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Taxation of an Ohio Limited Liability Company under Revenue Procedure 95-10

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NOTES

TAXATION OF AN OHIO LIMITED LIABILITY COMPANY UNDER REVENUE PROCEDURE 95-10

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I. INTRODUCTION

Ohio business planners have spent many sleepless nights searching for the perfect form of business organization. In their endless efforts to combine the "pass-through" tax treatment of partnerships[1] with the limited liability of corporations,[2] business planners have found themselves restrained by the limitations of Subchapter S corporations[3] and limited partnerships.[4] In 1994, the Ohio General Assembly created a new type of organization that combines the favorable attributes of several organizational forms, the limited liability company (LLC).[5] An Ohio LLC can obtain the pass-through tax treatment of

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1. Partnerships enjoy "pass-through" income tax treatment because a partnership is not a taxable entity under the federal income tax laws and, therefore, is not subject to taxation. I.R.C. § 701 (1988). The partnership's income, gains, and losses flow to the partners and are reported on the partners' personal income tax returns.

2. Shareholders of a corporation have limited liability for corporate obligations. HARRY G. HENN, HANDBOOK OF THE LAW OF CORPORATIONS AND OTHER BUSINESS ENTERPRISES (2d ed. 1970). Limited liability shields shareholders from personal liability for the corporation's debts and obligations, unless the shareholder contracts to be personally liable or the shareholder commits a personal tort. *Id.*; *see infra* notes 59-63 and accompanying text.

3. A Subchapter S corporation is a corporation in which the shareholders elect to be taxed under Subchapter S of the Internal Revenue Code (I.R.C.). The shareholders may elect Subchapter S status only if they unanimously vote to do so, and (1) there are no more than 35 shareholders; (2) all of the shareholders are either individuals, partnerships, or certain kinds of trusts; (3) there is only one class of stock; and (4) no shareholder is a non-resident alien. I.R.C. § 1361(b) (1988).

4. Limited partnerships provide limited liability to their limited partners, but require at least one general partner to be personally liable for all of the partnership debts. OHIO REV. CODE ANN. § 1784.24 (Anderson 1994). Limited partners cannot actively participate in the management of the partnership and retain the protection of limited liability. *Id.* § 1782.19.

5. The Governor signed Ohio Substitute Senate Bill 74 [hereinafter LLC Act] on April 1, 1994, and

a partnership for federal income taxation purposes and the limited liability protection of a corporation without the organizational and managerial restrictions that plague the Subchapter S corporation and the limited partnership.[6]

In January 1995, the Internal Revenue Service (IRS or Service) issued Revenue Procedure 95-10,[7] which provides the factors and circumstances the IRS considers when ruling that a LLC will be taxed as a partnership and not an association.[8] In order for an Ohio LLC to be taxed as a partnership for federal income taxation purposes, a LLC must lack at least two of the following four corporate characteristics: limited liability,[9] free transferability of interest,[10] centralized management,[11] and continuity of life.[12] The Ohio LLC Act contains

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the Bill became law on July 1, 1994. *See id.* §§ 1705.01-.58. The Ohio Legislature, in the LLC Act, created another new entity, the limited liability partnership (LLP). The LLP, however, is beyond the scope of the Note.

6. Steven A. Martin, *Senate Bill 74: LLC's and More Expanded Flexibility for Ohio Businesses and Professionals*, 94-65 OHIO CONTINUING LEGAL EDUC. INST. 1.1, 1.10 (1994) (this reference manual can be obtained through the Ohio CLE Institute, P.O. Box 8, Columbus, OHIO 43216-0008, 1-800-232-7124 or (614) 487-8585). Many commentators predict that the LLC will replace Subchapter S corporations and limited partnerships as the preferred form of business organization in states that have adopted LLC statutes. One commentator recognized that "the advent and growth of the LLC may relegate the place of Subchapter S to a historical footnote." Brian L. Schorr, *Limited Liability Companies: Considerations in Choosing a Business Entity*, *in* FORMING AND USING LIMITED LIABILITY COMPANIES AND LIMITED LIABILITY PARTNERSHIPS 1994, at 171 (Corporate Law and Practice Course Handbook Series No. B-836, 1994). The former Commissioner of the Internal Revenue Service (IRS), Jerome Kurtz, stated that "LLCs will come to be the vehicle of choice for most new non public entities." Jerome Kurtz, *The Limited Liability Company and the Future of Business Taxation: A Comment on Professor Berger's Plan*, 47 TAX L. REV. 815, 832 (1992). Another analyst commented that "[i]t is difficult to conceive of a reason why any business that in the past would have adopted a general partnership form will not in the future use an LLC." Richard L. Parker, *Corporate Benefits Without Corporate Taxation: Limited Liability Company and Limited Partnership Solutions to the Choice of Entity Dilemma*, 29 SAN DIEGO L. REV. 399, 469 (1992). Finally, Larry E. Ribstein, the reporter for the American Bar Association Prototype Limited Liability Company Act stated that "the partnership form of business will greatly diminish in importance . . . [and] [a]fter a transitional period, partnership will survive, if at all, as a residual form for firms that have no customized agreement." Larry E. Ribstein, *The Deregulation of Limited Liability and the Death of Partnership*, 70 WASH. U. L.Q. 417 (1992).

