuant to the Internal Revenue Code.

(See page 6-26 of the course material.)

14. A: True is incorrect. Losses of a C corporation are not passed through to the shareholders, but must be used at the corporate level to offset earnings.

B: False is correct. Losses of an S corporation are passed through to shareholders per IRC 1366(a)(1).

(See page 6-37 of the course material.)
Chapter 7: Professional Business Associations

The choice of entity is a concern for almost all types of businesses. It is a special concern for professionals, who traditionally were relegated to the position of sole practitioner or a general partnership. Historically, professionals were prohibited from incorporating their firms; limited partnerships do not provide liability protection for active participants in the practice.

The advent of the limited liability company and the limited liability partnership (referred to in some states as the registered limited partnership or registered limited liability partnership, or, in Ohio, as "Partnerships with Limited Liability" or "PLL") have added to the level of complexity surrounding the choice of entity for professionals. In addition, all 50 states now recognize some sort of professional corporation. Some of these states give the full protection of limited liability to the shareholders of professional corporations while others have limitations.

Given the heavy influence of state law in the choice of entity, anyone contemplating a choice of entity for a professional firm needs to take a close look at the state in which they wish to operate. There can be significant differences from state to state. In Texas, for example, the professional corporation is a more popular choice of entity than the professional limited liability company or limited liability partnership. At least part of the reason is due to the fact that Texas imposes a franchise tax that is applicable to corporations and limited liability companies, but not to professional corporations. This is just one example of the types of differences in state law that can influence choice of entity.

This chapter provides guidance on the basic models of state law treatment of these various entities.

I. Professional Partnerships

As mentioned above, the traditional notion of the partnership, while certainly available as a choice of entity for professionals, has a major drawback: it does not provide limited liability for its participants. Even in the case of a limited partnership, active participants are precluded from enjoying limited liability. This makes the traditional partnership and the traditional limited partnership less desirable options for most professionals than either the limited liability partnership, the limited liability company or the professional corporation. As of 2001, all fifty states had adopted some form of limited liability partnership statutory scheme.

Chapter 2, Formation of Business Entities, provides an overview of state law governing the organization of a limited liability partnership. The scope of limited liability provided to partners of limited liability partnerships is addressed in Chapter 5, Liability of Owners.

Table 7.1 provides a summary of the major advantages and disadvantages provided to professionals of each type of business entity.

Professional Business Associations  7-1
Table 7.1 Entity Options for Professionals

<table>
<thead>
<tr>
<th>ENTITY</th>
<th>MAJOR ADVANTAGE(S)</th>
<th>MAJOR DISADVANTAGE(S)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sole Proprietorship</td>
<td>Ease of administration, no formalities or registration requirements</td>
<td>Unlimited personal liability for owner</td>
</tr>
<tr>
<td>General Partnership</td>
<td>Relative ease of administration, pass through taxation of income</td>
<td>Unlimited liability for every partner</td>
</tr>
<tr>
<td>Limited Partnership</td>
<td>Relative ease of administration, pass through taxation of income</td>
<td>Because limited partners cannot be actively involved, all persons practicing profession subject to unlimited liability</td>
</tr>
<tr>
<td>Limited Liability Company</td>
<td>Flexibility in management and limited liability</td>
<td>Availability limited in some states</td>
</tr>
<tr>
<td>Professional Corporations</td>
<td>Limited liability for shareholders</td>
<td>Corporate formalities must be followed; may be some entity level taxes in the form of state fees</td>
</tr>
</tbody>
</table>

II. Professional Limited Liability Companies

The many advantages of limited liability company status – pass-through taxation, limited liability, flexibility in management, to name a few – makes it a desirable option for many types of businesses. One area in particular where the LLC has become a very popular and advantageous business form is for professionals, who historically utilized the partnership as their entity of choice.

Professional LLCs are allowed in almost every state and the District of Columbia. Only Rhode Island and California prohibit “professional” limited liability companies. A “professional” generally means someone who is licensed by a state to perform a specified service, e.g. doctor, dentist, accountant, attorney, architect, and veterinarian.

The most obvious advantage for a group of professionals to form a limited liability company rather than a partnership is the avoidance of personal liability. This is particularly true with professionals such as doctors and lawyers who face the increased prospect of professional liability lawsuits, i.e. malpractice. Although members are protected in general from the debts and liability of the enterprise, they are generally not protected against suits arising out of their own malpractice.

In addition, since all states allow single member LLC’s, a sole practitioner can have the benefit of the protections offered by an LLC rather than the more cumbersome route of forming a professional corporation.

The majority of states expressly authorize professional limited liability companies. These states are: Alabama, Arizona, Arkansas, Connecticut, Florida, Georgia, Idaho, Iowa, Kansas, Kentucky, Maine, Maryland, Massachusetts, Michigan, Minnesota, Mississippi, Missouri, Montana, Nebraska, Nevada, New Hampshire, New York, North Carolina, North Dakota, Ohio, Oregon, Tennessee, Texas, Utah, Vermont, Virginia, Washington,
West Virginia, and Wyoming. They are also expressly authorized in the District of Columbia.

Professional limited liability companies are implicitly permitted in the following states: Alaska, Colorado, Delaware, Hawaii, Illinois, Indiana, Louisiana, New Jersey, New Mexico, Oklahoma, Pennsylvania, South Carolina, South Dakota, and Wisconsin.

Despite this widespread approval of professional LLCs, there are still some restrictions on the type of businesses that can be operated under this type of entity in certain states. For example, Illinois bars limited liability companies from engaging in banking. Arizona, Delaware, Illinois, Kansas, Oklahoma and Pennsylvania prohibit limited liability companies from engaging in both the banking and insurance industries. California – in addition to prohibiting professional LLCs – prohibits banking, insurance and trusts.

A. REQUIREMENTS FOR NAMING AND FORMATION

Each state specifies the information that must be included in a limited liability company’s articles of organization. Additional information is normally required for a professional LLC, including the fact that the entity is a limited liability company and a description of the specific professional service to be rendered.

States expressly authorizing professional LLCs require the entity to identify itself as such in its name. For example, Texas provides:

Art. 11.02. A. A professional limited liability company may adopt a name not contrary to the law or ethics regulating the practice of the professional service rendered through the professional limited liability company. The name of the limited liability company must contain the words "Professional Limited Liability Company" or the abbreviations "P.L.L.C." or "PLLC" and must contain other words as may be required by law. A limited liability company formed before September 1, 1993, that complied with Section A of Article 2.03 of this Act or with Section A of Article 7.03 of this Act on the date of formation, but does not comply with this Article, is not required to change its name.

B. LIMITATIONS ON MEMBERSHIP AND PRACTICE

1. Single Profession Rule

Most states limit professional LLCs to the practice of a single profession, hence attorneys and CPAs could not be members of the same professional LLC (even if allowed pursuant to statute, such LLCs would likely violate the professional rules of conduct which preclude professionals from being partners with those not so licensed). However, in Texas, for example, certain medical providers are allowed to be members in the same LLC even if they are not technically the same profession, e.g. podiatrists may be members in the same LLC with medical doctors.

Professionals should remember that regardless of what is provided in statute, they must abide by applicable professional rules of conduct or face disciplinary proceedings by the licensing agency of their state.
2. Membership Restrictions

Unlike other types of LLCs where there are normally no restrictions on who can become a member, professional LLCs are closed to non-professionals as members. Most states prohibit a person who is not a member of the profession from being a member, manager or officer of the company. Likewise, a membership interest in a professional LLC can only be transferred to someone licensed in the profession. This also means that only individuals can be members of a professional LLC, as opposed to other types of LLCs where, for example, a corporation or a partnership might have a membership.

If a member becomes disbarred, or otherwise loses their license to practice the particular profession, they must cease to be a member of the LLC immediately. States generally require the LLC to repurchase the ownership interest from the former member under these circumstances. The company’s articles of organization or operation may contain a formula for determining the valuation of a membership interest under these circumstances, such as when an attorney or accountant gives up his license to practice and retires. He can then no longer be a member of the company.

If the person in question was the sole member of the company, they are normally allowed to continue to act in the capacity of manager or member for the limited purpose of winding up the affairs of the company. They may not continue to render or provide professional services during this time.

If someone who is not a professional receives an interest in the company from a member, e.g. an attorney member of a professional LLC dies and leaves his share to his wife, the LLC must immediately purchase the membership, hopefully pursuant to a formula provided in the company’s operating agreement. Members of a professional LLC are also precluded from assigning any right with respect to their membership to anyone who is not a licensed professional. New York, for example, provides:

No member of a professional service limited liability company shall enter into a voting trust agreement, proxy or any other type of agreement vesting in another person, other than another member of such limited liability company or professional who would be eligible to become a member of such limited liability company, the authority to exercise voting power of any or all of the membership interests of such limited liability company. All membership interests or proxies granted or agreements made in violation of this section shall be void.

Anyone employed by the LLC to perform the profession must likewise be licensed. Professional LLCs are also free, of course, to hire non-professional personnel, including secretaries, technicians, nurses and assistants.

C. LIABILITY OF MEMBERS OF PROFESSIONAL LLC

The LLC is a desirable option for many reasons, not the least of which is limited liability for its members. In the case of a professional LLC, liability is limited, but not to the degree it would be with other types of businesses. While members of a professional LLC will not have personal liability for the debts or obligations of the company or for the acts or omissions of other members – e.g. malpractice – they are normally liable for their own actions. In addition, members of an LLC are still subject to all rules of professional responsibility that govern their profession, including, in the case of doctors, doctor-patient privilege.
States that expressly recognize professional limited liability companies have specific statutory provisions that address this area. The provisions in Texas law are representative of the national trend:

Art. 11.05. A. Notwithstanding anything contained in . . . this Act to the contrary, this Act does not alter or affect the professional relationship between a person rendering professional service and a person receiving the service, and a confidential relationship enjoyed in this state between those persons remains unchanged. This Act does not remove or diminish any rights at law that a person receiving professional service has against a person rendering the service for an error, an omission, negligence, incompetence, or malfeasance. A professional limited liability company, but not the other members, managers, officers, employees, or agents of such professional limited liability company (or their respective members, managers, officers, employees, or agents) is jointly and severally liable with a member, manager, officer, employee, or agent rendering professional service for an error, omission, negligence, incompetence, or malfeasance on the part of the member, manager, officer, employee or agent when the member, manager, officer, employee, or agent is rendering professional service in the course of employment for the professional limited liability company. If the member, manager, officer, employee, or agent rendering such professional service in such circumstances is itself a professional entity, then the professional limited liability company and such professional entity are jointly and severally liable with the partner, member, shareholder, manager, director, associate, officer, employee, or agent of such professional entity through which such professional entity renders such professional service for an error, omission, negligence, incompetence, or malfeasance on the part of such partner, member, shareholder, manager, director, associate, officer, employee, or agent of such professional entity.

D. FOREIGN PROFESSIONAL LLCS

As with other types of LLCs, foreign professional limited liability companies must comply with special state registration requirements if they wish to engage in business outside their state of formation. Texas, for example, provides:

Art. 11.07. A. A foreign professional limited liability company may apply for a certificate of authority to perform professional service in this state by filing an application in accordance with Part Seven of this Act. The Secretary of State may not issue the certificate unless the name of the foreign professional limited liability company or the name it elects in this state meets the requirements of Article 11.02 of this Act. A foreign professional limited liability company may render professional service in this state only through a member, manager, officer, employee, or agent described in Section A of Article 11.04 of this Act.

B. A certificate may not be issued to a limited liability company under this Article unless the application for the certificate includes a statement that the jurisdiction in which the limited liability company is organized would permit reciprocal admission of the limited liability company if it were organized in this state.
III. Professional Corporations

Historically states did not allow professional associations, e.g. law firms or public accountancy firms, to incorporate. The rationale was that such professionals should not be able to hide behind the protections of limited liability offered by corporate status. This notion has slowly changed to the point where all states recognize some form of professional corporate status. The parameters of state statute each vary. States tend to take one of two general approaches: some states authorize professional corporate status for any “licensed professional,” while other states list the specific professionals that are entitled to incorporate.

Massachusetts is one of the states that lists the specific professions eligible for incorporation. It also gives other “professionals” the opportunity to incorporate if so approved by their regulating board.

Specific professions authorized to incorporate under Massachusetts law (M.G.L.A. 156A § 2) are: registered physicians and surgeons, chiropractors, podiatrists, engineers, electrologists, physical therapists, psychologists, certified public accountants, public accountants, dentists, veterinarians, optometrists, acupuncturists, registered nurses, and attorneys.

Professional corporations are usually prohibited from rendering more than one kind of professional service. Texas law, for example, expressly provides that “[a] professional corporation may be organized under this Act only for the purpose of rendering one specific type of professional service and services ancillary thereto.”

Pennsylvania is one of the exceptions, allowing a professional corporation to engage in more than one type of professional service, based on certain conditions:

15 Pa.C.S.A. § 2903 Formation of professional corporations

(a) General rule.—A professional corporation shall be formed in accordance with Article B (relating to domestic business corporations generally) except that its articles shall contain a heading stating the name of the corporation and that it is a professional corporation.

(b) Legislative intent.—It is the intent of the General Assembly to authorize by this chapter licensed persons to render professional services by means of a professional corporation in all cases.

(c) Single-purpose corporations.—Except as provided in subsection (d), a professional corporation may be incorporated only for the purpose of rendering one specific kind of professional service.

(d) Multiple-purpose corporations.—
(1) A professional corporation may be incorporated to render two or more specific kinds of professional services to the extent that:
(i) the several shareholders of the professional corporation, if organized as a partnership, could conduct a combined practice of such specific kinds of professional services; or
(ii) the court, department, board, commission or other government unit regulating each profession involved in the professional corporation has by rule or regulation applicable to professional corporations expressly authorized the combined practice of the profession with each other profession involved in the corporation.

Even in the absence of such statutory limitations, however, remember that the rules of professional conduct governing many professionals, including attorneys and accountants, would prohibit cross-ownership, including partnerships.

State law also generally imposes limitations on the names of professional corporations (i.e. Texas law provides “a professional corporation may adopt any name that is not contrary to the law or ethics regulating the practice of the professional service rendered through the professional corporation. A professional corporation may use the initials "P.C." in its corporate name in lieu of the word, or in lieu of the abbreviation of the word, "corporation," "company," or "incorporated").

Beyond stating the qualification for incorporation, statutes governing professional corporations set forth the other formalities for formation and operation. Specific rules often govern the contents of the corporation’s articles of incorporation, for example.

A. ALL SHAREHOLDERS MUST BE ‘PROFESSIONALS’

Every state requires that in order to be a shareholder in a professional corporation, the individual must be a member of the profession. This also has the effect of limiting ownership in professional corporations to individuals only.

New Jersey law, for example, provides the following:

14A:17-10. Who may own shares; voting trust; estate ownership

(a) No professional corporation may issue any of its shares to anyone other than an individual who is duly licensed or otherwise legally authorized to render the same professional service as that for which the corporation was incorporated. No shareholder of a professional corporation shall enter into a voting trust agreement or proxy or any other type of agreement vesting another person not a shareholder of the corporation with the authority to exercise the voting power of any or all of his shares. Subject to the provisions of the corporation’s certificate of incorporation, the estate of a deceased shareholder may continue to hold the shares of such shareholder for a reasonable period of administration of the estate, but shall not be authorized to participate in any decisions concerning the rendering of professional service.

(b) A foreign professional legal corporation rendering legal services in this state shall have at least one shareholder who is an attorney-at-law licensed and eligible to practice in this state under the rules of the Supreme Court.

Upon the death of the shareholder, therefore, the estate must make provisions to transfer it to a person eligible to own it under the applicable state law. Washington state has an even more elaborate statutory scheme governing the disposition of shares of a deceased shareholder, providing that such shares may be transferred to remaining shareholders of the corporation (if any), or may be redeemed by the corporation pursuant to terms stated in the articles of incorporation or bylaws, or in a private
agreement (§18.100.116). In the absence of any such terms, the law further provides that such shares may be transferred to any individual eligible to be a shareholder of the corporation. Failure to transfer or redeem the shares within 12 months of the death of a shareholder requires the corporation to cancel the shares on its books.

A shareholder who, for whatever reason, loses his or her license to practice also becomes disqualified to own shares of a professional corporation. The corporation is then generally required, pursuant to applicable state law and its own articles of incorporation and bylaws, to repurchase the shares

B. TRANSFER OF SHARES

Restrictions on disposition in death apply equally to in vivo transfers. Thus Nevada law, for example (Section 89.070), provides that "[n]o shares of a corporation organized under this chapter may be sold or transferred except to a natural person who is eligible to be a stockholder of the corporation or to the personal representative or estate of a deceased or legally incompetent stockholder."

The Articles of Incorporation or bylaws of a professional corporation may provide specifically for additional restrictions on the transfer of shares and may provide for the redemption or purchase of the shares by the corporation, its stockholders or an eligible individual account plan complying with state law.

In the absence of a provision in the Articles of Incorporation or bylaws or a specific statute, however, a shareholder cannot generally compel a professional corporation to repurchase his or her shares.

Case-in-Point

In Corlett, Killian, Hardeman, McIntosh and Levi, P.A. v. Merritt (478 So.2d 828, Fla.App. 3 Dist., 1985), a Florida appellate court ruled that a shareholder of a professional corporation rendering legal services could not compel the corporation to repurchase his shares, even if he were forced out of the firm.

The defendant corporation, Corlett, Killian, Hardeman, McIntosh and Levi, P.A., is the successor to Corlett, Merritt, Killian and Sikes, P.A., a professional service corporation formed in 1973. When the corporation was formed, the only stock it issued was 2,000 shares to Edward Corlett in exchange for his transfer to the corporation of all of the law firm's assets which Corlett solely owned. In the years following, Corlett sold some of his stock to William C. Merritt (300 shares), Michael D. Sikes (240 shares), and Lawrance B. Craig, III (50 shares) for $50.00 per share.

On March 15, 1982, Merritt, Sikes and Craig voluntarily left the law firm and, unable to amicably resolve their claim that the successor corporation must redeem their shares, sued for this relief. The trial court sided with the plaintiff. The court on appeal reversed, writing that "while shares of stock in a professional corporation can be transferred only to a duly licensed member of the profession, they are otherwise freely transferable, and there is presently no requirement that they be transferred to an employee of the corporation."
The court went on to note that the corporation’s organizers could have avoided this problem by including a redemption provision in its articles of incorporation or bylaws:

“That a professional who resigns from the corporation could well be left in the unfortunate position of owning unmarketable shares of stock is generally true of the minority shareholders in all close corporations. But rather than being a compelling reason in favor of a court intervening, the distinct probability of this unfortunate state of affairs arising is a compelling reason why parties must agree in advance on a redemption provision,” the court wrote. “Where an employee who purchases such shares for valuable consideration either lacks the foresight or the bargaining power to insist upon a redemption agreement in the event of his resignation, it is not incumbent upon the courts to protect him from his own improvidence or lack of strength.”

In general, a stockholder may also transfer his shares in the corporation or any other interest in the assets of the corporation to a revocable trust if he acts as trustee of the revocable trust and any person who acts as co-trustee and is not licensed to perform the services for which the corporation was incorporated does not participate in any decisions concerning the rendering of those services.

Michigan law, for example, provides:

450.230. Transfer and redemption of shares of stock

Sec. 10. Shares of a corporation organized under this act shall not be sold or transferred except to an individual who is eligible to be a shareholder of the corporation or to the personal representative or estate of a deceased or legally incompetent shareholder or to a trust or split interest trust, in which the trustee and the current income beneficiary are both licensed persons in a professional corporation. The personal representative or estate of the shareholder may continue to own shares for a reasonable period but shall not be authorized to participate in any decisions concerning the rendering of professional service. The articles of incorporation or bylaws may provide specifically for additional restrictions on the transfer of shares and may provide for the redemption or purchase of the shares by the corporation or its shareholders at prices and in a manner specifically set forth.

State securities laws are normally expressly inapplicable to shares of a professional corporation.

**C. MERGER OF PROFESSIONAL CORPORATIONS**

Likewise, mergers are normally limited to other professional corporations.

New Jersey law, N.J.S.A. 14A:17-15, provides:

14A:17-15. Applicable law; consolidation, merger; report, contents

The Business Corporation Act of New Jersey shall be applicable to a professional corporation and to a foreign professional legal corporation except to the extent that any of the provisions of this act are interpreted to be in conflict with the provisions of the Business Corporation Act of New Jersey, and in such event the provisions and sections
of this act shall take precedence with respect to a professional corporation and a foreign professional legal corporation.

Except for a domestic professional legal corporation, a professional corporation organized under this act may consolidate or merge only with another professional corporation organized under this act and empowered to render the same professional service. A merger or consolidation with any foreign corporation is prohibited. A domestic professional legal corporation may consolidate or merge either with another domestic professional legal corporation or with a foreign professional legal corporation provided that the registration requirements of this act and the Rules of the Supreme Court are complied with.

A professional corporation shall annually furnish a report to the office of the Secretary of State on a date designated by the Secretary of State showing the names and post-office addresses of all its shareholders, directors and officers, which shall certify that, with the exception permitted in section 6, all such persons are duly licensed or otherwise legally authorized to render the same professional service in this State.

A foreign professional legal corporation shall annually furnish a report to the office of the Secretary of State on a date designated by the Secretary of State showing the names and post-office addresses of all its shareholders, directors and officers, and shall certify that the foreign professional legal corporation is authorized to render legal services of the type provided by attorneys-at-law in its state of incorporation and further certify that the shareholders and employees providing such services in this State are attorneys-at-law licensed and eligible to practice in this State.

This report shall be made on forms prescribed and furnished by the Secretary of State, but shall contain no information except that expressly called for by this section. It shall be signed by the president or vice-president and the secretary or an assistant secretary of the corporation, and acknowledged by the persons signing the report before a notary public or other officer duly authorized to administer oaths, shall be filed in the office of the Secretary of State, and shall be in lieu of the regular annual report of corporations otherwise required by the Business Corporation Act of New Jersey.

D. SHAREHOLDER LIABILITY

As stated at the beginning of this section, the lure of the professional corporation over the partnership has always been the availability of limited liability to all owners. As usual, state law specifies the parameters of that limited liability. Massachusetts law, for example, extends the same protections from liability to shareholders in professional corporations as they do to other corporate entities.

Case-in-Point

In Lichtman v. Estrin (723 N.Y.S.2d 185, 282 A.D.2d 326, 2001), an attorney sued the defendant law firm after he was terminated. He also named as a defendant the shareholder in the firm who was responsible for his discharge. The trial court dismissed the case against the individual shareholder.
Attorney/owner of law firm could not be held individually liable for alleged breach of employment contract by law firm, by piercing corporate shield, absent allegations that attorney was actually doing business in his individual capacity and using firm as mere device to further his personal rather than firm business.

“The complaint alleges that plaintiff worked for defendant Melvyn J. Estrin & Associates, P.C. While he alleges that Estrin asked him to continue working for the law firm and that, in exchange for his promise to do so, Estrin offered to pay his salary and benefits, plaintiff makes no sufficiently particularized statements that Estrin was actually doing business in his individual capacity, using the firm as a mere device to further his personal rather than firm business,” the court wrote.

Plaintiff argues that Estrin failed to perform his obligations under his agreement with plaintiff as an individual shareholder and officer of the professional corporation pursuant to Business Corporation Law § 1505(a), which states: "Each shareholder, employee or agent of a professional service corporation shall be personally and fully liable and accountable for any negligent or wrongful act or misconduct committed by him or by any person under his direct supervision and control while rendering professional services on behalf of such corporation."

The court rejected this argument based on the fact that the defendant’s alleged misconduct was not committed in the course of rendering professional services on behalf of the corporation.

The above case emphasizes the importance of state law in understanding liability issues. The issue of corporate shareholder liability is discussed in more detail in Chapter 5, Liability of Owners.

E. DISSOLUTION

State law again governs in this area. Remember that one of the key differences between a corporation and a partnership is that corporations have an unlimited life span. Thus, Texas law is illustrative of the general view that dissolution of a professional corporation be more difficult to achieve than that of a partnership.

Section 17 of the Texas Professional Corporation Act.

*Continuity of Existence. Unless the Articles of Incorporation expressly provide otherwise, a professional corporation shall continue as a separate entity for all purposes and for such period of time as is provided in the Articles of Incorporation until dissolved by a vote of its shareholders. A professional corporation shall continue to exist regardless of the death, incompetency, bankruptcy, resignation, withdrawal, retirement or expulsion of any one or more of its shareholders or the transfer of any of its shares to any new holder or the happening of any other event which under the laws of this state and under like circumstances would cause a dissolution of a partnership, it being the intent of this Section that such professional corporation shall have continuity of life independent of the life or status of its shareholders. No shareholder shall have power to dissolve the professional corporation by his independent act of any kind.*
F. FOREIGN CORPORATIONS

As we saw with limited liability companies, foreign entities are required to register with the applicable state agency before commencing operations in another state. Most states also require that at least one shareholder be licensed in that state before the corporation can operate. Indiana law, for example, provides that “a foreign professional corporation can practice a profession in Indiana only through shareholders, directors, officers, employees and agents who are licensed in this state, with the corporation having other shareholders, directors, officers, etc., who are licensed professionals in another state but who do not participate in the Indiana practice.”

Remember that state licensing authorities are free to impose additional requirements.
CHAPTER 7 – REVIEW QUESTIONS

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter. They do not need to be submitted in order to receive CPE credit. They are included as an additional tool to enhance your learning experience.

We recommend that you answer each review question and then compare your response to the suggested solution before answering the final exam questions related to this chapter.

1. What type of entity did professionals such as CPAs historically select:
   a) limited partnerships
   b) limited liability companies
   c) sole proprietorships and general partnerships
   d) limited liability partnerships

2. Professional limited liability companies are allowed in all states.
   a) true
   b) false

3. Professional corporations are:
   a) permitted in only a few states
   b) usually prohibited from rendering more than one kind of professional service
   c) generally permitted to use any name to represent themselves
   d) all of the above

4. According to the default rules, a shareholder of a professional corporation can generally compel the professional corporation to repurchase his or her shares.
   a) true
   b) false
CHAPTER 7 – SOLUTIONS AND SUGGESTED RESPONSES

1. A: Incorrect. Limited partnerships were traditionally not available to professionals.

   B: Incorrect. Limited liability companies are a relatively new concept.

   **C: Correct.** Sole proprietorships and general partnerships, neither of which insulate the owner from personal liability, were traditionally the only options for professionals like accountants, lawyers and doctors.

   D: Incorrect. This is a relatively new type of entity.

   (See page 7-1 of the course material.)

2. A: True is incorrect. Both Rhode Island and California prohibit the use of professional LLCs.

   **B: False is correct.** A “professional” generally means someone who is licensed by a state to perform a specified service, e.g., a doctor, accountant, attorney or veterinarian.

   (See page 7-2 of the course material.)

3. A: Incorrect. All states recognize some form of professional corporate status.

   **B: Correct.** Pennsylvania is one of the exceptions, allowing a professional corporation to engage in more than one type of professional service, based on certain conditions.

   C: Incorrect. State law generally imposes limitations on the names a professional corporation can use.

   D: Incorrect. Only one (not all) of the statements listed is correct.

   (See pages 7-6 to 7-7 of the course material.)

4. A: True is incorrect. Absent of a provision in the Articles of Incorporation, the bylaws or a specific statute, a shareholder can generally not compel a professional corporation to repurchase his or her shares.

   **B: False is correct.** A specific provision is generally required. There is no such default rule.

   (See page 7-8 of the course material.)
Chapter 8: Transfer, Conversion, and Merger of Entities

Hypothetical 1: Bill and Dan pool their resources and open a bar. Bill and Dan form a general partnership. Both work full time in the business. The bar becomes wildly popular and Bill and Dan want to expand. David wants to invest money in the business to help with the expansion but does not want to give up his job. He also does not want to assume personal liability for the business. Can Bill and Dan simply “admit” David to their partnership as a limited partner?

Hypothetical 2: John is a successful businessman who owns a number of rental properties throughout the town. He holds each property in his own name. John’s son, Frank, is close to graduating from college and coming to work with John. John eventually wants to transfer his property to his son and retire. What type of entity would make this type of transfer easy?

These hypothetical situations illustrate the importance of considering ease of transfer, conversion and merger when making a choice of business entity. The issue can arise in many contexts, including, as the above examples illustrate, the need for additional capital infusion or estate planning considerations.

I. Partnerships

A. TRANSFER

Partners normally retain the right to transfer their interest in receiving the profits of the partnership but are limited in their ability to transfer the partnership interest as a whole. Pursuant to the Uniform Partnership Act and as generally set forth in state law, a partner may only transfer his or her interest in receipt of partnership profits. An ownership interest in a partnership itself can only be transferred by consent of all other partners, unless otherwise provided in a written partnership agreement. The policy behind this restriction is basically the freedom to contract: a person should not be forced to become a partner with someone not of his or her own choosing. This makes sense particularly in light of the fact that general partners are jointly and severally liable for the debts and obligations of the partnership. The rights of a transferee of a partnership are set forth in state law and normally include:

- The right to receive, in accordance with the terms of the assignment, any distributions to which the transferor would otherwise have been entitled under the partnership agreement before dissolution;

- After dissolution, the right to receive the net amount that would otherwise have been distributed to the transferor upon the winding up of the business;

Transfer, Conversion, and Merger of Entities
Standing to seek a judicial dissolution and winding up of the partnership business; and

The right to an account of partnership transactions, limited to the period since the date of the last account agreed to by all of the partners.

A partner has other interests in the partnership that may not be transferred absent the required consent of the other partners, such as the right to participate in the management of the business. Those rights are included in the broader concept of a "partner's interest in the partnership."

B. MERGER

A partnership may convert or merge in any manner provided by applicable state law. A number of states currently authorize the merger of limited partnerships, and some authorize them to merge with other business entities such as corporations and limited liability companies. A few states currently authorize the merger of a general and a limited partnership or the conversion of a general to a limited partnership.

1. Plan of Merger

The first step in the process of a merger is normally the adoption of a plan of merger by the merging entities.

Pursuant to the UPA, § 905, the plan of merger must set forth:

- The name of each partnership or limited partnership that is a party to the merger;
- The name of the surviving entity into which the other partnerships or limited partnerships will merge;
- Whether the surviving entity is a partnership or a limited partnership and the status of each partner;
- The terms and conditions of the merger;
- The manner and basis of converting the interests of each party to the merger into interests or obligations of the surviving entity, or into money or other property in whole or part; and
- The street address of the surviving entity's chief executive office.

UPA § 905 (c) provides that the plan of merger must be approved: (1) by all the partners of each general partnership that is a party to the merger, unless its partnership agreement specifically provides otherwise for mergers; and (2) by all the partners, including both general and limited partners, of each limited partnership that is a party to the merger, notwithstanding a contrary provision in its partnership agreement, unless specifically authorized by the law of the jurisdiction in which that limited partnership is organized. As we said during the discussion on conversions, the purpose of the unanimity requirement is to protect limited partners from exposure to liability as general partners without their clear and knowing consent.
California law, Corporations Code § 15678.2, allows the plan of merger to be approved by “all general partners of each constituent limited partnership and the principal terms of the merger shall be approved by a majority in interest of each class of limited partners of each constituent limited partnership, unless a greater approval is required by the partnership agreement of the constituent limited partnership.”

However, if the limited partners of any constituent limited partnership become personally liable for any obligations of a constituent limited partnership or constituent other business entity as a result of the merger, the principal terms of the agreement of merger must, under California law, be approved by all of the limited partners of the constituent limited partnership.

UPA § 905 (d) provides that the plan of merger may be amended or abandoned at any time before the merger takes effect, if the plan so provides.

2. Effective Date of Merger

The merger takes effect, according to UPA § 905 (e), on the later of:

- Approval by all parties to the merger;
- Filing of all required documents; or
- The effective date specified in the plan.

The surviving entity must file all notices and documents relating to the merger required by other applicable statutes governing the entities that are parties to the merger, such as articles of merger or a certificate of limited partnership. It may also amend or cancel a statement of partnership authority previously filed by any party to the merger.

3. Effect of Merger

When a merger of partnerships takes effect, the separate legal existence of the merging partnerships ceases and all property of the merging entities vests with the surviving partnership. Likewise, all obligations of every partnership or limited partnership that is a party to the merger become the obligations of the surviving entity, and any action or proceeding pending against a partnership or limited partnership that is a party to the merger may be continued as if the merger had not occurred, or the surviving entity may be substituted as a party to the action or proceeding.

4. Liability of Partners

A partner of the surviving partnership or limited partnership is normally liable for:

- All obligations of a party to the merger for which the partner was personally liable before the merger;
- All other obligations of the surviving entity incurred before the merger by a party to the merger, but those obligations may be satisfied only out of property of the entity; and

- All obligations of the surviving entity incurred after the merger takes effect; however, those obligations may be satisfied only out of property of the entity if the partner is a limited partner.

If the obligations incurred before the merger by a party to the merger are not satisfied out of the property of the surviving partnership or limited partnership, the general partners of that party immediately before the effective date of the merger are required to contribute the amount necessary to satisfy that party’s obligations to the surviving entity.

