

See SBT 1995 Advanced Drafting Estate Planning & Probate “D”

DRAFTING GUIDE TO THE LIMITED LIABILITY COMPANY

THOMAS C. BAIRD

Burrows, Baird, Miller, & Crews, P.C.

401 North Third Street, 2nd Floor

Post Office Box 1260

Temple, Texas 76503

(817) 774-8333

Fax (817) 774-9353

6TH ANNUAL ADVANCED DRAFTING:

ESTATE PLANNING & PROBATE COURSE

Fort Worth, Texas

October 26-27, 1995

## D-2 Adv. Drafting: Estate Plan & Probate, 1995

### Table of Contents

I. INTRODUCTION	4
II. REVENUE PROCEDURE 95-10	4
A. Rev. Proc. 95-10 Provides Ruling Guidelines.	4
B. Tax Status of One-Member LLC Is Still Unanswered.	4
C. LLC Must Lack at Least Two of the Four Corporate Characteristics to be Classified as a Partnership.	4
D. Continuity of Life.	5
1. <u>INTERNAL REVENUE CODE REGULATIONS</u>	5
2. <u>THE SERVICE'S POSITION ON CONTINUITY OF LIFE</u>	5
3. <u>WHAT IS A MEMBER-MANAGER?</u>	5
4. <u>WHAT IS A MAJORITY-IN-INTEREST?</u>	5
5. <u>THE DEFAULT PROVISIONS OF STATE LLC STATUTES AUTOMATICALLY CAUSE THE LLC TO LACK CONTINUITY OF LIFE</u>	5
6. <u>EVENTS OF DISSOLUTION APPLY ONLY TO MEMBER-MANAGERS</u>	5
a. <u>Safety Net</u>	5
b. <u>Picking and Choosing from the Laundry List</u>	6
c. <u>The Triggering Event Causing Dissolution Applied Only to the Single Member-Manager</u>	6
7. <u>DIFFERENCES BETWEEN LLCs AND LIMITED PARTNERSHIPS IN THE CONTINUITY-OF-LIFE AREA</u>	6
8. <u>SUMMARY</u>	6
E. Centralization of Management	6
1. <u>INTERNAL REVENUE CODE REGULATIONS</u>	6

## Drafting Guide to the LLC D-3

7	2. <u>THE SERVICE'S POSITION ON CENTRALIZATION OF MANAGEMENT</u>	
	3. <u>SUMMARY</u>	7
	F. Limited Liability	7
	1. <u>INTERNAL REVENUE CODE REGULATIONS</u>	7
	2. <u>THE SERVICE'S POSITION ON LIMITED LIABILITY</u>	7
	a. <u>Section 5.04 of Rev. Proc. 95-10</u>	7
	b. <u>Texas Authorization for a Member Assuming Liability</u>	7
	c. <u>Summary</u>	8
	G. Free Transferability of Interests	8
	1. <u>INTERNAL REVENUE CODE REGULATIONS</u>	8
8	2. <u>THE SERVICE'S POSITION ON FREE TRANSFERABILITY OF INTERESTS</u>	
	3. <u>SUMMARY</u>	8
	H. Failing the Rev. Proc. 95-10 Guidelines Does Not Mean You Automatically Fail to be Classified as a Partnership for Federal Income-Tax Purposes	8
	III. SIMPLIFICATION OF ENTITY CLASSIFICATION RULES (IRS Notice 95-14, 1995-1 C.B. 7)	9
	IV. ALLOCATIONS	9
	V. METHODS OF ACCOUNTING	9
	A. Importance of Cash Method of Accounting to LLC Members	9
	B. What Methods of Accounting May an LLC Use?	9
	C. When Is an LLC a Tax Shelter?	10
	D. When Is an LLC an Enterprise?	10
	E. When Is an LLC a Syndicate?	10
	F. When May a Member-Ruled Professional LLC Use the Cash Method of Accounting?	

**D-4 Adv. Drafting: Estate Plan & Probate, 1995**

G. When May a Manager-Ruled Professional LLC Use the Cash Method of Accounting?	10
VI. THE CONVERSION OF AN EXISTING ENTITY TO AN LLC	11
VII. NET INCOME FROM SELF-EMPLOYMENT	11
A. Introduction to Self-Employment Income	11
B. Is it Better to Do Business as an LLC or Limited Partnership?	11
C. When is Income Net Income from Self-employment?	11
D. Can Limited Partnerships Provide Professional Services?	12
E. An Unanswered Question	12
VIII. CHAPTER 14 CONSIDERATIONS	12
IX. PRIVATE LETTER RULINGS LACKING FREE TRANSFERABILITY OF INTEREST OR CENTRALIZATION OF MANAGEMENT WHEN AN LLC'S MEMBERS ARE CONTROLLED BY A COMMON SOURCE	13
A. PLR 9510037	13
B. PLR 9507004	14
C. PLR 9320045	14
X. USE OF AN LLC WITH AN FLP	14
A. An LLC Acting as General Partner of an FLP	14
B. Using an LLC as a General Partner of a Subsidiary Limited Partnership ("Sub-LP")	14
XI. CONCLUSION	15

NEW & IMPROVED -

DRAFTING GUIDE TO THE LIMITED LIABILITY COMPANY

## I. INTRODUCTION

This article is an update of the article, "The Limited Liability Company - A Drafting Guide" presented at the 3rd Annual Advanced Drafting: Estate Planning and Probate Course (1992). It is not intended to be a comprehensive treatise on the limited liability company ("LLC"). I will focus on drafting the LLC after Rev. Proc. 95-10 and the 1993 amendments to the Texas Limited Liability Company Act ("TLLCA"). In addition, LLC drafting alternatives have been included for situations when the LLC is coupled with a family limited partnership ("FLP") in an estate plan.

Virtually every state has adopted LLC legislation. Forty-seven states and the District of Columbia have adopted LLC acts. The only states that have not adopted LLC acts are Massachusetts, Vermont, and Hawaii. But it is anticipated that these three states will adopt LLC legislation this year.

The concern about doing business as an LLC in various states has disappeared. LLC legislation is so new, however, there is no uniformity among the various states. In addition, the LLC landscape is changing so rapidly it has become difficult to keep up with the evolving trends. All we know for certain is:

- ? LLCs are here to stay;
- ? new and expanded LLC uses are being discovered daily;
- ? the Internal Revenue Service ("Service") has a sympathetic attitude concerning LLCs being classified as partnerships; and
- ? LLCs have a definite place in business and estate planning.

