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## LIMITED LIABILITY COMPANIES: INCOME TAX TREATMENT

(Second of three parts)  
— by Neil E. Harl\*

In most instances, a major reason for forming limited liability companies (LLCs) is to obtain the income tax treatment of a partnership.<sup>1</sup> Although the IRS rulings issued to date generally support that outcome,<sup>2</sup> careful attention is needed in structuring an LLC to assure taxation as a partnership.<sup>3</sup>

An LLC is treated as a partnership unless it has more corporate than noncorporate characteristics.<sup>4</sup> Thus, an LLC must have no more than two of the following characteristics—

- Continuity of life (which LLCs generally do not possess).<sup>5</sup> The focus of the regulations is on whether any member has the power to dissolve the entity under local law upon voluntary or involuntary withdrawal.<sup>6</sup> The Utah act, for example, provides for continuation of the LLC on the consent of members holding a majority of the profits interest.<sup>7</sup> This could cause problems of classification of the entity as a partnership for federal income tax purposes.<sup>8</sup> On the other hand, if a state statute authorizes less than unanimous consent but the entity has not opted for such a provision, continuity of life may be lacking.<sup>9</sup>

- Centralized management (which LLCs typically do not possess).<sup>10</sup> IRS has ruled that where the articles of organization of the LLC provided that management was reserved to the members (who were entitled to vote in proportion to their interests in the LLC), and the members of the LLC individually had the power to incur debts and liabilities on behalf of the LLC under that state's LLC act, if management was reserved to the members, centralized management was lacking on the grounds that those powers were similar to the powers of a general partner to bind all partners.<sup>11</sup>

IRS has indicated that it will refuse to rule that centralized management does not exist if limited partners own more than 80 percent of the total interests in the partnership.<sup>12</sup> The ruling does not state, however, that a favorable ruling will be issued if the general partners own 20 percent or more of the total interest in the partnership. It is not clear what relationship these authorities on limited partnership classification bear to classification of LLCs.

- Free transferability of interests (which LLCs typically

do not possess).<sup>13</sup> A member of an LLC generally can assign or transfer that member's interest to another person who is not a member of the organization.<sup>14</sup> However, the assignee or transferee typically does not become a substitute member and does not acquire all of the attributes of the member's interest in the LLC unless all of the remaining members approve the assignment or transfer.<sup>15</sup> Therefore, LLCs usually lack the corporate characteristic of free transferability of interests. This is essential for partnership tax status.<sup>16</sup>

In the event the remaining members fail to approve the assignment, or transfer, the assignee or transferee has no right to participate in the management or become a member of the limited liability company. However, the assignee or transferee is entitled to receive the share of profits or other compensation and the return of contributions to which the transferring member would otherwise be entitled.<sup>17</sup>

- Limited liability (which LLCs possess).<sup>18</sup>

LLCs are conceded to have associates and an objective of carrying on a business and dividing the gains from the business. Of the remaining four characteristics, LLCs generally possess only limited liability. Thus, LLCs should generally be classified as a partnership for federal income tax purposes. Note, however, that even though classified as a partnership for federal income tax purposes an LLC may be subject to state corporate income tax in some states.<sup>19</sup>

### FOOTNOTES

1 See generally 8 Harl, *Agricultural Law* § 61.03 (1993).

2 E.g., Rev. Rul. 93-30, I.R.B. 1993-16, 4.

3 Rev. Rul. 93-38, I.R.B. 1993-21, 4, see p. 98 *supra*.

4 Treas. Reg. § 301.7701-2(a)(1). See *Larson v. Comm'r*, 66 T.C. 159 (1976), *acq.*, 1977-1 C.B. 1.

5 E.g., Rev. Rul. 93-30, I.R.B. 1993-16, 4; Rev. Rul. 93-5, I.R.B. 1993-3; Rev. Rul. 93-6, I.R.B. 1993-3; Rev. Rul. 88-76, 1988-2 C.B. 360; Ltr. Rul. 9320045, Feb. 24, 1993.

6 Treas. Reg. § 301.7701-2(b)(3).

7 Utah Code Ann. § 48-2b-137.

8 See Ltr. Rul. 9010027, Mar. 19, 1990.

9 See Ltr. Rul. 8937010, Oct. 25, 1989 (Florida law); Ltr. Rul. 9029019, July 25, 1990 (Texas law).

10 E.g., n. 5 *supra*.

11 Ltr. Rul. 9010027, Mar. 19, 1990; Ltr. Rul. 9320045, Feb. 24, 1993.

12 Rev. Proc. 89-12, 1989-1 C.B. 798, *amplified by* Rev. Proc. 91-13, 1991-1 C.B. 477.

13 E.g., n. 5 *supra*.

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<sup>14</sup> E.g., Iowa Code § 490A.902.

<sup>15</sup> *Id.*

<sup>16</sup> See Rev. Rul. 93-30, I.R.B. 1993-16, 4; Rev. Rul. 88-76, 1988-2 C.B. 360.

<sup>17</sup> E.g., Iowa Code § 490A.902.

<sup>18</sup> E.g., Nev. Rev. Stat. Ann. § 86.371. See n. 5 *supra*.