Any partner of a merging partnership who does not become a partner in the new entity is effectively disassociated from the partnership from the date the merger takes effect.

C. CONVERSION

1. Conversion of General Partnership to Limited Partnership

This process is governed by applicable state law. Normally, the process requires the conversion to be approved by all of the partners or a smaller number if specified in a partnership agreement.

After the conversion is approved by the general partners, they must essentially follow the requirements of state law for the formation of a limited partnership, including the filing of a certificate of limited partnership with the appropriate state agency (this process is discussed in Chapter 2, Formation of Business Entities). The conversion takes effect when the certificate of limited partnership is filed or at any later date specified in the certificate.

A general partner who becomes a limited partner as a result of the conversion remains liable as a general partner for an obligation incurred by the partnership before the conversion takes effect. Limited partners who are new to the partnership assume the full protections of state law afforded to limited partners.

Third parties who transact business with the converted partnership unaware of a general partner’s new status as a limited partner may have some protections, according to applicable state law. Problems can be avoided if the former general partner notifies third parties with whom business is conducted of his or her change in status.

2. Conversion of Limited Partnership to Partnership

The conversion of a limited partnership to a general partnership normally requires the approval of all partners, even if there is a contrary provision in a partnership agreement. That includes all of the general and limited partners. The purpose of the unanimity requirement is to protect a limited partner from exposure to personal liability as a general partner without clear and knowing consent at the time of conversion. Despite a general voting provision to the contrary in the partnership agreement, conversion to a general partnership may never have been contemplated by the limited partner when he or she invested in the partnership.
Once approved by the requisite number of partners, the partnership must cancel its certificate of limited partnership with the appropriate state agency. The conversion takes effect when the certificate of limited partnership is canceled.

A limited partner who becomes a general partner as a result of the conversion remains liable only as a limited partner for an obligation incurred by the limited partnership before the conversion takes effect. The partner is liable as a general partner for an obligation of the partnership incurred after the conversion takes effect.

3. Effect of Conversion

There is little practical effect of the conversion of a partnership other than the change in status of some of the partners. Pursuant to the UPA § 904, “a partnership or limited partnership that has been converted pursuant to this [article] is for all purposes the same entity that existed before the conversion.” When the conversion takes effect, therefore:

- All property owned by the converting partnership or limited partnership remains vested in the converted entity;
- All obligations of the converting partnership or limited partnership continue as obligations of the converted entity; and
- An action or proceeding pending against the converting partnership or limited partnership may be continued as if the conversion had not occurred.

II. Limited Liability Companies

A. TRANSFER, SALE AND ASSIGNMENT OF MEMBERSHIPS

Once again, since limited liability companies are governed by state law, look first to the laws of the state of organization to determine the rules regarding the transfer, sale or assignment of a membership in a limited liability company. Second, look to the entity’s own articles of organization to see what, if any, limitations the members themselves have created.

A number of states have laws that require the unanimous consent of all members before a membership can be transferred. These states include Alaska, Alabama, Arizona, Colorado, Delaware, Florida and Georgia. A number of other states, including California and Connecticut, require a majority of the members of a limited liability company to consent to the assignment of an interest therein. To the extent that an ownership interest in a limited liability company is considered a “security,” as discussed above, additional rules may apply to transfers.
B. MERGER

Almost all states expressly provide for mergers of a limited liability company with another business entity in their LLC statutory scheme; Nevada is one of the exceptions. To determine the requirements for merging an LLC with another business entity, whether it is another LLC or a different business form, look to the laws of the state under which the LLC is organized. Each state that authorizes mergers sets forth the technical requirements, including the voting requirements of members and required state filings, in detail.

Under the Uniform Limited Liability Company Act, for example, § 904, a limited liability company may merge with or into any of the following:

- Another limited liability company;
- Foreign limited liability company;
- Partnership;
- Corporation;
- Foreign corporation;
- Limited partnership; or
- Foreign limited partnership.

Some states that allow mergers are more restrictive in the types of entities with which an LLC may merge. In Connecticut, for example, a limited liability company may not merge with a professional corporation. However, a professional corporation is free to acquire the assets of an LLC.

The national trend is for states to give companies more flexibility in this area. New York, for example, recently amended its laws to allow corporations and limited partnerships to merge or consolidate with all other types of business entities in the same manner as was previously permissible only for limited liability companies. Now, business corporations, limited liability companies, limited partnerships and other business entities may merge or consolidate into any other statutorily authorized business entity by filing a certificate of merger or consolidation with the Department of State.

A limited liability company wishing to merge with an approved entity must first approve a plan of merger which sets forth certain required information, including the name of each entity that is a party to the merger, the name of the surviving entity into which the other entities will merge, the type of organization of the surviving entity and the terms and conditions of the merger.

The plan must be approved by all members of the limited liability company unless a smaller number is provided for in the company’s operating agreement. Alabama, for example, § 10-12-54, provides that: “Notwithstanding prior approval, an agreement of merger may be terminated prior to filing articles of merger with the Secretary of State or amended pursuant to a provision for the termination or amendment contained in the agreement of merger.
Each other entity involved in the merger must similarly approve the transaction according to that entity’s internal rules or applicable state law. A merger becomes effective upon the filing of the articles of merger with the appropriate state agency, or at such later date as the parties to the merger may provide in their articles of merger. The articles of merger, which must be filed with the state and signed by representatives of all parties to the merger, must include the specific information required by each state. Pursuant to § 905 of the ULLCA, all of the following must be included:

- The name and jurisdiction of formation or organization of each of the limited liability companies and other entities that are parties to the merger;
- For each limited liability company that is to merge, the date its articles of organization were filed with the appropriate state agency;
- That a plan of merger has been approved and signed by each limited liability company and other entity that is to merge;
- The name and address of the surviving limited liability company or other surviving entity;
- The effective date of the merger;
- If a limited liability company is the surviving entity, such changes in its articles of organization as are necessary by reason of the merger;
- If a party to a merger is a foreign limited liability company, the jurisdiction and date of filing of its initial articles of organization and the date when its application for authority was filed by the [Secretary of State] or, if an application has not been filed, a statement to that effect; and
- If the surviving entity is not a limited liability company, an agreement that the surviving entity may be served with process in this State and is subject to liability in any action or proceeding for the enforcement of any liability or obligation of any limited liability company previously subject to suit in this State which is to merge, and for the enforcement, as provided in this [Act], of the right of members of any limited liability company to receive payment for their interest against the surviving entity.

A merger will normally not be permitted if, as a result of the transaction, a member of the limited liability company will become personally liable for certain obligations in the absence of the express consent of that member.

Likewise, if one or more foreign limited liability companies or other entities is a party to the merger or is to be created by the terms of the plan of merger, the merger must be permitted by the laws under which the foreign entities are formed or organized. In the alternative, the merger must be permitted by the organizational or other constituent documents of the foreign limited liability company or other entity that are not inconsistent with those laws.
States may have other specific requirements for mergers. For example, the Secretary of State in all states will normally not accept articles of merger without first confirming with the appropriate state agency that the merging companies have paid all applicable franchise taxes. Texas and other states likewise impose filing fees on the merging entities.

C. CONVERSION

A sole proprietor operating an auto repair shop in California will have little difficulty “converting” his entity into a limited liability company. He or she must simply meet the requirements of California law for registration as a limited liability company. No other formal process or approval is necessary from any other person or entity. This is the easiest type of conversion.

What happens when other types of business entities want to convert to a limited liability company? Is it allowed under the applicable state law? If so, what are the procedures?

Table 8.1 Conversion of Existing Business to LLC

<table>
<thead>
<tr>
<th>ORIGINAL ENTITY</th>
<th>NEW ENTITY</th>
<th>RULE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sole proprietorship</td>
<td>LLC</td>
<td>Conversion allowed by simply meeting state</td>
</tr>
<tr>
<td></td>
<td></td>
<td>requirements for organization of LLC</td>
</tr>
<tr>
<td>Limited Partnership</td>
<td>LLC</td>
<td>Allowed in all states after following state’s</td>
</tr>
<tr>
<td></td>
<td></td>
<td>formalities, receiving approval of requisite</td>
</tr>
<tr>
<td></td>
<td></td>
<td>number of partners</td>
</tr>
<tr>
<td>General Partnership</td>
<td>LLC</td>
<td>Allowed in all states after following state’s</td>
</tr>
<tr>
<td></td>
<td></td>
<td>formalities, receiving approval of requisite</td>
</tr>
<tr>
<td></td>
<td></td>
<td>number of partners</td>
</tr>
<tr>
<td>Corporation</td>
<td>LLC</td>
<td>Allowed in a minority of states only</td>
</tr>
</tbody>
</table>

The procedures for conversion are similar to the procedures for merger transactions. However, unlike a merger, a conversion will not combine an entity with another pre-existing entity or divide an entity into two or more entities. A conversion effects a change in the organization of an entity without a disruption or interruption of the organization’s existence.
1. Conversion of Partnership to LLC

Although the rules may differ between general and limited partnerships, the general rule in all states is that all partners must agree to a plan of conversion, unless otherwise provided for in the partnership’s written partnership agreement. Some states set forth more detailed requirements.

For example, in New York, the conversion of a limited partnership to an LLC, an agreement of conversion requires approval of both the general partners and each class of limited partners. If the partnership agreement makes no provision for such a vote, all general partners and two-thirds of each class of limited partners must approve. State law prohibits operating agreements from authorizing a conversion without the approval of at least a majority of any particular voting group.

Conversion of a limited partnership requires the partners to hold a meeting of both the general and the limited partners after providing at least 20 days notice, unless provided otherwise in the partnership agreement. A dissenting limited partner has the rights under partnership law and will not be part of the LLC.

Both general and limited partnerships wishing to convert to limited liability company status are required to file a “Certificate of Conversion” with the New York Secretary of State. New York also requires converting entities to comply with certain public notice provisions.

A “Certificate of Conversion” for a **general partnership** must include:

- The date its initial certificate was filed with the department of state;
- Articles of organization for the limited liability company in the same manner as if newly formed pursuant to §203 of the Limited Liability Company Law;
- A statement that the partnership was, in accordance with the provisions of the Limited Liability Company Law, duly converted to a limited liability company from a partnership; and
- The name of the partnership.

A “Certificate of Conversion” for a **limited partnership** must include:

- The name of the partnership or limited partnership and in the case of a limited partnership the date its initial certificate was filed with the department of state;
- A statement that the limited partnership was, in accordance with the provisions of the Limited Liability Company Law duly converted to a limited liability company from a limited partnership; and
- The name of the limited liability company and the date its articles of organization were filed with the department of state.
2. **Conversion of Corporation to Limited Liability Company**

While all states allow a partnership, either general or limited, to be converted to an LLC, only a few allow a corporation to be converted directly into a limited liability company. The trend is to allow corporations to convert to LLC status. California made the change effective January 1, 2003. Other states that allow this conversion include Tennessee and Oklahoma.

Oklahoma, for example, allows *any* business entity to convert to a limited liability company so long as it complies with applicable state laws and files articles of conversion containing the mandated information and likewise files articles of organization required of all limited liability companies. In Oklahoma, articles of conversion to a limited liability company must provide the following:

- The date on which the business entity was first formed;
- The name of the business entity immediately prior to the filing of the articles of conversion to limited liability company; and
- The name of the limited liability company as set forth in its articles of organization.

It is also important to note that states generally do not require a converting business entity to wind up its affairs or pay its liabilities prior to conversion. And in general, a conversion is not deemed to constitute a dissolution of the business. Thus, when a business entity is converted into a limited liability company, the new company is normally deemed to be the same as the converting business entity.

3. **Articles of Conversion**

Each state provides entities with sample articles of conversion that contain the required information. By way of example, the following are articles of conversion of a corporation to a limited liability company in Tennessee.
ARTICLES OF CONVERSION OF A CORPORATION TO A LIMITED LIABILITY COMPANY
FOR ________[Name of LLC]

Pursuant to the provisions of the Tennessee Limited Liability Company Act (T.C.A. § 48-204-101) ("the Act"), the undersigned hereby execute the conversion of ________[name of corporation], a Tennessee corporation (the "corporation) to a limited liability company ("LLC").

1. The limited liability company was converted from a corporation.

2. The name of the former corporation was ________ and the principal business address of the former corporation was ________.

3. The name of the limited liability company into which the corporation will be converted is ________[must contain the words "Limited Liability Company," or the abbreviation "L.L.C." or "LLC"].

4. Shares of the corporation will be converted into membership interests of the limited liability company [as follows, or, is contained in the operating agreement proposed for such limited liability company].

5. The effective date and time of such conversion is ________[upon filing the articles of conversion/some later date].

6. The contents of the article of organization for the limited liability company (unless and until modified in accordance with Chapter 209 of the Act, are ________[attached hereto].

7. Notification of the approval of the conversion will be deemed to be execution of the operating agreement by the persons who will be the members of the limited liability company.

4. Treatment of Assets of a Converted Entity

The general rule of law in all states is that when a business entity converts to a new form, all of the rights of that business as well as all of the property of that entity vest in the new company. Likewise, the rights of creditors remain unchanged, as well as any liens that may exist on any of the entity's property.

Case-in-Point

In C & J Builders and Remodelers, LLC v. Geisenheimer, 733 A.2d 193 (1999), an appeals court ruled that a limited liability company had the same rights as the sole proprietorship that converted into an LLC.

In 1996, the defendants entered into a construction contract with Charles Pageau doing business as C & J Builders – a sole proprietorship -- for the renovation of the defendants' house. The contract included a provision that required the parties initially to refer any disputes arising out of the contract to Duo Dickinson, an architect who had been
involved in the renovations. In the event that either party was dissatisfied with Dickinson's decision, that party then could submit a written demand to compel a formal arbitration proceeding.

Later that year, Pageau filed an operating agreement establishing the plaintiff, C & J Builders and Remodelers, LLC. Pageau then ceased doing business as the sole proprietorship and began conducting his construction operations as the plaintiff, a limited liability company. The plaintiff assumed virtually the same name as Pageau's sole proprietorship; it operated at the same business address; and it carried on the business operations of the sole proprietorship. Specifically, the plaintiff continued the renovations to the defendants' summer residence pursuant to the contract that the defendants had entered into with the sole proprietorship. Moreover, the plaintiff's operating agreement states that it is the "successor to Charles Pageau [doing business as] C & J Builders and Remodelers." The operating agreement further provides that Pageau maintains a 99 percent ownership interest in the plaintiff, and that he exercises virtually absolute control over the plaintiff's business operations.

In 1997, a dispute arose regarding $87,667.12 that the plaintiff claimed was owed on the contract. Thereafter, the plaintiff referred the dispute to Dickinson and forwarded documentation supporting its claim. Dickinson agreed to render a decision after the defendants had submitted documentation contesting the plaintiff's claim. The defendants, however, did not submit any documentation to Dickinson, and consequently, he refused to render a decision in the matter. The plaintiff then submitted to the defendants a written demand for formal arbitration. The defendants, however, did not comply with that demand.

The plaintiff thereafter filed an application in the trial court seeking an order directing the defendants to submit to arbitration. The defendants, however, filed a special defense, claiming that the plaintiff was not a party to their contract with the sole proprietorship, and, therefore, that the plaintiff was not entitled to compel the defendants to arbitrate the dispute. The trial court, however, concluded that the plaintiff was entitled to enforce the contract and ordered the defendants to submit to arbitration.

On appeal, the defendants claim that the trial court improperly concluded that the plaintiff is entitled to compel arbitration, while the plaintiff contends that it is the "successor in interest" to the sole proprietorship and, as such, has assumed the rights and obligations of its predecessor by operation of law. Consequently, the plaintiff maintains that it is entitled to compel arbitration. The court of appeal ruled in favor of the plaintiff. In its ruling, the court wrote:

“We focus our analysis on General Statutes § 34-200, the statute that governs the effect of the conversion of a general or a limited partnership to a limited liability company. Specifically, § 34-200(a) provides that "[a] general or limited partnership that has been converted to a limited liability company pursuant to section 34-199 shall be deemed for all purposes the same entity that existed before the conversion, except that the converted entity, its members and managers shall be governed solely by the provisions of sections 34-100 to 34-242, inclusive." Moreover, subsection (b) of § 34-200 provides that upon conversion of a general or limited partnership to a limited liability company, "[a]ll property owned by the converting general or limited partnership remains vested in the converted
entity ... [and] ... all obligations of the converting general or limited partnership continue as obligations of the converted entity...." Thus, § 34-200 expressly provides that the actual business operations of the converting partnership are not affected by the conversion, and that all of the converting partnership's property and obligations are transferred to the newly converted limited liability company by operation of law. In effect, § 34-200 treats the converted limited liability company as the "successor in interest" to the converting partnership.

Conversion, the court concluded, has no effect on any pending claims against the converting partnership or its partners, and likewise that members of the newly converted limited liability company retain personal liability for the preexisting debts and obligations incurred by the converting partnership.

"It is readily apparent, therefore," the court said, that state law "evidences an intent to facilitate seamless transition between the converting partnership and the converted limited liability company. Moreover, this legislative mandate also recognizes the importance of protecting the interests and expectations of third parties who, prior to the conversion, had contracted with, or had maintained claims against, the converting partnership."

“We conclude, therefore, that where a sole proprietorship converts to a limited liability company, all of the interests and obligations incurred by, or chargeable against, the sole proprietorship or its assets are transferred to the limited liability company by operation of law," the court wrote. “Moreover, like the general partners in a converting general or limited partnership, the sole proprietor retains personal liability for all pre-conversion debts and obligations incurred by the sole proprietorship.” To determine the specific treatment of assets and liabilities, refer to the laws of each specific state.

Under the ULLCA, § 903, for example, the following rules apply when a general or limited partnership is converted to a limited liability company:

- All property owned by the converting partnership or limited partnership vests in the limited liability company;
- All debts, liabilities, and other obligations of the converting partnership or limited partnership continue as obligations of the limited liability company;
- An action or proceeding pending by or against the converting partnership or limited partnership may be continued as if the conversion had not occurred;
- Except as prohibited by other law, all of the rights, privileges, immunities, powers, and purposes of the converting partnership or limited partnership vest in the limited liability company; and
- Except as otherwise provided in the agreement of conversion, all of the partners of the converting partnership continue as members of the limited liability company.
According to the comments to the ULLCA, “A conversion is not a conveyance or transfer and does not give rise to claims of reverter or impairment of title based on a prohibited conveyance or transfer . . . [T]itle to all partnership property, including real estate, vests in the limited liability company as a matter of law without reversion or impairment.”

Under California law, Corporations Code § 17540.7, a converting limited liability company or other business entity that has real property in California that vests in the converted entity may establish record ownership by filing statements or certificates as specified with the appropriate county recorder.

5. Liability of Owners of Converted Entity

Individual state law generally provides that the conversion of any business entity into a domestic limited liability company does not affect any obligations or liabilities of the business entity incurred prior to its conversion to a domestic limited liability company or the personal liability of any person incurred prior to such conversion.

Under the Uniform Limited Liability Company Act, § 902(g), a general partner who becomes a member of a limited liability company as a result of a conversion remains liable as a partner for an obligation incurred by the partnership or limited partnership before the conversion takes effect.

Similar rules apply to limited partnerships. According to § 902 (h), a limited partner who becomes a member as a result of a conversion remains liable only to the extent the limited partner was liable for an obligation incurred by the limited partnership before the conversion takes effect.

When the conversion becomes effective, the former partner receives the protections of limited liability afforded to members of a limited liability company (see Chapter 5, Liability of Owners for a more detailed discussion).

D. CONVERSION OF A LIMITED LIABILITY COMPANY TO A NEW BUSINESS FORM

Conversion also works the other way. What if a limited liability company or some of the members of one want to convert to a different type of entity?

Members of a limited liability company are normally free to convert their business into a different type of entity – subject of course to limitations imposed by the company’s operating agreement or Articles of Organization. Each state has its own specific requirements for conversion, but they generally include a requirement that the LLC approve a written plan for conversion and also that the LLC file Articles of Conversion with the appropriate state agency, normally the Secretary of State.

There are many reasons an LLC might decide to convert to a different type of entity. The need for investment capital, for example, might spark conversion to a corporation. The ease of conversion will depend on a number of factors, including the number of members, the desired new business form and the laws of each individual state. Table 8.2, below, summarizes some of the issues involved.
Table 8.2 Conversion of LLC to Different Business Form

<table>
<thead>
<tr>
<th>New Business Form</th>
<th>Requirements for Conversion</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sole Proprietorship</td>
<td>Easy if dealing with single-member LLC; member files Articles of Dissolution and retains assets of LLC</td>
</tr>
<tr>
<td>General Partnership</td>
<td>Conversion can be accomplished with approval of all members of LLC unless smaller number provided in Operating Agreement or Articles of Organization; members must assent to acceptance of personal liability</td>
</tr>
<tr>
<td>Limited Partnership</td>
<td>Same as General Partnership</td>
</tr>
<tr>
<td>C Corporation</td>
<td>Conversion can be accomplished with approval of all members of LLC unless smaller number provided in Operating Agreement or Articles of Organization</td>
</tr>
<tr>
<td>S Corporation</td>
<td>May not be possible for all LLCs given ownership restrictions for S corporations</td>
</tr>
</tbody>
</table>

1. Plan of Conversion

The first step for a limited liability company to convert to a new business form is normally the company’s adoption of a formal plan of conversion. States often set forth specific requirements for such plans.

Under Texas law, for example, a plan of conversion must set forth the following:

- The name of the converting entity and the converted entity;
- A statement that the converting entity is continuing its existence in the organizational form of the converted entity;
- A statement as to the type of entity that the converted entity is to be and the state or country under the laws of which the converted entity is to be incorporated, formed, or organized;
- The manner and basis of converting the membership interests or other evidences of ownership of the converting entity into membership interests or other evidences of ownership or securities of the converted entity, or any combination thereof;
- In an attachment or exhibit, the articles of organization of the domestic limited liability company, if the converted entity is a domestic limited liability company; and
- In an attachment or exhibit, the articles of organization or other organizational documents of the converted entity, if the converted entity is not a domestic limited liability company.
The plan of conversion may also set forth such other provisions relating to the conversion not inconsistent with law, including the initial regulations of the converted entity.

2. **Articles of Conversion**

Once a plan of conversion has been adopted, the entity must then normally approve the Articles of Conversion which must be executed by an appropriate company officer and filed with the Secretary of State or other appropriate state agency. The conversion is normally deemed effective when the Secretary of State or other appropriate state agency issues a certificate of conversion.

Like conversions of other entities into limited liability companies, the newly converted entity that was formerly a limited liability company inherits all of the obligations, rights and property of the old entity. In addition, the former member’s membership interests must be converted into new interests and evidence thereof provided to those members.

And, if, after the effectiveness of the conversion, a shareholder, partner, member, or other owner of the converted entity would be liable under applicable law, in such capacity, for the debts or obligations of the converted entity, that shareholder, partner, member, or other owner of the converted entity will be liable for the debts and obligations of the converting entity that existed before the conversion takes effect only to the extent that such shareholder, partner, member, or other owner either:

- Agrees in writing to be liable for such debts or obligations; or
- Was liable under applicable law, prior to the effectiveness of the conversion, for such debts or obligations.

3. **Tax Clearance**

Before filing Articles of Conversion, the Secretary of State is required to determine that a converting entity that is subject to franchise tax (i.e., a domestic or foreign corporation or limited liability company) has paid all franchise taxes.

If a certificate of account status is not submitted with the Articles of Conversion, the Secretary of State will check the comptroller's database in an attempt to determine whether the entity is in good standing for the purpose of conversion. In the alternative, a conversion may be effected and filed without the necessary tax clearance or suggested tax certificate evidencing tax clearance if the articles of conversion or plan of conversion (or alternative statement filed in lieu of the plan) provides a statement that the converted entity will be responsible for the payment of all such fees and franchise taxes and that the converted entity will be obligated to pay such fees and franchise taxes if the same are not timely paid.

**E. LLC MEMBERSHIP AS A ‘SECURITY’**

A membership in a limited liability company is considered the personal property of the member. Compare this to a corporation where “owners” hold “shares” in a corporation which are treated under state and federal law as a “security.”
Whether federal securities laws apply to a membership in a limited liability company depends on the nature of each entity. In general, the more control members have over the day-to-day operations of the enterprise, the less likely their membership will be classified as a security.

The most significant fact that comes from classifying a membership interest in a limited liability company as a security for purposes of federal law is the triggering of registration and disclosure requirements involved in the purchase and sale of the security. A detailed discussion of these requirements is clearly beyond the scope of this material, although it is important to be aware that the issue does exist.

Each state may also have a statutory provision that discusses the nature of a membership interest in a limited liability company. Remember, however, that federal law preempts. This means that even if an interest is not treated as a security for purposes of state law, it may very well be under federal law.

Some states expressly define a membership in a limited liability company as a security for purposes of state law. These states include Alaska, Michigan, Nevada, New Mexico, Ohio and Vermont. Maine, on the other hand, expressly excludes memberships in a limited liability company as a security for purposes of state law. Texas expressly exempts only professional limited liability companies.

Other states have a statutory framework for determining the circumstances under which a membership will be treated as a security. For example, Indiana Code § 23-2-1-1 provides:

(k) "Security" means a note, stock, treasury stock, bond, debenture, evidence of indebtedness, an interest in a limited liability company or limited liability partnership and any class or series of an interest in a limited liability company or limited liability partnership (including any fractional or other interest in an interest in a limited liability company or limited liability partnership), certificate of interest or participation in a profit-sharing agreement, commodity futures contract, option, put, call, privilege, or other right to purchase or sell a commodity futures contract, margin accounts for the purchase of commodities or commodity futures contracts, collateral- trust certificate, preorganization certificate or subscription, transferable share, investment contract, viatical settlement contract, any fractional or pooled interest in a viatical settlement contract, voting-trust certificate, certificate of deposit for a security, certificate of interest or participation in an oil, gas, or mining title or lease or in payments out of production under the title or lease, an automatic extension or rollover of an existing security, or, in general, an interest or instrument commonly known as a "security", or a certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant, option, or right to subscribe to or purchase, any of the foregoing. "Security" does not include:

(1) an insurance or endowment policy or annuity contract under which an insurance company promises to pay money either in a lump sum or periodically for life or some other specified period;

(2) a contract or trust agreement under which money is paid pursuant to a charitable remainder annuity trust or a charitable remainder unitrust (described in Section 664 of the Internal Revenue Code) or a pooled income fund (described in Section 642(c)(5) of
the Internal Revenue Code) or an annuity contract under which the purchaser receives a charitable contribution deduction under Section 170 of the Internal Revenue Code; or

(3) an interest in a limited liability company or limited liability partnership if the person claiming that the interest is not a security can prove that all of the members of the limited liability company or limited liability partnership are actively engaged in the management of the limited liability company or limited liability partnership.

Refer first to state law and then to federal law to determine if a particular LLC interest will be classified as a “security.”

III. Corporations

Given the complex nature of corporations, it is not surprising that the merger or conversion of a corporation is generally a more complex process than the merger or conversion of either a partnership or a limited liability company.

A. TRANSFER

One of the desirable characteristics of corporate form is often the ease of transferability of interests. Absent a contrary provision in the Articles of Incorporation or bylaws, the holder of shares of a corporation is normally free to transfer that interest to any other third party. Keep in mind, however, that the ownership restrictions on subchapter S corporations limit the ability of a shareholder to transfer shares to certain persons or entities without risking the subchapter S status of the corporation (refer back to Chapter 2, Formation of Business Entities, for a discussion on ownership restrictions applicable to S corporations).

It is also fairly common for closely-held corporations to include rights of first refusal in the event a shareholder decides to sell.

B. MERGER

A corporation is free to merge with another entity according to the requirements of applicable state law if approved by the corporation’s Board of Directors.

1. Plan of Merger

The first step in the merger of a corporation with another entity is for the corporation to adopt a plan of merger. Tennessee law (§ 48-21-102), requires the plan to include:

- The name of each entity planning to merge;
- The name of the entity that will survive the merger;
- The terms and conditions of the merger; and
- The manner and basis of converting shares of each merging entity, i.e. shares or cash.
2. Certificate of Merger

The surviving entity is normally required to file a certificate of merger with the appropriate state agency setting forth the information mandated by the state of organization. In California, for example, the certificate must set forth the following:

- The name, place of incorporation or organization, and the Secretary of State's file number, if any, of each party to the merger, separately identifying the disappearing parties and the surviving party;

- The future effective date or time, not more than 90 days subsequent to the date of filing of the merger, if the merger is not to be effective upon the filing of the certificate of merger with the office of the Secretary of State;

- A statement, by each party to the merger which is a domestic corporation not organized under this division, a foreign corporation, or another business entity, of the statutory or other basis under which that party is authorized by the laws under which it is organized to effect the merger;

- Any other information required to be stated in the certificate of merger by the laws under which each party to the merger is organized; and

- Any other details or provisions that may be desired.

Most states require that the agreement of merger may not be filed until the merging entities receive tax clearance from the appropriate state agencies. The certificate of merger must be signed by each other party to the merger by those persons required or authorized to execute the certificate of merger by the laws under which that party is organized, specifying for that party the provision of law or other basis for the authority of the signing persons.

3. Effective Date of Merger

A merger normally becomes effective on the date the certificate of merger is filed with the appropriate state agency, unless another date is provided in the certificate of merger.

4. Effect of Merger

As we saw with the other entities discussed above, upon the effective date of merger, the separate existences of the disappearing parties to the merger cease and the surviving party to the merger retains all of the rights and liabilities of the merging entities, including all rights of creditors. Likewise, any action or proceeding pending by or against any disappearing corporation or disappearing party to the merger may be prosecuted to judgment, which shall bind the surviving party, or the surviving party may be proceeded against or substituted in its place.
If a limited partnership or a general partnership is a party to the merger, the merger does not normally affect the liability of a general partner of a disappearing limited partnership or general partnership which may exist in connection with the debts and liabilities of the disappearing limited partnership or general partnership existing prior to the time the merger is effective.

C. CONVERSION

State law governs the conversion of a corporation to a new entity. A corporation can normally be converted into any other type of entity with the requisite intent of the shareholders. The recent trend in state law is to treat a conversion in much the same way as a merger.

1. Plan of Conversion

The first step in a corporate conversion is the adoption, by the requisite percentage of shareholders, of a plan of conversion. Alabama law (§10-15-3), for example, provides that “the terms and conditions of a conversion of a corporation to another business entity must be approved by all of the corporation's shareholders except as otherwise provided in the corporation's articles of incorporation; but in no case may the vote required for shareholder approval be set at less than a majority of the votes entitled to be cast by each voting group entitled by law to vote separately on the conversion.”

The plan must also contain the information required in the state of conversion. Under Texas law, for example, the plan of conversion must include:

- The name of the converting entity and the converted entity;
- A statement that the converting entity is continuing its existence in the organizational form of the converted entity;
- A statement as to the type of entity that the converted entity is to be and the state or country under the laws of which the converted entity is to be incorporated, formed, or organized;
- The manner and basis of converting the shares, membership or partnership interests or other evidences of ownership of the converting entity into securities, partnership or membership interests, or other evidences of ownership of the converted entity, or any combination thereof; and
- In an attachment or exhibit, the organizational documents of the converted entity (foreign or domestic).

2. Articles of Conversion

Each state also sets forth specific requirements for the filing of Articles of Conversion with the secretary of state or other appropriate agency. A fee is usually charged.
3. Effective Date

Unless another date is selected by the converting entity, a conversion is effective upon the issuance of articles of conversion by the appropriate state agency.

4. Tax Clearance

Before filing Articles of Conversion, the Secretary of State or other appropriate state agency is required to determine that a converting entity that is subject to franchise tax (i.e., a domestic or foreign corporation or limited liability company) has paid all franchise taxes.
CHAPTER 8 – REVIEW QUESTIONS

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter. They do not need to be submitted in order to receive CPE credit. They are included as an additional tool to enhance your learning experience.

We recommend that you answer each review question and then compare your response to the suggested solution before answering the final exam questions related to this chapter.

1. The rights of a transferee of a partnership normally include:
   a) the right to receive any distributions to which the transferor would have been entitled to prior to dissolution
   b) the right to seek a judicial dissolution and winding up of a partnership business
   c) the right to an account of the partnership transactions, limited to the period since the date of the last account agreed upon by all of the partners
   d) all of the above

2. What is normally the first step when two partnerships decide to merge:
   a) a filing with the SEC
   b) adoption of a plan of merger
   c) partner approval
   d) court approval

3. The effective date of a merger will always be the effective date specified in the plan.
   a) true
   b) false

4. There is little practical effect of the conversion of a partnership other than the change in status of some of the partners.
   a) true
   b) false

5. The national trend is for states to be more restrictive as to which entities an entity can merge or consolidate with.
   a) true
   b) false
6. What percentage of the partners must agree before a partnership can be converted into a limited liability company:

   a) 50 percent
   b) 100 percent
   c) the number set forth in the partnership agreement
   d) either b or c

7. The general rule of law in all states is that when a business entity converts to a new form, all of the rights of that business vest in the new company.

   a) true
   b) false

8. Members of a limited liability company generally cannot convert their business into a different type of entity.

   a) true
   b) false

9. Which of the following entities is the most complicated to convert to a different type:

   a) sole proprietorship
   b) partnership
   c) corporation
   d) limited liability company

10. What type of entities can a corporation be converted into:

    a) none; once a corporation is created, it exists in perpetuity and cannot be converted into a different type of entity
    b) a limited liability company only
    c) a partnership only
    d) any other type of entity as approved by the shareholders
CHAPTER 8 – SOLUTIONS AND SUGGESTED RESPONSES

1. A: Incorrect. The transferee does have this right, but it is not the only correct answer.
   B: Incorrect. The transferee does have this right, but it is not the only correct answer.
   C: Incorrect. The transferee does have this right, but it is not the only correct answer.
   D: Correct. The transferee if a partnership has all of the above listed rights as well as the right after dissolution to receive the net amount that would otherwise have been distributed to the transferor upon the winding up of the business.
   (See pages 8-1 to 8-2 of the course material.)