## II. REVENUE PROCEDURE 95-10

### A. Rev. Proc. 95-10 Provides Ruling Guidelines.

## D-6 Adv. Drafting: Estate Plan & Probate, 1995

Ruling guidelines now exist for LLCs in the form of Rev. Proc. 95-10. Before Rev. Proc. 95-10, LLC drafters had to rely on the guidelines of Rev. Proc. 89-12. Rev. Proc. 89-12 applied to limited partnerships, and its provisions were difficult to apply to LLCs. The expense and delay of obtaining an LLC ruling from the Service under Rev. Proc. 89-12 and its progeny has been a hindrance to our clients in using an LLC. Although it does not directly mention LLCs, Rev. Proc. 89-12 is referred to in almost every domestic LLC private letter ruling. Section 1 and Section 6 of Rev. Proc. 95-10 expressly states that Rev. Proc. 89-12 no longer applies to LLCs. Rev. Proc. 95-10's principal benefit will be to provide guidance to LLC organizers. The TLLCA's default provisions provide tax-classification "safe harbors" for an LLC's organization and operation. Rev. Proc. 95-10 will provide expanded tax-classification safe harbors for an LLC's organization and operation. This allows organizers to diverge from the stricter statutory safe harbors with little fear that the LLC will suffer adverse tax classification.

### B. Tax Status of One-Member LLC Is Still Unanswered.

The first and foremost question concerning an LLC's classification is, "What is a one-member LLC's classification?" This question was not answered by Rev. Proc. 95-10. We are still waiting to see if a one-member LLC will be either a tax-flow-thru entity (taxed as a sole proprietorship) or an association (taxed as a corporation). Being taxed as a corporation will be disastrous for a one-member LLC. To determine if an LLC has more than one member, Rev. Proc. 95-10 tells us to look to the facts and circumstances. It does not provide for a one-percent-partnership-interest safe harbor as in Rev. Proc. 89-12 concerning limited partnerships. The question remains, if one member owns substantially all the LLC's ownership interest, then how little interest may a second member own and the LLC still be classified as a partnership? In other words, how little ownership interest may the second member own and the LLC not be deemed to be owned by one member? The one-percent analogy from Rev. Proc. 89-12 is probably as good as any in determining if there is more than one owner of the LLC. If you have the second member own less than one percent, you are taking a substantial risk. If the Service decides to treat a one-member LLC as an association (taxable as a corporation for federal income-tax purposes), there is no pass-through tax treatment to the LLC's members. Always try to have at least two members with each member owning at least one percent. You can then rely on Rev. Proc. 95-10 with some certainty.

### C. LLC Must Lack at Least Two of the Four Corporate Characteristics to be Classified as a Partnership.

To be classified as a partnership, the LLC must lack at least two of the four corporate characteristics. These four corporate characteristics are limited liability, centralization of management, free transferability of interest, and continuity of life. If the LLC has three or more of these characteristics, it will be classified as a corporation for federal income-tax purposes. If the LLC lacks two or more of these corporate characteristics, it will be classified as a partnership for federal income-tax purposes.

### D. Continuity of Life.

#### 1. INTERNAL REVENUE CODE REGULATIONS

## Drafting Guide to the LLC D-7

Continuity of life exists when an organization is not dissolved upon any member's death, insanity, bankruptcy, retirement, resignation, or expulsion. [Treas. Reg. 301.7701-2(b)(1)] Conversely, an organization that dissolves on the happening of one of these events does not have continuity of life.

The Treasury Regulations provide that a limited partnership will not have continuity of life, if (upon the occurrence of any specified withdrawal event for a general partner) the partnership may be continued by consent of the remaining general partners or at least a majority in interest of all remaining partners. Although the Treasury Regulations do not specifically address LLCs, after Rev. Proc. 95-10, it is clear that the Treasury Regulations apply to LLCs.

### 2. THE SERVICE'S POSITION ON CONTINUITY OF LIFE

In Rev. Proc. 95-10, the Service provided ruling guidelines for LLCs that are comparable to the current guidelines for limited partnerships. These guidelines set out the conditions that must be met to obtain an advanced ruling from the Service that the LLC will be classified as a partnership for federal income-tax purposes. Sections 501 and 5.02 of Rev. Proc. 95-10 state that if the governing LLC statute or regulations provide that the death, insanity, bankruptcy, retirement, resignation, or expulsion of any member or member-manager is an event of dissolution, the Service will rule that continuity of life does not exist. This list of events of dissolution is often referred to as the "Laundry List." In addition, the Service will rule that continuity of life does not exist even if the LLC may continue by a vote of at least a majority-in-interest of the members. The Laundry List must apply to all members if you have a member-ruled LLC. If you have a manager-ruled LLC, the events of dissolution must apply to either all members or all member-managers. Each member (including member-managers) must own at least one percent ownership-interest in the LLC. If only one of the dissolution events causes the LLC's dissolution, no ruling will be given unless it can be clearly established that there is a meaningful possibility of dissolution.

### 3. WHAT IS A MEMBER-MANAGER?

If a manager-ruled LLC is dissolved by the Laundry List applying only to the managers, the managers must be members who are also persons elected and statutorily authorized to serve as managers. If the managers are the keys to dissolution, the managers must be statutory managers under the TLLCA and they must own collectively at least one percent ownership interest in the LLC. Applying the Laundry List only to the managers for purposes of triggering the LLC's dissolution allows you to ignore what happens to the members.

### 4. WHAT IS A MAJORITY-IN-INTEREST?

## D-8 Adv. Drafting: Estate Plan & Probate, 1995

In determining majority-in-interest, you must take into consideration the LLC's economics. Rev. Proc. 94-46 provides a safe harbor as to when there is a majority-in-interest. A majority-in-interest must include both a majority of capital and majority of profits. The Treasury Regulations under Code §704(b) determine if there is a majority-in-interest in capital accounts. To determine a majority-in-interest in profits, you must ascertain the reasonable estimation of the profits from the date of the dissolution event to the LLC's termination date. If the LLC has a simple LLC agreement with the same profits-sharing ratio from the first day of operation to the LLC's termination, you do not have to ascertain the reasonable estimation of profits. If the LLC has a complicated LLC agreement where the profits ratio shifts over time (sometimes called a "flip"), you must use the reasonable-estimation-of-profits method.

### 5. THE DEFAULT PROVISIONS OF STATE LLC STATUTES AUTOMATICALLY CAUSE THE LLC TO LACK CONTINUITY OF LIFE

The Laundry List items included in all LLC statutes as triggering events of dissolution are sufficient to cause an LLC to automatically lack continuity of life. In all state LLC statutes, these events of dissolution automatically apply to all members. Upon an event of dissolution, the statutes also require, at a minimum, that the members having at least a majority-in-interest of the LLC's profits and capital must consent to continue the LLC. In most LLC statutes, the default provisions require unanimous consent of all remaining members to continue. In a number of states (including Texas), the default provisions may be overridden by agreement of the members. Therefore, you must be careful not to provide in your regulations for a standard that falls below that required by Rev. Proc. 95-10.