7. Rev. Proc. 95-10, 1995-3 I.R.B. 20. A revenue procedure is an official statement of a procedure that affects the rights and duties of taxpayers. Rev. Proc. 89-14, 1989-1 C.B. 814. A revenue ruling is an official interpretation by the IRS of the I.R.C. *Id.* Revenue procedures do not have force of law status, but only represent the IRS's policy for issuing revenue rulings. *See* Clark v. Modern Group, 9 F.3d 321, 335 (3d Cir. 1993); Virginia Educ. Fund v. Commissioner, 799 F.2d 903, 904 (9th Cir. 1986); United States v. Toyota of Visalia, 772 F. Supp. 481, 486 (E.D. Cal. 1991), *aff'd*, 988 F.2d 126 (9th Cir. 1993). Revenue rulings also do not have force of law status, but only express the IRS's response to a specific question raised by a taxpayer concerning his tax liability. Rev. Proc. 89-14, 1989-1 C.B. 814. The purpose of revenue procedures and revenue rulings is to promote uniform application of the tax laws. *Id.*

8. An "association" is "an organization whose characteristics require it to be classified for purposes of taxation as a corporation rather than as another type of organization such as a partnership or a trust." Treas. Reg. § 301.7701-2(a) (as amended in 1993).

9. Generally, an organization has the characteristic of limited liability if, under local law, no member of the organization is personally responsible for the debts of or the claims against the organization. *Id.* § 301.7701-2(d)(1); *see also infra* notes 59-63 and accompanying text.

10. Generally, an organization possesses the characteristic of free transferability of interest if each of its members, without the consent of the other members, may substitute a person who is not a member of the organization for themselves. Rev. Proc. 95-10, 1995-3 I.R.B. 20, 23; Treas. Reg. § 301.7701-2(e)(1); *see also infra* notes 132-44 and accompanying text.

11. Generally, an organization possesses the characteristic of centralized management if any person or

default provisions that guarantee a LLC formed under them will lack all of the four characteristics and, therefore, be classified as a partnership for federal taxation purposes.[13] The planner, however, in the operating agreement, may alter the default provisions of the LLC Act and organize a LLC so that the LLC technically lacks at least two of the corporate characteristics as defined in Revenue Procedure 95-10 while the LLC, for all practical purposes, retains those respective characteristics.

This Note discusses the provisions of the Ohio LLC Act that are relevant to the classification of a LLC for federal taxation purposes and examines how a LLC can be organized to technically satisfy Revenue Procedure 95-10 while retaining all four of the corporate characteristics for all practical purposes. First, Section II briefly discusses the evolution of the LLC and the Ohio LLC Act.[14] Second, Section II identifies the Ohio LLC Act as a "flexible" LLC statute[15] and discusses the provisions of the Ohio LLC Act that are relevant to classification, such as ownership,[16] changes in membership,[17] liability of the members,[18] management structures,[19] and dissolution.[20] Third, Section II traces the historical development of the classification criteria found in Revenue Procedure 95-10.[21] Section III examines how to organize an Ohio LLC to satisfy the requirements of Revenue Procedure 95-10 while maximizing the flexibility of the LLC.[22] This Note, in Section IV, concludes that the LLC will supersede both partnerships and Subchapter S corporations and will become the preferred business entity for any business that in the past would have adopted either a partnership or Subchapter S corporation form.

II. BACKGROUND

European and Latin American countries were among the first to create LLC-type entities.[23] In the United States, Wyoming passed the first LLC act

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group of persons, which does not include all of the members, has continuing exclusive authority to make management decisions necessary to the conduct of the business for which the organization was formed. Rev. Proc. 95-10, 1995-3 I.R.B. 20, 23-24; Treas. Reg. § 301.7701-2(c)(1); *see also infra* notes 145-54 and accompanying text.

12. Generally, an organization possesses the characteristic of continuity of life if the death, insanity, bankruptcy, retirement, resignation, or expulsion of any member will not cause a dissolution of the organization. Rev. Proc. 95-10, 1995-3 I.R.B. 20, (§ 5.01); Treas. Reg. § 301.7701-2 (b)(1); *see also infra* notes 109-31 and accompanying text.

13. *See infra* notes 35-45 and accompanying text.

14. *See infra* notes 23-34 and accompanying text.

15. *See infra* notes 35-45 and accompanying text.

16. *See infra* notes 49-52 and accompanying text.

17. *See infra* notes 53-58 and accompanying text.

18. *See infra* notes 59-63 and accompanying text.

19. *See infra* notes 64-70 and accompanying text.

20. *See infra* notes 71-76 and accompanying text.

21. *See infra* notes 77-106 and accompanying text.

22. *See infra* notes 107-54 and accompanying text.