2. A: Incorrect. The SEC has no jurisdiction over partnerships and no role in approving their mergers.
   B: Correct. The merging entities will traditionally prepare a plan of merger as the first step in the process.
   C: Incorrect. This is generally done after the merger plan is approved.
   D: Incorrect. A court of law is generally not involved in the process.
   (See page 8-2 of the course material.)

3. A: True is incorrect. The merger takes effect on the later of the approval by all parties to the merger, the filing of all required documents, or the effective date specified in the plan.
   B: False is correct. The surviving entity must file all notices and documents relating to the merger required by other applicable statutes governing the entities that are parties to the merger.
   (See page 8-3 of the course material.)

4. A: True is correct. According to UPA §904, “a partnership or limited partnership that has been converted pursuant to this [article] is for all purposes the same entity that existed before the conversion.”
   B: False is incorrect. When the conversion takes effect, all property owned by the converting partnership or limited partnership remains vested in the converted entity, all obligations of the converting partnership or limited partnership continue as obligations of the converted entity, and an action or proceeding pending against the converting partnership or limited partnership may be continued as if the conversion had not occurred.
   (See page 8-5 of the course material.)
5. A: True is incorrect. States have become more flexible rather than more restrictive.

B: False is correct. The national trend is for more flexibility. For example, New York amended its laws to allow corporations and limited partnerships to merge or consolidate with all other types of business entities in the same manner as was previously permissible only for limited liability companies.

(See page 8-6 of the course material.)

6. A: Incorrect. Most states require 100 percent consent unless otherwise provided in the partnership agreement.

B: Incorrect. Most states require all partners to consent to conversion. However, this is not the best answer.

C: Incorrect. Partners may provide the requirements for conversion in their partnership agreement. However, this is not the best answer.

D: Correct. Partners can choose the requirements for conversion in their partnership agreement. However, absent such a provision states generally require all partners to consent.

(See page 8-9 of the course material.)

7. A: True is correct. In addition, the property of the entity vests in the new company.

B: False is incorrect. The rights of creditors remain unchanged as well as any liens that may exist on any of the entity’s property.

(See page 8-11 of the course material.)

8. A: True is incorrect. Generally, LLCs are free to convert to another type of business entity, subject to limitations imposed by the company’s operating agreement or Articles of Organization.

B: False is correct. Each state has its own specific requirements for conversion, but they generally include a requirement that the LLC approve a written plan for conversion and also that the LLC file Articles of Conversion with the appropriate state agency.

(See page 8-14 of the course material.)
9. A: Incorrect. This is effectively not a separate legal entity and therefore cannot technically be converted. Rather, an entity is formed.

B: Incorrect. A partnership is one of the least complex entities and is not that hard to convert.

C: **Correct.** Because it is the most complex of the entities, it is the most complex to convert.

D: Incorrect. Limited liability companies are not as complex as corporations.

(See page 8-18 of the course material.)

10. A: Incorrect. Shareholders generally may agree to convert a corporation into any other type of entity as allowed by state law. There are usually no restrictions so long as the shareholders agree. The SEC has no jurisdiction over partnerships and no role in approving their mergers.

B: Incorrect. State laws generally allow a corporation to convert into any type of entity the shareholders agree to.

C: Incorrect. State laws generally allow a corporation to convert into any type of entity the shareholders agree to.

D: **Correct.** Shareholders are generally free, pursuant to the law of the state in which it is incorporated, to convert to a different type of entity as agreed by the shareholders.

(See page 8-20 of the course material.)
Chapter 9: Termination / Dissolution of Business Entities

I. Introduction

Few, if any, people launch a business with the vision that it will fail. Many people therefore do not consider rules of dissolution when considering an appropriate business entity. However, there are many reasons besides failure that some or all of the owners of a business may wish to dissolve the entity. A general partnership may end, for example, when one of the partners decides to retire and sell his or her interest to the remaining partner or to a third party. Understanding the way different business entities both begin and end their legal lives is therefore important before selecting a business structure.

The sole proprietorship is the easiest and most logical entity to begin this discussion. Because the sole proprietorship has no legal existence separate and apart from the owner, it literally dies when the owner dies. Short of death, the business ends at the will of the owner. This may take the form of a sale of assets to a third party or a simple decision to “hang it up.” Either way, there are no formalities other than those required if some or all of the assets are sold, e.g., a purchase contract.

The rules governing dissolution of more legally complex entities are obviously more detailed. The degree of complexity may depend on a number of factors, including the number of owners and the type of business the entity is engaged in. As with most areas this course discusses, it is state law that governs the nuts and bolts of the dissolution of business entities.

Different problems arise when some, but not all, of the owners wish to dissolve the entity. Do the remaining owners have the right to continue the business? What happens to the assets of the business? These are just a few of the questions that can arise under these circumstances.

Historically, one of the factors in selecting an entity was its legal duration. This is less of an issue today in the wake of IRS regulations that give limited liability companies an unlimited life span. And while partnerships do not have an unlimited life span, the partners can control most factors causing dissolution in their written partnership agreement.
Table 9.1 Comparison of Longevity of Different Business Forms

<table>
<thead>
<tr>
<th>TYPE OF ENTITY</th>
<th>LONGEVITY</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sole Proprietorship</td>
<td>Generally dies with the proprietor; assets may be sold or passed on to heirs</td>
</tr>
<tr>
<td>Partnership</td>
<td>Spelled out in partnership agreement; where silent subject to state default rules</td>
</tr>
<tr>
<td>C Corporation</td>
<td>Can be formed in perpetuity</td>
</tr>
<tr>
<td>S Corporation</td>
<td>Cannot be formed in perpetuity and maintain pass-through tax status</td>
</tr>
<tr>
<td>Limited Liability Company</td>
<td>May or may not have an expiration date; check-the-box regulations allow LLC to be formed in perpetuity</td>
</tr>
</tbody>
</table>

II. General Partnerships

A. TYPES OF PARTNERSHIPS

For purposes of dissolution, there are two types of partnerships: at-will partnerships and partnerships with a duration. An at-will partnership, by definition, can be dissolved at any time by any of the general partners. Most partnerships are of this type. A partnership with a duration is one that provides an ending date in its written partnership agreement.

Because a general partnership is nothing more than an agreement between two or more people to carry on a business or trade for profit, it would seem logical to assume that the partnership could be dissolved through a subsequent agreement between the same partners to end the business. This is basically true for an at-will partnership.

It is sometimes difficult to determine whether a partnership is at will or is for a definite term or the completion of a particular undertaking. Presumptively, every partnership is an at-will partnership. To constitute a partnership for a term or a particular undertaking, the partners must agree (i) that the partnership will continue for a definite term or until a particular undertaking is completed and (ii) that they will remain partners until the expiration of the term or the completion of the undertaking. Both are necessary for a term partnership; if the partners have the unrestricted right, as distinguished from the power, to withdraw from a partnership formed for a term or particular undertaking, the partnership is one at will, rather than a term partnership.

Under the Uniform Partnership Act, § 406, a partnership with a definite term can be extended even without an express agreement to do so:
Section 406. Continuation of Partnership Beyond Definite Term or Particular Undertaking.

(a) If a partnership for a definite term or particular undertaking is continued, without an express agreement, after the expiration of the term or completion of the undertaking, the rights and duties of the partners remain the same as they were at the expiration or completion, so far as is consistent with a partnership at will.

(b) If the partners, or those of them who habitually acted in the business during the term or undertaking, continue the business without any settlement or liquidation of the partnership, they are presumed to have agreed that the partnership will continue.

According to the drafters’ Comment to § 406, any partnership in which the partners have not agreed to remain partners until the expiration of a definite term or the completion of a particular undertaking is a "partnership at will." The distinction between an "at-will" partnership and a partnership for "a definite term or the completion of a particular undertaking" is important in determining the rights of dissociating and continuing partners following the dissociation of a partner.

B. RIGHT OF GENERAL PARTNER TO CAUSE DISSOLUTION

In the absence of a partnership for a duration, a general partnership will generally dissolve according to the terms of its partnership agreement (if any) or upon operation of law. A distinction must be recognized, however, between the power to dissolve a partnership and the right to dissolve it.

Every partner may have the power to dissolve a partnership at any time and for any reason – even if such dissolution violates specific provisions of a partnership agreement. However, a partner who wrongfully dissociates is subject to damages suffered by the partnership as a result. This right is codified in the Uniform Partnership Act and in the laws of every state.

If, however, the partnership is "at will," as defined above, any partner may terminate the partnership at any time without liability. The partner’s motivation for termination is not relevant.

Remember that regardless of whether the partnership is at will, its dissolution is governed by both the provisions of a written partnership agreement, if any, and by state law, which sets forth conditions that can cause dissolution. Common examples of statutory bases of dissolution include:

- The death of a partner;
- The bankruptcy of a partner; and
- Where continuation of the partnership would be a violation of law.

A partner may, however, in the event of a happening specified in the partnership agreement, agree to continue the business.
C. ADMINISTRATIVE AND JUDICIAL DISSOLUTIONS

Government agencies and courts will, under certain circumstances, step in and force the dissolution of a partnership. This is most likely to occur in a limited partnership or a limited liability partnership where there are more formalities required for operation than with a simple general partnership.

The Uniform Partnership Act, for example, § 401, provides that a partner may apply to a court of competent jurisdiction to have a partnership dissolved if:

- The economic purpose of the partnership is likely to be unreasonably frustrated;
- Another partner has engaged in conduct relating to the partnership business which makes it not reasonably practicable to carry on the business in partnership with that partner; or
- It is not otherwise reasonably practicable to carry on the partnership business in conformity with the partnership agreement.

The UPA also provides for judicial dissolution on application by a transferee of a partner's transferable interest in the partnership, including the purchaser of a partner's interest upon foreclosure or a charging order.

D. REQUIREMENTS FOR EFFECTIVE DISSOLUTION

1. Notice And Expression Of Desire To Dissolve

No specific form of notice is required to dissolve a general partnership, unless otherwise provided in a partnership agreement. The partner seeking dissolution must merely communicate his or her desire to dissolve with the other partner(s). The partnership is dissolved upon the provision of such notice. Notice may even be implied under certain circumstances.

2. Effective Date Of Dissolution

A partnership dissolution by operation of law dates generally from the occurrence of the event causing it. For example, in the case of a partnership at will, the date of a party's manifestation of his unequivocal election to dissolve the partnership is the correct date of its dissolution, and no later than the filing of an accounting action. A dissolution is not effective as to third persons until they are given actual notice.

E. PARTNERSHIP CONTINUES AFTER DISSOLUTION

State law normally provides that a partnership continues after dissolution for the purpose of winding up its business, after which it is terminated. No legal rights turn on the partnership's termination or the date thereof. Even after termination, if a previously unknown liability is asserted, all of the partners are still liable.

Any partner who has not wrongfully dissociated may participate in winding up the partnership's business. In the absence of any remaining partners, state law provides that the legal representative of the last surviving partner may wind up a partnership's
business. A person winding up a partnership's business may generally do the following, as necessary:

- Preserve the partnership business or property as a going concern for a reasonable time;
-Prosecute and defend actions and proceedings, whether civil, criminal, or administrative;
-Settle and close the partnership's business;
-Dispose of and transfer the partnership's property;
-Discharge the partnership's liabilities;
-Distribute the assets of the partnership pursuant to state law and the partnership agreement; and
-Settle disputes by mediation or arbitration, and perform other necessary acts.

A partner's fiduciary duties of care and loyalty discussed in Chapter 3 extend to winding up the business.

A partner acting in the course of winding up the affairs of the entity also retains authority to bind the partnership even after dissolution in transactions that are appropriate for winding up the partnership business.

**F. STATEMENT OF DISSOLUTION**

After dissolution, a partner who has not wrongfully dissociated may file a statement of dissolution stating the name of the partnership and that the partnership has dissolved and is winding up its business, as provided in state law.

Florida law, for example, § 620.8805, provides:

(1) After dissolution, a partner who has not wrongfully dissociated may file a statement of dissolution stating:

(a) The name of the partnership, as identified in the records of the Department of State; and
(b) That the partnership has dissolved and is winding up its business.

(2) A statement of dissolution cancels a filed statement of partnership authority for purposes of s. 620.8303(3) and is a limitation on authority for purposes of s. 620.8303(4).
(3) For purposes of ss. 620.8301 and 620.8804, a person who is not a partner is deemed to have notice of a dissolution, and the limitation on the partners’ authority as a result of the statement of dissolution, 90 days after it is filed.

(4) After filing and, if appropriate, recording a statement of dissolution, a dissolved partnership may file and, if appropriate, record a statement of partnership authority that will operate with respect to a person who is not a partner, as provided in s. 620.8303(3) and (4), in any transaction, whether or not the transaction is appropriate for winding up the partnership business.

The filing and recording of a statement of dissolution is optional. A statement of dissolution operates as a limitation on authority of the remaining partners and provides that third parties are deemed to know of a limitation on the authority of a partner to take certain actions, e.g. to transfer real property.

G. PARTNERS REMAIN LIABLE FOR PARTNERSHIP DEBTS

All parties remain liable for pre-existing debt or obligation after the dissolution of the partnership for the period of time provided in the applicable state law. The end of the partnership does not mean the end of the debt or obligation.

Example.

A&B Importers, a general partnership composed of two partners, entered into a contract for the purchase of 1,000 cases of stuffed monkeys with XYZ Corporation. After taking delivery but before paying for the monkeys, A&B Importers agreed to dissolve the partnership. XYZ may still sue the partnership and the individual partners to collect on the unpaid amount any time prior to the end of the statute of limitations for enforcement of a contract. A and B are not insulated merely because the partnership has ended.

In addition to debts to third parties, partners are normally still liable for contributions to the partnership even in the event of dissolution. Georgia law, for example, provides the following:

§ 14-8-34. Right of partner to contribution from copartners after dissolution

Subject to contrary agreement of the partners, each partner is liable to his or her copartners for his or her share of any liability created by any partner acting for the partnership after dissolution as if the partnership had not been dissolved; provided, however, that a partner shall not be liable to the partner acting for the partnership after dissolution where:

(1) The dissolution being by act of any partner, the partner acting for the partnership had knowledge of the dissolution;

(2) The dissolution being by the death of a partner, the partner acting for the partnership had knowledge or notice of the death;

(3) The dissolution is not by the act or death of a partner; or
(4) The liability is for a debt or obligation for which the partner is not liable as provided in subsection (b) of Code Section 14-8-15.

The Uniform Partnership Act provides that a partner is entitled to contribution with respect to liabilities created in post-dissolution transactions as if the partnership had not been dissolved, except in certain situations in which the partner who is seeking contribution was the acting partner and knew, had notice or should have known of the dissolution.

III. Dissolution of Limited Partnership

A. NON-JUDICIAL DISSOLUTION

Each state sets forth in statute the conditions or events that will cause dissolution of a limited partnership. These generally include:

- At the time specified in the certificate of limited partnership;
- Upon the happening of events specified in writing in the partnership agreement;
- Upon the written consent of all partners;
- Upon the withdrawal of the general partner unless provided otherwise in the written partnership agreement or agreed upon by all remaining partners; and
- Upon withdrawal of the last remaining general partner unless, within a specified amount of time, the limited partners agree to admit a new general partner.

B. ADMINISTRATIVE DISSOLUTION

Unlike general partnerships, each state imposes certain formalities on the creation of a limited partnership, including registration with the appropriate state agency. Failure to follow certain state-mandated formalities can result in administrative dissolution of a limited partnership.

C. JUDICIAL DISSOLUTION

Certain misconduct on the part of a limited partnership can result in judicial dissolution. A partner may apply to a court of competent jurisdiction for judicial dissolution. Events which commonly give rise to judicial dissolution include the finding of the following (as outlined in state law):

- That the economic purpose of the limited partnership is likely to be unreasonably frustrated;
- That another partner has engaged in conduct relating to the limited partnership business that makes it not reasonably practicable to carry on the business in limited partnership with that partner; or
● That is not reasonably practicable to carry on the business of the limited partnership in conformity with the partnership agreement.

**D. WINDING UP**

As with a general partnership, a limited partnership has authority to continue operating to “wind up” its business. State law normally requires a dissolved partnership to wind up its affairs as quickly as practicable, and gives authority to the remaining partners (so long as they have not wrongfully dissolved the partnership) to wind up the entity’s affairs. Things which may be required to wind up the partnership can include:

● Prosecuting or defending a lawsuit;

● Settling and closing the limited partnership’s business;

● Disposing of limited partnership property for cash (unless a written partnership agreement permits a transfer on noncash terms);

● Discharging or making reasonable provisions to pay the limited partnership’s liabilities; and

● Distributing to the partners any remaining assets of the limited partnership.

All creditors, including partners who are creditors, must be paid before partners receive any return of capital for their partnership interest.

**E. CERTIFICATE OF DISSOLUTION**

Because limited partnerships are required to register with the state at the time of formation, they are also required to file a certificate at the time of dissolution containing the information required by the applicable state law. California law, for example, Corporations Code 15623, requires a certificate to be filed with the Secretary of State and to include the following information:

● The name of the limited partnership and the Secretary of State’s file number;

● The event causing, and the date of, the dissolution; and

● Any other information the partners filing the certificate of dissolution determine to include.

**IV. IRS Rules Affecting Termination of Partnerships**

There are a number of consequences when a partnership is dissolved. One of the important consequences is the tax implications for the partners themselves. The IRS has its own set of rules governing when dissolution of a partnership is recognized and the implications thereof.
A partnership terminates when one of the following events takes place:

- All its operations are discontinued and no part of any business, financial operation, or venture is continued by any of its partners in a partnership; or

- At least 50% of the total interest in partnership capital and profits is sold or exchanged within a 12-month period, including a sale or exchange to another partner.

### A. DATE OF TERMINATION

The partnership's tax year ends on the date of termination. For the event described in (1), earlier, the date of termination is the date the partnership completes the winding up of its affairs. For the event described in (2), earlier, the date of termination is the date of the sale or exchange of a partnership interest that, by itself or together with other sales or exchanges in the preceding 12 months, transfers an interest of 50% or more in both capital and profits.

If a partnership is terminated before the end of the tax year, Form 1065 must be filed for the short period, which is the period from the beginning of the tax year through the date of termination. The return is due the 15th day of the fourth month following the date of termination.

### B. CONVERSION OF PARTNERSHIP INTO LLC

The conversion of a partnership into an LLC classified as a partnership for federal tax purposes does not terminate the partnership. The conversion is not a sale, exchange, or liquidation of any partnership interest, the partnership's tax year does not close, and the LLC can continue to use the partnership's taxpayer identification number.

However, the conversion may change some of the partners' bases in their partnership interests if the partnership has recourse liabilities that become nonrecourse liabilities. Because the partners share recourse and nonrecourse liabilities differently, their bases must be adjusted to reflect the new sharing ratios. If a decrease in a partner's share of liabilities exceeds the partner's basis, he or she must recognize gain on the excess. The same rules apply if an LLC classified as a partnership is converted into a partnership.

### V. Limited Liability Companies

There are several ways in which a limited liability company can be dissolved. First, under certain circumstances the state in which the company is organized has authority to dissolve the entity through administrative action. This occurs when the company fails to follow certain statutory requirements. Second, a member of a limited liability company can ask a court to dissolve the company, a process which is referred to as judicial dissolution. This can happen, for example, when a member believes that other members are not acting in the best interests of the company. Third, a limited liability company may dissolve according to the terms of its operating agreement or articles of organization, i.e. if the agreement provides an expiration period for the company. Fourth, the members of a company themselves may elect to dissolve the company. These different methods of dissolution are summarized in Table 9.2 below.
Table 9.2 Causes of Dissolution of LLC

<table>
<thead>
<tr>
<th>TYPE OF DISSOLUTION</th>
<th>TRIGGERING EVENT(S)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Natural Expiration of Entity</td>
<td>Some companies provide an expiration date either in their articles of organization or operating agreement; under these circumstances the company dissolves by its own terms</td>
</tr>
<tr>
<td>Express Terms of Articles of Organization or Operating Agreement</td>
<td>Most articles of organization and operating agreements provide a list of circumstances under which the company must or may dissolve, i.e. the death of a member</td>
</tr>
<tr>
<td>Administrative Dissolution</td>
<td>Instituted by the state of organization when the company fails to comply with certain technical requirements</td>
</tr>
<tr>
<td>Judicial Dissolution</td>
<td>Sought by member(s) or state attorney general in response to inappropriate action on the part of the company or certain of its members, i.e. fraud</td>
</tr>
</tbody>
</table>

A. CHECK THE BOX

Prior to 1997, federal regulations required limited liability companies to conform to certain operational characteristics in order to take advantage of pass-through taxation for its members.

The federal regulations were enacted in 1960 in response to the decision in *United States v. Kintner*, 216 F.2d 418 (9th Cir. 1954), in which the court sided with a medical partnership that purposefully structured itself with certain corporate characteristics to gain tax treatment as an association and thereby to obtain pension benefits not then available to partnerships.

The so-called Kintner Regulations provided that an unincorporated business association with certain corporate characteristics would be treated as a corporation for purposes of federal tax law. One of those corporate characteristics is an unlimited life span.

Under the 1960 regulations, an unincorporated organization is classified for tax purposes as a partnership if it lacks at least two of four corporate characteristics: (1) continuity of life, (2) centralization of management, (3) limited liability and (4) free transferability of interests.

This issue is discussed in more detail in Chapter 10, Taxation of Business Entities. As a result of these regulations, each state’s default provisions of LLC statutes were carefully drawn to avoid the corporate characteristic of continuity of life. This proved to be a negative for many investors who were put up by the uncertain future of the enterprise.
Under the so-called "check-the-box" regulations, which went into effect in 1997, a new unincorporated entity, including limited liability companies, with two or more members is automatically classified as a partnership unless it elects a different status. A new one-member entity is disregarded for tax purposes absent an election otherwise.

Many states have responded to the check-the-box regulations by amending their statutory schemes governing limited liability companies to provide for an unlimited life span. Under Texas law, for example, the initial Articles of Organization are required to set forth certain information, including “the period of duration [of the company], which may be perpetual.”

Limited liability companies now compare favorably to other business entities in terms of longevity.

B. TYPES OF DISSOLUTION

1. Administrative Dissolution

a. Grounds for dissolution

Every state has detailed laws governing the operation of limited liability companies, beginning with formation and ending with dissolution. These statutes all contain provisions that set forth certain events that can lead to an administrative dissolution of the entity, that is, one initiated by the state in which the company is organized. Events that commonly lead to administrative dissolution include:

- Failure to amend Articles of Organization, as required by state law;
- Failure to publish a required public notice;
- Failure to maintain a registered agent for service of process for a specified period of time, e.g. 60 days;
- Failure to pay a filing fee or an annual registration fee;
- Failure to file an annual report or other report as required by state law; and
- Failure to file mandatory statement of changes in the entity’s operation.

Regardless of the basis of the proposed administrative dissolution, the laws of every state generally requires the state administrative agency in question to notify the company of the violation of law and provide them with an opportunity to correct it. If such a correction is not made within the statutory period of time, the company is then dissolved through administrative action.

In addition, an entity must generally have a period of time in which to wind up its business affairs. For example, under the Uniform Limited Liability Company Act, § 810, provides that a company that has been administratively dissolved may carry on business necessary to “wind up and liquidate its business and affairs.” Likewise, the administrative dissolution of a company does not, under § 810, “terminate the authority of its agent for
service of process.” This latter provision is necessary to allow creditors the opportunity to fully resolve all pending claims against the dissolving company.

b. Reinstatement following administrative dissolution

The administrative dissolution of a limited liability company does not end the story for the entity. First, states generally provide a mechanism for an entity to seek “reinstatement” when they have corrected the violation or violations that led to their administrative dissolution.

Under Florida law, for example, § 608.4482, a limited liability company that has been dissolved through administrative action can apply to the Secretary of State for reinstatement. The application must include:

- The name of the limited liability company and the effective date of its administrative dissolution;
- The ground or grounds for dissolution either did not exist or have been eliminated and that no further grounds currently exist for dissolution; and
- A statement that all fees owed by the limited liability company and computed at the rate provided by law at the time the limited liability company applies for reinstatement have been paid.

If the Department of State determines that the application contains the required information and that the information is correct, it will cancel the certificate of dissolution and prepare a certificate of reinstatement. When the reinstatement is effective, it relates back to and takes effect as of the effective date of the administrative dissolution and the limited liability company resumes carrying on its business as if the administrative dissolution had never occurred.

2. Judicial Dissolution

Each state likewise generally provides a mechanism whereby a member of a limited liability company may ask a court of competent jurisdiction to dissolve the entity under specified circumstances. In Georgia, for example, such a dissolution is appropriate “whenever it is not reasonably practicable to carry on the business in conformity with the articles of organization or a written operating agreement.” In many states, the attorney general also has standing to ask a court for a judicial dissolution under certain circumstances.

Examples of circumstances that warrant member-initiated judicial dissolution in many states include:

- The economic purpose of the company is likely to be unreasonably frustrated;
- Another member has engaged in conduct relating to the company's business that makes it not reasonably practicable to carry on the company's business with that member;
- It is not otherwise reasonably practicable to carry on the company's business in conformity with the articles of organization and the operating agreement;

- The company failed to purchase the petitioner's distributional interest as required by state law;

- The managers or members in control of the company have acted, are acting, or will act in a manner that is illegal, oppressive, fraudulent, or unfairly prejudicial to the petitioner;

- The managers, directors, or any other persons in control of the limited liability company are deadlocked in the management of the affairs of the limited liability company, the members are unable to break the deadlock, and irreparable injury to the limited liability company is threatened or being suffered;

- Liquidation is reasonably necessary for the protection of the rights or interests of the complaining member; or

- The assets of the limited liability company are being misapplied or wasted.

States often allow their attorney general to seek judicial dissolution under certain circumstances, including:

- Where the attorney general has made a finding that the limited liability company obtained its articles of organization through fraud; and

- Where the limited liability company has exceeded or abused the authority conferred upon it by state law.

Colorado, for example, authorized the state Attorney General to seek judicial dissolution of a limited liability company under certain circumstances, including fraudulent business practices. Colorado also allows creditors of a limited liability company to seek judicial dissolution if the creditor has an unsatisfied judgment against the company and the creditor can show that the company is insolvent. Under these circumstances, a court has authority to liquidate the assets of the company and to supervise any continued business (§ 7-80-808).

State laws obviously do not provide a complete list of circumstances that will justify judicial intervention into the status of a limited liability company. In certain circumstances, members of a company may themselves initiate judicial proceedings for the purpose of dissolving their entity. In these situations, courts will generally look to the terms of the entity's operating agreement and uphold dissolution provisions according to basic contract law principles.
Cases-in-Point

a. Member disagreements

In *Weinmann v. Duhon*, 818 So. 2d 206 (2002), two owners of limited liability company sought judicial intervention to dissolve company following their disagreement with other owners over company's management. The trial judge dismissed the suit of the plaintiffs, a husband and wife who were 40 percent owners of the defendant limited liability company. The plaintiffs, Robert and Cindy Weinmann, appealed.

On June 19, 1997, Regency Motors of Metairie, L.L.C. was organized. The original members were Robert Weinmann, with an interest of 40%, Michael Seago with an interest of 35%, and Troy Duhon with an interest of 25%. The initial resolutions of the company authorized Duhon to purchase in its name Interstate Ford, Inc., an automobile dealership. Duhon, the person with expertise in operating a dealership became the Dealer Operator of the company.

During the next several months the company operated under several interim agreements among the members. Then, on February 10, 1998, a document entitled "Operating Agreement" for the company was adopted. That document recites that the ownership interests in the company were now to include two new members, David Williams who acquired a 5% interest from Seago, and Allen Krake who acquired a 10% interest from Seago. That document was signed by Weinmann, Seago, Krake and Williams, but not by Duhon. A side agreement relating to certain voting rights was also signed on the same day by the above four parties.

Matters came to a head in mid-1999 over actions taken by Krake, who by then had become General Manager. On December 22, 1998, Weinmann had assigned a 10% interest in the company to his wife Cindy. Pursuant to Section 1.4(d) of the Operating Agreement, Cindy thus automatically became a member/manager of the company. On June 25, 1999, the Weinmanns notified Krake that they were terminating him as General Manager pursuant to Section 5.3(e) of the Operating Agreement, which authorized such action by any Member holding at least 20% interest with the concurrence of another Member holding at least a 5% interest. On June 30, 1999, the Weinmanns filed the present action for judicial dissolution of the company, and alternatively for a declaratory judgment clarifying the rights of the parties under their various agreements.

In response to this suit, on July 12, 1999, Duhon, Seago, Krake and Williams notified the Weinmanns that they had expelled them from the company as a members and managers.

As a preliminary observation, the court noted that “the parties here have expressed unequivocally that they do not wish to continue in business together.” The court then turned to resolving the dispute by examining Louisiana's Limited Liability Company Law, La. R.S. 12:1335, which states:

“On application by or for a member, any court of competent jurisdiction may decree dissolution of a limited liability company whenever it is not reasonably practicable to carry on the business in conformity with the articles of organization or operating agreement.”
“What has occurred here is simply that the parties have different ideas about how their business should be conducted, and under their contractual arrangements they have reached a point where the business can not go forward pursuant to those arrangements. This situation is precisely what La. R.S. 12:1335 governs when it states that dissolution is proper "whenever it is not reasonably practicable to carry on the business in conformity with the articles of organization or the operating agreement," the court concluded.

b. Member withdrawal does not trigger dissolution

In Lieberman v. Wyoming.Com LLC, 11 P.3d (2000), the Supreme Court of Wyoming affirmed the principle that the withdrawal of one member of the company does not automatically lead to its dissolution. The plaintiff, Lieberman, was both a member and an employee of the company. After he was terminated from his position as Vice President, he demanded the return of his capital contribution and sought judicial dissolution of the company. In such a situation, the court said they must look first to the applicable state law and then to the company’s articles of organization.

In this case, Wyoming state law provides that an LLC must dissolve when a member withdraws unless all the remaining members of the company consent to continue under a right to do so stated in the articles of organization. The articles of organization of the company, Wyoming.com, allowed continuation upon the consent of the remaining members. Since the remaining members agreed unanimously to continue with the business, Lieberman was not in a position to demand dissolution so long as the company returned any capital contribution to which the withdrawing member is entitled. Since the company offered to return his $20,000 capital contribution, the court said, Lieberman could not compel dissolution (Lieberman rejected the return of $20,000, his actual contribution, arguing he was entitled to fair market value for his interest in the company. The Wyoming Supreme Court remanded the case to the trial court to address that specific issue).

3. Membership Initiated Dissolution

In the absence of any other basis for dissolution, each state gives the member of a limited liability company authority to dissolve the entity. States differ, however, in what percentage of the membership must consent to the dissolution. Some states, for example, require the written consent of all members of the company, unless otherwise provided in the company’s operating agreement or articles of organization.

One circumstance that warrants special consideration in this area is what happens when a member with a minority interest in a limited liability company is being frozen or squeezed out of the decision-making process. Under analogous provisions of corporate law, shareholders have options to seek the dissolution of the corporation.

Most states give minority shareholders the right to seek a judicial dissolution in the event of oppressive conduct on the part of majority owners. Some states have provided similar rights for members of limited liability companies. For example, the Uniform Limited Liability Company Act, § 801, permits member-initiated judicial dissolution when "the managers or members in control of the company have acted, are acting, or will act in a manner that is illegal, oppressive, fraudulent, or unfairly prejudicial to the petitioner."
Likewise, California authorizes judicial dissolution of LLCs whenever it is "reasonably necessary for the protection of the rights or interests of the complaining members" or when controlling members "knowingly countenanced persistent and pervasive fraud, mismanagement, or abuse of authority."

4. Effect Of Operating Agreement On Dissolution Disputes

The freedom that limited liability companies have to form the agreements that govern their operation allows members to avoid a costly and contentious dissolution by planning ahead for the possibility that some or all members of the company may want to dissolve at some point in the future.

Every state allows members to adopt a written operating agreement containing any provision they want, so long as that provision does not conflict with an express provision of state law. Every limited liability company, therefore – with the exception of single-member companies – should include provisions for dissolution in their operating agreement. The precise terms will, of course, depend on many factors, including: the nature of the business and its capital structure; the number of members and the resources of each; whether the LLC is family-owned; the magnitude of any possible threat to the LLC’s liquidity posed by a member buyout; and the relative bargaining power of the parties to the operating agreement. So long as the particular mechanism adopted reflects the parties’ voluntary agreement to avoid dissolution and to carry on the business notwithstanding the alleged detriment to the complaining LLC member, that mechanism will be enforced by a court of law.