### 6. EVENTS OF DISSOLUTION APPLY ONLY TO MEMBER-MANAGERS

#### a. Safety Net

An LLC may be drafted in a manner so that the Laundry List items triggering dissolution apply only to the member-managers. But if the LLC is to continue upon an event of dissolution, the regulations must require the consent of the members holding a majority-in-interest. If you have a complicated LLC with shifting-profits interest, the regulations may need a safety net. This safety net needs to provide that upon an event of dissolution, a majority-in-interest or 2/3 of all members, whichever is greater, must consent to continue the LLC.

#### b. Picking and Choosing from the Laundry List

Rev. Proc. 95-10 allows you to pick and choose from the Laundry List to identify one or more items as the key to dissolution. One event is sufficient to trigger the dissolution. The only limitation is that the event chosen must have a meaningful possibility of causing dissolution. If an LLC has corporate members and the only event causing dissolution is a member's death, there is no meaningful possibility of dissolution. Members who are corporations do not die. Bankruptcy as the triggering event does have a meaningful possibility of causing dissolution. Bankruptcy is a possibility for both individuals and corporations. The Service has stated that a meaningful possibility of dissolution means a legal possibility of dissolution. It does not mean a factual possibility of dissolution. Bankruptcy as the triggering event causing dissolution is one of the best choices that can be made from the Laundry List. Even well-capitalized corporate subsidiaries have a legal possibility of filing bankruptcy.

c. The Triggering Event Causing Dissolution Applied Only to the Single Member-Manager

You may choose one Laundry List item as the triggering event of an LLC's dissolution. Even if the LLC has only one member-manager, the triggering event may apply to the member-manager so long as that triggering event has a meaningful possibility of causing dissolution. The triggering event may not be applied to only one member. If you chose only one triggering event of dissolution, it must apply to either all the members or all the member-managers. If you only have one member-manager, that member-manager must own at least one percent ownership interest in the LLC. If there is only one member-manager and there is only one triggering event of dissolution (i.e., bankruptcy), the LLC will lack continuity of life. If there are two or more member-managers, the triggering event of dissolution must apply to all member-managers. If the triggering event of dissolution applies to only one of several member-managers, the LLC will have continuity of life. If the triggering event of dissolution applies to only one of several members, the LLC will have continuity of life. If an LLC has three member-managers (one individual and two corporations) and your triggering event for dissolution is a member-manager's death, continuity of life exists. It exists because the triggering event applies only to one of the member-managers. If the triggering event is either a member-manager's death or a corporation member-manager's dissolution, the LLC should lack the corporate characteristic of continuity of life. Death or corporate dissolution is common to both the individual member-manager and the corporate member-managers. This should work, although there is no guidance from the Service.

7. DIFFERENCES BETWEEN LLCs AND LIMITED PARTNERSHIPS IN THE CONTINUITY-OF-LIFE AREA

In regards to continuity of life, one small difference between LLCs and limited partnerships exists. In limited partnerships, the triggering events of dissolution may be applicable only to the general partners. And if an event of dissolution is triggered by one general partner, the remaining general partners may continue the limited partnership without the limited partners' consent or vote. In an LLC, if the triggering events of dissolution apply only to the member-managers and one of the member-managers triggers an event of dissolution, a majority-in-interest of the members must consent to continue the LLC. Upon the triggering event of dissolution, the LLC's remaining member-managers may not unilaterally consent to continue the LLC as the remaining general partners may in a limited partnership. No logical reason exists for this difference.

8. SUMMARY

## D-10 Adv. Drafting: Estate Plan & Probate, 1995

Some states' LLC statutes are drafted very narrowly and always lack continuity of life. Wyoming has this type of drafting scheme. Other states, including Texas, have a more flexible drafting scheme. Under a flexible LLC statute, the drafter may create an LLC either lacking continuity of life or having continuity of life. Unless the members take full advantage of the available flexibility in the organizational documents, even LLCs formed in states where the flexibility is allowed will not have continuity of life. After Rev. Proc. 92-35 and the newly revised Treas. Reg. §301.7701-2(b)(1), a majority-in-interest standard, rather than a unanimity standard, now exists regarding the ability to continue a limited partnership on the occurrence of a dissolution event. PLR 9308027 adopted this majority-in-interest standard for an LLC. This resulted in comparable treatment of LLCs and limited partnerships on the continuity-of-life issue. Rev. Proc. 95-10 is the latest confirmation that the Service will now treat LLCs and limited partnerships consistently.

### E. Centralization of Management

#### 1. INTERNAL REVENUE CODE REGULATIONS

An organization will have centralized management if any person or group of persons consisting of less than all the owners has the continuing exclusive authority to make management decisions for the business. [Treas. Reg. §301.7701-2(c)(1)] The manager's ability (as a manager and not as an owner) to contractually bind the organization determines whether centralization of management exists. The Service has recognized a safe harbor providing that centralization of management does not exist in a limited partnership if the general partners own 20% or more of the partnership interests. The theory is that a general partner with such a substantial stake as an owner is acting for itself, not just in a representative capacity for the limited partners. After Rev. Rul. 93-6, it appeared that the Service was not going to allow this same safe harbor for LLCs. The Service's position in Rev. Rul. 93-6 was severely criticized because it ignored the analogy between general partners and managers and between limited partners and nonmanager-members. The Service has remedied this anomaly with its issuance of Rev. Proc. 95-10.

#### 2. THE SERVICE'S POSITION ON CENTRALIZATION OF MANAGEMENT

In Rev. Proc. 95-10, the Service issued ruling guidelines as to when an LLC will lack centralization of management. Failure to meet these guidelines does not mean that the LLC automatically has centralization of management. Even if all ruling guidelines are met, the Service reserves the right to look at all relevant facts and circumstances in determining if an LLC lacks centralization of management. If management of the LLC is reserved to the members, the LLC will lack centralization of management. If management of the LLC is reserved to the member-managers, the Service will not issue a ruling that an LLC lacks centralized management if:

    ?the member-managers, in the aggregate, own at least 20% of the total interest in the LLC;

    ?the member-managers are subject to periodic elections by the members; or

    ?the nonmanaging members have a substantially unrestricted power to remove the member-managers.