23. Martin, *supra* note 6, at 1.11. The German "Gesellschaft mit beschrankter Haftung" (company with limited liability) first provided the combination of pass-through taxation with limited liability in a single

in 1977.[24] Other states were slow to respond to Wyoming's lead because of uncertainty regarding the IRS's treatment of the entity.[25] Prior to 1990, Florida was the only other state to adopt a LLC act.[26] In 1988, the IRS issued Revenue Ruling 88-76, which classified a LLC formed in Wyoming as a partnership for federal income taxation purposes.[27] Although not having the force of law, this Revenue Ruling indicated that the IRS would take this position for all LLCs.[28] As a result, forty-seven states plus the District of Columbia have adopted LLC acts.[29]

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entity. *Id.* Soon thereafter, some South American countries, for example Argentina, Brazil and Chile, permitted the formation of similar organizations known as "sociedad de responsabilidad limitada" (Limitada). Raul Anibal Etchererry, *The Mercosur: Business Enterprise Organization and Joint Ventures*, 39 ST. LOUIS U. L.J. 979, 992-93 (1995).

24. Act of March 4, 1977, ch. 155, 1977 Wyo. Sess. Laws 512, WYO. STAT. §§ 17-15-101 to -136 (1989). One commentator noted that oil companies requested that the benefits of the Limitada be available to the United States. Thomas E. Geu, *Limited Liability Companies: Gaining Momentum*, PROB. & PROP., Nov.-Dec. 1993, at 47, 47. The Wyoming Legislature, however, insisted that the purpose of the Act was to lure additional business to the state. *See id.* This objective, however, was not accomplished because the IRS did not take an affirmative stance on the federal income tax status of a LLC until 1988. *See* Martin, *supra* note 6, at 1.11.

25. *See* Martin, *supra* note 6, at 1.11.

26. Robert R. Keatinge et al., *The Limited Liability Company: A Study of the Emerging Entity*, 47 BUS. LAW. 378, 383-84 (1992); Florida Limited Liability Company Act, 1982 Fla. Laws ch. 82-177 (codified at FLA. STAT. ANN. §§ 608.401-.471 (West 1993)).

27. Rev. Rul. 88-76, 1988-2 C.B. 360, 361. Revenue Rulings generally are the IRS's answer to a specific question raised by a taxpayer concerning the taxpayer's tax liability. Revenue Rulings reflect the IRS's current policies, but do not have the force and effect of the Regulations.

28. Since 1988, the IRS has issued eighteen Revenue Rulings for LLCs formed in other states. *See* Rev. Rul. 95-9, 1995-3 I.R.B. 17 (S.D.; Jan. 17, 1995); Rev. Rul. 94-79, 1994-51 I.R.B. 7, 8 (Conn.; Dec. 19, 1994); Rev. Rul. 94-51, 1994-32 I.R.B. 11, 13 (N.J.; Aug. 8, 1994); Rev. Rul. 94-30, 1994-19 I.R.B. 6, 8 (Kan.; May 9, 1994); Rev. Rul. 94-6, 1994-3 I.R.B. 11, 13 (Ala.; Jan. 18, 1994); Rev. Rul. 94-5, 1994-2 I.R.B. 21, 23 (La.; Jan. 10, 1994); Rev. Rul. 93-93, 1993-42 I.R.B. 13, 16 (Ariz.; Dec. 27, 1993); Rev. Rul. 93-92, 1993-42 I.R.B. 11, 13 (Okla.; Dec. 27, 1993); Rev. Rul. 93-91, 1993-41 I.R.B. 22, 24 (Utah; Dec. 20, 1993); Rev. Rul. 93-81, 1993-38 I.R.B. 7, 9 (R.I.; Nov. 29, 1993); Rev. Rul. 93-53, 1993-26 I.R.B. 7, 9 (Fla.; Aug. 2, 1993); Rev. Rul. 93-50, 1993-25 I.R.B. 13, 15 (W. Va.; July 19, 1993); Rev. Rul. 93-49, 1993-25 I.R.B. 11, 13 (Ill.; July 19, 1993); Rev. Rul. 93-38, 1993-1 C.B. 233, 235 (Del.; May 24, 1993); Rev. Rul. 93-30, 1993-1 C.B. 231, 233 (Nev.; Apr. 19, 1993); Rev. Rul. 93-6, 1993-1 C.B. 229, 231 (Colo.; Dec. 24, 1992); Rev. Rul. 93-5, 1993-1 C.B. 227, 229 (Va.; Dec. 24, 1992). As of the date of publication of this article, the IRS, however, has not issued a Revenue Ruling for a LLC formed in Ohio.