Case-in-Point

In *Investcorp, L.P. v. Simpson Inv. Co., L.C.*, 267 Kan 840 (1999), the Supreme Court of Kansas said the operating agreement must determine who controls the dissolution of the company. The company was owned by two families who each controlled 50 percent of the company. The sole asset of the company was 104 acres of commercial real estate. One of the family trusts opted to withdraw from the company based on differences of opinion with the other member trust. Under the terms of the operating agreement, the company was required to dissolve upon the withdrawal of a member, absent unanimous consent of the remaining members to continue the company. Not all the remaining members agreed to continue the company, but the majority of the remaining members refused to dissolve it. The court ruled that the company was dissolved by the terms of the operating agreement. The member trust that had not resigned argued that the resigning member should not be able to participate in the dissolution of the company because it was no longer a “member.” The court interpreted the language of the operating agreement to find that even withdrawing members were still members for purpose of dissolution. However, the court decided to grant the control of the dissolution to the managers of the company who were members at the time the dissolution was commenced.

In its analysis, the court also noted the law that controls this issue in the absence of express provision in a company’s operating agreement. The Uniform Limited Liability Company Act, the court noted, excluded from participation in dissolution managers or members who “wrongfully” dissolve the company. Under Kansas law, however, there is
no distinction between wrongfully and rightfully dissolving members of a limited liability company. The court also noted that there is no uniform approach among the states to whether a withdrawing member has the right to participate in the dissolution of a company, with some states, including Arizona, making such members “assignees” of the dissolved company, meaning they have a right to receive their portion of the proceeds but not to actively participate.

C. TECHNICALITIES OF DISSOLUTION

1. Formalities Of Dissolution

An LLC that wishes to dissolve is generally required to file papers accordingly in the state in which it is registered. This is due in part to the requirement to give notice to people that they will be ceasing operation.

For example, in California a domestic limited liability company is required to file a Certificate of Dissolution (LLC-3) and a Certificate of Cancellation (LLC-4/7), unless all the members vote to dissolve, in which case the Certificate of Dissolution (LLC-3) is not required. A valid Tax Clearance Certificate or a Request For Tax Clearance Certificate (FTB Form 3555L) must be submitted with other required forms. If the Certificate of Cancellation is received with the Request For Tax Clearance Certificate (FTB Form 3555L) instead of the actual Tax Clearance Certificate, the Secretary of State’s office will forward the request to the Franchise Tax Board, and the Certificate of Cancellation will be filed on a pending basis. The limited liability company will remain in active status until the Tax Clearance Certificate is received from the Franchise Tax Board. Once the Franchise Tax Board has determined that all fees and penalties have been paid or secured, they will forward a copy of the Tax Clearance Certificate to this office, and the limited liability company will be completely canceled as of the date the Certificate of Cancellation was filed.

A foreign limited liability company is required to file a Certificate of Cancellation (LLC-4/7). A valid Tax Clearance Certificate or a Request For Tax Clearance Certificate (FTB Form 3555L) must be submitted with the above forms. If the Certificate of Cancellation is received with the Request For Tax Clearance Certificate (FTB Form 3555L) instead of the actual Tax Clearance Certificate, the Secretary of State’s office will forward the request to Franchise Tax Board, and the Certificate of Cancellation will be filed on a pending basis. The limited liability company will remain in active status until the Tax Clearance Certificate is received from the Franchise Tax Board. Once the Franchise Tax Board has determined that all fees and penalties have been paid or secured, they will forward a copy of the Tax Clearance Certificate to this office, and the limited liability company will be completely canceled as of the date the Certificate of Cancellation was filed.

2. Winding Up Business Of Dissolved Company

Even after dissolution has been granted, many companies will still have unresolved business to be completed. Each state has its own statutory provision for the winding up of the affairs of a dissolved limited liability company. For example, under Florida law, managers remaining at the time of dissolution are required to serve as trustees for the members and creditors of the dissolved limited liability company; and as trustees they have authority to distribute any property of the limited liability company discovered after
dissolution, to convey real estate, and to take such other action as may be necessary on behalf of and in the name of such dissolved limited liability company.

Under the Uniform Limited Liability Company Act, § 803, the "person winding up a limited liability company's business may preserve the company's business or property as a going concern for a reasonable time, prosecute and defend actions and proceedings, whether civil, criminal, or administrative, settle and close the company's business, dispose of and transfer the company's property, discharge the company's liabilities, distribute the assets of the company pursuant to [statute], settle disputes by mediation or arbitration, and perform other necessary acts."

**a. Discharge of obligations**

In winding up a limited liability company's business, the assets of the company must first be applied to discharge its obligations to creditors, including members who are creditors. Any surplus remaining is distributed first to the members who have not previously received a return of all of their respective contributions -- with any amount remaining being distributed in equal shares. Any assets remaining thereafter can be distributed to the full membership.

**b. Role of managers**

Managers are normally vested with authority for winding up the affairs of a dissolving company. Under certain circumstances, such as where there are no remaining managers, a court can appoint a person to wind up the affairs of the company. The person charged with winding up the company's affairs is required to collect all assets, dispose of all property that will not be distributed in kind to members and make arrangements for discharging all of the company's liabilities. The only business allowed to be conducted during this period is that which is necessary to wind up and liquidate the business, i.e. the sale of assets.

A manager or member still has authority to bind a limited liability company by their actions following dissolution where their actions are appropriate for the winding up of the company's business. According to the Uniform Limited Liability Company Act, § 804(b), however, "a member or manager who, with knowledge of the dissolution, subjects a limited liability company to liability by an act that is not appropriate for winding up the company's business is liable to the company for any damage caused to the company arising from the liability."

**c. Status of assets following dissolution**

In addition, the dissolution of a limited liability company generally does not result in the transfer of title to its assets, prevent the assignment of its member interests, subject its managers to standards of conduct different from those required under state law or change any provisions of its operating agreement unless expressly provided.

3. **Notice To Creditors**

Part of the process of dissolving a limited liability company, by whatever means, is to provide adequate notice to creditors so that they have the opportunity to protect their interests. Each state has a specific procedure for the type of notice that must be
provided. Notice must generally be in writing and contain at least the following information:

- Specify the information required to be included in a claim;
- Provide a statement that the limited liability company has dissolved and is in the process of winding up its affairs;
- Provide the address of the office to which written claims against the limited liability company must be presented;
- Provide the date by which all the claims must be received a statement that the limited liability company has filed with the secretary of state a notice of dissolution; and
- The date of filing the notice of dissolution.

A creditor who is given adequate notice pursuant to state law and fails to file a claim within the statutory period of time is barred from filing a claim in a court of law. A dissolving limited liability company is also required under the laws of most states to publish a public notice advertisement notifying any potential claimant of their impending dissolution.

4. Merger Of Dissolving Entity

Some states expressly allow a limited liability company that is being voluntarily dissolved to merge with another entity. Minnesota, for example, provides as part of the process of winding up, a limited liability company may merge with another entity so long as the dissolving entity does not become the surviving business.

In the comment to the statute, the Minnesota legislature wrote: "To facilitate continuation of the business while ensuring that the dissolved limited liability company terminates as a legal entity, section 322B.81, subdivision 3 allows a dissolved limited liability company to merge itself out of existence. A dissolved limited liability company cannot be the surviving organization in a winding up merger. If the dissolved limited liability company were to survive the merger, its legal existence would not terminate.

"A business continuation agreement can obligate the limited liability company to consummate such a winding up merger, or the board of governors and the members may simply decide on such a merger following dissolution. Unless the merger is pursuant to a business continuation agreement made after dissolution, members may dissent from the merger.

5. Revocation Of Dissolution

Under some circumstances, a limited liability company that has been or is in the process of being dissolved may revoke the dissolution.

Every state has its own rules governing this issue. Revocation is most likely to be allowed when the decision to dissolve was made voluntarily by the members of the company who have, for whatever reason, now changed their minds. Under Texas law,
for example, a limited liability company is entitled to revoke voluntary dissolution proceedings upon written consent of all members at any time prior to the Secretary of State’s issuance of a certificate of dissolution. “Upon the revocation of voluntary dissolution proceedings, the limited liability company may again carry on its business,” Texas law further provides.

Minnesota allows dissolution of a limited liability company to be revoked prior to the filing of the articles of termination. The revocation must be approved by every member at a duly noticed meeting to discuss and vote on the issue. If the proposed revocation is approved at a meeting by the affirmative vote of the owners of a majority of the voting power of all membership interests entitled to vote, the dissolution is revoked. Revocation of dissolution is effective when a notice of revocation is filed with the Secretary of State. After the notice is filed, the limited liability company may cease to wind up its affairs.

California allows the members holding a majority interest in a dissolved limited liability company to file for a Certificate of Continuation with the Secretary of State if: (1) remaining members vote unanimously to continue the company; or (2) if the dissolution was voluntary and all those who voted for dissolution now vote for revocation.

VI. Corporations

Individual state law governs formation, operation and dissolution of corporations. There are two basic types of dissolution: voluntary and involuntary. This section will address each in turn.

A. VOLUNTARY DISSOLUTION

1. Procedures

The voluntary dissolution of a domestic stock corporation is initiated by an election to dissolve that meets the requirements of the applicable state law. The election to dissolve may be made in California, for example, by the vote or written consent of at least fifty percent of the outstanding shares of the corporation, by the board of directors if no shares have been issued, or, in limited circumstances, by a majority of the incorporators, if no directors have been named in the Articles of Incorporation and none have been elected.

Following the election, a Certificate of Election to Wind Up and Dissolve must be prepared, submitted to and filed by the California Secretary of State. To complete the dissolution, a Certificate of Dissolution must also be prepared, submitted to and filed by the Secretary of State. The Certificate of Election must be filed prior to, or simultaneously with, the Certificate of Dissolution. If the election to dissolve is made by the vote of all the outstanding shares, the Certificate of Election does not have to be filed, provided the Certificate of Dissolution includes the following statement: The election to dissolve was made by the vote of all the outstanding shares.

Depending on the circumstances, voluntary dissolution may be authorized by the incorporators, shareholders, or board of directors. If a corporation has not issued shares or has not commenced business, it may be dissolved by action of its directors or incorporators alone. A corporation that has issued shares and commenced business may generally dissolve voluntarily only with the approval of its shareholders.
Under Florida law, for example, if a corporation either has not issued shares or has not commenced business, a majority of the incorporators or directors, as appropriate, may dissolve the corporation without shareholder action by filing articles of dissolution with the Department of State. The articles of dissolution are required to contain:

- The name of the corporation;
- The date the corporation's articles of incorporation were filed;
- Either that none of the corporation's shares have been issued or that the corporation has not commenced business;
- That the corporation does not have unpaid debts;
- That the net assets of the corporation remaining after winding up have been distributed to the shareholders, if shares were issued; and
- That the dissolution has been authorized by a majority of the directors or incorporators.

2. Notice

Before voluntary dissolution can be effective, the corporation must follow the applicable state law governing notice to creditors and other third parties who might have claims against the corporation. Failure to follow prescribed notice procedures can result in directors being held personally liable for corporate debts.

3. Revocation Of Dissolution

State law sets forth both the mechanism for voluntary dissolution and for revocation of dissolution. Under Florida law, for example, Section 607.1404, a dissolved corporation may apply for revocation by filing Articles of Revocation containing the following:

- The name of the corporation;
- The effective date of the dissolution that was revoked;
- The date that the revocation of dissolution was authorized;
- If the incorporators or board of directors revoked the dissolution, a statement to that effect;
- If the board of directors revoked a dissolution authorized by the shareholders, a statement that the revocation was permitted by director action alone under that authorization; and
If shareholder action is required to revoke the dissolution, a statement that the number of votes cast for revocation of dissolution was sufficient for approval or, if voting by voting groups was required, a statement that the number of votes cast for revocation of dissolution was sufficient for approval for each voting group entitled to vote on the revocation.

To be effective, the revocation must be approved in the same manner as the dissolution. The revocation of dissolution is effective on the effective date of the articles of revocation, but if the revocation relates back to and takes effect as of the effective date of the dissolution. As a result, the corporation resumes carrying on its business as if dissolution had never occurred.

B. INVOLUNTARY DISSOLUTION

1. Judicial Dissolution

Judicial dissolution is governed by the laws of each state which sets forth both the procedure and grounds for dissolution. Common grounds include:

- The directors are deadlocked in the management of the corporate affairs, the shareholders are unable to break the deadlock, and irreparable injury to the corporation is threatened or being suffered, or the business and affairs of the corporation can no longer be conducted to the advantage of the shareholders generally, because of the deadlock;

- The directors or those in control of the corporation have acted, are acting, or will act in a manner that is illegal, oppressive, or fraudulent;

- The shareholders are deadlocked in voting power and have failed, for a specified period of time, to elect successors to directors whose terms have expired;

- The corporate assets are being misapplied or wasted;

- That the corporation obtained its articles of incorporation through fraud; or

- The corporation has continued to exceed or abuse the authority conferred upon it by law; and

- In a proceeding by a creditor, a finding that the creditor's claim has been reduced to judgment, the execution on the judgment returned unsatisfied, and the corporation is insolvent.

State law often designates the attorney general as the appropriate officer to bring suits for involuntary dissolution by the state. Actions for judicial dissolution can also be brought by shareholders. In such cases, courts often have broad authority to fashion remedies to protect the interests of the shareholders, including the following:

- Issue an injunction preventing certain action by the corporation;

- Appoint a receiver to protect the assets of the corporation;
Cancel or amend an act of the board; and

Provide for the purchase of shares either by the corporation or another shareholder.

Cases-in-Point

In *Brenner v. Berkowitz* (617 A.2d 1225, N.J.Super.A.D., 1992), the plaintiff was a minority shareholder in a closely held corporation who had been shut out of involvement in corporate affairs. He brought an action against the majority shareholder alleging a number of items of wrongdoing, including:

- Committing fraud against a third party;
- Misappropriating proceeds from cash sales;
- Illegally failing to pay certain taxes; and
- Acting oppressively towards plaintiff

Plaintiff asked the court to either allow him to buy out the majority shareholders, to have the majority of the corporation purchase her stock or a dissolution of the corporation, appoint a custodian, for the court to allow plaintiff to purchase the stock of defendants and for the corporation to be dissolved. The trial court enjoined the defendant from engaging in conduct that was in breach of his duties as a corporate director, but held that because he had ceased illegal activity, he could not award plaintiff any damages or consider any other measures. On appeal, the court reversed.

The court on appeal noted first that willful abuse by an officer, which involves a breach of trust, has long been recognized as a basis for dissolving a corporation. The court then rejected the trial court’s conclusion that relief was not available because the illegal conduct had ended.

“A requirement that the fraudulent conduct must be ongoing frustrates this stated purpose because it allows the majority to abuse the minority as long as the abuse ceases prior to the date a decision is rendered in the legal action complaining of such abuse,” the court wrote.

“Until the defendants decided to change their fraudulent and illegal practices, most of which occurred or continued after this litigation was instituted, plaintiff as a minority shareholder and the corporation too, for that matter, were at risk from several sources,” the court continued. “In short, defendants' fraudulent and illegal actions exposed plaintiff to a very real, although ultimately unrealized, potential for a significant diminution in the value of her minority share.”

The court said it was allowed to consider, in fashioning a remedy, both the potential risk to a minority shareholder based on any pattern of prohibited conduct that may develop and the resources a minority shareholder has to cope with potential abuses. In saying this, the court noted the vulnerable position of a minority shareholder in a closely held corporation.
The court then ordered the case remanded to allow the parties to work out a buy-out of the stock.

In Matter of Kemp & Beatley, Inc. (484 N.Y.S.2d 799, 64 N.Y.2d 63, 473 N.E.2d 1173), the court of appeals ruled that the trial court did not abuse its discretion in ordering a corporation's dissolution subject to opportunity for buy out of minority shareholders where controlling faction of company was, in effect, attempting to "squeeze-out" minority shareholders by offering them no return on their investment while at the same time increasing other executive compensation.

The business concern of Kemp & Beatley, Incorporated under the laws of New York, designs and manufactures table linens and sundry tabletop items. The company's stock consists of 1,500 outstanding shares held by eight shareholders. Petitioner Dissin had been employed by the company for 42 years when, in June 1979, he resigned. Prior to resignation, Dissin served as vice-president and a director of Kemp & Beatley. Over the course of his employment, Dissin had acquired stock in the company and currently owns 200 shares.

Petitioner Gardstein, like Dissin, had been a long-time employee of the company. Hired in 1944, Gardstein was for the next 35 years involved in various aspects of the business including material procurement, product design, and plant management. His employment was terminated by the company in December 1980. He currently owns 105 shares of Kemp & Beatley stock.

Apparent unhappiness surrounded petitioners' leaving the employ of the company. Of particular concern was that they no longer received any distribution of the company's earnings. Petitioners considered themselves to be "frozen out" of the company; whereas it had been their experience when with the company to receive a distribution of the company's earnings according to their stockholdings, in the form of either dividends or extra compensation. That distribution was no longer forthcoming.

Gardstein and Dissin, together holding 20.33% of the company's outstanding stock, commenced the instant proceeding in June 1981, seeking dissolution of Kemp & Beatley. Their petition alleged "fraudulent and oppressive" conduct by the company's board of directors such as to render petitioners' stock "a virtually worthless asset."

Upon considering the testimony of petitioners and the principals of Kemp & Beatley, the trial court concluded that "the corporate management has by its policies effectively rendered petitioners' shares worthless, and * * * the only way petitioners can expect any return is by dissolution". Petitioners were found to have invested capital in the company expecting, among other things, to receive dividends or "bonuses" based upon their stockholdings. Also found was the company's "established buy-out policy" by which it would purchase the stock of employee shareholders upon their leaving its employ.

“Liquidation of the corporate assets was found the only means by which petitioners would receive a fair return,” the appeals court wrote.

“As the stock of closely held corporations generally is not readily salable, a minority shareholder at odds with management policies may be without either a voice in protecting his or her interests or any reasonable means of withdrawing him or her with the apparent purpose underlying the provision under review,” the court wrote. “A
shareholder who reasonably expected that ownership in the corporation would entitle him or her to a job, a share of corporate earnings, a place in corporate management, or some other form of security, would be oppressed in a very real sense when others in the corporation seek to defeat those expectations and there exists no effective means of salvaging the investment.”

Given the nature of close corporations and the remedial purpose of the statute, court on appeal held that utilizing a complaining shareholder's "reasonable expectations" as a means of identifying and measuring conduct alleged to be oppressive is appropriate. A court considering a petition alleging oppressive conduct must investigate what the majority shareholders knew, or should have known, to be the petitioner's expectations in entering the particular enterprise. Majority conduct should not be deemed oppressive simply because the petitioner's subjective hopes and desires in joining the venture are not fulfilled.

In light of an apparent deterioration in relations between petitioners and the governing shareholders of Kemp & Beatley, it was not unreasonable for the court to have determined that a forced buy-out of petitioners' shares or liquidation of the corporation's assets was the only means by which petitioners could be guaranteed a fair return on their investments, the court concluded.

Short of dissolution, courts generally have authority to take other action to protect corporate shareholders and creditors. Options include appointment of a provisional director or, in the case of action by a shareholder, purchase of the complaining shareholder's shares.

A provisional director who is someone who is neither a shareholder nor a creditor of the corporation. He or she serves until removed by the court. He or she is also required to report to the court overseeing the case.

In the case of a buy-out, the court will supervise the process of determining the fair market value of the stock.

2. Administrative Dissolution

As we saw with limited liability companies, the failure to follow certain state law requirements can lead to involuntary administrative dissolution. The same principle applies to corporations. State law sets forth both the procedure for and grounds for administrative and judicial dissolution.

a. Grounds for dissolution

Common grounds include:

- The corporation has failed to file annual reports or pay annual fees as required by state law;
The corporation has failed to appoint or is without a registered agent for service of process for a prescribed period of time (i.e. 90 days); and

The corporation continues to operate after expiration of its period of duration as stated in its articles of incorporation.

When the appropriate state agency decides to initiate administrative dissolution, state law mandates certain procedures, including the provision of notice to the offending corporation and the opportunity to correct the deficiency, if applicable, within a specified period of time.

Once administratively dissolved, a corporation may only carry on that business necessary to wind up its affairs and liquidate the business.

b. Reinstatement

State law provides procedures whereby a corporation that has been administratively dissolved may apply for reinstatement under certain circumstances. Hawaii, for example, provides as follows:

TITLE 23. (§ 414-403). Reinstatement following administrative dissolution.

(a) A corporation administratively dissolved under section 414-402 may apply to the department director for reinstatement within two years after the effective date of dissolution. The application must:

(1) Recite the name of the corporation and the effective date of its administrative dissolution;

(2) Contain all reports due and unfiled;

(3) Contain the payment of all delinquent fees and penalties; and

(4) Contain a certificate from the department of taxation reciting that all taxes owed by the corporation have been paid.

(b) Within the applicable reinstatement period, should the name of the corporation, or a name substantially identical thereto be registered or reserved by another corporation, partnership, limited partnership, limited liability company, or limited liability partnership, or should the name or a name substantially identical thereto be registered as a trade name, trademark, or service mark, then reinstatement shall be allowed only upon the registration of a new name by the involuntarily dissolved corporation pursuant to the amendment provisions of this chapter.

(c) When the reinstatement is effective, it relates back to and takes effect as of the effective date of the administrative dissolution and the corporation resumes carrying on its business as if the administrative dissolution had never occurred.
c. Professional corporations

States often have special provisions governing the administrative dissolution of certain professional corporations.

Hawaii law, for example, provides:

§ 415A-18 Involuntary dissolution; reinstatement.

(a) The director may commence a proceeding to dissolve a professional corporation administratively if the corporation fails to:

(1) Pay any fees prescribed by law;

(2) File its annual report for a period of two consecutive years;

(3) Appoint and maintain an agent for service of process as required; or

(4) File a statement of a change in the name or business address of the agent as required under this chapter.

Before the director may declare a corporation dissolved, the director shall give notice of the ground or grounds for dissolution as provided in section 414-401 by mailing the notice to the professional corporation at its last known address appearing in the records of the director, and may give public notice of the intention to dissolve the corporation.

(b) Parties of interest may petition a court of competent jurisdiction to appoint a trustee to settle the affairs of any professional corporation so dissolved. If a trustee is appointed, the trustee shall pay to the State out of any funds that may come into the trustee's hands as trustee, a sum equal to any penalty imposed under section 414-473. If a trustee is not appointed by a court of competent jurisdiction, the last directors of the dissolved corporation shall be and act as trustees for the creditors and shareholders of the dissolved professional corporation with full powers to settle its affairs.

(c) The director shall, in each case, deliver a copy of the decree of dissolution to the director of taxation and to the finance officer of each county.

(d) In each case where the director has given a professional corporation notice of intention to dissolve the corporation on the grounds that its articles of incorporation have been procured through fraud, the corporation shall be entitled to petition for an administrative hearing under chapter 91 and shall give written notice to the director thereof, before the director may declare the corporation dissolved under subsection (a) of this section.
(e) **Within two years after the involuntary dissolution of a professional corporation under this section, the corporation may be reinstated by the director upon a written application executed by any two officers of the corporation setting forth such information as the director may require, and the payment of all delinquent fees, penalties, assessments, taxes, costs of involuntary dissolution, and the filing of all reports due and unfiled. Within the applicable reinstatement period, should the name of the professional corporation, or a name substantially identical thereto be registered or reserved by another corporation, partnership, limited liability company, or limited liability partnership, or should the name or a name substantially identical thereto be registered as a trade name, trademark, or service mark, then reinstatement shall be allowed only upon the registration of a new name by the involuntarily dissolved professional corporation pursuant to the amendment provisions of this chapter.**

(f) **A professional corporation whose articles of incorporation have expired shall cease to exist by operation of law.**
CHAPTER 9 – REVIEW QUESTIONS

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter. They do not need to be submitted in order to receive CPE credit. They are included as an additional tool to enhance your learning experience.

We recommend that you answer each review question and then compare your response to the suggested solution before answering the final exam questions related to this chapter.

1. Which of the following entities can last in perpetuity:
   a) sole proprietorship
   b) sole proprietorship and a general partnership
   c) corporation
   d) corporation and a sole proprietorship

2. Every partner may have the power to dissolve a partnership at any time.
   a) true
   b) false

3. A person winding up a partnership’s business may generally do all of the following except:
   a) prosecute and defend actions and proceedings, whether civil, criminal, or administrative
   b) decide unilaterally to keep the partnership running indefinitely
   c) discharge the partnership’s liabilities
   d) settle disputes by mediation or arbitration

4. Which of the following is a common ground for dissolution of a limited partnership:
   a) the happening of events specified in the partnership agreement
   b) the consent of all of the partners
   c) expiration of the partnership pursuant to the partnership agreement
   d) all of the above

5. When does a partner’s tax year generally end if the partnership is dissolved:
   a) upon the date of termination or dissolution
   b) upon the date of the agreement to dissolve or terminate the partnership
   c) at the end of the normal tax year for that partnership, regardless of when the partnership is terminated
   d) only after the winding up of all the business of the partnership
6. An administrative dissolution is one that is initiated by the state in which the company is organized.
   a) true
   b) false

7. Before voluntary dissolution can be effective, the corporation must follow the applicable state law governing notice to creditors and other third parties who might have claims against the corporation.
   a) true
   b) false
CHAPTER 9 – SOLUTIONS AND SUGGESTED RESPONSES

1. **A: Incorrect.** A sole proprietorship dies with the owner and therefore cannot last in perpetuity.

   **B: Incorrect.** A general partnership generally lasts only as long as one of the partners remains and a sole proprietorship dies with the owner.

   **C: Correct.** Historically, a corporation is the only type of entity that could last in perpetuity. It is the only one in the list of options that is correct.

   **D: Incorrect.** While a corporation can last in perpetuity, the sole proprietorship cannot.

   (See page 9-2 of the course material.)

2. **A: True is correct.** The partner has the power even if the dissolution violates the specific provisions of a partnership agreement.

   **B: False is incorrect.** However, a partner who wrongfully dissociates is subject to damages suffered by the partnership as a result as codified in the UPA and the laws of every state.

   (See page 9-3 of the course material.)

3. **A: Incorrect.** This is one of the tasks a person can perform when winding up the business.

   **B: Correct.** This is not one of the tasks listed that a person can generally perform when winding up a business.

   **C: Incorrect.** This is one of the tasks a person can perform when winding up the business.

   **D: Incorrect.** This is one of the tasks a person can perform when winding up the business.

   (See page 9-5 of the course material.)
4. **A**: Incorrect. A partnership agreement may contain a provision calling for dissolution upon the happening of specified events. However, this is not the best answer.

   **B**: Incorrect. The consent of all of the partners is sufficient to dissolve a partnership. However, this is not the best answer.

   **C**: Incorrect. A partnership agreement may contain a term creating a period of operation. However, this is not the best answer.

   **D**: Correct. All of the above are common and appropriate grounds for dissolution. Therefore, this is the best answer.

   (See page 9-7 of the course material.)

5. **A**: Correct. For federal tax purposes, the tax year ends on the date the partnership ends.

   **B**: Incorrect. The date of agreement to dissolve does not end the tax year.

   **C**: Incorrect. This is not correct. The end of the tax year is when the partnership terminates.

   **D**: Incorrect. This may or may not coincide with the date of termination which ends the tax year.

   (See page 9-9 of the course material.)

6. **A**: True is correct. Where an administrative dissolution is initiated by the state, generally a member indicates a judicial dissolution.

   **B**: False is incorrect. An administrative dissolution is commonly the result of, among other events, the failure to amend Articles of Organization, as required by state law, failure to publish a required public notice, failure to pay a filing fee, or failure to file a mandatory statement of changes in the entity’s operation.

   (See page 9-11 of the course material.)

7. **A**: True is correct. Failure to follow prescribed notice procedures can result in directors being held personally liable for corporate debts.

   **B**: False is incorrect. Depending on the circumstances, voluntary dissolution may be authorized by the incorporators, shareholders, or board of directors.

   (See pages 9-20 to 9-21 of the course material.)
Chapter 10: Taxation of Business Entities

Taxes are certainly a huge consideration in a choice of entity. While federal taxes are probably the largest consideration, state taxes and fees can also play an important role in choosing an appropriate entity. Because state law treatment varies so significantly, a detailed discussion is beyond the scope of this course. However, it will be referred to in a few select areas, particularly in considering limited liability companies.

For purposes of federal tax, the law sets forth three basic models of taxation of businesses and individuals: subchapter C, subchapter K and subchapter S. Subchapter C applies to corporations. It imposes an entity level tax on the corporation as well as a tax on individual shareholders who receive corporate distributions (i.e. dividends).

### Table 10.1 Business Form and Taxation: Advantages and Disadvantages

<table>
<thead>
<tr>
<th>BUSINESS FORM</th>
<th>ADVANTAGE(S)</th>
<th>DISADVANTAGE(S)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sole Proprietorship</td>
<td>No “double taxation”; income reported on individual return</td>
<td>Owner pays twice the amount of social security and Medicare tax than he would as an employee</td>
</tr>
<tr>
<td>Limited Liability Company</td>
<td>IRS “check-the-box” regulations allow entity to choose federal tax treatment</td>
<td>Active members subject to self-employment tax for social security and Medicare</td>
</tr>
<tr>
<td>Partnership</td>
<td>No “double taxation”; income taxed proportionately to each partner on their own personal returns</td>
<td>No personal limited liability protection for general partners</td>
</tr>
<tr>
<td>S Corporation</td>
<td>May elect to be treated similar to a partnership for purposes of federal taxation, so income is “passed through” to shareholders</td>
<td>Shareholders entitled to only limited employee benefits; limited to no more than 100 shareholders</td>
</tr>
<tr>
<td>C Corporation</td>
<td>Corporate tax rate does not go as high as individual tax rate; health insurance and group life insurance premiums (up to certain amount) are fully deductible and not taxable to employees</td>
<td>Shareholders not entitled to deduct the losses of the corporation; “double taxation”</td>
</tr>
</tbody>
</table>

Subchapter S status is available to C corporations that meet certain strict statutory requirements. It allows shareholders or relatively small corporations to avoid entity-level taxation: similar to partnership treatment, all of the profits and losses of the corporation are passed through to the individual shareholders.

Finally, subchapter K applies to partnerships, limited liability companies and certain other unincorporated entities. Like S corporations, owners are allowed to elect pass-through taxation. Partnerships are not subject to the income tax. However, a partnership is required to file Form 1065, which reports the results of the partnership’s business activities. Individual partners pay taxes on their individual returns.

The partnership net profit (loss) and the separately reported items are allocated to each partner according to the partnership’s profit sharing agreement, and the partners receive
separate K-1 schedules from the partnership. Schedule K-1 reports each partner’s share of the partnership net profit and separately reported income and expense items. Each partner reports these items on his or her own tax return.

The two types of federal taxation that are most frequently considered in making a choice of entity are income tax and self-employment tax. Rules regarding income taxation of specific entities will be discussed below. Following is a discussion of self-employment tax and its application in choice of entity.

I. Self-Employment Tax

Self-employment tax is a social security and Medicare tax that mainly affects persons who work for themselves. Many people consider ways to avoid self-employment taxes when considering a choice of entity. The reason is that the self-employment tax rate is 15.3%.

1 This rate consists of two parts: 12.4% for social security (old-age, survivors, and disability insurance) and 2.9% for Medicare (hospital insurance). There is, however, a cap on the amount of income that is subject to the social security tax. In 2010, the first $106,800 of combined net earnings was subject to social security tax. For 2011, that amount remains at $106,800. All net earnings of at least $400 are subject to the Medicare part.

Taxpayers can deduct half of their self-employment tax in figuring adjusted gross income; however, the adjustment does not affect the amount of self-employment tax actually owed.

A. DEFINITION OF “SELF-EMPLOYED”

The IRS considers the following groups of people to be self-employed and therefore subject to self-employment tax:

- Persons who carry on a trade or business as a sole proprietor or an independent contractor; and
- Members of a partnership that carries on a trade or business; and
- Persons who are otherwise in business for themselves.

A trade or business is generally an activity carried on for a livelihood or in good faith to make a profit. The facts and circumstances of each case determine whether or not an activity is a trade or business. The regularity of activities and transactions and the production of income are important elements. You do not need to actually make a profit to be in a trade or business as long as you have a profit motive. You do need, however, to make ongoing efforts to further the interests of your business.

1. Part-time Business

Individuals do not have to carry on regular full-time business activities to be self-employed. Having a part-time business in addition to a regular job or business may also constitute self-employment.

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1 Note that for 2011, Congress reduced the social security tax rate for the employee from 6.2% to 4.2%, effectively reducing the total from 12.4% to 10.4%. Therefore, for 2011, the self-employment tax rate is reduced to 13.3%.
Example.