3. SUMMARY

Rev. Proc. 95-10 states that if the LLC is member-managed, it lacks centralization of management. In a member-managed LLC, the authority to bind the LLC will reside with each member. In many cases, however, the LLC may want to have managers and still lack centralization of management. Rev. Proc. 95-10 provides a possibility for an LLC to have managers and still lack centralization of management. For a manager-ruled LLC to lack centralization of management, the managers must be members and own at least 20% of the ownership interest in the LLC at all times. The managers may not be subject to periodic elections by the members and must serve as a manager in an LLC in the same way that a general partner serves in a limited partnership. The members may not have substantial removal powers to remove the member-managers. The member-managers may not be removed for ordinary negligence, but nonmember-managers may remove the member-managers for gross negligence, fraud, or dishonesty. Even if the manager-ruled LLC is drafted with all these provisions, the Service may still look to the facts and circumstances to determine whether a manager-ruled LLC will lack centralization of management. Because of the uncertainty as to whether a manager-ruled LLC will lack centralization of management without a ruling from the Service, very few LLCs will rely on this approach to lack centralization of management.

F. Limited Liability

1. INTERNAL REVENUE CODE REGULATIONS

An organization will have the corporate characteristic of limited liability if no member of the organization has personal liability for the organization's debts. [Treas. Reg. ?301.7701-2(d)(1)] For limited partnerships, limited liability may be present if the general partner is without substantial assets available to the partnership's creditors and is a "dummy" acting as the agent for the limited partners. [Treas. Reg. ?301.7701-2(d)(2)]

2. THE SERVICE'S POSITION ON LIMITED LIABILITY

a. Section 5.04 of Rev. Proc. 95-10

Section 5.04 of Rev. Proc. 95-10 provides that the Service will rule that an LLC lacks limited liability if:

? at least one member validly assumes personal liability for all (but not less than all) the LLC's obligations; and

? the assumption of liability is made pursuant to express authority granted in the controlling LLC statute.

b. Texas Authorization for a Member Assuming Liability

## D-12 Adv. Drafting: Estate Plan & Probate, 1995

Most state LLC statutes limit a member's liability for the LLC's obligations. Some state LLC statutes allow you to modify the member's liability in the organizational documents. No LLC-classification ruling has been published that has allowed an LLC to lack limited liability. A ruling finding that a Texas LLC lacks limited liability is possible because the Texas LLC statute authorizes the LLC's articles or regulations to impose member liability for the LLC's debts. For a Texas LLC to lack limited liability, the organizational documents must impose liability for the LLC's debts on one or more members. Furthermore, the assuming members must have an aggregate net worth equal to at least 10% of the total contributions to the LLC and must maintain that net worth. If an assuming member falls short of this safe harbor, the assuming member may show that it has substantial assets that may be reached by a creditor, and still obtain a ruling that limited liability for the LLC does not exist.

### c. Summary

Rev. Proc. 95-10 allows for an LLC to lack limited liability if the controlling state statute specifically provides that a member may assume all the LLC's liability. The assuming member, however, must own at least one percent ownership interest in the LLC at all times. The assuming member may not pick and choose the liabilities that the assuming member will assume. The assuming member will also have to meet the substantial net worth or the ten-percent-net-worth-facts-and-circumstances test similar to that of general partners of limited partnerships. The Service allows LLCs to lack limited liability in the same way limited partnerships lack limited liability. It is believed the Service has taken this position so that LLCs and Limited Partnerships will be on equal footing in regards to classification issues.

### G. Free Transferability of Interests

#### 1. INTERNAL REVENUE CODE REGULATIONS

Membership interests are not freely transferable under Treas. Reg. ?301.7701-2(e)(1) unless each member (or members who own substantially all the interests in the entity) has the power, without the consent of the other members, to substitute for himself or herself in the same organization a person who is not a member of the organization. For the requisite power of substitution to exist, the transferring member must be able to confer upon the member's transferee all the attributes of the transferring member's interest in the organization, without the other members' consent. Free transferability of interests will not exist where the voting rights associated with a member's interest are not transferable, even if the economic rights associated with the interest are fully transferable.

#### 2. THE SERVICE'S POSITION ON FREE TRANSFERABILITY OF INTERESTS

## Drafting Guide to the LLC D-13

In Rev. Proc. 92-33, 1992-17 I.R.B. 28, the Service supplemented Rev. Proc. 89-12 by stating that with respect to the "substantially all" phrase found in the Treasury Regulations, a partnership will lack free transferability of interests if throughout the life of the partnership the partnership agreement expressly restricts the transferability of partnership interests representing more than 20% of all interests in partnership capital, income, gain, loss, deduction, and credit. Rev. Proc. 95-10 may achieve the same result for LLCs, although the operative language is somewhat different. If "each member, or those members owning more than 20 percent" of the interests in the LLC have no power to transfer their membership interests and confer on the transferee all attributes of membership without the approval of a majority-in-interest of the nontransferring members, the Service will rule that free transferability of interests does not exist. In connection with free transferability of interests, "majority" means either a "majority-in-interest" or a per-capita majority. The test applies either among the member-managers or all the members, depending on the facts of the particular ruling request.

### 3. SUMMARY

Rev. Proc. 95-10 states that an LLC will lack free transferability of interest if members owning more than 20% ownership interest in the LLC must receive consent to transfer their entire interest in the LLC to a third party and substitute the third party for themselves in the LLC. The entire interests being transferred to the third party must include both the governing rights and the economic rights. The consent given must be from either a majority of the member-managers or a majority of the members. The member-managers granting the consent must each own a one percent ownership interest in the LLC. If the LLC has nonmember managers, the consent must be given by a majority of the members. "Majority" may mean per capita, majority-in-capital only, majority-in-profits interest only, or majority-in-interest similar to that described in connection with continuity of life. The majority-interest test for free transferability of interest is more flexible than the continuity-of-life test. The restriction limiting free transferability must be meaningful. This means that consent may be withheld even if the refusal to consent is done unreasonably. The default rules of most LLC statutes will cause an LLC to lack free transferability of interest automatically. The default rules require that each member must receive consent to transfer their entire ownership interests from either all the other members or a majority-in-interest of the other members. An LLC may be drafted to provide flexibility in regards to free transferability of interest. The LLC may be drafted so that only slightly more than 20% ownership interest in the LLC is restricted. If there are member-managers, then a majority of the managers will have the right to consent to the transfer of the restricted ownership interest. In most closely-held LLCs, the meaningful-restriction limitation is not a hindrance. An LLC may be drafted to provide for the transfer of ownership interests to permitted transferees without the other members' consent. The permitted transferees may be family members or those who are transferees by operation of law. Although this technique should work, it may be better to provide that the permitted transferees will only be assignees.