29. As of September 1995, forty-seven states including Ohio plus the District of Columbia have adopted LLC acts. ALA. CODE §§ 10-12-1 to -61 (1994); ALASKA STAT. §§ 10.50.010-.995 (Supp. 1994); ARIZ. REV. STAT. ANN. §§ 29-601 to -857 (Supp. 1994); ARK. CODE ANN. §§ 4-32-101 to -1316 (Michie Supp. 1993); CAL. CORP. CODE §§ 17000-17705 (West Supp. 1995); COLO REV. STAT. §§ 7-80-101 to -913 (Supp. 1995); CONN. GEN. STAT. §§ 34-100 to -242 (Supp. 1995); DEL. CODE ANN. tit. 6, §§ 18-101 to -1107 (1993 & Supp. 1994); D.C. CODE ANN. §§ 29-1301 to -1375 (Supp. 1995); FLA. STAT. ANN. §§ 608.401 to -471 (West 1993 & Supp. 1995); GA. CODE ANN. §§ 14-11-100 to -1109 (Harrison 1994 & Supp. 1995); IDAHO CODE §§ 53-601 to -672 (1994); ILL. ANN. STAT. ch. 805, ¶¶ 180/1-1 to 180/60-1 (Smith-Hurd 1995); IND. CODE. ANN. §§ 23-18-1-1 to -13-1 (Burns 1994); IOWA CODE §§ 490A.100-.1601 (Supp. 1995); KAN. STAT. ANN. §§ 17-7601 to -7652 (Supp. 1994); KY. REV. STAT. ANN. §§ 275.001-.450 (Baldwin 1994); LA. REV. STAT. ANN. §§ 12:1301-:1369 (West 1994); ME. REV. STAT. ANN. tit. 31, §§ 601-762 (West Supp. 1994); MD. CODE ANN. CORPS. & ASS'NS §§ 4A-101 to -1103 (1993); MICH. COMP. LAWS ANN. §§ 450.4101-.5200 (West Supp. 1995); MINN. STAT. §§ 322B.01-.960 (1995); MISS. CODE ANN. §§ 79-29-101 to -1204 (Supp. 1995); MO. REV. STAT. §§ 347.010-.187 (Supp. 1995); MONT. CODE ANN. §§ 35-8-101 to -1307 (1993); NEB. REV. STAT. §§ 21-2601 to -2645 (Supp. 1993); NEV. REV. STAT. ANN. §§ 86.011-.571 (Michie 1994); N.H. REV. STAT. ANN. §§ 304-C:1 to :85 (1995); N.J. REV. STAT. §§ 42:2B-1 to -70 (Supp. 1995); N.M. STAT. ANN. §§ 53-19-1 to -74 (Michie Supp. 1993); N.Y. LLC LAW §§ 101-1403 (Consol. 1995); N.C. GEN.

In 1989, the Ohio State Bar Association's (OSBA) Corporate Law Committee proposed changes to Ohio's limited partnership law and began to pressure the Ohio General Assembly to adopt legislation allowing the formation of LLCs.[30] Soon thereafter, the Ohio Society of Certified Public Accountants (OSCPA) became involved in the LLC legislation.[31] The OSCPA suggested the inclusion of provisions allowing professionals to do business as LLCs.[32] By March of 1993, the OSBA Corporate Law Committee drafted Ohio's LLC legislation, and a bill was introduced.[33] Both the Ohio House of Representatives and the Ohio Senate passed the Ohio LLC Act unanimously in 1994.[34] It is necessary to understand the relevant provisions of the Ohio LLC Act in order to fully understand the facts and circumstances the IRS considers in determining whether a LLC will be taxed as a partnership. Thus, this Section next identifies the Ohio LLC Act as a flexible LLC statute and examines the Act's provisions relevant to ownership, transfer of ownership interests, liability of the members, management, and dissolution.

A. Overview of the Ohio LLC Act

The Ohio General Assembly enacted a flexible LLC statute.[35] LLC statutes are either "flexible" or "bulletproof."[36] Flexible and bulletproof statutes contain different provisions concerning limited liability, transferability of interest, centralized management, and continuity of life.[37] Bulletproof statutes contain mandatory provisions which dictate how a LLC must be structured.[38] The mandatory provisions guarantee that a LLC organized under

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STAT. §§ 57C-1-01 to -03 (1993); N.D. Cent. Code §§ 10-32-01 to -155 (1995); OHIO REV. CODE ANN. §§ 1705.01-.58 (Anderson Supp. 1994); OKLA. STAT. tit. 18, §§ 2000-2060 (Supp. 1995); OR. REV. STAT. §§ 63.001-.990 (1994); 15 PA. CONS. STAT. §§ 8901-8998 (1995); R.I. GEN. LAWS §§ 7-16-1 to -75 (1992); S.C. CODE ANN. §§ 33-43-101 to -1409 (Law. Co-op 1994); S.D. CODIFIED LAWS ANN. §§ 47-34-1 to -59 (Supp. 1995); TENN. CODE ANN. §§ 48-201-101 to -248-606 (1994); TEX. REV. CIV. STAT. ANN. art. 1528n, arts. 1.01-11.07 (West Supp. 1995); UTAH CODE ANN. §§ 48-2b-101 to -157 (1994 & Supp. 1995); VA. CODE ANN. §§ 13.1-1000 to -1073 (Michie 1993 & Supp. 1995); WASH. REV. CODE §§ 25.15.005-.902 (Supp. 1995); W. VA. CODE §§ 31-1A-1 to -69 (Supp. 1995); WIS. STAT. §§ 183.0102-.1305 (Supp. 1994); WYO. STAT. §§17-15-101 to -136 (1993 & Supp. 1995). The only states that have not adopted LLC statutes are Hawaii, Massachusetts and Vermont. These three states, however, have LLC statutes pending in the respective legislatures.