<sup>19</sup> Fla. Stat. Ann. § 608.471.

## CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr.

### BANKRUPTCY

#### GENERAL

**CONSOLIDATION.** The debtor filed a Chapter 11 case in 1990 and the debtor's wholly-owned farm corporation filed for Chapter 11 in 1992. The debtor moved for substantive consolidation of the cases. The court held that consolidation was untimely because no evidence was available to determine the effect on the creditors in each case. *In re Stevenson*, 153 B.R. 52 (Bankr. D. Idaho 1993).

#### EXEMPTIONS-ALM § 13.03.\*

**HOMESTEAD.** The debtors owned two neighboring buildings which they rented as four apartments and used the fifth apartment as their residence. The court held that the debtors could claim a homestead exemption only as to the portion of the buildings used as their personal residence. *In re Wierschem*, 152 B.R. 345 (Bankr. M.D. Fla. 1993).

**LIFE INSURANCE.** The debtor was the surviving spouse of a person who had five life insurance policies, all of which named the surviving spouse as beneficiary; two had been assigned to the surviving spouse by the decedent, two were owned by the decedent and one was owned by the decedent's corporation. The court held that under N.Y. Ins. Law § 3212(b), the proceeds of the policies assigned to the surviving spouse were exempt but the other policies were not exempt. *In re Rundlett*, 153 B.R. 126 (S.D. N.Y. 1993), *aff'g*, 142 B.R. 649 (Bankr. S.D. N.Y. 1992).

**TAX REFUND.** At the time of the bankruptcy filing, the IRS held \$12,000 of excess taxes owed to the debtors as a refund. The debtors claimed that the refund was exempt under Mo. Rev. Stat. § 513.427 because the refund was not subject to attachment. The court held that under I.R.C. § 6402, the refund was subject to attachment in specific instances, although not by any current creditor of the debtors; therefore, the refund was not eligible for the exemption. *In re Robinson*, 152 B.R. 956 (Bankr. E.D. Mo. 1993).

The debtor sought to exempt as wages federal and state income tax refunds resulting from taxes withheld from the debtor's wages during the 90 days prior to filing for bankruptcy. The court held that the refunds were not "wages" for purposes of the exemption statute, Okla. Stat. tit. 31 § 1(A)(18). *In re Miles*, 153 B.R. 72 (Bankr. N.D. Okla. 1993).

**WILD CARD.** The debtor's fax machine, copier, office desk and chair, and file cabinet used in the debtor's business were eligible for the tools of the trade exemption to the extent of the dollar limit of that exemption, with any excess amount eligible for the "wild card" exemption. The debtor's bank account was not eligible for the tools of the trade exemption and was not eligible for the "wild card"

exemption. *In re King*, 153 B.R. 229 (Bankr. N.D. Ill. 1993).

#### CHAPTER 12

**PLAN-ALM § 13.03[8][c].\*** The Chapter 12 plan was not confirmed where the plan failed to include (1) payment of trustee fees on impaired claims paid by the debtor directly, (2) a source of operating funds for restarting the debtor's dairy and livestock operations, and (3) several expense items. *In re Oster*, 152 B.R. 960 (Bankr. D. N.D. 1993).

Although the debtor's spouse did not join in the bankruptcy case, the debtor's plan included the spouse's nonfarm income in the amount of income available to meet farm expenses. A creditor objected to the plan, arguing that the nondebtor spouse's income is not subject to the jurisdiction of the bankruptcy court and the spouse cannot be legally forced to contribute to the debtor's plan payments. The court held that the plan would be confirmed. The court noted that the court is also powerless to force the debtor to make plan payments; therefore, the court's inability to force the debtor's spouse to contribute income to the plan payments did not affect the confirmability of the plan. In both cases, the result of a failure to pay would be a default under the plan with the only remedy being denial of discharge. *In re Soper*, 152 B.R. 985 (Bankr. D. Kan. 1993).

The Chapter 12 debtor's plan provided that stock in a Farm Credit Bank would be transferred to the bank in partial satisfaction of a secured claim of the bank. The bank objected to the plan, arguing that the stock could not be redeemed without permission of the bank. The court held that Section 1225(a)(5)(C) has precedence over the Farm Credit Bank regulations and that the redemption of the stock could be required by the plan. *In re Davenport*, 153 B.R. 551 (Bankr. 9th Cir. 1993).

**TRUSTEE FEES-ALM § 13.03[8][b].\*** The debtor's Chapter 12 plan was confirmed in 1989 and included a trustee fee of 6 percent. The trustee sought an increase in the fee to 10 percent in 1992 after the statutory fee was increased by order of the U.S. Attorney General. The court held that the fee could not be increased because (1) the trustee had not demonstrated that the debtor could make the payments with the increase in fees, (2) the trustee failed to show that the modification of the fee was proper, and (3) the confirmed plan was *res judicata* as to the trustee fee. *In re Roesner*, 153 B.R. 328 (Bankr. D. Kan. 1993).

#### FEDERAL TAXATION

**ATTORNEY'S FEES.** Although the court held that the IRS was not deemed to have waived sovereign immunity for purposes of awarding attorney's fees and costs resulting from repeated violations of the discharge order, the court