H. Failing the Rev. Proc. 95-10 Guidelines Does Not Mean You Automatically Fail to be Classified as a Partnership for Federal Income-Tax Purposes

## **D-14 Adv. Drafting: Estate Plan & Probate, 1995**

If an LLC fails to comply with the Rev. Proc. 95-10 guidelines, the LLC has not automatically flunked its classification as a partnership for federal income-tax purposes. If the LLC is outside the guidelines, the LLC may still be classified as a partnership for federal income-tax purposes, but it must prove its status as a partnership under the 301.7701 Treasury Regulations. If the LLC meets the guidelines of Rev. Proc. 95-10, you can take reasonable comfort that you have an LLC that will be classified as a partnership. This is especially true in the continuity-of-life area.

### **III. SIMPLIFICATION OF ENTITY CLASSIFICATION RULES (IRS Notice 95-14, 1995-1 C.B. 7)**

On March 29, 1995, the Service issued Notice 95-14 announcing a proposed simplification of entity-classification rules. The Service and the Treasury Department are considering simplifying the classification regulations to allow taxpayers on an elective basis to treat domestic, unincorporated business organizations as partnerships or as associations. The notice recognizes the narrowing in the past several years of the differences under local law between corporations and partnerships. The consequence of this is that taxpayers are able to achieve partnership tax treatment for entities that are almost indistinguishable from corporations. The Notice acknowledges the considerable resources that are expended to determine the proper classification for "domestic, unincorporated business organizations".

If the classification regulations are simplified, taxpayers may elect to treat domestic, unincorporated business organizations as either partnerships or associations for federal income-tax purposes. Unless classification is determined by another Internal Revenue Code provision, it is anticipated that any unincorporated organization with two or more associates and an objective to carry on business and divide the profits will be eligible to make the election. An example of another Code section governing classification is Code §7704 which classifies publicly traded partnerships as corporations. All affirmative elections will be prospective from the date the election is filed or a later date designated in the election. Retroactive elections will not be allowed. All members will be required to execute the elections. After the election is made, it will be binding on all members until superseded by a subsequent election.

The Notice proposes that an entity that elects to change classification will be subject to the same federal tax consequences that exist under current law. If an organization that is classified as an association and taxable as a corporation elects to be classified as a partnership, the election will be treated as a complete liquidation of the corporation and a formation of a new partnership. This will require a final return for the corporation and a first-year return for the partnership. The new partnership will also have to ensure that its allocations comply with Code §704(b) and its accompanying regulations.

It is proposed that a new unincorporated business organization that does not make an affirmative election will automatically be treated as a partnership for federal income-tax purposes. Unless an affirmative election is made, existing entities will retain their current classification status.

## Drafting Guide to the LLC D-15

Some state LLC statutes have taken a conservative approach concerning classification issues. These "bulletproof" state statutes that do not allow divergence from a strict structure that guarantees compliance with the classification rules will be at a disadvantage if the proposal announced in Notice 95-14 becomes reality.

### IV. ALLOCATIONS

LLCs have tremendous flexibility to allocate their profits and losses, which is one of the principal advantages of an LLC over an "S" Corporation. Code §704(b) defines "substantial economic effect" and requires that all allocations in a partnership must have substantial economic effect. Most partnership tax lawyers, however, will say they don't understand what the regulations are really saying in regards to the definition of "substantial economic effect". It is generally agreed that if a member is going to take a deduction or if a member is going to be allocated income from an LLC's operations, that allocation must be reflected in that member's capital account. It is also agreed that "at the end of the day", the member must receive liquidating distributions in accordance with that member's positive capital accounts balance. The bottom line is that the tax benefits or liabilities follow the dollars. An LLC must be drafted in accordance with the allocation requirements of Code §704(b) and its accompanying regulations.

### V. METHODS OF ACCOUNTING

#### A. Importance of Cash Method of Accounting to LLC Members

Methods of accounting are a dry topic. They can be critically important, however, to certain clients who are interested in forming an LLC. Often the owners of LLC membership interests want to make sure they can use the cash method of accounting for the LLC. Taxpayers don't want to pay income on money they do not receive. Thus, the cash method of accounting is very important to LLC members.

B. What Methods of Accounting May an LLC Use? Under Code §446(c), a number of permissible methods of accounting may be used that include the accrual and cash methods of accounting. The exception to this general rule under Code §448(a) is that "C" corporations, partnerships with "C" corporations, and tax shelters may not use the cash method of accounting. An exception to the exception, however, is the \$5 million gross-receipts test. If the corporation or partnership cash receipts is less than \$5 million, the corporation or partnership may be on the cash method of accounting. This \$5 million gross-receipts test does not apply to tax shelters. The question becomes whether the LLC can qualify for the cash method of accounting. An LLC is not a corporation, but it is a partnership for tax purposes. Thus, an LLC under Code §446(c) will be eligible for either the accrual or cash method of accounting. Even though an LLC is a partnership, if it is a tax shelter, it will not be able to use the cash method of accounting. An LLC that is a partner with a "C" Corporation will not be eligible for the cash method of accounting unless it has less than \$5 million in gross receipts.

#### C. When Is an LLC a Tax Shelter?

## D-16 Adv. Drafting: Estate Plan & Probate, 1995

If an LLC is a tax shelter, it will not be able to use the cash method of accounting. If an LLC is a general operating business, it will not be a tax shelter. The problem is that after all the cross references in the Code are followed, there are several troubling tax rules that emerge. The LLC will be treated as a tax shelter if the LLC is treated as an enterprise, a syndicate, or a tax shelter under Code §6662. The definition of a tax shelter under Code §6662 is one that most laymen will consider to be a tax shelter. This means that most LLCs our clients create are not tax shelters under this definition, and this Code section will not effect most LLCs we create.

### D. When Is an LLC an Enterprise?

Under Code §461(i)(3), an LLC will be an enterprise classified as a tax shelter if at any time interests in the LLC to be offered must be registered with a state or federal agency. The temporary regulations under this Code section define "registration" to mean that under applicable federal or state law a notice of exemption from securities registration must be filed with the state agency. Thus, the LLC may be eligible to make an offering of its membership interests that is exempt from registration under the securities laws and be eligible to use the cash method of accounting. But if the LLC must file a notice document with the state securities agency to comply with the exemption, the LLC will be an enterprise and may not use the cash method of accounting. This test only applies if the LLC interest in question will be classified as a security.