30. Jeanne Rickert, *The ABCs of LPS, LLPs, LLCs and Inc.s*, 8 OHIO LAW., May-June 1994, at 8.

31. *Id.*

32. *Id.* The OSCPA promoted "the deletion of the prohibition against the formation of corporations under Chapter 1701 to render professional services; [and] changes to professional statutes to permit the formation of limited liability companies . . . ." *Id.*

33. *Id.* The major sponsors of parts of the bill were Sen. Barry J. Levey (R-Middletown), Sen. Roy L. Ray (R-Akron), and Rep. Michael G. Verich (D-Warren). *Id.*

34. *Id.*

35. Bruce Lowry, *Tax Implications of Sub. S.B. 74*, 94-65 OHIO CONTINUING LEGAL EDUC. INST. 3.1 (1994) (this manual can be obtained through The Ohio CLE Institute, P.O. Box 8, Columbus, OHIO 43216-0008; phone 1-800-232-7124 or (614) 487-8585.)

36. Schorr, *supra* note 6, at 182.

37. *Id.*

38. *Id.*

a bulletproof statute will be classified as a partnership for federal income taxation purposes.[39]

Flexible statutes contain default provisions.[40] Contrary to the mandatory provisions of bulletproof statutes, flexible statutes permit the organizers to modify the organization's structure. If the organizers do not modify the default provisions, the default provisions guarantee that a LLC will be classified as a partnership for federal income tax purposes.[41] If the organizers alter the default provisions, classification of a LLC as a corporation or partnership for federal income taxation purposes depends upon the specific provisions of the operating agreement.[42]

Since Ohio has a flexible LLC Act, the planner, in the LLC's operating agreement, can alter the default provisions of the LLC Act and structure the LLC specifically to meet the needs of the members.[43] A LLC's operating

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39. *Id.*

40. *Id.* at 182-83.

41. *Id.* at 183.

42. Lowry, *supra* note 35, at 3.1; *see infra* notes 107-54 and accompanying text. At the formation stage of a LLC, the planner must recognize the differences between pass-through taxation and double taxation. The planner also must understand those factors which the IRS will consider when determining the LLC's tax status. *See infra* notes 107-54 and accompanying text.

43. Many of the provisions of chapter 1705 of the Ohio Revised Code state a general rule, but provide for the rules to be varied by the operating agreement. Some of the provisions of chapter 1705 of the Ohio Revised Code can only be varied if the operating agreement so provides in writing, while other provisions can be varied by any statement in the operating agreement. The following is a list of the provisions whereby any statement, written or oral, in the operating agreement can vary the provisions of the statute: (1) limit the authority of a LLC, § 1705.03(B); (2) restrict the ability of a LLC to invest excess funds not needed in its business, § 1705.03(D); (3) alter the rule that member contribution obligations are enforceable even if the member is unable to contribute because of death, disability or any other reason, § 1705.09(C); (4) alter the rule that all of the members of the LLC must consent to a compromise to make a contribution or to return improper distributions, § 1705.09(D); (5) alter the distributions of cash and other property from the LLC to its members, other than distributions made in proportion to contributions, adjusted to reflect withdrawals, § 1705.11; *cf.* § 1705.23 (stating that a member who receives improper distributions is liable to the LLC for the amount distributed in excess to which he was otherwise entitled); (6) provide for distribution upon withdrawal of a member and for a member's right to receive, within a reasonable time after withdrawal, the fair value of his interest, § 1705.12; (7) provide for the admission of an additional member to the LLC, if other than unanimous consent is required for admission, § 1705.14(B)(1); (8) provide for the removal or expulsion of a member, § 1705.15(B); (9) prohibit or restrict assignment of membership interest, § 1705.18; (10) provide member liability to non-member assignees, § 1705.18; (11) terminate the membership of an assignor, § 1705.18; (12) establish reasonable standards governing rights of members to information, § 1705.22(A); (13) alter the statutory rights of limited liability company to keep certain information confidential, § 1705.22(B); (14) set authority of members or managers, § 1705.25; (15) grant (and define) voting rights, § 1705.26; (16) provide for managers, § 1705.29(A); (17) opt out of the rule that gives managers protection against damages by clear and convincing, deliberate intent, etc. standard, § 1705.29(D); (18) alter rules relating to procedures to validate certain conflict of interest transactions, § 1705.31; (19) expand the situations when member approval is required if the limited liability company is to be the surviving entity in a merger, § 1705.36(D)(1); (20) alter the rule that unanimous member and manager approval are required if the limited liability company is not the survivor in a merger or consolidation, § 1705.36(F); (21) alter the notice period prior to a meeting when a merger or consolidation transaction is to be presented; § 1701.36(E); (22) establish a reasonable basis to determine and pay the fair cash value of membership interests in a merger or consolidation (to foreclose dissenter's rights to court determined valuation), § 1705.41(F); *see* § 1705.40; (23) grant a dissenting member continuing rights as a member until member's interest is terminated by payment, § 1705.41(H); (24) set the period for the duration of the limited liability

agreement includes "all of the valid written or oral agreements of the members as to the affairs of a limited liability company and the conduct of its business."[44] Because the operating agreement alters the default provisions of the LLC Act, the operating agreement must be drafted with the applicable federal income tax constraints in mind, otherwise the LLC might be taxed as a corporation and not a partnership.[45]