John is employed full time as an engineer at the local plant. He fixes televisions and radios during the weekends. John has his own shop, equipment, and tools. He gets his customers from advertising and word-of-mouth. John is self-employed as the owner of a part-time repair shop.

2. Sole Proprietor

An individual is a sole proprietor if he or she owns an unincorporated business alone.

3. Independent Contractor

People such as doctors, dentists, veterinarians, lawyers, accountants, contractors, subcontractors, public stenographers, or auctioneers who are in an independent trade, business, or profession in which they offer their services to the general public are generally independent contractors. However, whether these people are independent contractors or employees depends on the facts in each case. The general rule is that an individual is an independent contractor if the payer has the right to control or direct only the result of the work and not what will be done and how it will be done. The earnings of a person who is working as an independent contractor are subject to SE tax.

An individual is not an independent contractor if they perform services that can be controlled by an employer (what will be done and how it will be done). This applies even if the individual is given freedom of action. What matters is that the employer has the legal right to control the details of how the services are performed.

If an employer-employee relationship exists (regardless of what the relationship is called), an individual is not an independent contractor and their earnings are generally not subject to SE tax. However, their earnings as an employee may be subject to SE tax under other rules discussed in this section.

II. Sole Proprietors

A sole proprietorship has no existence separate and apart from its owner. It does not file a tax return and is not liable for taxes. The proprietor himself is liable for all of the profits and losses of the business.

A sole proprietor is required to report all net profits from the business, whether they are retained in the business’ account or not. The individual reports his income on Schedule C of Form 1040.

Sole proprietors are, as mentioned above, subject to self-employment tax on business profits. Because a sole proprietor is not an employee, no deduction is permitted for fringe benefits offered by the business. However, since 2003, a sole proprietor may deduct 100 percent of the premiums paid for accident and health insurance coverage for themselves, their spouses and dependents. However, pursuant to IRC § 162, this deduction is not taken into account in determining an individual’s net earnings from self-employment.
A sole proprietor may deduct 100 percent of insurance premiums paid for accident and health insurance, as well as medical reimbursements, for the sole proprietor and the proprietor’s spouse and dependents if the sole proprietor provides the coverage to his or her spouse who is an employee of the business. The spouse may exclude the premium payments from income and/or any medical expense reimbursements, provided that the spouse is a bona fide employee of the business. However, if the spouse is self-employed (e.g., a partner) in the business, the accident and health insurance premiums and/or medical expense reimbursements, while deductible by the proprietorship, are included in the spouse’s income and may be deducted by the spouse to the extent allowed to a sole proprietor.

III. Required Forms

The type of entity determines the forms which must be filed and the type of taxed owed (e.g. self-employment tax), as the chart below illustrates:

Table 10.2 Required Forms by Type of Entity

<table>
<thead>
<tr>
<th>If You Are A:</th>
<th>You May Be Liable For:</th>
<th>Use Form:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sole proprietor</td>
<td>Income tax</td>
<td>1040 and Schedule C ¹ or C-EZ (Schedule F ² for farm business)</td>
</tr>
<tr>
<td></td>
<td>Self-employment tax</td>
<td>1040 and Schedule SE</td>
</tr>
<tr>
<td></td>
<td>Estimated tax</td>
<td>1040-ES</td>
</tr>
<tr>
<td></td>
<td>Employment taxes:</td>
<td></td>
</tr>
<tr>
<td></td>
<td>· Social security and Medicare taxes and income tax withholding</td>
<td>941 (943 for farm employees)</td>
</tr>
<tr>
<td></td>
<td>· Federal unemployment (FUTA) tax</td>
<td>940 or 940-EZ</td>
</tr>
<tr>
<td></td>
<td>· Depositing employment taxes</td>
<td>8109 ²</td>
</tr>
<tr>
<td></td>
<td>Excise taxes</td>
<td>See Excise Taxes</td>
</tr>
<tr>
<td>Partnership</td>
<td>Annual return of income</td>
<td>1065</td>
</tr>
<tr>
<td></td>
<td>Employment taxes</td>
<td>Same as sole proprietor</td>
</tr>
<tr>
<td></td>
<td>Excise taxes</td>
<td>See Excise Taxes</td>
</tr>
<tr>
<td>Partner in a partnership</td>
<td>Income tax</td>
<td>1040 and Schedule E ³</td>
</tr>
<tr>
<td>(individual)</td>
<td>Self-employment tax</td>
<td>1040 and Schedule SE</td>
</tr>
<tr>
<td></td>
<td>Estimated tax</td>
<td>1040-ES</td>
</tr>
<tr>
<td>Corporation or S corporation</td>
<td>Income tax</td>
<td>1120 (corporation) 1120S (S corporation)</td>
</tr>
<tr>
<td></td>
<td>Estimated tax</td>
<td>1120-W (corporation only) and 8109 ²</td>
</tr>
<tr>
<td></td>
<td>Employment taxes</td>
<td>Same as sole proprietor</td>
</tr>
<tr>
<td></td>
<td>Excise taxes</td>
<td>See Excise Taxes</td>
</tr>
<tr>
<td>S corporation shareholder</td>
<td>Income tax</td>
<td>1040 and Schedule E ³</td>
</tr>
<tr>
<td></td>
<td>Estimated tax</td>
<td>1040-ES</td>
</tr>
</tbody>
</table>

¹ File a separate schedule for each business.
² Do not use if you deposit taxes electronically.
³ Various other schedules may be needed.
IV. Disregarded Entities: The Limited Liability Company

Historically, businesses had to choose between the protection from liability offered by the corporation and the pass-through taxation offered by the partnership or sole proprietorship. This has changed dramatically over the past few decades.

Today, all 50 states allow businesses to choose limited liability company (LLC) status and limited liability partnerships (LLP), which essentially allow all partners the protections of limited partner status in a general partnership. Each state has its own specific laws that determine what types of partnerships are eligible and the scope of limited liability offered.

A. HISTORICAL TREATMENT

One of the many benefits of limited liability company status is the ability of the owners to elect pass-through taxation. But when the IRS first recognized the existence of LLCs as a business form, not all LLCs were able to qualify for pass-through tax status. Federal regulations in place prior to 1997 required an unincorporated business entity – whether it be a limited liability company or a partnership – to possess certain characteristics or else it was treated as a corporation for federal tax purposes.

Under the old regulations (known as the “Kintner Regulations”), an unincorporated business association would be taxed as a partnership only if it possessed no more than two of the following corporate characteristics:

- Centralization of management;
- Continuity of life;
- Free transferability of interests; and
- Limited liability

The continuity of life restriction was the biggest impediment to limited liability companies being taxed as partnerships. It led most early state statutes governing limited liability companies to impose time limitations on the existence of the entity in order to protect its pass-through tax status. That all changed with the adoption of the so-called “check-the-box” regulations by the IRS.

Check-the-box regulations became effective in 1997, eliminating application of the so-called Kintner regulations that had previously been used to determine if a business association should be treated as a partnership or corporation for purposes of federal taxation. The key change was the elimination of the requirement that a limited liability company have a limited life span in order to qualify for pass-through taxation (under the old regulation, a company with an unlimited life span was too similar to a corporation to avoid being taxed as such).

The changes also made possible more flexibility in other types of unincorporated business associations, such as limited liability partnerships.
The so-called check-the-box regulations, § 301.7701-3, provide, in part, as follows:

(a) In general. A business entity that is not classified as a corporation under § 301.7701-2(b)(1), (3), (4), (5), (6), (7), or (8) (an eligible entity) can elect its classification for federal tax purposes as provided in this section. An eligible entity with at least two members can elect to be classified as either an association (and thus a corporation under § 301.7701-2(b)(2)) or a partnership, and an eligible entity with a single owner can elect to be classified as an association or to be disregarded as an entity separate from its owner. Paragraph (b) of this section provides a default classification for an eligible entity that does not make an election. Thus, elections are necessary only when an eligible entity chooses to be classified initially as other than the default classification or when an eligible entity chooses to change its classification. An entity whose classification is determined under the default classification retains that classification (regardless of any changes in the members' liability that occurs at any time during the time that the entity's classification is relevant as defined in paragraph (d) of this section) until the entity makes an election to change that classification under paragraph (c)(1) of this section. Paragraph (c) of this section provides rules for making express elections. Paragraph (d) of this section provides special rules for foreign eligible entities. Paragraph (e) of this section provides special rules for classifying entities resulting from partnership terminations and divisions under section 708(b). Paragraph (f) of this section sets forth the effective date of this section and a special rule relating to prior periods.

(b) Classification of eligible entities that do not file an election—(1) Domestic eligible entities. Except as provided in paragraph (b)(3) of this section, unless the entity elects otherwise, a domestic eligible entity is—

(i) A partnership if it has two or more members; or

(ii) Disregarded as an entity separate from its owner if it has a single owner.

While a few states still comply with the outdated federal regulations and have provisions for mandatory dissolution of LLCs, most now give limited liability companies the option of an unlimited life span. Minnesota, for example, provides, pursuant to Section 322B.20:

(a) A limited liability company whose existence begins before August 1, 1999, has a limited duration of 30 years from the date the articles of organization are filed with the secretary of state, unless the articles of organization state a shorter or longer period of duration, which may be perpetual.

(b) A limited liability company whose existence begins on or after August 1, 1999, has perpetual duration.

B. FEDERAL TAX RETURNS

For federal tax purposes, a limited liability company can be treated as either a sole proprietorship, a partnership or a corporation. In order to elect treatment as a partnership, a limited liability company must have at least two members. Those with only one can elect to be treated either as a sole proprietorship or a corporation.
Consequently, the applicable tax payment requirements of a limited liability company – as discussed above – depend on the tax treatment elected by the company. To the extent that a limited liability company elects to be treated as a partnership for purposes of federal taxation, normal rules governing taxation of partnerships apply. To the extent a limited liability company elects to be treated as a corporation for purposes of federal taxation, normal rules governing taxation of corporations likewise generally apply. An in depth discussion of partnership and corporation taxation is obviously well beyond the scope of this course. This section will therefore be limited to a discussion of a few significant areas of taxation affecting limited liability companies.

Even though a co-owned LLC itself does not pay income taxes, it must file Form 1065 with the IRS. This form, the same one that a partnership files, is an informational return that the IRS reviews to make sure the LLC members are reporting their income correctly. The LLC must also provide each LLC member with a "Schedule K-1," which breaks down each member’s share of the LLC’s profits and losses. In turn, each LLC member reports this profit and loss information on his individual Form 1040, with Schedule E attached.

The check-the-box regulations give limited liability companies flexibility in deciding how they want to be taxed and therefore what type of tax return to file.

1. Single Member LLC

Generally, when an LLC has only one member, the fact that it is an LLC is ignored or “disregarded” for the purpose of filing a federal tax return. The LLC has the following options for purposes of federal taxation:

- If the only member of the LLC is an individual, the LLC income and expenses are reported on Form 1040, Schedule C, E, or F;
- If the only member of the LLC is a corporation, the LLC income and expenses are reported on the corporation’s return, usually Form 1120 or Form 1120S; and
- If a single-member LLC wishes to file as a corporation instead of as a “disregarded entity,” Form 8832 must be submitted. Otherwise, there is no need to file Form 8832. Single-member LLCs may not file a partnership return.

For a single-member LLC being disregarded as an entity, the taxable year of the proprietor (usually the calendar year) is automatically the taxable year of the proprietorship.

There are tax-deductible fringe benefits available to a sole proprietor, although they are more limited than those available to a corporation. A sole proprietor may contribute annually to a Keogh plan to the same limits available under corporate plans, and a proprietor may contribute to an individual retirement account.

2. Multiple Member LLCs

Most LLCs with more than one member file a partnership return, Form 1065. A multi-member LLC that wants to file as a corporation must submit Form 8832. Form 8832 does not need to be submitted if the LLC wants to file as a partnership.
There is one significant limitation to the ability of a multi-member LLC to be treated as a partnership for tax purposes. Pursuant to I.R.S. Code § 7704, interests in the company cannot be publicly traded if the company wants to be treated as a partnership.

Table 10.3, below, summarizes the forms that a LLC is required to file depending on the number of members it has and the manner in which it elects to be taxed.

**Table 10.3 Tax Forms Filed by Limited Liability Companies**

<table>
<thead>
<tr>
<th>TYPE OF ENTITY</th>
<th>FORM</th>
</tr>
</thead>
<tbody>
<tr>
<td>Single-member LLC when member is an individual</td>
<td>1040</td>
</tr>
<tr>
<td>Single-member LLC when member is a corporation</td>
<td>8832 and 1120 (or 1120S)</td>
</tr>
<tr>
<td>Multi-member LLC filing as partnership</td>
<td>1065</td>
</tr>
<tr>
<td>Multi-member LLC filing as corporation</td>
<td>8832 and 1120 (or 1120S)</td>
</tr>
</tbody>
</table>

**C. EMPLOYMENT AND SELF-EMPLOYMENT TAXES**

As we saw in the earlier discussion, employment tax requirements apply to LLCs in much the same way as other types of unincorporated businesses. Employees of all LLCs are subject to withholding taxes. Forms W-2 and Forms 1099 must be filed when required of all employers.

1. **Self-Employment Taxes**

Because LLC members are not employees but self-employed business owners, contributions to the social security and Medicare systems (collectively called the "self-employment" tax) are not withheld from their paychecks. Instead, most LLC owners are required to pay the self-employment tax directly to the IRS.

With an S corporation, on the other hand, a shareholder pays the payroll tax on money received as compensation for services, but not on profits that automatically pass through as a shareholder.

The current rule is that any owner who works in or helps manage the business must pay this tax on his or her distributive share – i.e. his or her share of profits. However, owners who are not active in the LLC – that is, those who have merely invested money but don't provide services or make management decisions for the LLC – may be exempt from paying self-employment taxes on their share of profits.

Each owner who is subject to the self-employment tax reports it on Schedule SE, which is submitted annually with a 1040 tax return. LLC owners pay twice as much self-employment tax as regular employees, since regular employees' contributions to the self-employment tax are matched by their employers.
a. LLCs filing Schedule C or E

Members are subject to self-employment taxes on earnings.

b. LLCs filing partnership returns

Generally, members pay self-employment tax on their share of partnership earnings. There is a special rule for members who are the equivalent of limited partners. They pay self-employment tax only if the LLC pays them a “guaranteed payment” for services.

As a member, an owner’s liability for LLC debts are limited by state law. However, members, like shareholders in corporations, may be held personally liable in situations involving unpaid employee withholdings if the member in question is determined to be the person responsible for making the payments.

Proposed IRS regulations would impose the self-employment tax on an LLC owner’s entire share of LLC profits in any of the following situations:

- The owner participates in the business for more than 500 hours during the LLC’s tax year;
- The LLC provides professional services in the fields of health, law, engineering, architecture, accounting, actuarial science or consulting (no matter how many hours the owner works); or
- The owner is empowered to sign contracts on behalf of the LLC.

Until the IRS clarifies the rules on self-employment tax for members of an LLC, members should assume that 100% of their earnings could be subject to self-employment tax.

D. EMPLOYEE IDENTIFICATION NUMBER

A single-member LLC with no employees, like a sole proprietorship, is not required to file for a Federal Tax ID number for the LLC. This is because the member will pay taxes on the profits of the LLC at his or her individual rate. Table 10.4, below, shows a comparison of EIN requirements for different business entities.

Table 10.4 Employee Identification Number Requirements

<table>
<thead>
<tr>
<th>BUSINESS ENTITY</th>
<th>EIN REQUIREMENT</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sole Proprietorship</td>
<td>Required if SP has employees</td>
</tr>
<tr>
<td>Partnership</td>
<td>Required</td>
</tr>
<tr>
<td>C Corporation</td>
<td>Required</td>
</tr>
<tr>
<td>S Corporation</td>
<td>Required</td>
</tr>
<tr>
<td>LLC</td>
<td>Required for multi-member LLC</td>
</tr>
</tbody>
</table>

The following recent Internal Revenue Service Revenue Ruling provides guidance on the retention of an entity's employer identification number upon changing under §301.7701-3 of the regulations from a partnership to a disregarded entity or from a disregarded entity to a partnership.
Revenue Ruling 2001-61

EMPLOYER IDENTIFICATION NUMBERS
Published: December 10, 2001

ISSUES

(1) If an entity classified as a partnership becomes disregarded as an entity separate from its owner (disregarded entity) for federal tax purposes and if the disregarded entity chooses to calculate, report, and pay its employment tax obligations under its own name and employer identification number (EIN) pursuant to Notice 99-6 (1999-1 C.B. 321) does the disregarded entity retain the same EIN it used as a partnership?

(2) If an entity classified as a disregarded entity for federal tax purposes calculates, reports, and pays its employment tax obligations under its own name and EIN pursuant to Notice 99-6 and if the federal tax classification of that entity changes to a partnership, does the partnership retain the same EIN it used as a disregarded entity?

FACTS

In each of the following situations, the eligible entity (as defined in § 301.7701-3(a) of the Procedure and Administration Regulations) does not elect under § 301.7701-3(c) to be treated as an association for federal tax purposes at any time.

Situation 1. X, an eligible entity classified as a partnership, becomes a disregarded entity for federal tax purposes when the entity's ownership is reduced to one member. (See, for example, Rev. Rul. 99-6 (1999-1 C.B. 432) X chooses to calculate, report, and pay its employment tax obligations under its own name and EIN pursuant to Notice 99-6.

Situation 2. Y is a disregarded entity for federal tax purposes. Pursuant to Notice 99-6, Y calculates, reports, and pays its employment tax obligations under its own name and EIN. Y becomes a partnership for federal tax purposes when the entity's ownership expands to include more than one member. (See, for example, Rev. Rul. 99-5 (1999-1 C.B. 434.)

LAW & ANALYSIS

Section 6109(a)(1) of the Internal Revenue Code provides that any person required to make a return, statement, or other document shall include in the return, statement, or other document the identifying number as may be prescribed for securing proper identification of the person.

Section 301.6109-1(h)(1) provides that any entity that has an EIN will retain that EIN if its federal tax classification changes under § 301.7701-3.

Section 301.6109-1(h)(2)(i) provides that except as otherwise provided in regulations or other guidance, a single owner entity that is disregarded as an entity separate from its owner under § 301.7701-3 must use its owner's taxpayer identification number (TIN) for federal tax purposes.
Section 301.6109(h)(2)(ii) provides that if a single owner entity’s classification changes so that it is recognized as a separate entity for federal tax purposes, and that entity had an EIN, then the entity must use that EIN and not the TIN of the single owner. If the entity did not already have its own EIN, then the entity must acquire an EIN and not use the TIN of the single owner.

Section 301.7701-3(a) provides that a business entity that is not classified as a corporation under § 301.7701-2(b)(1), (3), (4), (5), (6), (7), or (8) (an eligible entity) can elect its classification for federal tax purposes. An eligible entity with at least two members can elect to be classified as either an association (and thus a corporation under § 301.7701-2(b)(2)) or a partnership, and an eligible entity with a single owner can elect to be classified as an association or to be disregarded as an entity separate from its owner.

Section 301.7701-3(f)(2) provides that an eligible entity classified as a partnership becomes a disregarded entity when the entity’s membership is reduced to one member. A disregarded entity becomes classified as a partnership when the entity’s membership is increased to more than one member.

Notice 99-6 provides that the Service generally will accept reporting and payment of employment taxes with respect to the employees of a disregarded entity if made in one of two ways: (1) calculation, reporting, and payment of all employment tax obligations with respect to employees of a disregarded entity by its owner (as though the employees of the disregarded entity are employed directly by the owner) and under the owner's name and TIN; or (2) separate calculation, reporting, and payment of all employment tax obligations by each state law entity with respect to its employees under its own name and TIN.

In Situation 1, X's change in federal tax classification from a partnership to a disregarded entity is a change described in § 301.7701-3(f)(2). Thus X is required to retain its EIN under § 301.6109-1(h)(1) if it chooses to calculate, report, and pay its employment tax obligations under its own name and EIN pursuant to Notice 99-6 upon its federal tax classification changing to a disregarded entity. For all federal tax purposes other than employment obligations or except as otherwise provided in regulations or other guidance, X must use the TIN of its owner pursuant to § 301.6109-1(h)(2).

In Situation 2, because Y calculates, reports, and pays its employment tax obligations under its own name and EIN prior to its federal tax classification changing from a disregarded entity to a partnership, § 301.6109-1(h)(2)(ii) requires that Y retain its EIN for use for all federal tax purposes as a partnership.

**HOLDINGS**

(1) If an entity classified as a partnership becomes a disregarded entity for federal tax purposes and if the disregarded entity chooses to calculate, report, and pay its employment tax obligations under its own name and EIN pursuant to Notice 99-6, the disregarded entity must retain the same EIN for employment tax purposes it used as a partnership. For all federal tax purposes other than employment obligations or except as otherwise provided in regulations or other guidance, a disregarded entity must use the TIN of its owner.
(2) If an entity classified as a disregarded entity for federal tax purposes calculates, reports, and pays its employment tax obligations under its own name and EIN pursuant to Notice 99-6 and if the federal tax classification of that entity changes to a partnership, the partnership must retain the same EIN it used as a disregarded entity.

E. TAXATION OF DISTRIBUTIONS

Each LLC member’s share of profits and losses, called a distributive share, is set out in the LLC operating agreement. Most operating agreements provide that a member's distributive share is in proportion to his percentage interest in the business. For instance, if Bill owns 70% of the LLC, and John owns the other 30%, Bill will be entitled to 70% of the LLC's profits and losses, and John will be entitled to the other 30%. If the members want to divide profits and losses in a manner that is not proportionate to the members' percentage interests in the business, it is called a "special allocation," and must comply with specific IRS rules.

Distributions to equity owners of businesses taxed as partnerships are normally not subject to income tax pursuant to IRC § 731, which provides, in part, that “gain shall not be recognized . . . except to the extent that any money distributed exceeds the adjusted basis of such partner's interest in the partnership immediately before the distribution.”

Any gain recognized is generally treated as capital gain from the sale of the partnership interest on the date of the distribution. If partnership property (other than marketable securities treated as money) is distributed to a partner, he or she generally does not recognize any gain until the sale or other disposition of the property.

**Example.**

The adjusted basis of Jo's partnership interest is $14,000. She receives a distribution of $8,000 cash and land that has an adjusted basis of $2,000 and a fair market value of $3,000. Because the cash received does not exceed the basis of her partnership interest, Jo does not recognize any gain on the distribution. Any gain on the land will be recognized when she sells or otherwise disposes of it. The distribution decreases the adjusted basis of Jo’s partnership interest to $4,000 \([14,000 - (8,000 + 2,000)]\).

Likewise, I.R.C. §731 provides that a member of a limited liability company may not declare a loss “except that upon a distribution in liquidation of a partner’s interest in a partnership where no property other than that described in subparagraph (A) or (B) is distributed to such partner, loss shall be recognized to the extent of the excess of the adjusted basis of such partner’s interest in the partnership over the sum of: (A) any money distributed; and (B) the basis to the distributee.”

In addition, passive activity limitations and at-risk rules that apply to partnerships generally may restrict the amount a member of a limited liability company may deduct.

The at risk rules of I.R.C. § 465 provide that the members are allowed to deduct their shares of LLC losses to the extent they have an adequate amount at risk in the relevant activity. Generally, nonrecourse debt is not included in the amount at risk, but an exception exists for "qualified nonrecourse financing," which typically exists when a commercial lender makes a nonrecourse loan secured by real property.
Unlike a limited partnership in which the general partner is fully liable for partnership obligations, in an LLC no member may be liable for the LLC's obligations (except to the extent a member has separately agreed to assume them). Accordingly, even if the debt of an LLC is nominally recourse at the entity level, it may be nonrecourse to the members, thereby making it easier for LLC debt secured by real property to constitute "qualified nonrecourse financing."

**Case-in-Point**

In a case of first impression, a federal district court in *Gregg v. U.S.*, 186 F.Supp.2d 1123 (2000) ruled that a member of a limited liability company was entitled to be treated like a general rather than a limited partner for purposes of determining whether he was an active participant in the business and therefore not subject to passive income limits.

The case arose in response to an I.R.S. audit of plaintiff’s income tax return. It disallowed his characterization of flow-through loss from the limited liability company of which he was a member as an ordinary loss and re-characterized that loss as a passive activity loss. The issue was whether plaintiff’s ratable share of the flow-through operating loss from the LLC should be characterized as ordinary loss or passive activity loss in plaintiffs’ joint tax return.

Ordinary losses can be applied against any income; however, passive activity losses can be applied only against passive activity income. Passive activity losses that are not currently deductible are carried forward to the next taxable year. The IRS characterized plaintiff's flow-through loss from the limited liability company of which he was a member as a passive activity loss, thus limiting any deductions to applicable passive gains.

In general, a “passive activity” is one in which the taxpayer does not “materially participate.” The IRS has specific regulations which govern whether a taxpayer has materially participated in the business. Those regulations differentiate between general and limited partners, making it much more difficult for a limited partner to be considered an active participant in the business than a general partner.

The IRS argued that a member of a limited liability company should be treated as a limited partner because members of an LLC, like limited partners, are not personally liable for the debts and obligations of the entity.

The plaintiff, on the other hand, said existing IRS regulations governing partnerships were obsolete as applied to limited liability companies because of the unique characteristics of the relatively new type of business entity. The court agreed with the plaintiff, writing:

“A **limited partnership must have at least one general partner who is personally liable for the obligation of the limited partnership. If, for federal tax purposes, an LLC is treated as a limited partnership, and all members of the LLC are treated as limited partners because of their limited liability, the consequence of such a treatment does not satisfy the requirement of ‘at least one general partner.’ In addition, LLC members retain their limited liability regardless of their level of participation in the management of the LLC. But a limited partner in a limited partnership cannot, by definition, participate in the management.”

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“Furthermore, the legislative history clearly shows that Congress enacted the limited partnership test for the purpose of the passive activity loss rules to thwart the deduction by investors, such as limited partners in a limited partnership, of ‘passive’ losses from ‘tax shelter’ investments against other non-passive income, since ‘a limited partner generally is precluded from participating in the partnership’s business if he is to retain his limited liability status.’”

The limited partnership test is not applicable to all LLC members, Because LLCs are designed to permit active involvement by LLC members in the management of the business, the court concluded that the limited partnership test is not applicable to all LLC members. Further, the court said, LLC members – unlike limited partners – may materially participate in the LLC without losing their limited liability protection. “In the absence of any regulation asserting that an LLC member should be treated as a limited partner of a limited partnership,” the court said, “defendant's conclusion is inappropriate. Therefore, the higher standard of material participation test for limited partners should not be applied to plaintiff.”

F. RETAINED EARNINGS

The benefits of pass-through taxation available to most limited liability companies are obvious. However, there are certain circumstances under which an LLC might benefit from corporate tax status, depending on the nature of the business. One situation where this might be true is when a company has a large amount of retained earnings – that is when a company elects to keep a substantial amount of profits in the company rather than distributing it to its members.

Unlike an LLC, a corporation is responsible for paying taxes on corporate profits left or retained in the business. An LLC that elects corporate tax status, therefore, means that the company will pay tax on the earnings based on the income tax rates that apply to corporations. The members do not have to pay personal income taxes on those profits which are left in the company. And, because the corporate income tax rates for the first $75,000 of corporate taxable income are lower than the individual income tax rates that apply to most LLC owners, this can save you and your co-owners money in overall taxes.

Example.

*If your LLC needs to purchase expensive equipment at the beginning of each year, it may decide to leave $50,000 in the business at the end of the year. With the regular pass-through taxation of an LLC, these retained profits would probably be taxed at the member’s individual tax rate, which is probably over 27%. But with corporate taxation, that $50,000 is taxed at the lower 15% corporate rate.*

A limited liability company that elects corporate tax status by filing Form 8832 is precluded from switching back to partnership status for five years.
G. TAXATION OF A CONVERTED ENTITY

The conversion of a partnership into an LLC classified as a partnership for federal tax purposes does not terminate the partnership. The conversion is not a sale, exchange or liquidation of any partnership interest, the partnership’s tax year does not close, and the LLC can continue to use the partnership’s taxpayer identification number.

However, the conversion may change some of the partners’ bases in their partnership interests if the partnership has recourse liabilities that become nonrecourse liabilities. Because the partners share recourse and nonrecourse liabilities differently, their bases must be adjusted to reflect the new sharing ratios. If a decrease in a partner’s share of liabilities exceeds the partner’s basis, he or she must recognize gain on the excess.

The same rules apply if an LLC classified as a partnership is converted into a partnership. The following recent IRS Revenue Rulings discuss the tax implications of converting a disregarded entity to a partnership and converting a partnership to a disregarded entity.

Revenue Ruling 99-5

DISREGARDED ENTITY TO PARTNERSHIP
Published: February 8, 1999

Disregarded entity to partnership. This ruling describes the federal income tax consequences when a single member limited liability company that is disregarded as an entity separate from its owner under section 301.7701-3 of the Procedure and Administration Regulations becomes an entity with more than one owner that is classified as a partnership for federal tax purposes.

ISSUE

What are the federal income tax consequences when a single member domestic limited liability company (LLC) that is disregarded for federal tax purposes as an entity separate from its owner under § 301.7701-3 of the Procedure and Administration Regulations becomes an entity with more than one owner that is classified as a partnership for federal tax purposes?

FACTS

In each of the following two situations, an LLC is formed and operates in a state which permits an LLC to have a single owner. Each LLC has a single owner, A, and is disregarded as an entity separate from its owner for federal tax purposes under § 301.7701-3. In both situations, the LLC would not be treated as an investment company (within the meaning of § 351) if it were incorporated. All of the assets held by each LLC are capital assets or property described in § 1231. For the sake of simplicity, it is assumed that neither LLC is liable for any indebtedness, nor are the assets of the LLC subject to any indebtedness.
Situation 1. B, who is not related to A, purchases 50% of A’s ownership interest in the LLC for $5,000. A does not contribute any portion of the $5,000 to the LLC. A and B continue to operate the business of the LLC as co-owners of the LLC.

Situation 2. B, who is not related to A, contributes $10,000 to the LLC in exchange for a 50% ownership interest in the LLC. The LLC uses all of the contributed cash in its business. A and B continue to operate the business of the LLC as co-owners of the LLC.

After the sale, in both situations, no entity classification election is made under § 301.7701-3(c) to treat the LLC as an association for federal tax purposes.

**LAW AND ANALYSIS**

Section 721(a) generally provides that no gain or loss shall be recognized to a partnership or to any of its partners in the case of a contribution of property to the partnership in exchange for an interest in the partnership.

Section 722 provides that the basis of an interest in a partnership acquired by a contribution of property, including money, to the partnership shall be the amount of the money and the adjusted basis of the property to the contributing partner at the time of the contribution increased by the amount (if any) of gain recognized under § 721(b) to the contributing partner at such time.

Section 723 provides that the basis of property contributed to a partnership by a partner shall be the adjusted basis of the property to the contributing partner at the time of the contribution increased by the amount (if any) of gain recognized under § 721(b) to the contributing partner at such time.

Section 1001(a) provides that the gain or loss from the sale or other disposition of property shall be the difference between the amount realized therefrom and the adjusted basis provided in § 1011.

Section 1223(1) provides that, in determining the holding period of a taxpayer who receives property in an exchange, there shall be included the period for which the taxpayer held the property exchanged if the property has the same basis in whole or in part in the taxpayer’s hands as the property exchanged, and the property exchanged at the time of the exchange was a capital asset or property described in §1231. Section 1223(2) provides that, regardless of how a property is acquired, in determining the holding period of a taxpayer who holds the property, there shall be included the period for which such property was held by any other person if the property has the same basis in whole or in part in the taxpayer’s hands as it would have in the hands of such other person.

**HOLDING(S)**

Situation 1. In this situation, the LLC, which, for federal tax purposes, is disregarded as an entity separate from its owner, is converted to a partnership when the new member, B, purchases an interest in the disregarded entity from the owner, A. B’s purchase of 50% of A’s ownership interest in the LLC is treated as the purchase of a 50% interest in each of the LLC’s assets, which are treated as held directly by A for federal tax purposes. Immediately thereafter, A and B are treated as contributing their respective
interests in those assets to a partnership in exchange for ownership interests in the partnership.

Under § 1001, A recognizes gain or loss from the deemed sale of the 50% interest in each asset of the LLC to B.

Under § 721(a), no gain or loss is recognized by A or B as a result of the conversion of the disregarded entity to a partnership.

Under § 722, B's basis in the partnership interest is equal to $5,000, the amount paid by B to A for the assets which B is deemed to contribute to the newly-created partnership. A's basis in the partnership interest is equal to A’s basis in A’s 50% share of the assets of the LLC.

Under § 723, the basis of the property treated as contributed to the partnership by A and B is the adjusted basis of that property in A’s and B’s hands immediately after the deemed sale.

Under § 1223(1), A's holding period for the partnership interest received includes A's holding period in the capital assets and property described in § 1231 held by the LLC when it converted from an entity that was disregarded as an entity separate from A to a partnership. B's holding period for the partnership interest begins on the day following the date of B's purchase of the LLC interest from A. See Rev. Rul. 66-7, 1966-1 C.B. 188, which provides that the holding period of a purchased asset is computed by excluding the date on which the asset is acquired. Under § 1223(2), the partnership's holding period for the assets deemed transferred to it includes A's and B's holding periods for such assets.