### E. When Is an LLC a Syndicate?

Under Code §1256, a syndicate is any entity that has more than 35% of the entity's taxable losses in a taxable year allocable to limited partners or limited entrepreneurs. Allocable means actually allocated. The term "limited entrepreneur" means a person who has an interest in an enterprise other than as a limited partner and does not actively participate in the enterprise's management. An ownership interest in an entity is not held by a limited partner or limited entrepreneur if that ownership interest is owned by an individual who actively participates at all times during that tax year in the entity's management. This section does not pertain to "C" corporations. If the LLC does not have any losses, it does not come within the definition of syndicate. But what happens in a year where 35% of the LLC's losses are allocated to limited entrepreneurs? Before this question can be answered, the question of whether LLC members are limited entrepreneurs must be answered. In the Treasury Regulations, an interest in an entity is not treated as being held by limited entrepreneurs if the holder of the interest actively participates at all times in the entity's management. If an LLC is member-ruled and all members are participating in the LLC's management, the LLC will not be a syndicate even though 35% of the LLC's losses are allocated to the members.

### F. When May a Member-Ruled Professional LLC Use the Cash Method of Accounting?

If the LLC is a professional LLC, the LLC must be member-ruled, and all members must participate in management in varying degrees. The members of a professional LLC may establish an executive committee to handle the day-to-day management of the LLC's professional practice. Delegating many of the management responsibilities to an "Executive Committee" does not preclude a conclusion that the members actively participate in management. An LLC will be eligible for the cash method of accounting if:

## Drafting Guide to the LLC D-17

- ? it is member-ruled;
- ? its does not have to register or file notice with a state or federal securities agency; and
- ? all its members participate in the LLC's management.

### G. When May a Manager-Ruled Professional LLC Use the Cash Method of Accounting?

In PLR 9321047 and PLR 9328005, a professional manager-ruled LLC was permitted to use the cash method of accounting. In these rulings, the LLCs met all requirements necessary to use the cash method of accounting despite the fact that the members delegated the LLC's management to member-managers. These rulings support the position that members of a manager-ruled LLC are not necessarily limited entrepreneurs. In each ruling, the LLC members elected managers to a management committee. All the managers were members of the LLC. The management committee had the authority and responsibility to manage the LLC. The members, however, were required to vote on certain key matters, such as

- ? election of members to the management committee;
- ? election of members to the compensation committee;
- ? admission of a member or provisional member;
- ? removal of a member from a committee;
- ? dismissal of a member;
- ? amendment of the Regulations;
- ? dissolution of the LLC;
- ? major decisions facing the LLC; and
- ? approval of compensation committee recommendations.

## VI. THE CONVERSION OF AN EXISTING ENTITY TO AN LLC

What happens when an existing entity converts to an LLC? As a general rule, there will be adverse tax consequences if a "C" corporation is converted to an LLC. If the "C" corporation is converted to an LLC, the corporation will be deemed to have liquidated, creating two levels of tax. One level of tax is at the corporate level, and the second level of tax is at the shareholder level. If an "S" corporation is converted to an LLC, the corporation will also be deemed to have liquidated, and there will be at least one level of tax. If a partnership is converted into an LLC, the conversion is treated as a continuation of the partnership under Code §708. In most cases, converting a partnership to an LLC does not create a taxable event. When a partnership converts to an LLC, there is no requirement to obtain a new taxpayer ID number.

## VII. NET INCOME FROM SELF-EMPLOYMENT

### A. Introduction to Self-Employment Income

Until recent guidance from the Service, the treatment of a member's share of an LLC's income and loss for self-employment tax purposes was uncertain. This apparently minor issue can be very important in many circumstances. The self-employment income of every individual is subject to taxation under the Self-Employment Contributions Act and an uncapped 2.9% Medicare tax, although there is a deduction for half the self-employment taxes paid. Under Code §1402, self-employment income includes a partner's distributive share of net income and loss from a partnership engaged in a trade or business. An LLC, for federal income-tax purposes, will be treated as a partnership. The only exception is that a limited partner's distributive share of income or loss will generally not be included in net income from self-employment. This determination of whether members will be subject to the rules developed for general partners or limited partners arises in virtually every important tax question involving LLCs.

### B. Is it Better to Do Business as an LLC or Limited Partnership?

The answer often turns on whether the allocated income to a member of an LLC or a partner of a limited partnership is going to be treated as self-employment income. Whether an LLC's members are going to be treated as general partners or limited partners must be determined when deciding if an LLC's members will recognize allocated income as net income from self-employment. A member's decision to be treated as a general partner or a limited partner depends on whether it is better to have the income (from the entity's business activities) to the member treated as net income from self-employment. Taxpayers have two competing objectives concerning this issue. On one hand, passive investors would like to use an LLC to do business and not have the allocated income treated as self-employment income. On the other hand, individuals involved in LLCs operating a personal service business need the income to be treated as net income from self-employment. These individuals need to use that income to make contributions to retirement plans.

### C. When is Income Net Income from Self-employment?

## Drafting Guide to the LLC D-19

A partnership that has income will allocate its income among its partners. A partner's allocable share of income from a partnership will generally be treated as net income from self-employment if the partnership is engaged in a trade or business. The partners of a general partnership engaged in a trade or business who are allocated income from the partnership's trade or business operations must treat the allocated income as self-employment income. An exception: If the partnership's income is dividends, interest, or rents from real property, however, the income will not be treated as net income from self-employment. Another exception: The net income allocated to limited partners will not be treated as self-employment income unless the net income is a payment for services rendered by the limited partner. If an LLC is a member-ruled LLC engaged in a trade or business, the income from that LLC will be net income from self-employment unless the income is from interest, dividends, or rent from real property. If an LLC is a manager-ruled LLC engaged in a trade or business, the income from the LLC will be net income from self-employment unless the income is from interest, dividends, or rent from real property or unless a member qualifies for the exception in proposed Treas. Reg. ?1.1402(a)-18. The exception under proposed Treas. Reg. ?1.1402(a)-18 applies when the LLC members engaged in a trade or business are treated as limited partners. The Service in proposed Treas. Reg. ?1.1402(a)-18 attempts to solve this dilemma by identifying those LLC members who are analogous to limited partners. The members of an LLC engaged in a trade or business will be treated as limited partners if:

? the Member is not a manager of the LLC;

? the LLC is engaged in a business that may also be engaged in by a limited partnership in the same jurisdiction; and

?the member is eligible to be a limited partner if the business was operated as a limited partnership.