Regardless of whether the organizers alter the default provisions of the LLC Act in the operating agreement, two or more persons[46] must file an "articles of organization" with the Secretary of State to form[47] a LLC.[48] In

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company, § 1701.43(A)(1); (25) provide for whom shall have the authority to wind-up the affairs of the limited liability company, § 1705.44; (26) authorize the continuation of the business after the dissolution of the company to maximize its value as a going concern, § 1705.45(A)(1); (27) provide for the termination of the authority of a manager, officer, or other agent of the company upon its dissolution, § 1705.45(A)(5); (28) vary the rules for distributions to members in the event of liquidation, §§ 1705.46(A)(2),(3), 1705.46(B).

The following is a list of the provisions of the statute that can only be varied by a written statement in the operating agreement: (1) provide for the allocation of profits, losses, gains, deductions, credits or similar items, other than allocations based on the contributions of the members, adjusted to reflect withdrawals, § 1705.10; (2) give a member the right to demand and receive any distribution from the LLC distributions other than cash, § 1705.13; (3) alter the rule that distribution of in kind assets must be pro rata, § 1705.13; (4) give a member the right to grant an assignee the right to become a member of the LLC, § 1705.14(B)(2); (5) alter the withdrawal and resignation of a member, §§ 1705.15(A), 1705.16; (6) alter the rule that a member making an assignment for the benefit of a creditor, filing of a petition in bankruptcy, is adjudicated bankrupt or insolvent, etc., causes the withdrawal of that member, § 1705.15(C); (7) alter the rule that a member's involuntary bankruptcy petition, appointment of a trustee, etc., causes withdrawal of that member, § 1705.15(D); (8) alter the rule that a member's death or incompetence causes withdrawal of the member, § 1705.15(E); (9) alter the rule that termination of a trust causes the withdrawal of a member trust, § 1705.15(F); (10) alter the rule that dissolution and commencement of winding up of a member partnership causes withdrawal of a member partnership, § 1705.15(G); (11) alter the rule that dissolution and commencement of winding up of a member LLC causes withdrawal of member LLC, § 1705.15(H); (12) alter the rule that dissolution or revocation of the charter of a member corporation causes withdrawal of member corporation, § 1705.15(I); (13) alter the rule that distribution by estate of membership interest causes withdrawal of member estate, § 1705.15(J); (14) give members the right to cause assignee of membership interest to become a member, § 1705.20(A)(1); (15) alter the rule that management is by members in proportion to capital at risk, § 1705.24; (16) provide that there shall be no dissenter's rights in connection with a merger or consolidation, § 1705.40; (17) specify other events that will cause dissolution of the limited liability company, § 1701.43(A)(2); (18) provide the right for remaining members to continue the company after withdrawal of a member, § 1701.43(A)(4).

44. *Id.* § 1705.01(J). An operating agreement, therefore, is not a single document labeled "operating agreement." Rather, the operating agreement contains all written and oral agreements among the members subsequent to the formation of the LLC. Jeanne M. Rickert, *The ABC's of LLC's*, 94-65 OHIO CONTINUING LEGAL EDUC. INST. 2.1, 2.9 (1994) (this reference manual can be obtained through the Ohio CLE Institute, P.O. Box 8, Columbus, OHIO 43216-0008, 1-800-232-7124 or (614) 487-8585).

45. See *infra* notes 107-54 and accompanying text for a discussion of the organizational characteristics that determine the federal income tax treatment of a LLC.

46. As defined, "'[p]erson' means any natural person; partnership, limited partnership, trust, estate, association, limited liability company, or corporation; any custodian, nominee, trustee, executor, administrator or other fiduciary; or any other individual or entity in its own or any representative capacity." *Id.* § 1705.01(K). The residence, domicile, or state of organization of the persons forming the LLC does not have to be Ohio. *Id.* § 1705.04(A).

47. A LLC generally may be formed for any lawful purpose. OHIO REV. CODE ANN. § 1705.02 (Anderson Supp. 1994). If, however, the Ohio Revised Code "contains special provisions for the formation of any designated type of corporation other than a professional association," a LLC may not be formed for the purposes for which that type of corporation may be formed. *Id.*

48. *Id.* § 1705.04(A). "Articles of organization" are analogous to the articles of incorporation of a

order for a person to become a member of a LLC, a person must own a membership interest.[49] A person can become a member either at the time the LLC is formed or at any later time that is specified in the operating agreement of a LLC.[50] In the latter, a person can acquire a membership interest either directly from a LLC[51] or by an assignment of a membership interest from an existing member.[52]