**Situation 2.** In this situation, the LLC is converted from an entity that is disregarded as an entity separate from its owner to a partnership. When a new member, B, contributes cash to the LLC, B's contribution is treated as a contribution to a partnership in exchange for an ownership interest in the partnership. A is treated as contributing all of the assets of the LLC to the partnership in exchange for a partnership interest.

Under § 721(a), no gain or loss is recognized by A or B as a result of the conversion of the disregarded entity to a partnership.

Under § 722, B's basis in the partnership interest is equal to $10,000, the amount of cash contributed to the partnership. A's basis in the partnership interest is equal to A's basis in the assets of the LLC which A was treated as contributing to the newly-created partnership.

Under § 723, the basis of the property contributed to the partnership by A is the adjusted basis of that property in A's hands. The basis of the property contributed to the partnership by B is $10,000, the amount of cash contributed to the partnership.
Under §1223(1), A’s holding period for the partnership interest received includes A’s holding period in the capital and §1231 assets deemed contributed when the disregarded entity converted to a partnership. B’s holding period for the partnership interest begins on the day following the date of B’s contribution of money to the LLC. Under §1223(2), the partnership’s holding period for the assets transferred to it includes A’s holding period.

Revenue Ruling 99-6

PARTNERSHIP TO DISREGARDED ENTITY
Published: February 8, 1999

Partnership to disregarded entity. This ruling describes the federal income tax consequences if one person purchases all of the ownership interests in a domestic limited liability company (LLC) that is classified as a partnership under section 301.7701-3 of the Procedure and Administration Regulations, causing the LLC’s status as a partnership to terminate under section 708(b)(1)(A) of the Code.

ISSUE

What are the federal income tax consequences if one person purchases all of the ownership interests in a domestic limited liability company (LLC) that is classified as a partnership under § 301.7701-3 of the Procedure and Administration Regulations, causing the LLC’s status as a partnership to terminate under § 708(b)(1)(A) of the Internal Revenue Code?

FACTS

In each of the following situations, an LLC is formed and operates in a state which permits an LLC to have a single owner. Each LLC is classified as a partnership under § 301.7701-3. Neither of the LLCs holds any unrealized receivables or substantially appreciated inventory for purposes of § 751(b). For the sake of simplicity, it is assumed that neither LLC is liable for any indebtedness, nor are the assets of the LLC subject to any indebtedness.

Situation 1. A and B are equal partners in AB, an LLC. A sells A’s entire interest in AB to B for $10,000. After the sale, the business is continued by the LLC, which is owned solely by B.

Situation 2. C and D are equal partners in CD, an LLC. C and D sell their entire interests in CD to E, an unrelated person, in exchange for $10,000 each. After the sale, the business is continued by the LLC, which is owned solely by E.

After the sale, in both situations, no entity classification election is made under § 301.7701-3(c) to treat the LLC as an association for federal tax purposes.
Section 708(b)(1)(A) and § 1.708-1(b)(1) of the Income Tax Regulations provide that a partnership shall terminate when the operations of the partnership are discontinued and no part of any business, financial operation, or venture of the partnership continues to be carried on by any of its partners in a partnership.

Section 731(a)(1) provides that, in the case of a distribution by a partnership to a partner, gain is not recognized to the partner except to the extent that any money distributed exceeds the adjusted basis of the partner's interest in the partnership immediately before the distribution.

Section 731(a)(2) provides that, in the case of a distribution by a partnership in liquidation of a partner's interest in a partnership where no property other than money, unrealized receivables (as defined in § 751(c)), and inventory (as defined in § 751(d)(2)) is distributed to the partner, loss is recognized to the extent of the excess of the adjusted basis of the partner's interest in the partnership over the sum of (A) any money distributed, and (B) the basis to the distributee, as determined under § 732, of any unrealized receivables and inventory.

Section 732(b) provides that the basis of property (other than money) distributed by a partnership to a partner in liquidation of the partner's interest shall be an amount equal to the adjusted basis of the partner's interest in the partnership, reduced by any money distributed in the same transaction.

Section 735(b) provides that, in determining the period for which a partner has held property received in a distribution from a partnership (other than for purposes of § 735(a)(2)), there shall be included the holding period of the partnership, as determined under § 1223, with respect to the property.

Section 741 provides that gain or loss resulting from the sale or exchange of an interest in a partnership shall be recognized by the transferor partner, and that the gain or loss shall be considered as gain or loss from a capital asset, except as provided in § 751 (relating to unrealized receivables and inventory items).

Section 1.741-1(b) provides that § 741 applies to the transferor partner in a two-person partnership when one partner sells a partnership interest to the other partner, and to all the members of a partnership when they sell their interests to one or more persons outside the partnership.

Section 301.7701-2(c)(1) provides that, for federal tax purposes, the term "partnership" means a business entity (as the term is defined in § 301.7701-2(a)) that is not a corporation and that has at least two members.

In Edwin E. McCauslen v. Commissioner, 45 T.C. 588 (1966), one partner in an equal, two-person partnership died, and his partnership interest was purchased from his estate by the remaining partner. The purchase caused a termination of the partnership under § 708(b)(1)(A). The Tax Court held that the surviving partner did not purchase the deceased partner's interest in the partnership, but that the surviving partner purchased the partnership assets attributable to the interest. As a result, the surviving partner was not permitted to succeed to the partnership's holding period with respect to these assets.
Rev. Rul. 67-65, 1967-1 C.B. 168, also considered the purchase of a deceased partner's interest by the other partner in a two-person partnership. The Service ruled that, for the purpose of determining the purchaser's holding period in the assets attributable to the deceased partner's interest, the purchaser should treat the transaction as a purchase of the assets attributable to the interest. Accordingly, the purchaser was not permitted to succeed to the partnership's holding period with respect to these assets. See also Rev. Rul. 55-68, 1955-1 C.B. 372.

ANALYSIS AND HOLDINGS

Situation 1. The AB partnership terminates under § 708(b)(1)(A) when B purchases A's entire interest in AB. Accordingly, A must treat the transaction as the sale of a partnership interest. Reg. § 1.741-1(b). A must report gain or loss, if any, resulting from the sale of A's partnership interest in accordance with § 741.

Under the analysis of McCauslen and Rev. Rul. 67-65, for purposes of determining the tax treatment of B, the AB partnership is deemed to make a liquidating distribution of all of its assets to A and B, and following this distribution, B is treated as acquiring the assets deemed to have been distributed to A in liquidation of A's partnership interest. B's basis in the assets attributable to A's one-half interest in the partnership is $10,000, the purchase price for A's partnership interest. Section 1012. Section 735(b) does not apply with respect to the assets B is deemed to have purchased from A. Therefore, B's holding period for these assets begins on the day immediately following the date of the sale. See Rev. Rul. 66-7, 1966-1 C.B. 188, which provides that the holding period of an asset is computed by excluding the date on which the asset is acquired.

Upon the termination of AB, B is considered to receive a distribution of those assets attributable to B's former interest in AB, B must recognize gain or loss, if any, on the deemed distribution of the assets to the extent required by § 731(a). B's basis in the assets received in the deemed liquidation of B's partnership interest is determined under § 732(b). Under § 735(b), B's holding period for the assets attributable to B's one-half interest in AB includes the partnership's holding period for such assets (except for purposes of § 735(a)(2)).

Situation 2. The CD partnership terminates under § 708(b)(1)(A) when E purchases the entire interests of C and D in CD. C and D must report gain or loss, if any, resulting from the sale of their partnership interests in accordance with § 741.

For purposes of classifying the acquisition by E, the CD partnership is deemed to make a liquidating distribution of its assets to C and D. Immediately following this distribution, E is deemed to acquire, by purchase, all of the former partnership's assets. Compare Rev. Rul. 84-111, 1984-2 C.B. 88 (Situation 3), which determines the tax consequences to a corporate transferee of all interests in a partnership in a manner consistent with McCauslen, and holds that the transferee's basis in the assets received equals the basis of the partnership interests, allocated among the assets in accordance with § 732(c).

E's basis in the assets is $20,000 under § 1012. E's holding period for the assets begins on the day immediately following the date of sale.
H. STATE TAXES AND FEES

The IRS’s classification of an LLC as a partnership for tax purposes does not govern state law treatment. Most states that do impose a state income tax do, however, follow the federal lead and allow LLC’s to elect pass-through tax status for state tax purposes.

Utah’s law is indicative of that in most states. Section 59-10-801 provides that “For purposes of taxation under this title, a limited liability company or a foreign limited liability company transacting business in the state shall be classified in the same manner as it is classified for federal income tax purposes.”

Most states also do not distinguish between domestic and foreign limited liability companies for state tax purposes.

While an LLC might benefit from electing pass-through status for state tax purposes, or may even choose to operate in a state that does not impose an income tax, there could still be other costs associated with operating. For example, a number of states now impose an entity tax on LLCs as well as filing or registration fees which operate as a type of indirect tax.

California, for example, imposes an $800 annual franchise fee on LLCs, while Massachusetts imposes a fee of $500 per year. Florida, which does not have a state income tax, does impose its intangibles tax, below, to membership interests in an LLC:

§ 199.052. Annual tax returns; payment of annual tax

(1) An annual intangible tax return must be filed with the department by every corporation authorized to do business in this state or doing business in this state and by every person, regardless of domicile, who on January 1 owns, controls, or manages intangible personal property which has a taxable situs in this state. For purposes of this chapter, "control" or "manage" does not include any ministerial function or any processing activity. The return shall be due on June 30 of each year. It shall list separately the character, description, and just valuation of all such property.

(2) No person, corporation, agent, or fiduciary shall be required to pay the annual tax in any year when the aggregate annual tax upon the intangible personal property, after exemptions but before application of any discount for early filing, would be less than $60. In such case, an annual return is not required. Agents and fiduciaries shall report for each person for whom they hold intangible personal property if the aggregate annual tax on such person is $60 or more.

V. Partnerships

A partnership is not a taxable entity. It files a return, but it is purely informational. A partnership computes its income and files its return in the same manner as an individual. However, certain deductions are not allowed to the partnership. This section will address basic rules in computing profit and loss.
A. SEPARATELY STATED ITEMS

Certain items must be separately stated on the partnership return and included as separate items on the partners’ returns. These items, listed on Schedule K (Form 1065), are the following:

- Ordinary income or loss from trade or business activities;
- Net income or loss from rental real estate activities;
- Net income or loss from other rental activities;
- Gains and losses from sales or exchanges of capital assets;
- Gains and losses from sales or exchanges of property described in section 1231 of the Internal Revenue Code;
- Charitable contributions;
- Dividends (passed through to corporate partners) that qualify for the dividends-received deduction;
- Taxes paid or accrued to foreign countries and U.S. possessions;
- Other items of income, gain, loss, deduction, or credit, as provided by regulations. Examples include nonbusiness expenses, intangible drilling and development costs, and soil and water conservation expenses.

B. ELECTIONS

The partnership makes the most choices about how to figure income. These include choices for the following items:

- Accounting method;
- Depreciation method;
- Method of accounting for specific items, such as depletion or installment sales;
- Nonrecognition of gain on involuntary conversions of property; and
- Amortization of certain organization fees and business start-up costs of the partnership.

However, each partner chooses how to treat the partner’s share of foreign and U.S. possessions taxes, certain mining exploration expenses, and income from cancellation of debt.
C. ORGANIZATION EXPENSES AND SYNDICATION FEES

Neither the partnership nor any partner can deduct, as a current expense, amounts paid or incurred to organize a partnership or to promote the sale of, or to sell, an interest in the partnership.

The partnership can choose to deduct up to $5,000 of organization expenses, unless such expenses exceed $50,000, after which there is a phase-out. The remaining organization expenses may be amortized over a period of 180 months. The period must start with the month the partnership begins business. If the partnership elects to amortize these expenses and is liquidated before the end of the amortization period, the remaining balance in this account is deductible as a loss.

1. Making the Election

The election to amortize organization expenses is made by attaching a statement to the partnership's return for the tax year the partnership begins its business. The statement must provide all the following information:

- A description of each organization expense incurred (whether or not paid);
- The amount of each expense;
- The date each expense was incurred;
- The month the partnership began its business; and
- The number of months (not less than 60) over which the expenses are to be amortized.

Expenses less than $10 need not be separately listed, provided the total amount is listed with the dates on which the first and last of the expenses were incurred. A cash basis partnership must also indicate the amount paid before the end of the year for each expense.

2. Amortizable Expenses

Amortization applies to expenses that are:

- Incident to the creation of the partnership;
- Chargeable to a capital account; and
- The type that would be amortized if they were incurred in the creation of a partnership having a fixed life.

To satisfy (1), an expense must be incurred during the period beginning at a point that is a reasonable time before the partnership begins business and ending with the date for filing the partnership return (not including extensions) for the tax year in which the partnership begins business. In addition, the expense must be for creating the partnership and not for starting or operating the partnership trade or business.
To satisfy (3), the expense must be for a type of item normally expected to benefit the partnership throughout its entire life. Organization expenses that can be amortized include the following:

- Legal fees for services incident to the organization of the partnership, such as negotiation and preparation of a partnership agreement;
- Accounting fees for services incident to the organization of the partnership; and
- Filing fees.

3. Expenses Not Amortizable

Expenses that cannot be amortized (regardless of how the partnership characterizes them) include expenses connected with the following actions:

- Acquiring assets for the partnership or transferring assets to the partnership;
- Admitting or removing partners other than at the time the partnership is first organized;
- Making a contract relating to the operation of the partnership trade or business (even if the contract is between the partnership and one of its members); and
- Syndicating the partnership. Syndication expenses, such as commissions, professional fees, and printing costs connected with the issuing and marketing of interests in the partnership, are capitalized. They can never be deducted by the partnership, even if the syndication is unsuccessful.

VI. Taxation of Corporations

The classic “knock” on corporate status is the onus of double taxation: the corporation pays federal income on its income at the entity level; the profits taken by shareholders – normally in the form of dividends – are then taxed to the individual. As we saw in Chapter 6, Distributions to Owners, shareholders who are also employees are allowed to receive a salary that is tax deductible to the corporation so long as it is not “excessive.” But that does not relieve the corporation of paying taxes on its profits.

A. INCOME TAX RETURN

Unless exempt under § 501 of the Internal Revenue Code, all domestic corporations in existence for any part of a taxable year (including corporations in bankruptcy) must file an income tax return whether or not they have taxable income.

A corporation must generally file Form 1120 to report its income, gains, losses, deductions, credits, and to figure its income tax liability. Certain organizations must file special returns. For more information, see the instructions for Form 1120.
Generally, a corporation must file its income tax return by the 15th day of the 3rd month after the end of its tax year. A new corporation filing a short-period return must generally file by the 15th day of the 3rd month after the short period ends. A corporation that has dissolved must generally file by the 15th day of the 3rd month after the date it dissolved.

Form 7004 can be filed to request a 6-month extension of time to file a corporation income tax return. The IRS will grant the extension if you complete the form properly, file it, and any tax due is paid by the original due date for the return.

Form 7004 does not extend the time for paying the tax due on the return. Interest, and possibly penalties, will be charged on any part of the final tax due not shown as a balance due on Form 7004. The interest is figured from the original due date of the return to the date of payment. For more information, see the instructions for Form 7004.

A corporation that does not file its tax return by the due date, including extensions, may be penalized 5% of the unpaid tax for each month or part of a month the return is late, up to a maximum of 25% of the unpaid tax. If the corporation is charged a penalty for late payment of tax for the same period of time, the penalty for late filing is reduced by the amount of the penalty for late payment. The minimum penalty for a return that is over 60 days late is the smaller of the tax due or $100. The penalty will not be imposed if the corporation can show the failure to file on time was due to a reasonable cause. Corporations that have a reasonable cause to file late must attach a statement explaining the reasonable cause.

A corporation that does not pay the tax when due may be penalized ½ of 1% of the unpaid tax for each month or part of a month the tax is not paid, up to a maximum of 25% of the unpaid tax. The penalty will not be imposed if the corporation can show that the failure to pay on time was due to a reasonable cause.

If income, social security, and Medicare taxes that a corporation must withhold from employee wages are not withheld or are not deposited or paid to the United States Treasury, the trust fund recovery penalty may apply. The penalty is the full amount of the unpaid trust fund tax. This penalty may apply to you if these unpaid taxes cannot be immediately collected from the business.

The trust fund recovery penalty may be imposed on all persons who are determined by the IRS to be responsible for collecting, accounting for, and paying these taxes, and who acted willfully in not doing so.

A “responsible person” can be an officer or employee of a corporation, an accountant, or a volunteer director/trustee. A responsible person also may include one who signs checks for the corporation or otherwise has authority to cause the spending of business funds.

“Willfully” means voluntarily, consciously, and intentionally. A responsible person acts willfully if the person knows the required actions are not taking place.
B. INCOME AND DEDUCTIONS

Rules on income and deductions that apply to individuals also apply, for the most part, to corporations. However, some of the following special provisions apply only to corporations.

1. Below-Market Loans

A below-market loan is a loan on which no interest is charged or on which interest is charged at a rate below the applicable federal rate. A below-market loan generally is treated as an arm's-length transaction in which the borrower is considered as having received both the following:

- A loan in exchange for a note that requires payment of interest at the applicable federal rate; and
- An additional payment.

2. Capital Losses

A corporation can deduct capital losses only up to the amount of its capital gains. In other words, if a corporation has an excess capital loss, it cannot deduct the loss in the current tax year. Instead, it carries the loss to other tax years and deducts it from capital gains that occur in those years.

First, carry a net capital loss back three years. Deduct it from any total net capital gain that occurred in that year. If you do not deduct the full loss, carry it forward one year (two years back) and then one more year (one-year back). If any loss remains, carry it over to future tax years, one year at a time, for up to five years. When you carry a net capital loss to another tax year, treat it as a short-term loss. It does not retain its original identity as long term or short term.

Example.

*In 2010, a calendar year corporation has a net short-term capital gain of $3,000 and a net long-term capital loss of $9,000. The short-term gain offsets some of the long-term loss, leaving a net capital loss of $6,000. The corporation treats this $6,000 as a short-term loss when carried back or forward.*

*The corporation carries the $6,000 short-term loss back three years to 2007. In 2007, the corporation had a net short-term capital gain of $8,000 and a net long-term capital gain of $5,000. It subtracts the $6,000 short-term loss first from the net short-term gain. This results in a net capital gain for 2007 of $7,000. This consists of a net short-term capital gain of $2,000 ($8,000 - $6,000) and a net long-term capital gain of $5,000.*

3. S Corporation Status

A corporation may not carry a capital loss from, or to, a year for which it is an S corporation.
4. Rules for Carryover and Carryback

When carrying a capital loss from one year to another, the following rules apply:

- When figuring the current year's net capital loss, taxpayers may not combine it with a capital loss carried from another year. In other words, taxpayers can carry capital losses only to years that would otherwise have a total net capital gain;
- If a taxpayer carries capital losses from two or more years to the same year, they must deduct the loss from the earliest year first; and
- Taxpayers cannot use a capital loss carried from another year to produce or increase a net operating loss in the year to which they carry it back.

5. Charitable Contributions

A corporation can claim a limited deduction for charitable contributions made in cash or other property. The contribution is deductible if made to, or for the use of, a qualified organization. A corporation may not take a deduction if any of the net earnings of an organization receiving contributions benefit any private shareholder or individual.

a. Cash method corporation

A corporation using the cash method of accounting deducts contributions in the tax year paid.

b. Accrual method corporation

A corporation using an accrual method of accounting can choose to deduct unpaid contributions for the tax year the board of directors authorizes them if it pays them within 2½ months after the close of that tax year. Make the choice by reporting the contribution on the corporation’s return for the tax year. A copy of the resolution authorizing the contribution and a declaration stating that the board of directors adopted the resolution during the tax year must accompany the return. An officer authorized to sign the return must sign the declaration under penalties of perjury.

c. Limit

A corporation cannot deduct charitable contributions that exceed 10% of its taxable income for the tax year. Figure taxable income for this purpose without the following:

- The deduction for charitable contributions;
- The deduction for dividends received;
- Any net operating loss carryback to the tax year; and
- Any capital loss carryback to the tax year.
d. Carryover of excess contributions

A corporation may carry over, within certain limits, to each of the subsequent five years any charitable contributions made during the current year that exceed the 10% limit. A corporation may lose any excess not used within that period. For example, if a corporation has a carryover of excess contributions paid in 2009 and it does not use all the excess on its return for 2010, it can carry the rest over to 2011, 2012, 2013, and 2014. Do not deduct a carryover of excess contributions in the carryover year until after deducting contributions made in that year (subject to the 10% limit). A taxpayer cannot deduct a carryover of excess contributions to the extent it increases a net operating loss carryover.

6. Corporate Preference Items

A corporation must make special adjustments to certain items before it takes them into account in determining its taxable income. These items are known as corporate preference items and they include the following:

- Gain on the disposition of § 1250 property;
- Percentage depletion for iron ore and coal (including lignite);
- Amortization of pollution control facilities; and
- Mineral exploration and development costs.

For more information on corporate preference items, see § 291 of the Internal Revenue Code.

7. Dividends-Received Deduction

A corporation can deduct a percentage of certain dividends received during its tax year. This section discusses the general rules that apply.

a. Dividends from domestic corporations

A corporation can deduct, within certain limits, 70% of the dividends received if the corporation receiving the dividend owns less than 20% of the corporation distributing the dividend. If the corporation owns 20% or more of the distributing corporation's stock, it can, subject to certain limits, deduct 80% of the dividends received.

b. Ownership

Determine ownership, for these rules, by the amount of voting power and value of the paying corporation's stock (other than certain preferred stock) the receiving corporation owns.
c. Small business investment companies

Small business investment companies can deduct 100% of the dividends received from taxable domestic corporations.

d. Dividends from regulated investment companies

Regulated investment company dividends received are subject to certain limits. Capital gain dividends received from a regulated investment company do not qualify for the deduction. For more information, see section 854 of the Internal Revenue Code.

e. No deduction allowed for certain dividends

Corporations cannot take a deduction for dividends received from the following entities:

- A real estate investment trust (REIT);
- A corporation exempt from tax under § 501 or 521 of the Internal Revenue Code either for the tax year of the distribution or the preceding tax year;
- A corporation whose stock was held less than 46 days during the 90-day period beginning 45 days before the stock became ex-dividend with respect to the dividend. Ex-dividend means the holder has no rights to the dividend;
- A corporation whose preferred stock was held less than 91 days during the 180-day period beginning 90 days before the stock became ex-dividend with respect to the dividend if the dividends received are for a period or periods totaling more than 366 days; and
- Any corporation, if your corporation is under an obligation (pursuant to a short sale or otherwise) to make related payments with respect to positions in substantially similar or related property.

Dividends on deposits or withdrawable accounts in domestic building and loan associations, mutual savings banks, cooperative banks, and similar organizations are interest, not dividends. They do not qualify for this deduction.

The total deduction for dividends received or accrued is generally limited (in the following order) to:

- 80% of the difference between taxable income and the 100% deduction allowed for dividends received from affiliated corporations, or by a small business investment company, for dividends received or accrued from 20%-owned corporations, then
- 70% of the difference between taxable income and the 100% deduction allowed for dividends received from affiliated corporations, or by a small business investment company, for dividends received or accrued from less-than-20%-owned corporations (reducing taxable income by the total dividends received from 20%-owned corporations).
In figuring the limit, determine taxable income without the following items:

- The net operating loss deduction;
- The deduction for dividends received;
- Any adjustment due to the nontaxable part of an extraordinary dividend; and
- Any capital loss carryback to the tax year.

If a corporation has a net operating loss (NOL) for a tax year, the limit of 80% (or 70%) of taxable income does not apply. To determine whether a corporation has an NOL, figure the dividends-received deduction without the 80% (or 70%) of taxable income limit.

Example 1.

A corporation loses $25,000 from operations. It receives $100,000 in dividends from a 20%-owned corporation. Its taxable income is $75,000 ($100,000 - $25,000) before the deduction for dividends received. If it claims the full dividends-received deduction of $80,000 ($100,000 × 80%) and combines it with an operations loss of $25,000, it will have an NOL of ($5,000). Therefore, the 80% of taxable income limit does not apply. The corporation can deduct the full $80,000.

Example 2.

Assume the same facts as in Example 1, except that the corporation only loses $15,000 from operations. Its taxable income is $85,000 before the deduction for dividends received. After claiming the dividends-received deduction of $80,000 ($100,000 × 80%), its taxable income is $5,000. Because the corporation will not have an NOL after applying a full dividends-received deduction, its allowable dividends-received deduction is limited to 80% of its taxable income, or $68,000 ($85,000 × 80%).

8. Extraordinary Dividends

If a corporation receives an extraordinary dividend on stock held two years or less before the dividend announcement date, it generally must reduce its basis in the stock by the non-taxed part of the dividend. The non-taxed part is any dividends-received deduction allowable for the dividends.

An extraordinary dividend is any dividend on stock that equals or exceeds a certain percentage of the corporation's adjusted basis in the stock. The percentages are: (1) 5% for stock preferred as to dividends, or (2) 10% for other stock.

Corporation should treat all dividends received that have ex-dividend dates within an 85-consecutive-day period as one dividend. Corporations should treat all dividends received that have ex-dividend dates within a 365-consecutive-day period as extraordinary dividends if the total of the dividends exceeds 20% of the corporation's adjusted basis in the stock.
Any dividend on disqualified preferred stock is treated as an extraordinary dividend regardless of the period of time the corporation held the stock. Disqualified preferred stock is any stock preferred as to dividends if any of the following apply.

- The stock when issued has a dividend rate that declines (or can reasonably be expected to decline) in the future;
- The issue price of the stock exceeds its liquidation rights or stated redemption price; or
- The stock is otherwise structured to avoid the rules for extraordinary dividends and to enable corporate shareholders to reduce tax through a combination of dividends-received deductions and loss on the disposition of the stock.

These rules apply to stock issued after July 10, 1989, unless it was issued under a written binding contract in effect on that date, and thereafter, before the issuance of the stock.

C. GOING INTO BUSINESS

When going into business, certain costs incurred to get the business started are treated as capital expenses. A corporation can choose to expense the first $5,000 on the first year’s tax return and amortize the remaining costs over a period of 180 months. To qualify, the cost must be one of the following: (1) a business start-up cost, or (2) an organizational cost, and total costs may not exceed $50,000.

1. Business Start-up Costs

Start-up costs are costs incurred for creating an active trade or business or for investigating the creation or acquisition of an active trade or business. Start-up costs include any amounts paid or incurred in connection with an activity engaged in for profit or for the production of income in anticipation of the activity becoming an active trade or business. A start-up cost is amortizable if it meets both of the following tests;

- It is a cost the taxpayer could deduct if they paid or incurred it to operate an existing active trade or business (in the same field); and
- It is a cost the taxpayer paid or incurred before the date their active trade or business begins.

Start-up costs include costs for the following:

- An analysis or survey of potential markets, products, labor supply, transportation facilities, etc.;
- Advertisements for the opening of the business;
- Salaries and wages for employees who are being trained, and their instructors;
- Travel and other necessary costs for securing prospective distributors, suppliers, or customers; and
- Salaries and fees for executives and consultants, or for similar professional services.

Start-up costs do not include deductible interest, taxes, or research and experimental costs.

2. Purchasing an Active Trade or Business

Amortizable start-up costs for purchasing an active trade or business include only investigative costs incurred in the course of a general search for, or preliminary investigation of, the business. Investigative costs are costs that help an individual or entity decide whether to purchase any business and which business to purchase. Alternatively, costs you incur in an attempt to purchase a specific business are capital expenses and you cannot amortize them.

If an individual or entity completely disposes of their business before the end of the amortization period, they can deduct any remaining deferred start-up costs to the extent allowable under § 165 of the Internal Revenue Code.

3. Organizational Costs

The costs of organizing a corporation are the direct costs of creating the corporation. Organizational costs may be amortized only if they meet all of the following tests:

- It is for the creation of the corporation;
- It is chargeable to a capital account;
- It could be amortized over the life of the corporation, if the corporation had a fixed life; and
- It is incurred before the end of the first tax year in which the corporation is in business. A corporation using the cash method of accounting can amortize organizational costs incurred within the first tax year, even if it does not pay them in that year.

The following are examples of organizational costs:

- The cost of temporary directors;
- The cost of organizational meetings;
- State incorporation fees;
- The cost of accounting services for setting up the corporation; and
- The cost of legal services (such as drafting the charter, bylaws, terms of the original stock certificates, and minutes of organizational meetings).
The following costs are not organizational costs. They are capital expenses that cannot be amortized:

- Costs for issuing and selling stock or securities, such as commissions, professional fees, and printing costs; and
- Costs associated with the transfer of assets to the corporation.

4. Related Persons

A corporation that uses an accrual method of accounting cannot deduct business expenses and interest owed to a related person who uses the cash method of accounting until the corporation makes the payment and the corresponding amount is includible in the related person's gross income. Determine the relationship, for this rule, as of the end of the tax year for which the expense or interest would otherwise be deductible. If a deduction is denied under this rule, the rule will continue to apply even if the corporation's relationship with the person ends before the expense or interest is includible in the gross income of that person. These rules also deny the deduction of losses on the sale or exchange of property between related persons. For purposes of this rule, the following persons are related to a corporation:

- Another corporation that is a member of the same controlled group as defined in § 267(f) of the Internal Revenue Code;
- An individual who owns, directly or indirectly, more than 50% of the value of the outstanding stock of the corporation;
- A trust fiduciary when the trust or the grantor of the trust owns, directly or indirectly, more than 50% in value of the outstanding stock of the corporation;
- An S corporation if the same persons own more than 50% in value of the outstanding stock of each corporation;
- A partnership if the same persons own more than 50% in value of the outstanding stock of the corporation and more than 50% of the capital or profits interest in the partnership; and
- Any employee-owner if the corporation is a personal service corporation (defined later), regardless of the amount of stock owned by the employee-owner.

To determine whether an individual directly or indirectly owns any of the outstanding stock of a corporation, the following rules apply:

(1) Stock owned, directly or indirectly, by or for a corporation, partnership, estate, or trust is treated as being owned proportionately by or for its shareholders, partners, or beneficiaries;

(2) An individual is treated as owning the stock owned, directly or indirectly, by or for his or her family. Family includes only brothers and sisters (including half brothers and half sisters), a spouse, ancestors, and lineal descendants; and
(3) Any individual owning (other than by applying rule (2)) any stock in a corporation is treated as owning the stock owned directly or indirectly by that individual's partner.

To apply rule (1), (2), or (3), stock constructively owned by a person under rule (1) is treated as actually owned by that person. But stock constructively owned by an individual under rule (2) or (3) is not treated as actually owned by the individual for applying either rule (2) or (3) to make another person the constructive owner of that stock.

5. Personal Service Corporation

For this purpose, a corporation is a personal service corporation if it meets all of the following requirements:

- It is not an S corporation;
- Its principal activity is performing personal services. Personal services are those performed in the fields of accounting, actuarial science, architecture, consulting, engineering, health (including veterinary services), law, and performing arts;
- Its employee-owners substantially perform the services above; and
- Its employee-owners own more than 10% of the fair market value of its outstanding stock.

Where it is necessary to clearly show income or prevent tax evasion, the IRS can reallocate gross income, deductions, credits, or allowances between two or more organizations, trades, or businesses owned or controlled directly, or indirectly, by the same interests. The disallowance of losses from the sale or exchange of property between related persons does not apply to liquidating distributions.

6. U.S. Real Property Interest

If a domestic corporation acquires a U.S. real property interest from a foreign person or firm, the corporation may have to withhold tax on the amount it pays for the property. The amount paid includes cash, the fair market value of other property, and any assumed liability. If a domestic corporation distributes a U.S. real property interest to a foreign person or firm, it may have to withhold tax on the fair market value of the property. A corporation that fails to withhold may be liable for the tax, and any penalties and interest that apply.

VII. Subchapter S Corporations

The essence of a subchapter S corporation is that its owners have the limited liability offered by a corporation and the pass-through taxation of a partnership or limited liability company. This can be particularly useful for closely-held corporations that expect to suffer a loss, particularly at the beginning of the business. Subchapter S status allows the loss to be passed through directly to the shareholder. This loss can be offset against gains from other activities, subject to the limitations of the passive-income and at-risk
rules. Some of the factors to consider when making a choice of entity that includes S corporation status include:

- The IRS treats a subchapter S corporation like a partnership for income tax purposes, but as a corporation for determining the tax treatment on dissolution;
- There are significant limits on who, and how many people, can have an ownership interest in an S corporation; and
- Failure to meet the strict statutory requirements for S corporation status can result in a retroactive loss of status and additional tax liabilities.

To be eligible for S corporation status, the corporation must first be duly organized under the laws of its state of organization. S corporation status must then be affirmatively elected by all shareholders. This election is made using Form 2553 and must be filed within the first two and one-half months of the taxable year of the corporation or at any time prior to that, but not more than one year. A late election is considered valid for the following year.