### D. Can Limited Partnerships Provide Professional Services?

The Service believes that professionals (such as lawyers, accountants, etc.) who provide professional services may not do business as a limited partnership. At least one state, however, allows professionals to provide their professional services through a limited partnership. Professional corporation acts and professional LLC acts provide safeguards to insure that nonlicensed individuals do not provide professional services. If these types of safeguards are applied to limited partnerships, there is no philosophical hindrance limiting professionals from providing their professional services through a limited partnership. The income to a member of an LLC providing a professional service should not be classified as self-employment income if:

?the member is a licensed professional;

?a limited partnership can provide that professional service in that particular jurisdiction;

?the professional can qualify as a limited partner;

?the professional is a nonmanager member;

?the professional is not providing professional services on the LLC's behalf; and

## D-20 Adv. Drafting: Estate Plan & Probate, 1995

?the LLC is authorized to provide that professional service in that particular jurisdiction.

### E. An Unanswered Question

Still unanswered: Whether a member who is both a member-manager and a member acting as a passive investor may treat part of his or her allocable income as net income from self-employment and the balance as income that is not self-employment income. The allocable income received by the member-manager in the capacity as member-manager will be net income from self-employment. Under the proposed Treasury Regulations, that portion of the member's income received as a passive investor will also be treated as net income from self-employment, because that member in the capacity as a passive investor is also a member-manager. Thus, a manager-ruled LLC where a member is both a manager (analogous to a general partner) and a member acting as a passive investor (analogous to a limited partner) will be treated differently (for purposes of determining what is net income from self-employment) from a partner in a limited partnership. In a limited partnership, the allocable income of a partner in the capacity as general partner will be net income from self-employment. The allocable net income of that partner in the capacity as limited partner will not be net income from self-employment. The different treatment of allocable income to an LLC member from that of a partner in a limited partnership is another example of how an LLC is treated differently from a limited partnership by the Service. At this time, it does not appear that an LLC member who is both a member-manager and a passive investor may split the tax treatment on his or her allocable share of income from the LLC.

## VIII. CHAPTER 14 CONSIDERATIONS

Under Code ?2704(b) of Chapter 14, substantially different transfer-tax results occur depending on the type entity and the state law governing the entity. The value of interest in a family business gifted or transferred at death from one family member to another may vary tremendously. The value often depends upon whether the transferee has the ability to liquidate his or her interest or to force the entity to liquidate in total. If the entity can be liquidated, the transferred interest in the entity will be determined based upon the liquidation value of the underlying assets. If the entity cannot be liquidated, the value of the underlying assets becomes irrelevant. The cash flow that will be distributed to the entity's owners becomes the important factor. This method of determining value based upon cash flow is called the "distributable-cash-flow method" or "going-concern-value method". For the distributable-cash-flow method to be available to transfers among family members, the default provisions of the state law governing the entity must provide that an owner may not unilaterally cause the entity's liquidation.

Under Code ?2704(b), if the entity has an applicable restriction, that restriction's effect on value will be disregarded. The default provision of state law affecting the entity's ability to liquidate will replace the applicable restriction and will be used to determine the value of the interest transferred. Transfers of ownership interests between family members that are subject to restrictions that affect the transferred interest's value may be applicable restrictions. If the restriction is an applicable restriction and that restriction can be removed by the family, its effect on determining value will be ignored. An applicable restriction is a limitation on an entity's ability to liquidate, in whole or in part, that is more restrictive than a limitation imposed by state law. In addition, one of the following conditions must also exist:

## Drafting Guide to the LLC D-21

? at any time after an ownership interest in the entity is transferred, the limitation lapses by its own terms; or

? the transferor, transferor's estate, or member of the transferor's family may remove the restriction immediately after the transfer of an ownership interest in the entity.

Because of their applicable default provisions of state law, limited partnerships have been the entity of choice in estate plans to achieve valuation discounts applicable to ownership interests transferred among family members. Many commentators have debated whether LLCs may also be used to achieve similar discounts. For the reasons discussed below, limited partnerships are still the superior entity to achieve favorable valuation discounts. Two problems arise if an LLC is used instead of a limited partnership. First, under most state statutes, LLC members may withdraw from the LLC at will. After a member withdraws, the member is entitled to receive fair value for his or her interest in a reasonable period of time. Second, under most LLC acts, a member's withdrawal automatically causes the LLC to have an event of dissolution. If a dissolution event occurs, the LLC will liquidate unless all remaining members consent to reconstitute and continue the LLC. In limited partnerships, however, limited partners may not withdraw at will in a term limited partnership. Even if the limited partners may withdraw at will, a limited partner's withdrawal does not cause an event of dissolution. Only a general partner's withdrawal will be an event of dissolution. If a general partner withdraws, all remaining general partners must consent to reconstitute and continue the limited partnership. The limited partners do not vote as to whether the limited partnership may continue after a general partner's withdrawal unless there are no remaining general partners. If all members must consent to continue an entity that has had an event of dissolution, any one member may prevent the entity from continuing. Thus, an ownership interest in an entity requiring unanimous consent to continue the entity may be discounted less than that of an entity that does not require unanimous consent to continue. If many owners must vote to continue the entity, it is more likely that one will not vote to continue, which causes the entity to liquidate. If only a few owners must vote to continue the entity, it is more likely that those owners will vote to continue the entity.

Most LLC acts provide a put right for a member's membership interest when the member withdraws from the LLC. Four different methods have been adopted by LLC statutes. They are as follows: First, the traditional partnership approach, which has been adopted by the Uniform LLC Act, provides that a member of a term LLC does not have a put right. A member of a nonterm LLC, however, does have a put right.

Second, the Arizona approach states that if an LLC is family-controlled within the meaning of Code §2704(b), a member has the right to put the member's interest to the LLC. But the amount the member may receive is similar to what a member may receive under a discounted-cash-flow method of determining value. The assets are treated as if they are locked into the LLC for a 25-year period.

? Third, the Colorado approach, referred to as the "hotel Colorado approach", states that an LLC member may leave at any time and, thus, cut off that member's fiduciary duties. But that interest is converted into an assignee's interest, and an assignee of a converted membership interest may not withdraw from the LLC. The member may leave the LLC but not check out.

## D-22 Adv. Drafting: Estate Plan & Probate, 1995

? Fourth, the Texas approach is that a member may not terminate the member's membership interest in the absence of a contractual provision in the regulations. A member of a Texas LLC may not withdraw from the LLC unless the regulations specifically give the member that right. In effect, Texas has made each LLC's regulations the default provision of state law as to that LLC.