An assignment of a membership interest, in whole or in part, however, does not entitle an assignee to become a member or exercise the rights or powers of a member, unless otherwise provided for in the operating agreement.[53] An assignor of an interest remains a member of the LLC and retains those rights that the assignee is not entitled to receive.[54] For an assignee to become a member, the assignor must give the assignee the right to become a member and all the other members must unanimously consent to the transfer of the membership, or the operating agreement must give the assignor the authority to grant the assignee membership.[55]

Once an assignee has become a member, an assignee has the rights and powers of a member and is subject to the restrictions and liabilities of a member under the operating agreement and chapter 1705 of the LLC Act.[56] Additionally, an assignee is liable to make contributions to the LLC on behalf of his assignor.[57] An assignee, however, is not liable for obligations that could not be ascertained from a written provision in the operating agreement and that were unknown to the assignee at the time the assignee became a member.[58]

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corporation and to the certificate of limited partnership utilized in a limited partnership. The organizers must file the articles of organization on Form LCA and need only include limited information. Specifically, the articles of organization must contain the name of the LLC, the period of the LLC's duration, the address to which interested parties may direct requests for copies of the LLC's operating agreement and/or by-laws, and any other provisions from the operating agreement that are not inconsistent with the law and that the members elect to place in the articles of organization. *Id.* § 1705.04(A)(1)-(4).

49. As defined, a member is "a person whose name appears on the records of the limited liability company as the owner of a membership interest in that company." *Id.* § 1705.01(G). A membership interest is defined as "a member's share of the profits and losses of a limited liability company and the right to receive distributions from that company." *Id.* § 1705.01(H). A member is essentially the equivalent of a shareholder in a corporation or a partner in a partnership.

50. *Id.* § 1705.14(A).

51. The operating agreement must provide for the direct acquisition of an interest from a LLC or all the members must consent in writing. *Id.* § 1705.14(B)(1).

52. The operating agreement must provide, in writing, that the member assigning the interest has the power to grant an assignee the right to become a member and that the member must comply with the conditions limiting the grant or exercise of that power. *Id.* § 1705.14(B)(2).

53. *Id.* § 1705.18. An assignment only entitles the assignee to receive the distributions of cash, other property, and the allocations of profits and losses to which the assignor would have been entitled. *Id.*

54. *Id.* These rights generally include the right to vote and to participate in management. *See id.* §§ 1705.25-.26. Until the assignee becomes a member, however, the assignee does not have liability as a member solely because of the assignment. *Id.* § 1705.18.

55. *Id.* § 1705.20(A).

56. *Id.* § 1705.20(B).

57. *Id.*

58. *Id.*

No matter how the members acquire their membership interests, all of the members enjoy limited liability similar to the limited liability enjoyed by corporate shareholders. The limited liability available to a LLC's members is one of the primary benefits of a LLC. The Ohio LLC Act provides that:

> Except as otherwise provided . . . [t]he debts, obligations, and liabilities of a limited liability company, whether arising in contract, tort, or otherwise, are solely . . . [those] of the [LLC, and] [n]either the members . . . nor any managers . . . are personally liable to satisfy any judgment, decree, or order of a court . . . or . . . any other . . . debt, obligation, or liability of the company solely by reason of being a member or manager of the limited liability company.[59]

This provision, however, does not affect the personal liability of a member or manager for the member or manager's own acts or omissions.[60] In addition to the statutory exceptions to the limited liability of LLCs,[61] LLCs may be subject to the common law doctrine of piercing the corporate veil.[62] Furthermore, if

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59. *Id.* § 1705.48(A)-(B).

60. *Id.* § 1705.48(C). This provision does not affect any statutory or common law of Ohio, or any other state, pertaining to the relationship of a professional and the recipient of the professional service. *Id.* § 1705.48(D).

61. There are statutory exceptions to this limited liability protection. Section 1705.48 of the Ohio Revised Code specifically states that the Ohio statutory exceptions include, but are not limited to, § 3734.908 (personal liability for individuals responsible to make filings under solid and hazardous waste law), § 5739.33 (responsible person's personal liability for failure of a corporation or business trust to remit its sales tax), § 5743.57 (responsible person's personal liability for failure of a corporation or business trust to remit its cigarette tax), § 5747.07 (personal liability of corporate officer or employee concerning income tax), and § 5753.09 (responsible person's personal liability for failure of a corporation or business trust to remit its beverage tax). The LLC Act provides exceptions to this limited liability protection as well. For example, under § 1705.09 of the Ohio Revised Code, members are personally liable for failing to make promised contributions, unless otherwise provided for in the operating agreement. *Id.* § 1705.09(B)-(C). Also, members are personally liable for knowingly receiving any distributions that are prohibited by the articles of organization or the operating agreement. *Id.* § 1705.23.

62. Because of similarities between the limited liability of LLC members and corporate shareholders, courts will likely apply corporate veil piercing theories to LLCs. *See* Keatinge, *supra* note 26, at 445. As with corporations, courts will pierce the veil of a LLC when failing to pierce "would produce injustice or inequitable consequences." Bucyrus-Erie Co. v. General Products Corp., 643 F.2d 413, 419 (6th Cir. 1981).