Once elected, income and deductions pass through to the shareholder in the same fashion as a partnership. However, special allocations available to a partnership (as discussed above) are not available to S corporations. This also holds true for losses, except that they are limited by the shareholders’ basis in corporate stock. This is similar to partnership losses, as discussed above. Likewise, capital gains pass through.

Subchapter S status may be terminated either voluntarily – through a vote of the shareholders – or involuntarily. Involuntary termination occurs whenever any of the preconditions for electing the status fail to longer exist, i.e. when the maximum number of shareholders is exceeded or when a second class of stock is created or stock passes into the hands of an unqualified shareholder.

The holders of more than 50% of the stock may terminate the election voluntarily. No special form is required. Once an election has been terminated, the corporation may not again elect for the next four years, except under certain circumstances with the consent of the IRS.

### A. RIGHT TO OFFSET OTHER INCOME

Because subchapter S corporation income and loss items pass through to the shareholders, losses can offset income generated from other activities by shareholders. The losses the subchapter S corporation generates may offset income generated by other activities, provided the shareholder's basis in his or her stock is sufficient to permit the deduction of the loss.

### B. TAX ON EXCESSIVE PASSIVE INVESTMENT INCOME

The tax on excessive passive investment income also applies only to subchapter S corporations that had a prior existence as subchapter C corporations. Excessive passive investment income may terminate the subchapter S election, but even if the IRS waives termination, this excess income will give rise to a corporate level tax at the normal corporate tax rate.
The detailed rules of S corporation election and revocation are provided in I.R.C. § 1362:

§ 1362. Election; revocation; termination

(a) Election.—

(1) In general.—Except as provided in subsection (g), a small business corporation may elect, in accordance with the provisions of this section, to be an S corporation.

(2) All shareholders must consent to election.—An election under this subsection shall be valid only if all persons who are shareholders in such corporation on the day on which such election is made consent to such election.

(b) When made.—

(1) In general.—An election under subsection (a) may be made by a small business corporation for any taxable year--

(A) at any time during the preceding taxable year, or

(B) at any time during the taxable year and on or before the 15th day of the 3d month of the taxable year.

(2) Certain elections made during 1st 2 1/2 months treated as made for next taxable year.--If--

(A) an election under subsection (a) is made for any taxable year during such year and on or before the 15th day of the 3d month of such year, but

(B) either--

(i) on 1 or more days in such taxable year before the day on which the election was made the corporation did not meet the requirements of subsection (b) of section 1361, or

(ii) 1 or more of the persons who held stock in the corporation during such taxable year and before the election was made did not consent to the election, then such election shall be treated as made for the following taxable year.

(3) Election made after 1st 2 1/2 months treated as made for following taxable year.--If--

(A) a small business corporation makes an election under subsection (a) for any taxable year, and

(B) such election is made after the 15th day of the 3d month of the taxable year and on or before the 15th day of the 3rd month of the following taxable year, then such election shall be treated as made for the following taxable year.
(4) Taxable years of 2 1/2 months or less.—For purposes of this subsection, an election for a taxable year made not later than 2 months and 15 days after the first day of the taxable year shall be treated as timely made during such year.

(5) Authority to treat late elections, etc., as timely.—If—

(A) an election under subsection (a) is made for any taxable year (determined without regard to paragraph (3)) after the date prescribed by this subsection for making such election for such taxable year or no such election is made for any taxable year, and

(B) the Secretary determines that there was reasonable cause for the failure to timely make such election, the Secretary may treat such an election as timely made for such taxable year (and paragraph (3) shall not apply).

(c) Years for which effective.—An election under subsection (a) shall be effective for the taxable year of the corporation for which it is made and for all succeeding taxable years of the corporation, until such election is terminated under subsection (d).

(d) Termination.—

(1) By revocation.—

(A) In general.—An election under subsection (a) may be terminated by revocation.

(B) More than one-half of shares must consent to revocation.—An election may be revoked only if shareholders holding more than one-half of the shares of stock of the corporation on the day on which the revocation is made consent to the revocation.

(C) When effective.—Except as provided in subparagraph (D)—

(i) a revocation made during the taxable year and on or before the 15th day of the 3d month thereof shall be effective on the 1st day of such taxable year, and

(ii) a revocation made during the taxable year but after such 15th day shall be effective on the 1st day of the following taxable year.

(D) Revocation may specify prospective date.—If the revocation specifies a date for revocation which is on or after the day on which the revocation is made, the revocation shall be effective on and after the date so specified.

(2) By corporation ceasing to be small business corporation.—

(A) In general.—An election under subsection (a) shall be terminated whenever (at any time on or after the 1st day of the 1st taxable year for which the corporation is an S corporation) such corporation ceases to be a small business corporation.
(B) When effective.--Any termination under this paragraph shall be effective on and after the date of cessation.

(3) Where passive investment income exceeds 25 percent of gross receipts for 3 consecutive taxable years and corporation has accumulated earnings and profits.--

(A) Termination.--

(i) In general.--An election under subsection (a) shall be terminated whenever the corporation--

(I) has accumulated earnings and profits at the close of each of 3 consecutive taxable years, and

(II) has gross receipts for each of such taxable years more than 25 percent of which are passive investment income.

(ii) When effective.--Any termination under this paragraph shall be effective on and after the first day of the first taxable year beginning after the third consecutive taxable year referred to in clause (i).

(iii) Years taken into account.--A prior taxable year shall not be taken into account under clause (i) unless--

(I) such taxable year began after December 31, 1981, and

(II) the corporation was an S corporation for such taxable year.

(B) Gross receipts from sales of capital assets (other than stock and securities).--For purposes of this paragraph, in the case of dispositions of capital assets (other than stock and securities), gross receipts from such dispositions shall be taken into account only to the extent of the capital gain net income therefrom.

(C) Passive investment income defined.--For purposes of this paragraph--

(i) In general.--Except as otherwise provided in this subparagraph, the term "passive investment income" means gross receipts derived from royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities (gross receipts from such sales or exchanges being taken into account for purposes of this paragraph only to the extent of gains therefrom).

(ii) Exception for interest on notes from sales of inventory.--The term "passive investment income" shall not include interest on any obligation acquired in the ordinary course of the corporation's trade or business from its sale of property described in section 1221(a)(1).
(iii) Treatment of certain lending or finance companies.--If the S corporation meets the requirements of section 542(c)(6) for the taxable year, the term "passive investment income" shall not include gross receipts for the taxable year which are derived directly from the active and regular conduct of a lending or finance business (as defined in section 542(d)(1)).

(iv) Treatment of certain liquidations.--Gross receipts derived from sales or exchanges of stock or securities shall not include amounts received by an S corporation which are treated under section 331 (relating to corporate liquidations) as payments in exchange for stock where the S corporation owned more than 50 percent of each class of stock of the liquidating corporation.

(D) Special rule for options and commodity dealings.--

(i) In general.--In the case of any options dealer or commodities dealer, passive investment income shall be determined by not taking into account any gain or loss (in the normal course of the taxpayer's activity of dealing in or trading section 1256 contracts) from any section 1256 contract or property related to such a contract.

(ii) Definitions.--For purposes of this subparagraph--

(I) Options dealer.--The term "options dealer" has the meaning given such term by section 1256(g)(8).

(II) Commodities dealer.--The term "commodities dealer" means a person who is actively engaged in trading section 1256 contracts and is registered with a domestic board of trade which is designated as a contract market by the Commodities Futures Trading Commission.

(III) Section 1256 contract.--The term "section 1256 contract" has the meaning given to such term by section 1256(b).

(E) Treatment of certain dividends.--If an S corporation holds stock in a C corporation meeting the requirements of section 1504(a)(2), the term "passive investment income" shall not include dividends from such C corporation to the extent such dividends are attributable to the earnings and profits of such C corporation derived from the active conduct of a trade or business.

(F) Exception for banks; etc.--In the case of a bank (as defined in section 581), a bank holding company (within the meaning of section 2(a) of the Bank Holding Company Act of 1956 (12 U.S.C. 1841(a))), or a financial holding company (within the meaning of section 2(p) of such Act), the term "passive investment income" shall not include--

(i) interest income earned by such bank or company, or
(ii) dividends on assets required to be held by such bank or company, including stock in the Federal Reserve Bank, the Federal Home Loan Bank, or the Federal Agricultural Mortgage Bank or participation certificates issued by a Federal Intermediate Credit Bank.

(e) Treatment of S termination year.--

(1) In general.--In the case of an S termination year, for purposes of this title--

(A) S short year.--The portion of such year ending before the 1st day for which the termination is effective shall be treated as a short taxable year for which the corporation is an S corporation.

(B) C short year.--The portion of such year beginning on such 1st day shall be treated as a short taxable year for which the corporation is a C corporation.

(2) Pro rata allocation.--Except as provided in paragraph (3) and subparagraphs (C) and (D) of paragraph (6), the determination of which items are to be taken into account for each of the short taxable years referred to in paragraph (1) shall be made--

(A) first by determining for the S termination year--

(i) the amount of each of the items of income, loss, deduction, or credit described in section 1366(a)(1)(A), and

(ii) the amount of the nonseparately computed income or loss, and

(B) then by assigning an equal portion of each amount determined under subparagraph (A) to each day of the S termination year.

(3) Election to have items assigned to each short taxable year under normal tax accounting rules.--

(A) In general.--A corporation may elect to have paragraph (2) not apply.

(B) Shareholders must consent to election.--An election under this subsection shall be valid only if all persons who are shareholders in the corporation at any time during the S short year and all persons who are shareholders in the corporation on the first day of the C short year consent to such election.

(4) S termination year.--For purposes of this subsection, the term "S termination year" means any taxable year of a corporation (determined without regard to this subsection) in which a termination of an election made under subsection (a) takes effect (other than on the 1st day thereof).
(5) Tax for C short year determined on annualized basis.--

(A) In general.--The taxable income for the short year described in subparagraph (B) of paragraph (1) shall be placed on an annual basis by multiplying the taxable income for such short year by the number of days in the S termination year and by dividing the result by the number of days in the short year. The tax shall be the same part of the tax computed on the annual basis as the number of days in such short year is of the number of days in the S termination year.

(B) Section 443(d)(2) to apply.--Subsection (d) of section 443 shall apply to the short taxable year described in subparagraph (B) of paragraph (1).

(6) Other special rules.--For purposes of this title--

(A) Short years treated as 1 year for carryover purposes.--The short taxable year described in subparagraph (A) of paragraph (1) shall not be taken into account for purposes of determining the number of taxable years to which any item may be carried back or carried forward by the corporation.

(B) Due date for S year.--The due date for filing the return for the short taxable year described in subparagraph (A) of paragraph (1) shall be the same as the due date for filing the return for the short taxable year described in subparagraph (B) of paragraph (1) (including extensions thereof).

(C) Paragraph (2) not to apply to items resulting from section 338.-- Paragraph (2) shall not apply with respect to any item resulting from the application of section 338.

(D) Pro rata allocation for S termination year not to apply if 50-percent change in ownership.--Paragraph (2) shall not apply to an S termination year if there is a sale or exchange of 50 percent or more of the stock in such corporation during such year.

(f) Inadvertent invalid elections or terminations.--If--

(1) an election under subsection (a), section 1361(b)(3)(B)(ii), or section 1361(c)(a)(A)(ii) by any corporation--

(A) was not effective for the taxable year for which made (determined without regard to subsection (b)(2)) by reason of a failure to meet the requirements of section 1361(b) or to obtain shareholder consents, or

(B) was terminated under paragraph (2) or (3) of subsection (d), section 1361(b)(3)(C), or section 1361(c)(1)(D)(iii),

(2) the Secretary determines that the circumstances resulting in such ineffectiveness or termination were inadvertent,
(3) no later than a reasonable period of time after discovery of the circumstances resulting in such ineffectiveness or termination, steps were taken—

(A) so that the corporation for which the election was made or the termination occurred is a small business corporation or a qualified subchapter S subsidiary, as the case may be, or

(B) to acquire the required shareholder consents, and

(4) the corporation for which the election was made or the termination occurred, and each person who was a shareholder in such corporation at any time during the period specified pursuant to this subsection, agrees to make such adjustments (consistent with the treatment of such corporation as an S corporation or a qualified subchapter S subsidiary, as the case may be) as may be required by the Secretary with respect to such period, then, notwithstanding the circumstances resulting in such ineffectiveness or termination, such corporation shall be treated as an S corporation or a qualified subchapter S subsidiary, as the case may be during the period specified by the Secretary.

(g) Election after termination.—If a small business corporation has made an election under subsection (a) and if such election has been terminated under subsection (d), such corporation (and any successor corporation) shall not be eligible to make an election under subsection (a) for any taxable year before its 5th taxable year which begins after the 1st taxable year for which such termination is effective, unless the Secretary consents to such election.

VIII. Passive Activity Limitations

Passive income and at-risk rules affect the losses that can be used to offset income from other sources. Remember that in considering these rules in a choice of entity that the at-risk rules must be applied before the passive activity rules apply.

A. PASSIVE ACTIVITY LIMITS

In general, taxpayers can deduct passive activity losses only from passive activity income (a limit on loss deductions). The taxpayer carries any excess loss forward to the following year or years until used, or until deducted in the year they dispose of their entire interest in the activity in a fully taxable transaction. Before applying this limit on passive activity losses, the taxpayer must first determine the amount of their loss disallowed under the at-risk rules explained in the second part of this publication.

1. Passive Activity Credits

A taxpayer can subtract passive activity credits only from the tax on net passive income. Passive activity credits include the general business credit and other special business credits, such as the credit for fuel produced from a non-conventional source. Credits that are more than the tax on income from passive activities are carried forward.
Unallowed passive activity credits, unlike unallowed passive activity losses, cannot be claimed when the taxpayer disposes of their entire interest in an activity. However, to determine their gain or loss from the disposition, they can elect to increase the basis of the credit property by the amount of the original basis reduction for the credit, to the extent that the credit was not allowed because of the passive activity limits. They cannot elect to adjust the basis for a partial disposition of their interest in a passive activity.

2. Publicly Traded Partnership

A taxpayer must apply the rules in this part separately to their income or loss from a passive activity held through a publicly traded partnership (PTP). They also must apply the limit on passive activity credits separately to their credits from a passive activity held through a PTP.

A taxpayer can offset losses from passive activities of a PTP only against income or gain from passive activities of the same PTP. Likewise, they can offset credits from passive activities of a PTP only against the tax on the net passive income from the same PTP.

3. Persons Subject to Rules

The passive activity rules apply to:

- Individuals;
- Estates;
- Trusts (other than grantor trusts);
- Personal service corporations; and
- Closely held corporations.

Even though the rules do not apply to grantor trusts, partnerships, and S corporations directly, they do apply to the owners of these entities.

A closely held corporation can offset net active income with its passive activity loss. It also can offset the tax attributable to its net active income with its passive activity credits. However, a closely held corporation cannot offset its portfolio income (defined later, under Passive Activity Income) with its passive activity loss. Net active income is the corporation's taxable income figured without any income or loss from a passive activity or any portfolio income or loss.

4. Passive Activities

There are two kinds of passive activities:

- Trade or business activities in which an individual does not materially participate during the year; and
- Rental activities, even if an individual does materially participate in them, unless they are a real estate professional.
5. Former Passive Activities

A former passive activity is an activity that was a passive activity in any earlier tax year, but is not a passive activity in the current tax year. A taxpayer can deduct a prior years' unallowed loss from the activity up to the amount of their current year net income from the activity. A taxpayer should treat any remaining prior year unallowed loss like they treat any other passive loss.

In addition, any prior year unallowed passive activity credits from a former passive activity offset the allocable part of an individual’s current year tax liability. The allocable part of the current year tax liability is that part of this year's tax liability that is allocable to the current year net income from the former passive activity. A taxpayer can figure this after they reduce your net income from the activity by any prior year unallowed loss from that activity (but not below zero).

6. Trade or Business Activities

A trade or business activity is an activity that:

- Involves the conduct of a trade or business (that is, deductions would be allowable under § 162 of the Internal Revenue Code if other limitations, such as the passive activity rules, did not apply);

- Is conducted in anticipation of starting a trade or business; or

- Involves research or experimental expenditures that are deductible under Internal Revenue Code § 174 (or that would be deductible if a taxpayer chooses to deduct rather than capitalize them).

A trade or business activity does not include a rental activity or the rental of property that is incidental to an activity of holding the property for investment.

a. Rental activities

A rental activity is a passive activity even if a taxpayer materially participated in that activity, unless they materially participated as a real estate professional. An activity is a rental activity if tangible property (real or personal) is used by customers or held for use by customers, and the gross income (or expected gross income) from the activity represents amounts paid (or to be paid) mainly for the use of the property. It does not matter whether the use is under a lease, a service contract, or some other arrangement.

An activity is not a rental activity if any of the following apply:

- The average period of customer use of the property is 7 days or less. You figure the average period of customer use by dividing the total number of days in all rental periods by the number of rentals during the tax year. If the activity involves renting more than one class of property, multiply the average period of customer use of each class by a fraction. The numerator of the fraction is the gross rental income from that class of property and the denominator is the activity's total gross rental income. The activity's average period of customer use will equal the sum of the amounts for each class;
The average period of customer use of the property, as figured in (1) above, is 30 days or less and you provide significant personal services with the rentals. Significant personal services include only services performed by individuals. To determine if personal services are significant, all relevant facts and circumstances are taken into consideration, including the frequency of the services, the type and amount of labor required to perform the services, and the value of the services relative to the amount charged for use of the property. Significant personal services do not include the following.

- Services needed to permit the lawful use of the property;
- Services to repair or improve property that would extend its useful life for a period substantially longer than the average rental; and
- Services that are similar to those commonly provided with long-term rentals of real estate, such as cleaning and maintenance of common areas or routine repairs.

You provide extraordinary personal services in making the rental property available for customer use. Services are extraordinary personal services if they are performed by individuals and the customers' use of the property is incidental to their receipt of the services;

The rental is incidental to a nonrental activity. The rental of property is incidental to an activity of holding property for investment if the main purpose of holding the property is to realize a gain from its appreciation and the gross rental income from the property is less than 2% of the smaller of the property's unadjusted basis or fair market value. The unadjusted basis of property is its cost not reduced by depreciation or any other basis adjustment. The rental of property is incidental to a trade or business activity if all of the following apply:

- You own an interest in the trade or business activity during the year;
- The rental property was used mainly in that trade or business activity during the current year, or during at least 2 of the 5 preceding tax years; and
- Your gross rental income from the property is less than 2% of the smaller of its unadjusted basis or fair market value. Lodging provided to an employee or the employee's spouse or dependents is incidental to the activity or activities in which the employee performs services if the lodging is furnished for the employer's convenience.

You customarily make the rental property available during defined business hours for nonexclusive use by various customers;

You provide the property for use in a nonrental activity in your capacity as an owner of an interest in the partnership, S corporation, or joint venture conducting that activity.

If you meet any of the exceptions listed above, see the instructions for Form 8582 for information about how to report any income or loss from the activity. If you or your spouse actively participated in a passive rental real estate activity, you can deduct up to $25,000 of loss from the activity from your nonpassive income. This special allowance is
an exception to the general rule disallowing losses in excess of income from passive activities. Similarly, you can offset credits from the activity against the tax on up to $25,000 of nonpassive income after taking into account any losses allowed under this exception.

If you are married, filing a separate return, and lived apart from your spouse for the entire tax year, your special allowance cannot be more than $12,500. If you lived with your spouse at any time during the year and are filing a separate return, you cannot use the special allowance to reduce your nonpassive income or tax on nonpassive income.

The maximum special allowance is reduced if your modified adjusted gross income exceeds certain amounts.

Example.

Kate, a single taxpayer, has $70,000 in wages, $15,000 income from a limited partnership, a $26,000 loss from rental real estate activities in which she actively participated, and less than $100,000 of modified adjusted gross income. She can use $15,000 of her $26,000 loss to offset her $15,000 passive income from the partnership. She actively participated in her rental real estate activities, so she can use the remaining $11,000 rental real estate loss to offset $11,000 of her nonpassive income (wages).

b. Active participation

Active participation is not the same as material participation, defined later. Active participation is a less stringent standard than material participation. For example, you may be treated as actively participating if you make management decisions in a significant and bona fide sense. Management decisions that count as active participation include approving new tenants, deciding on rental terms, approving expenditures, and similar decisions.

Only individuals can actively participate in rental real estate activities. However, a decedent's estate is treated as actively participating for its tax years ending less than 2 years after the decedent's death, if the decedent would have satisfied the active participation requirement for the activity for the tax year the decedent died. A decedent's qualified revocable trust can also be treated as actively participating if both the trustee and the executor (if any) of the estate choose to treat the trust as part of the estate. The choice applies to tax years ending after the decedent's death and before:

- two years after the decedent's death if no estate tax return is required; or
- six months after the estate tax liability is finally determined if an estate tax return is required.

The choice is irrevocable and cannot be made later than the due date for the estate's first income tax return (including any extensions). Limited partners are not treated as actively participating in a partnership's rental real estate activities.
You are not treated as actively participating in a rental real estate activity unless your interest in the activity (including your spouse's interest) was at least 10% (by value) of all interests in the activity throughout the year. Active participation is not required to take the low-income housing credit, the rehabilitation investment credit, or commercial revitalization deduction from rental real estate activities.

Example.

Mike, a single taxpayer, had the following income and loss during the tax year:

<table>
<thead>
<tr>
<th>Income/Loss</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Salary</td>
<td>$42,300</td>
</tr>
<tr>
<td>Dividends</td>
<td>300</td>
</tr>
<tr>
<td>Interest</td>
<td>1,400</td>
</tr>
<tr>
<td>Rental loss</td>
<td>(4,000)</td>
</tr>
</tbody>
</table>

The rental loss came from a house Mike owned. He advertised and rented the house to the current tenant himself. He also collected the rents and either did the repairs or hired someone to do them. Even though the rental loss is a loss from a passive activity, Mike can use the entire $4,000 loss to offset his other income because he actively participated.

c. Phaseout rule

The maximum special allowance of $25,000 ($12,500 for married individuals filing separate returns and living apart at all times during the year) is reduced by 50% of the amount of your modified adjusted gross income that is more than $100,000 ($50,000 if you are married filing separately). If your modified adjusted gross income is $150,000 or more ($75,000 or more if you are married filing separately), you generally cannot use the special allowance.

d. Modified adjusted gross income

Modified adjusted gross income for this purpose is your adjusted gross income figured without the following:

- Taxable social security and tier 1 railroad retirement benefits;
- Deductible contributions to individual retirement accounts (IRAs) and § 501(c)(18) pension plans;
- The exclusion from income of interest from qualified U.S. savings bonds used to pay qualified higher education expenses;
- The exclusion from income of amounts received from an employer's adoption assistance program;
- Passive activity income or loss included on Form 8582;
- Any rental real estate loss allowed because you materially participated in the rental activity as a real estate professional;
Any overall loss from a publicly traded partnership;
The deduction for one-half of self-employment tax;
The deduction allowed for interest on student loans; or
The deduction for qualified tuition and related expenses.

Example.

During 2009, John was unmarried and was not a real estate professional. For 2009, he had $120,000 in salary and a $31,000 loss from his rental real estate activities in which he actively participated. His modified adjusted gross income is $120,000. When he files his 2009 return, he may deduct only $15,000 of his passive activity loss. He must carry over the remaining $16,000 passive activity loss to 2010. He figures his deduction and carryover as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Adjusted gross income, modified as required</td>
<td>$120,000</td>
</tr>
<tr>
<td>Minus amount not subject to phaseout</td>
<td>$100,000</td>
</tr>
<tr>
<td>Amount subject to phaseout rule</td>
<td>$20,000</td>
</tr>
<tr>
<td>Multiply by 50%</td>
<td>x 50%</td>
</tr>
<tr>
<td>Required reduction to special allowance</td>
<td>$10,000</td>
</tr>
<tr>
<td>Maximum special allowance</td>
<td>$25,000</td>
</tr>
<tr>
<td>Minus required reduction (see above)</td>
<td>$15,000</td>
</tr>
<tr>
<td>Adjusted special allowance</td>
<td>$15,000</td>
</tr>
<tr>
<td>Passive loss from rental real estate</td>
<td>$31,000</td>
</tr>
<tr>
<td>Deduction allowable/Adjusted special allowance</td>
<td>$15,000</td>
</tr>
<tr>
<td>Amount that must be carried forward</td>
<td>$16,000</td>
</tr>
</tbody>
</table>

e. Exceptions to the phaseout rules

A higher phaseout range applies to low-income housing credits for property placed in service before 1990 and rehabilitation investment credits from rental real estate activities. For those credits, the phaseout of the $25,000 special allowance starts when your modified adjusted gross income exceeds $200,000 ($100,000 if you are a married individual filing a separate return and living apart at all times during the year).

There is no phaseout of the $25,000 special allowance for low-income housing credits for property placed in service after 1989 or for the commercial revitalization deduction. If you hold an indirect interest in the property through a partnership, S corporation, or other pass-through entity, the special exception for the low-income housing credit will not apply unless you also acquired your interest in the pass-through entity after 1989.

f. Ordering rules

If you have more than one of the exceptions to the phaseout rules in the same tax year, you must apply the $25,000 phaseout against your passive activity losses and credits in the following order:
The portion of passive activity losses not attributable to the commercial revitalization deduction;

The portion of passive activity losses attributable to the commercial revitalization deduction;

The portion of passive activity credits attributable to credits other than the rehabilitation and low-income housing credits;

The portion of passive activity credits attributable to the rehabilitation credit and low-income housing credit for property placed in service prior to 1990; and

The portion of passive activity credits attributable to the low-income housing credit for property placed in service after 1989.

7. Activities That Are Not Passive Activities

The following are not passive activities.

- Trade or business activities in which you materially participated for the tax year;

- A working interest in an oil or gas well which you hold directly or through an entity that does not limit your liability (such as a general partner interest in a partnership). It does not matter whether you materially participated in the activity for the tax year. However, if your liability was limited for part of the year (for example, you converted your general partner interest to a limited partner interest during the year) and you had a net loss from the well for the year, some of your income and deductions from the working interest may be treated as passive activity gross income and passive activity deductions. See Temporary Regulations section 1.469-1T(e)(4)(ii);

- The rental of a dwelling unit that you also used for personal purposes during the year for more than the greater of 14 days or 10% of the number of days during the year that the home was rented at a fair rental;

- An activity of trading personal property for the account of those who own interests in the activity. See Temporary Regulations section 1.469-1T(e)(6); and

- Rental real estate activities in which you materially participated as a real estate professional.

8. Material Participation

A trade or business activity is not a passive activity if you materially participated in the activity. You materially participated in a trade or business activity for a tax year if you satisfy any of the following tests:
You participated in the activity for more than 500 hours;

Your participation was substantially all the participation in the activity of all individuals for the tax year, including the participation of individuals who did not own any interest in the activity;

You participated in the activity for more than 100 hours during the tax year, and you participated at least as much as any other individual (including individuals who did not own any interest in the activity) for the year;

The activity is a significant participation activity, and you participated in all significant participation activities for more than 500 hours. A significant participation activity is any trade or business activity in which you participated for more than 100 hours during the year and in which you did not materially participate under any of the material participation tests, other than this test;

You materially participated in the activity for any 5 (whether or not consecutive) of the 10 immediately preceding tax years;

The activity is a personal service activity in which you materially participated for any 3 (whether or not consecutive) preceding tax years. An activity is a personal service activity if it involves the performance of personal services in the fields of health (including veterinary services), law, engineering, architecture, accounting, actuarial science, performing arts, consulting, or any other trade or business in which capital is not a material income-producing factor;

Based on all the facts and circumstances, you participated in the activity on a regular, continuous, and substantial basis during the year.

You did not materially participate in the activity under test (7) if you participated in the activity for 100 hours or less during the year. Your participation in managing the activity does not count in determining whether you materially participated under this test if:

Any person other than you received compensation for managing the activity, or

Any individual spent more hours during the tax year managing the activity than you did (regardless of whether the individual was compensated for the management services).

In general, any work you do in connection with an activity in which you own an interest is treated as participation in the activity. You do not treat the work you do in connection with an activity as participation in the activity if both of the following are true:

The work is not work that is customarily done by the owner of that type of activity; and

One of your main reasons for doing the work is to avoid the disallowance of any loss or credit from the activity under the passive activity rules.
You do not treat the work you do in your capacity as an investor in an activity as participation unless you are directly involved in the day-to-day management or operations of the activity. Work you do as an investor includes:

- Studying and reviewing financial statements or reports on operations of the activity;
- Preparing or compiling summaries or analyses of the finances or operations of the activity for your own use; and
- Monitoring the finances or operations of the activity in a nonmanagerial capacity.

Your participation in an activity includes your spouse's participation. This applies even if your spouse did not own any interest in the activity and you and your spouse do not file a joint return for the year.

You can use any reasonable method to prove your participation in an activity for the year. You do not have to keep contemporaneous daily time reports, logs, or similar documents if you can establish your participation in some other way. For example, you can show the services you performed and the approximate number of hours spent by using an appointment book, calendar, or narrative summary.

**a. Limited partners**

If you owned an activity as a limited partner, you generally are not treated as materially participating in the activity.

You are not treated as a limited partner, however, if you also were a general partner in the partnership at all times during the partnership's tax year ending with or within your tax year (or, if shorter, during that part of the partnership's tax year in which you directly or indirectly owned your limited partner interest).

**b. Corporations**

A closely held corporation or a personal service corporation is treated as materially participating in an activity only if one or more shareholders holding more than 50% by value of the outstanding stock of the corporation materially participate in the activity.

A closely held corporation can also satisfy the material participation standard by meeting the first two requirements for the *qualifying business exception* from the at-risk limits.

**B. AT-RISK LIMITS**

The at-risk rules limit the losses from most activities to the amount an individual has *at risk* in the activity. Any loss that is disallowed because of the at-risk limits is treated as a deduction from the same activity in the next tax year. If your losses from an at-risk activity are allowed, they are subject to recapture in later years if your amount at risk is reduced below zero. The at-risk rules must be applied *before* the passive activity rules discussed in the previous section.
1. “Loss” Defined

A “loss” is the excess of allowable deductions from the activity for the year (including depreciation or amortization allowed or allowable and disregarding the at-risk limits) over income received or accrued from the activity during the year. Income does not include income from the recapture of previous losses.

Form 6198 is used to figure how much loss from an activity can be deducted. The form must be filed with a tax return if: (a) a taxpayer has a loss from any part of an activity that is covered by the at-risk rules, and (b) the individual is not at risk for some of your investment in the activity.

2. Loss Limits for Partners and S Corporation Shareholders

Three separate limits apply to a partner's or shareholder's distributive share of a loss from a partnership or S corporation, respectively. The limits determine the amount of the loss each partner or shareholder can deduct on his or her own return. These limits and the order in which they apply are:

- The adjusted basis of:
  - The partner's partnership interest, or
  - The shareholder's stock plus any loans the shareholder makes to the corporation,
- The at-risk rules; and
- The passive activity rules.

3. Who Is Affected?

The at-risk limits apply to individuals (including partners and S corporation shareholders), estates, trusts, and certain closely held corporations (other than S corporations).

For the at-risk rules, a corporation is a closely held corporation if at any time during the last half of the tax year, more than 50% in value of its outstanding stock is owned directly or indirectly by or for five or fewer individuals. To figure if more than 50% in value of the stock is owned by five or fewer individuals, apply the following rules:

1. Stock owned directly or indirectly by or for a corporation, partnership, estate, or trust is considered owned proportionately by its shareholders, partners, or beneficiaries.
2. An individual is considered to own the stock owned directly or indirectly by or for his or her family.
3. Family includes only brothers and sisters (including half-brothers and half-sisters), a spouse, ancestors, and lineal descendants.
(4) If a person holds an option to buy stock, he or she is considered to be the owner of that stock.

When applying rule (1) or (2), stock considered owned by a person under rule (1) or (3) is treated as actually owned by that person. Stock considered owned by an individual under rule (2) is not treated as owned by the individual for again applying rule (2) to consider another the owner of that stock. Stock that may be considered owned by an individual under either rule (2) or (3) is considered owned by the individual under rule (3).

4. Activities Covered by the At-Risk Rules

Persons involved in one of the following activities as a trade or business or for the production of income are subject to the at-risk rules.

- Holding, producing, or distributing motion picture films or video tapes;
- Farming;
- Leasing § 1245 property, including personal property and certain other tangible property that is depreciable or amortizable;
- Exploring for, or exploiting, oil and gas;
- Exploring for, or exploiting, geothermal deposits (for wells started after September 1978); and
- Any other activity not included in (1) through (5) that is carried on as a trade or business or for the production of income.

a. Section 1245 property

Section 1245 property includes any property that is or has been subject to depreciation or amortization and is:

- Personal property;
- Other tangible property (other than a building or its structural components) that is:
  - Used in manufacturing, production, extraction or furnishing transportation, communications, electrical energy, gas, water, or sewage disposal services;
  - A research facility;
  - A facility used in any of the activities for the bulk storage of fungible commodities;
  - A single purpose agricultural or horticultural structure; or
  - A storage facility (other than a building or its structural components) used for the distribution of petroleum.
b. Exception for holding real property placed in service before 1987

The at-risk rules do not apply to the holding of real property placed in service before 1987. They also do not apply to the holding of an interest acquired before 1987 in a pass-through entity engaged in holding real property placed in service before 1987. This exception does not apply to holding mineral property.