One real problem with utilizing an LLC instead of an FLP is that the Laundry List items cause the LLC to dissolve under the state-law default rule. Unless the remaining members unanimously consent to reconstitute and continue the LLC, it will be forced to liquidate. Whether or not the LLC is member-ruled or manager-ruled does not change this result. In an FLP with multiple general partners, the Laundry List items cause the FLP to dissolve unless all remaining general partners consent to reconstitute and continue. The limited partners do not vote on whether the FLP may continue or liquidate. Upon an event of dissolution, every member of an LLC may vote, and one negative vote may prevent the LLC from continuing. If an event of dissolution occurs, an LLC is more likely to liquidate than an FLP.

### IX. PRIVATE LETTER RULINGS LACKING FREE TRANSFERABILITY OF INTEREST OR CENTRALIZATION OF MANAGEMENT WHEN AN LLC'S MEMBERS ARE CONTROLLED BY A COMMON SOURCE

#### A. PLR 9510037

In PLR 9510037, a parent organization has two wholly owned subsidiaries. The two subsidiaries formed a Texas LLC. The LLC will dissolve upon any member's resignation, expulsion, bankruptcy, or dissolution or any other event that terminates a member's continued membership in the LLC. In addition, the LLC will dissolve upon the attempted transfer of a membership interest in contravention of the transfer restrictions in the regulations. The LLC's regulations provide that LLC membership is restricted to the initial members; that no membership interest, in whole or in part, may be assigned; and that no new members may be admitted. The initial members may transfer membership interest between themselves. The LLC lacked the corporate characteristics of continuity of life and free transferability of interest, even though both subsidiaries were controlled by the parent organization.

#### B. PLR 9507004

In PLR 9507004, a parent organization owns a wholly-owned subsidiary. The parent organization and its wholly-owned subsidiary form an LLC. The LLC will dissolve upon any member's death, retirement, resignation, bankruptcy, or dissolution or any other event that terminates a member's continued membership in the LLC. The LLC's operating agreement provides that no member may sell, transfer, or assign its interest in the LLC. It further provides that if any member sells, transfers, or assigns its interest in the LLC, the LLC will dissolve. The LLC lacked the corporate characteristics of continuity of life and free transferability of interest, even though the parent organization controlled the subsidiary and the LLC.

#### C. PLR 9320045

## Drafting Guide to the LLC D-23

In PLR 9320045, an individual formed a corporation. The individual contributed one percent ownership in oil and gas properties to the corporation. The individual owned all the stock and was the sole director of the corporation. The individual and the corporation formed an LLC. The individual contributed 99% interest in the oil and gas properties to the LLC, and the corporation contributed its one percent ownership interest in the oil and gas properties to the LLC. The LLC was member-ruled, although the corporation managed the day-to-day affairs of the oil and gas properties through a management agreement. The LLC will dissolve upon any member's death, retirement, resignation, expulsion, bankruptcy, adjudication of insanity, incompetency or incapacity, or dissolution or any other event that terminates a member's continued membership in the LLC. The LLC lacked the corporate characteristics of continuity of life and centralization of management, even though the individual controlled the corporation and the LLC.

### X. USE OF AN LLC WITH AN FLP

#### A. An LLC Acting as General Partner of an FLP

In drafting an FLP, having an entity serve as the general partner is often useful. An LLC makes an excellent general partner because the LLC's ownership is not limited to certain types of shareholders as in an "S" corporation. The LLC may also assist in obtaining additional creditor protection. One disadvantage of using an LLC as the general partner is: If the LLC dissolves upon a member's death, bankruptcy, retirement, etc., the LLC will suffer an event of dissolution. This event of dissolution requires that all remaining members consent to continue the LLC. If the LLC dissolves because any member votes against continuing the LLC, the LLC's dissolution will be an event of dissolution for the FLP, which we want to avoid. I normally draft an LLC acting as a general partner of an FLP to lack:

- ? centralization of management by making it member-ruled;
- ? free transferability of interest by restricting the transfer of ownership interest in the LLC without the consent of all remaining members; and
- ? continuity of life by providing that the LLC will dissolve only upon the bankruptcy of any member unless the holders of a majority in interest in the capital and profits of the remaining members elect to continue.

If only bankruptcy causes an LLC to lack continuity of life and if only holders of a majority in interest in the capital and profits of the remaining members may elect to continue, the likelihood that the LLC will dissolve is substantially lessened. Before Rev. Proc. 95-10, I drafted the LLC as described above, except I provided that the LLC would not dissolve upon a member's death, bankruptcy, resignation, etc. This resulted in the LLC having the corporation characteristic of continuity of life. After Rev. Proc. 95-10, I can insure that the LLC lacks continuity of life and accomplish almost the same benefit to the LLC as I formerly accomplished by making the LLC have the corporate characteristic of continuity of life.

#### B. Using an LLC as a General Partner of a Subsidiary Limited Partnership ("Sub-LP")

## D-24 Adv. Drafting: Estate Plan & Probate, 1995

In an estate plan that uses an FLP, to accomplish creditor protection and maximum income and franchise-tax benefits, it is often necessary to form a Sub-LP. The Sub-LP will hold high-risk assets or operate an active business. To insure that the parent FLP is fully protected and has limited liability from the Sub-LP's assets or business operations, a limited liability entity needs to serve as the Sub-LP's general partner. The Sub-LP's general partner may be a "C" corporation or an LLC. An "S" corporation may not be used as the Sub-LP's general partner, because the parent FLP's ownership of the corporation's stock will prevent the corporation from electing status as an "S" corporation. If a corporation is used as the Sub-LP's general partner, there is no pass-through for federal income-tax treatment from the corporation to the parent FLP. If an LLC is used as the Sub-LP's general partner, the parent FLP may hold the membership interest in the LLC. The pass-through treatment for federal income-tax purposes will then be preserved.

In drafting an LLC as a Sub-LP's general partner, the LLC must be classified as a partnership for federal income-tax purposes. The LLC general partner of the Sub-LP will typically be owned 50% by the general partner of the parent FLP and 50% by the parent FLP. I normally draft an LLC acting as a Sub-LP's general partner to lack the following corporate characteristics:

- ? centralization of management by making it member-ruled;
- ? free transferability of interest by preventing the transfer of ownership interest in the LLC and requiring that the LLC dissolve if the ownership interest is transferred as outlined in PLR 9510037 summarized above; and
- ? continuity of life by providing that the LLC will dissolve only upon the bankruptcy of any member unless the holders of a majority in interest in the capital and profits of the remaining members elect to continue.

## XI. CONCLUSION

This article and the attached sample documents have incorporated the latest revisions to the TLLCA and the Service's most current positions in regards to LLCs. The law is developing very quickly, and the Service is making new pronouncements concerning LLCs constantly. Blind use of the sample documents without modification to fit your client's facts and circumstances or to incorporate the Service's latest pronouncements will be hazardous to your legal health.