Personal property and services that are incidental to making real property available as living accommodations are included in the activity of holding real property. For example, making personal property, such as furniture, and services available when renting a hotel or motel room or a furnished apartment is considered incidental to making real property available as living accommodations.

c. Exception for equipment leasing by a closely held corporation

If a closely held corporation is actively engaged in equipment leasing, the equipment leasing is treated as a separate activity not covered by the at-risk rules. A closely held corporation is actively engaged in equipment leasing if 50% or more of its gross receipts for the tax year are from equipment leasing. Equipment leasing means the leasing, purchasing, servicing, and selling of equipment that is section 1245 property.

However, equipment leasing does not include the leasing of master sound recordings and similar contractual arrangements for tangible or intangible assets associated with literary, artistic, or musical properties, such as books, lithographs or artwork, or musical tapes. A closely held corporation cannot exclude these leasing activities from the at-risk rules nor count them as equipment leasing for the gross receipts test.

The equipment leasing exclusion also is not available for leasing activities related to other at-risk activities, such as motion picture films and video tapes, farming, oil and gas properties, and geothermal deposits. For example, if a closely held corporation leases a video tape, it cannot exclude this leasing activity from the at-risk rules under the equipment leasing exclusion.

d. Controlled group of corporations

A controlled group of corporations is subject to special rules for the equipment leasing exclusion. For more information refer to § 465(c) of the Internal Revenue Code.

e. Special exception for qualified corporations

A qualified corporation is not subject to the at-risk limits for any qualifying business carried on by the corporation. Each qualifying business is treated as a separate activity. A qualified corporation is a closely held corporation, defined earlier, that is not:

- A personal holding company;
- A foreign personal holding company; or
- A personal service corporation (defined in section 269A(b) of the Internal Revenue Code, but determined by substituting 5% for 10%).
5. At-Risk Amounts

An individual is considered at risk in any activity for:

1. The money and adjusted basis of property you contribute to the activity, and

2. Amounts you borrow for use in the activity if:
   a. You are personally liable for repayment, or
   b. You pledge property (other than property used in the activity) as security for the loan.

3. Amounts borrowed. You are at risk for amounts borrowed to use in the activity if you are personally liable for repayment. You are also at risk if the amounts borrowed are secured by property other than property used in the activity. In this case, the amount considered at risk is the net fair market value of your interest in the pledged property. The net fair market value of property is its fair market value (determined on the date the property is pledged) less any prior (or superior) claims to which it is subject. However, no property will be taken into account as security if it is directly or indirectly financed by debt that is secured by property you contributed to the activity.

If you borrow money to finance a contribution to an activity, you cannot increase your amount at risk by the contribution and the amount borrowed to finance the contribution. You may increase your at-risk amount only once.

Even if you are personally liable for the repayment of a borrowed amount or you secure a borrowed amount with property other than property used in the activity, you are not considered at risk if you borrowed the money from a person having an interest in the activity or from someone related to a person (other than you) having an interest in the activity. This does not apply to:

- Amounts borrowed by a corporation from its shareholders;
- Amounts borrowed from a person having an interest in the activity as a creditor; or
- An activity described under “Activities Covered by the At-Risk Rules,” earlier.

Related persons include:

1. Members of a family, but only brothers and sisters, half-brothers and half-sisters, a spouse, ancestors (parents, grandparents, etc.), and lineal descendants (children, grandchildren, etc.),
2. Two corporations that are members of the same controlled group of corporations determined by applying a 10% ownership test,
3. The fiduciaries of two different trusts, or the fiduciary and beneficiary of two different trusts, if the same person is the grantor of both trusts,
4. A tax-exempt educational or charitable organization and a person who directly or indirectly controls it (or a member of whose family controls it),
5. A corporation and an individual who owns directly or indirectly more than 10% of the value of the outstanding stock of the corporation,
6. A trust fiduciary and a corporation of which more than 10% in value of the outstanding stock is owned directly or indirectly by or for the trust or by or for the grantor of the trust,

7. The grantor and fiduciary, or the fiduciary and beneficiary, of any trust,

8. A corporation and a partnership if the same persons own over 10% in value of the outstanding stock of the corporation and more than 10% of the capital interest or the profits interest in the partnership,

9. Two S corporations if the same persons own more than 10% in value of the outstanding stock of each corporation,

10. An S corporation and a regular corporation if the same persons own more than 10% in value of the outstanding stock of each corporation,

11. A partnership and a person who owns directly or indirectly more than 10% of the capital or profits of the partnership,

12. Two partnerships if the same persons directly or indirectly own more than 10% of the capital or profits of each,

13. Two persons who are engaged in business under common control, and


To determine the direct or indirect ownership of the outstanding stock of a corporation, apply the following rules:

- Stock owned directly or indirectly by or for a corporation, partnership, estate, or trust is considered owned proportionately by or for its shareholders, partners, or beneficiaries;

- Stock owned directly or indirectly by or for an individual's family is considered owned by the individual. The family of an individual includes only brothers and sisters, half-brothers and half-sisters, a spouse, ancestors, and lineal descendants;

- Any stock in a corporation owned by an individual (other than by applying rule (2)) is considered owned directly or indirectly by the individual's partner;

- When applying rule (1), (2), or (3), stock considered owned by a person under rule (1) is treated as actually owned by that person. But, if a person constructively owns stock because of rule (2) or (3), he or she does not own the stock for purposes of applying either rule (2) or (3) to make another person the constructive owner of the same stock; and

- Effect of government price support programs. A government target price program (such as provided by the Agriculture and Consumer Protection Act of 1973) or other government price support programs for a product that you grow does not, without agreements limiting your costs, reduce the amount you have at risk.

Any loss that is allowable in a particular year reduces your at-risk investment (but not below zero) as of the beginning of the next tax year and in all succeeding tax years for that activity. If you have a loss that is more than your at-risk amount, the loss disallowed will not be allowed in later years unless you increase your at-risk amount. Losses that are suspended because they are greater than your investment that is at risk are treated as a deduction for the activity in the following year. Consequently, if your amount at risk increases in later years, you may deduct previously suspended losses to the extent that
the increases in your amount at risk exceed your losses in later years. However, your deduction of suspended losses may be limited by the passive loss rules.

6. Amounts Not At Risk

You are not considered at risk for amounts protected against loss through nonrecourse financing, guarantees, stop loss agreements, or other similar arrangements.

Nonrecourse financing is financing for which you are not personally liable. If you borrow money to contribute to an activity and the lender's only recourse is to your interest in the activity or the property used in the activity, the loan is a nonrecourse loan.

You are not considered at risk for your share of any nonrecourse loan used to finance an activity or to acquire property used in the activity unless the loan is secured by property not used in the activity. However, you are considered at risk for qualified nonrecourse financing secured by real property used in an activity of holding real property.

Qualified nonrecourse financing is financing for which no one is personally liable for repayment and that is:

- Borrowed by you in connection with the activity of holding real property;
- Secured by real property used in the activity;
- Not convertible from a debt obligation to an ownership interest; and
- Loaned or guaranteed by any federal, state, or local government, or borrowed by you from a qualified person.

The rules below apply to any financing incurred after August 3, 1998. You also can choose to apply these rules to financing you obtained before August 4, 1998. If you do that, you must reduce the amounts at risk as a result of applying these rules to years ending before August 4, 1998, to the extent they increase the losses allowed for those years.

In determining whether qualified nonrecourse financing is secured only by real property used in the activity of holding real property, disregard property that is incidental to the activity of holding real property. Also disregard other property if the total gross fair market value of that property is less than 10% of the total gross fair market value of all the property securing the financing. For this purpose, treat yourself as owning directly your proportional share of the assets in any partnership in which you own, directly or indirectly, an equity interest.

A qualified person is a person who actively and regularly engages in the business of lending money. The most common example is a bank. However, none of the following persons can be a qualified person:
A person related to you in one of the ways listed under “related persons”, earlier. However, a person related to you may be a qualified person if the nonrecourse financing is commercially reasonable and on the same terms as loans involving unrelated persons;

A person from which you acquired the property or a person related to that person;

A person who receives a fee due to your investment in the real property or a person related to that person.

Any capital you have contributed to an activity is not at risk if you are protected against economic loss by an agreement or arrangement for compensation or reimbursement. For example, you are not at risk if you will be reimbursed for part or all of any loss because of a binding agreement between yourself and another person.

Example 1.

Some commercial feedlots reimburse investors against any loss sustained on sales of the fed livestock above a stated dollar amount per head. Under such stop loss orders, the investor is at risk only for the portion of the investor's capital for which the investor is not entitled to a reimbursement.

Example 2.

You are personally liable for a mortgage, but you separately obtain insurance to compensate you for any payments you must actually make because of your personal liability. You are considered at risk only to the extent of the uninsured portion of the personal liability to which you are exposed. You can include in the amount you have at risk the amount of any premium which you paid from your personal assets for the insurance. However, if you obtain casualty insurance or insurance protecting yourself against tort liability, it does not affect the amount you are otherwise considered to have at risk.

7. Reductions of Amounts At Risk

The amount you have at risk in any activity is reduced by any losses allowed in previous years under the at-risk rules. It may also be reduced because of distributions you received from the activity, debts changed from recourse to nonrecourse, or the initiation of a stop loss or similar agreement. If the amount at risk is reduced below zero, your previously allowed losses are subject to recapture, as explained next.

8. Recapture Rule

If the amount you have at risk in any activity at the end of any tax year is less than zero, you must recapture at least part of your previously allowed losses. You do this by adding to your income from the activity for that year the lesser of the following amounts:
The negative at-risk amount (treated as a positive amount); or

The total amount of losses deducted in previous tax years beginning after 1978, minus any amounts you previously added to your income from that activity under this recapture rule.

IX. Note on Fringe Benefits

One other subject matter deserves attention in this discussion: fringe benefits. This is particularly true with persons starting small businesses who want to be able to deduct the cost of benefits, including health and life insurance.

A C corporation is allowed to deduct as a business expense the cost of providing fringe benefits to its employees, including shareholder-employees, pursuant to the Internal Revenue Code:

§ 162. Trade or business expenses

(a) In general.--There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including--

(1) a reasonable allowance for salaries or other compensation for personal services actually rendered (emphasis added).

Other types of entities – partnerships, S corporations and limited liability companies – do not have the ability to provide these benefits without a cost to the owner-employee. For example, a C corporation may provide health benefits to its shareholder-employee and his or her spouse or dependents, and deduct the cost as a normal business expense. The benefit is also tax-free to the shareholder-employee. If, on the other hand, a partnership provides health insurance benefits to a partner, the partner must include the cost of the insurance premium as income. That is because the IRS considers the cost of the premium to be compensation for services. The partnership or other entity has the option of not taking a deduction for the cost of providing the benefit, in which case the value of the benefit is not considered taxable compensation to the individual.

If the owner-employee is a partner, a member of an LLC, or a subchapter S shareholder who owns more than two percent of the corporation's stock by vote or by value, the owner is allowed – pursuant to IRC §162(l) – to deduct a percentage of the cost of the premium paid by the entity. The amount that is deductible is specified in a schedule provided for in the statute.

An S corporation is treated as a partnership for purposes of determining taxation of fringe benefits. Any shareholder owning either more than 2% of the S corporation's outstanding stock, or stock possessing more than 2% of the total combined voting power of all stock of the S corporation, is treated as a partner.
I.R.C. § 1372. Partnership rules to apply for fringe benefit purposes

(a) General rule.—For purposes of applying the provisions of this subtitle which relate to employee fringe benefits—

(1) the S corporation shall be treated as a partnership, and

(2) any 2-percent shareholder of the S corporation shall be treated as a partner of such partnership.

(b) 2-percent shareholder defined.—For purposes of this section, the term "2-percent shareholder" means any person who owns (or is considered as owning within the meaning of section 318) on any day during the taxable year of the S corporation more than 2 percent of the outstanding stock of such corporation or stock possessing more than 2 percent of the total combined voting power of all stock of such corporation.

This means that any amounts paid for employee-fringe benefits for a more-than-2% shareholder-employee are deductible by an S corporation only if they would have been deductible in computing a partnership’s taxable income if paid for a partner. As a result, amounts not deductible are likely to be treated as a distribution to the shareholder-employee for whom they were paid. Amounts paid or incurred by an S corporation for fringe benefits for 2%-or-less shareholders may be deducted as a business expense.

All participants in a cafeteria plan must be employees. A self-employed individual, as defined by federal law, is not an employee for purposes of the cafeteria plan rules. Likewise, a shareholder of an S corporation who owns more than 2 percent of the corporation’s outstanding stock or combined voting power is not an “employee” for purposes of cafeteria plan participation.
CHAPTER 10 – REVIEW QUESTIONS

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter. They do not need to be submitted in order to receive CPE credit. They are included as an additional tool to enhance your learning experience.

We recommend that you answer each review question and then compare your response to the suggested solution before answering the final exam questions related to this chapter.

1. The self-employment tax is not a significant factor in choosing a choice of entity since it must be paid under all business forms.
   a) true
   b) false

2. How many members must a limited liability company have if it wishes to be treated as a partnership for federal income tax purposes:
   a) only one
   b) at least two
   c) at least three
   d) at least five

3. How is each member's share of the profits and losses of an LLC determined:
   a) each member’s share of the profits and losses is set forth in the entity’s operating agreement
   b) federal law requires all members to share equally in the profits and the losses of an LLC
   c) all states require members of an LLC to share equally in the profits and losses of an LLC
   d) all states require members to share profits and losses of an LLC in proportion to their capital contribution

4. The conversion of a partnership into an LLC classified as a partnership for federal tax purposes:
   a) terminates the partnership
   b) closes the partnership’s tax year
   c) may change some of the partner’s bases in their partnership interests
   d) all of the above

5. Among the expenses that can be amortized by a partnership are the expenses incurred in acquiring assets for the partnership.
   a) true
   b) false
6. All of the rules that apply to individuals regarding income and deductions also apply to corporations.

   a) true
   b) false

7. Which of the following corporations would benefit most from Subchapter S designation:

   a) large corporations with huge profits
   b) closely-held companies
   c) companies that expect to suffer a loss
   d) both b and c

8. In general, you can only deduct passive activity losses from passive activity income.

   a) true
   b) false

9. The at-risk rules limit the losses from most activities to the amount an individual has "at risk" in the activity.

   a) true
   b) false
CHAPTER 10 – SOLUTIONS AND SUGGESTED RESPONSES

1. A: True is incorrect. The self-employment tax rate is significant at 15.3%. Many people consider ways to avoid self-employment taxes when considering a choice of entity.

B: False is correct. The self-employment tax consists of both social security and Medicare. Taxpayers can deduct half of their self-employment tax in figuring adjusted gross income. Due to the large percentage of tax, many business owners try to operate in a method to avoid it.

(See page 10-2 of the course material.)

2. A: Incorrect. To elect the pass-through taxation of a partnership, a limited liability company must have at least two members.

B: Correct. One of the hallmarks of an LLC is the ability to elect tax status for purposes of federal income tax. To elect pass through taxation, the limited liability company must have at least two members.

C: Incorrect. The actual number is fewer.

D: Incorrect. The actual requirement is fewer.

(See pages 10-6 to 10-7 of the course material.)

3. A: Correct. The operating agreement of an LLC governs its operations, including distributions of profits and allocations of losses.

B: Incorrect. Federal law does not have any say in the manner of distributing profits and losses, only in how they are taxed.

C: Incorrect. The members of an LLC are free to designate distribution of profits and losses, and this is done in their operating agreement.

D: Incorrect. While this is generally how members elect to distribute profits, it is not mandated by state laws.

(See page 10-12 of the course material.)
4. **A:** Incorrect. The partnership does not terminate due to the conversion.

   **B:** Incorrect. The partnership’s tax year does not close.

   **C:** Correct. The partner’s bases may change if the partnership has recourse liabilities that become nonrecourse liabilities.

   **D:** Incorrect. The answer cannot be “all of the above” since the responses for A and B are not correct.

   (See page 10-15 of the course material.)

5. **A:** True is incorrect. The organization expenses that can be amortized include legal and accounting fees for services incident to the organization of the partnership and filing fees.

   **B:** False is correct. Other expenses that cannot be amortized as organizational expenses are the costs associated with admitting or removing partners other than at the time the partnership is first organized, making a contract relating to the operation of the partnership trade or business, and syndication expenses.

   (See page 10-24 of the course material.)

6. **A:** True is incorrect. There are a few special provisions that only apply to corporations.

   **B:** False is correct. Special provisions that only apply to corporations (and not individuals) include below-market loans, capital losses, S corporation status, rules for carryover and carryback of capital losses, and charitable contributions.

   (See pages 10-26 to 10-31 of the course material.)

7. **A:** Incorrect. The type of entity that most benefits from subchapter S status is a smaller one (there are limits on the number of shareholders) that expect a loss rather than huge profits.

   **B:** Incorrect. Closely-held corporations are the best candidates for subchapter S election. However, this is not the best answer.

   **C:** Incorrect. If a company, particularly in the beginning, suffers a loss then subchapter S election is beneficial because the owners can take the losses themselves. However, this is not the best answer.

   **D:** Correct. The ideal candidate for subchapter S election is a closely-held company that expects to suffer a loss.

   (See pages 10-34 to 10-35 of the course material.)
8. **A: True is correct.** You carry any excess loss forward to the following year or years until used, or until deducted in the year you dispose of the entire interest in the activity in a fully taxable transaction.

   **B: False is incorrect.** Before applying the limit on passive activity losses, you must first determine the amount of your loss disallowed under the at-risk rules.

   (See page 10-42 of the course material.)

9. **A: True is correct.** Any loss that is disallowed because of the at-risk limits is treated as a deduction from the same activity in the next tax year.

   **B: False is incorrect.** If your losses from an at-risk activity are allowed, they are subject to recapture in later years if your amount “at risk” is reduced below zero.

   (See page 10-51 of the course material.)
<table>
<thead>
<tr>
<th>Legal Status</th>
<th>Sole Proprietorship</th>
<th>General Partnership</th>
<th>Limited Partnership</th>
<th>Limited Liability Partnership</th>
<th>Corporation</th>
<th>S Corporation</th>
<th>Limited Liability Company</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Legal Status</strong></td>
<td>No legal status separate and apart from owner; can sue and be sued in owner’s name only</td>
<td>Has some attributes of separate legal entity; i.e. can hold property in name of partnership</td>
<td>Recognized as a separate legal entity aside from its partners</td>
<td>Recognized as a separate legal entity aside from its partners</td>
<td>A separate legal entity from its owners</td>
<td>Treated as a corporation under state law. Are recognized as separate legal entity</td>
<td>A separate legal entity from its owners</td>
</tr>
<tr>
<td><strong>Formation</strong></td>
<td>No legal requirements; may require local business license to operate</td>
<td>No special formalities other than agreement to form a partnership; no writing required; courts can ascertain intent of the parties</td>
<td>Requires filing certificate of limited liability with appropriate state agency, normally Secretary of State</td>
<td>Requires compliance with applicable state law, which normally includes filing of certificate of limited partnership containing specified information and proof of insurance in statutory amount to cover liabilities of the partnership</td>
<td>Formalities: A corporation can be created only by substantial compliance with the General Corporation Law, which requires filing of articles of incorporation containing certain essential provisions, prepayment of certain fees, etc.</td>
<td>Requires formation of C corporation as prescribed by applicable state law and filing election of subchapter S status with Internal Revenue Service</td>
<td>Requires filing of Articles of Organization with appropriate state agency, normally Secretary of State; some states also require formal articles of operation and public notice advertising</td>
</tr>
<tr>
<td><strong>Formalities</strong></td>
<td>None required by law</td>
<td>Generally none unless required by partnership agreement, if any</td>
<td>Normally none unless required by partnership agreement; limited partners are entitled to certain information and access to certain records per statute</td>
<td>As required by applicable state law, normally includes filing of annual report; others as mandated by applicable partnership agreement</td>
<td>Significant formalities required for initial incorporation and for subsequent operation. This type of entity has the most formalities.</td>
<td>The same basic formalities provided by state law that govern C corporations likewise apply to subchapter S corporations</td>
<td>Once formed, no formalities required unless specified in Articles of Organization or Operation</td>
</tr>
<tr>
<td><strong>Ownership</strong></td>
<td>By definition, one individual</td>
<td>By definition, at least two general partners; there is no upper limit</td>
<td>At least one general partner and one limited partner; there is no upper limit</td>
<td>Restricted in many states to certain professionals, e.g. attorneys, CPAs and architects</td>
<td>May have a single shareholder</td>
<td>Maximum of 100 shareholders allowed (members of a family counted as a single person); must all be natural persons</td>
<td>All states allow single-member companies; no upper limit on number of owners allowed</td>
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<tr>
<td>ENTITY CHARACTERISTIC SUMMARY TABLE (cont.)</td>
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<td><strong>Management &amp; Control</strong></td>
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<tr>
<td>Sole Proprietorship</td>
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<td>Limited Partnership</td>
<td>Limited Liability Partnership</td>
<td>Corporation</td>
<td>S Corporation</td>
<td>Limited Liability Company</td>
<td></td>
</tr>
<tr>
<td>Owner has total control; may or may not hire employees</td>
<td>Each general partner has an equal right to manage the enterprise</td>
<td>Each general partner has equal right to manage the enterprise; limited partners risk losing limited liability status by participating in management and are usually “passive” investors</td>
<td>As provided in applicable state law and individual partnership agreement</td>
<td>Management and control normally vested in the board of directors, elected by the shareholders of the corporation</td>
<td>Management and control normally vested in the board of directors, elected by the shareholders of the corporation</td>
<td>Vested in all of its members unless provided otherwise in articles of organization</td>
<td></td>
</tr>
<tr>
<td><strong>Liability of Owner(s)</strong></td>
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</tr>
<tr>
<td>Unlimited personal liability for debts and acts of agents, if any</td>
<td>Each general partner is jointly and severally liable for the debts and obligations of the partnership</td>
<td>Each general partner is jointly and severally liable for the debts and obligations of the partnership; limited partners not liable as long as they do not become to actively involved in the partnership</td>
<td>Varies from state to state; partners normally not liable for the acts or omissions of other partners absent complicity in act giving rise to liability</td>
<td>Normally, the shareholders, directors or officers of the corporation are not legally responsible for corporate liabilities</td>
<td>Shareholders generally have the same liability protection afforded by C corporations</td>
<td>All members normally enjoy limited liability even if they actively participate in management</td>
<td></td>
</tr>
<tr>
<td><strong>Profits &amp; Losses</strong></td>
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<td></td>
</tr>
<tr>
<td>Owner retains all profits and is liable for all losses; each is reported on owner's personal tax return</td>
<td>Share of profits, losses, distributions: Partnership profits, losses and distributions are shared in proportion to the partners' contributions, unless the partnership agreement provides otherwise</td>
<td>Share of profits, losses, distributions: Partnership profits, losses and distributions are shared in proportion to the partners' contributions, unless the partnership agreement provides otherwise</td>
<td>Share of profits and losses shared in proportion to partners' contribution unless provided otherwise in partnership agreement</td>
<td>Profits taxed at the entity level; dividends paid to shareholders taxed again at the rate of the individual recipient</td>
<td>S corporation's income, deduction, and credit flows through to the shareholders on a pro rata basis</td>
<td>Distributed among members as allocated by the operating agreement; otherwise, they are allocated in proportion to each member's capital contribution</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Sole Proprietorship</td>
<td>General Partnership</td>
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</tr>
<tr>
<td><strong>Transferability</strong></td>
<td>Owner can sell business or assets thereof as desired</td>
<td>General partner does not have the right to transfer ownership rights to a third party without the consent of the other partners as required by state law; may “assign” rights to profits without consent</td>
<td>Neither general nor limited partner has right to transfer ownership interest without consent of other partners as required by state law; either general or limited partners may “assign” right to receive profits without consent</td>
<td>Partner normally does not have the right to transfer ownership rights to a third party without the consent of the other partners as required by state law; may “assign” rights to profits without consent</td>
<td>Shareholders are normally free to transfer ownership interests without consent of the corporation absent contrary provisions in the Articles of Incorporation or Bylaws, such as one giving other shareholders or corporation right of first refusal</td>
<td>Shareholders are normally free to transfer ownership interests without consent of the corporation absent contrary provisions in the Articles of Incorporation or Bylaws, such as one giving other shareholders or corporation right of first refusal</td>
<td>Normally no one can become a member without the consent of all members, unless provided otherwise in articles of organization or operation</td>
</tr>
<tr>
<td><strong>Conversion</strong></td>
<td>Owner may convert to another entity pursuant to state law</td>
<td>May convert subject to requirements of partnership agreement and applicable state law</td>
<td>May convert subject to requirements of partnership agreement and applicable state law</td>
<td>May convert subject to requirement of partnership agreement and applicable state law</td>
<td>May convert to other entity pursuant to applicable state law; first requires shareholder approval</td>
<td>May convert to other entity pursuant to applicable state law; first requires shareholder approval</td>
<td>May be converted to partnership or corporation as provided by state law</td>
</tr>
<tr>
<td><strong>Duration</strong></td>
<td>Within the control of the owner</td>
<td>Normally presumed to be at-will unless written partnership agreement contains term of duration or specific purpose</td>
<td>May or may not have a specified date of termination contained in the certificate of limited liability filed with the state; if not, it lasts until a qualifying event triggers dissolution</td>
<td>May or may not have a specified date of termination contained in the certificate of limited liability filed with the state; if not, it lasts until a qualifying event triggers dissolution</td>
<td>As a separate legal entity, the corporation is capable of continuing indefinitely. Its existence is not affected by death or incapacity of its shareholders, officers or directors, or by transfer of its shares from one person to another</td>
<td>Duration dependant on compliance with strict requirements for S Corporation status; election can be terminated voluntarily by shareholders or involuntarily pursuant to federal law</td>
<td>May be formed in perpetuity in most states; may provide a duration in Articles of Organization</td>
</tr>
<tr>
<td><strong>Taxation</strong></td>
<td>Sole Proprietorship</td>
<td>General Partnership</td>
<td>Limited Partnership</td>
<td>Limited Liability Partnership</td>
<td>Corporation</td>
<td>S Corporation</td>
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<tr>
<td>Disregarded entity; does not file its own return</td>
<td>A disregarded entity for purposes of federal taxation; partnership files informational return and profits and losses flow through directly to partners</td>
<td>A disregarded entity for purposes of federal taxation; partnership files informational return and profits and losses flow through directly to partners; limited partners subject to “at risk” and “passive loss” rules</td>
<td>A disregarded entity for purposes of federal taxation; partnership files information return; profits and losses flow through directly to partners</td>
<td>Profits are taxed directly to the C corporation as an entity at the applicable federal and state rate; shareholders only taxed on dividends of other profits (non-salary) if received</td>
<td>For Federal income tax purposes, however, taxation of S corporations resembles that of partnerships; as with partnerships, the income, deductions, and tax credits of an S corporation flow through to shareholders annually, regardless of whether dividends are paid</td>
<td>Multi-member company may elect either partnership or corporate tax treatment</td>
<td></td>
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</tbody>
</table>

<table>
<thead>
<tr>
<th><strong>Events Triggering Dissolution</strong></th>
<th>Sole Proprietorship</th>
<th>General Partnership</th>
<th>Limited Partnership</th>
<th>Limited Liability Partnership</th>
<th>Corporation</th>
<th>S Corporation</th>
<th>Limited Liability Company</th>
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</thead>
<tbody>
<tr>
<td>At the whim of the proprietor</td>
<td>An event specified in the partnership agreement, the expiration of the partnership's term or completion of the partnership's undertaking, a determination by a court under certain circumstances, or an event that makes it unlawful for all or substantially all of the business to be continued</td>
<td>A date of dissolution may be provided in certificate of limited liability filed with state; otherwise, dissolution can be triggered by an event(s) specified in the partnership agreement, by written consent of all partners and, under certain circumstances, by withdrawal from the partnership of general partner(s)</td>
<td>A date of dissolution may be provided in certificate filed with state or in partnership agreement or can be triggered pursuant to events specified in partnership agreement. Withdrawal of partner(s) can also lead to dissolution in some cases, pursuant to applicable state law</td>
<td>Requires an affirmative vote of shareholders for voluntary dissolution; state law provides for judicial and administrative dissolution under specified circumstances</td>
<td>S corporation status can be voluntarily by election of shareholders or involuntarily terminated for failure to meet federal eligibility requirements</td>
<td>Can be triggered by events specified in articles of operation or organization, by administrative or judicial action in state of organization or, in some circumstances, by withdrawal of a member</td>
<td></td>
</tr>
<tr>
<td>Limitations</td>
<td>Sole Proprietorship</td>
<td>General Partnership</td>
<td>Limited Partnership</td>
<td>Limited Liability Partnership</td>
<td>Corporation</td>
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<tr>
<td>Limitations</td>
<td>Owner has personal liability for all aspects of the business; spouse can sometimes be liable as well</td>
<td>All partners are jointly and severally liable for the debts and obligations of the partnership</td>
<td>Unlike limited liability company where all members can participate in management and retain limited liability, limited partners may not actively participate in the enterprise and maintain their limited liability status</td>
<td>Limited to certain professionals in many states; partners still subject to personal liability under some circumstances</td>
<td>Complex requirements for formation and operation pursuant to applicable state law</td>
<td>One of the greatest disadvantages of forming an S corporation is the inflexibility of subchapter S of the Code, under which an S corporation and its shareholders are taxed; subchapter S imposes strict eligibility requirements that must be met before a corporation may make an election to be an S corporation; if an S corporation ceases to satisfy the eligibility requirements for subchapter S status, its S election will terminate; also may have only one class of stock</td>
<td>Many states prohibit certain professionals from utilizing this business form</td>
</tr>
</tbody>
</table>

**NOTE:** The provisions in this chart are illustrative of state law treatment of each topic. Given the significance variation from state-to-state, please refer specific questions to the applicable jurisdiction.
Glossary

**Articles of Conversion** – Required to be filed with the state when a limited liability company seeks to convert to a different type of entity.

**Articles of Operation** – Document that governs the operations of a limited liability company. Akin to the bylaws of a corporation, it sets forth the rules governing the operation of the entity.

**Articles of Organization** – Documents filed with appropriate state agency required to create a limited liability company.

**Below-market Loans** – A loan on which no interest is charged or on which interest is charged at a rate below the applicable federal rate.

**Business Judgment Rule** – A common law rule which provides that as long as an officer or director makes a decision on behalf of a corporation that is well-informed and based on advice from experts in their field, that officer or director will not be liable if the decision turns out to be a poor one. Rule is also applied to members of a limited liability company.

**Contribution** – The money or other item(s) of value invested by a member in a limited liability company.

**Conversion** – The process by which a limited liability company is transformed into a different type of entity.

**Corporation** – A legal entity that has rights usually only reserved for individuals. The primary advantage of a corporation is that it provides its shareholders with a right to participate in the profits without any personal liability.

**Dissolution** – The act of ending, terminating or winding-up a company. For example, when the life of a company is ended by normal legal means, it is said to be dissolved.

**Distribution** – Payments made to members, partners, or shareholders. May include dividends from earnings, capital gains from sale of portfolio holdings and return of capital.

**General Partnership** – A partnership in which each general partner shares in the administration, profits and losses of the operation. It is composed of two or more general partners. No formal registration is required with the state.

**In-kind Contribution** – A contribution to the capital formation of an entity other than cash. For example, a member may provide professional services to a company in lieu of a cash contribution.

**Limited Liability Company** – A legal entity that has the option of being taxed like a partnership, but shields personal assets from business debt like a corporation.
**Limited Liability Partnership** – All of the partners are normally entitled to limited liability status for the acts or omissions of the partnership, though generally not for his or her own acts or omissions. Many states reserve this form of entity for certain professional associations.

**Limited Partnership** – A partnership that is a business arrangement whereby the operation is administered by one or more general partners and funded by limited or silent partners who are legally responsible for losses based on the amount of their investment.

**Manager** – Individual designated to manage the affairs of a limited liability company. May or may not be a member of the company.

**Manager-managed Company** – A limited liability company that is managed by a manager or managers rather than the members of the company.

**Member** – The term used to describe the owner of an interest in a limited liability company.

**Member-managed Company** – A limited liability company that is managed by its owners. Unless specified otherwise in the articles of operation, a limited liability company is presumed to be managed by its members.

**Merger** – The process by which one business entity combines with another business entity.

**Partnership** – A partnership is a business entity in which two or more individuals carry on a continuing business for profit as co-owners. Legally, a partnership is regarded as a group of individuals rather than as a single entity, although each of the partners file their share of the profits on their individual tax returns.

**Plan of Conversion** – Normally initial step for an entity to convert to a different type of entity is the adoption of a plan of conversion setting forth specific information required by the applicable state law.

**S Corporation** – A special type of corporation in which shareholders receive the benefits of pass through taxation generally available to partnerships while still maintaining limited liability. A number of requirements limit the type of entities eligible for this type of federal tax treatment.

**Sole Proprietorship** – A business owned and operated by one person. The business has no legal existence separate from that of the owner.
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