Application of the "instrumentality" test to LLCs, however, produces even more problems than those associated with corporations. The instrumentality test presupposes that organizations have decentralized management, while the LLC Act allows LLCs to be organized with centralized or decentralized management. See *infra* notes 64-70 and accompanying text for a discussion of the management structures allowed under the LLC Act. The LLC Act provides that when the management of the LLC is reserved to its members, every member is an agent of the LLC for the purpose of the LLC's business. OHIO REV. CODE ANN. § 1705.25; *see infra* notes 64-70 and accompanying text. If the court is applying the instrumentality test without considering the additional factors applied to corporations, such as lack of observance of corporate formalities, initial undercapitalization of the corporation, commingling of shareholder and corporate affairs, insolvency of the debtor corporation at the time the debt is incurred, and the fact that the dominant shareholder used the corporation as a mere facade for his personal operations, and the LLC's management is reserved to its members, the instrumentality requirement of the piercing test would always be satisfied. Steven C. Bahls, *Application of Corporate Common Law Doctrines to Limited Liability Companies*, 55 MONT. L. REV. 43, 62 (1994). Accordingly, a court should not focus on whether the LLC is an agent of the members, but instead should focus on whether the LLC has a separate existence apart from its members. Courts, therefore, should apply the additional factors employed in corporate piercing cases when determining if they should hold the members of a LLC personally liable for the LLC's obligations. Because of the differences between a LLC and a corporation, courts should modify the factors for application to a LLC.

a LLC conducts business in a state that does not formally recognize LLCs, the state also may not recognize the limited liability of members and managers of a LLC.[63]

In addition to the limited liability an LLC provides its members, the Ohio LLC Act provides tremendous flexibility in structuring the management of a LLC and permits the members to fashion a management scheme that will best fit the members' particular needs. Unless otherwise provided in the operating agreement, the management of a LLC vests in its members in proportion to their contributions to the capital of the LLC.[64] The operating agreement, however, may direct that management rights be distributed to managers who need not be members of the LLC.[65] Thus, the management structure of the LLC can either be organized as a decentralized partnership or as a centralized corporate form of management.

If a LLC reserves management to its members, the authority of a member is comparable to that of a general partner.[66] If the LLC does not reserve

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In applying the observance of corporate formalities factor, courts should consider whether members of a LLC observed limited liability formalities instead of considering whether the members observed corporate formalities. Courts are less likely to pierce the veil of a LLC for failure to comply with formalities because the LLC Act imposes few corporate-type formalities. *Compare* OHIO REV. CODE ANN. ch. 1705 *with id.* ch. 1701. The primary difference between the formalities of a LLC and the formalities of a corporation is that LLCs are not required to be managed by a centralized board. *See infra* notes 64-70. Thus, a LLC is not required to hold annual shareholder meetings and will not have to elect directors.

The appropriate formalities of a LLC for a court to consider are: (1) transacting business within the LLC's purpose; (2) maintaining a registered agent in Ohio; (3) only making distributions permitted by statute or the operating agreement; and (4) maintaining the required documents at the principal office of the LLC. *Id.* § 1705.02 (purpose); *id.* § 1705.06 (registered agent); *id.* §§ 1705.11-.13(distributions); *id.* § 1705.28 (documents). Other factors a court should consider are more similar to those applied to corporations. These factors include initial undercapitalization of a LLC, commingling of member and LLC affairs, insolvency of a debtor LLC at the time a debt is incurred, and the fact that a dominant member used the LLC as a mere facade for his personal operations. *See* LeRoux's Billyle Supper Club v. MA, 602 N.E.2d 685, 690-91 (Ohio Ct. App. 1991); *see also Bucyrus-Erie Co.*, 643 F.2d 413. Thus, in evaluating whether to pierce the LLC veil, courts should continue to look to corporate law for guidance, but develop new rules that are more applicable to a LLC.

63. See *supra* note 29 for a list of the states that have adopted LLC statutes.

64. OHIO REV. CODE ANN. § 1705.24. The proportion of the members' contributions to the capital of a LLC is adjusted from time to time to properly reflect any additional contributions or withdrawals by the members. *Id.* The initial capitalization of a LLC consists of members' contributions of cash, property, services rendered, promissory notes, or any other obligation to pay cash or property or to perform services in the future. *Id.* § 1705.09(A). For an obligation to be enforceable, it must be in writing and signed by the member promising the contribution to the LLC. *Id.* § 1705.09(B). Except as provided in the operating agreement, a member is obligated to a LLC to make contributions or perform services, even if the member is unable to do so "because of death, disability, or another reason." *Id.* § 1705.09(C). Also, a member's promise of a future contribution to a LLC only may be forgiven by the consent of all the members of a LLC. *Id.* § 1705.09(C)-(D). If a member fails to make a required contribution of property or services, a LLC may require a contribution of equivalent value in cash. *Id.* § 1705.09(C). The cash contribution must be equal to the portion of the value stated in the records which is required to be maintained under § 1705.28 of the Ohio Revised Code. *Id.* This right of the LLC to require the member to make the contribution does not preclude other rights the LLC may have under the operating agreement or applicable laws against the member. *Id.*

65. *Id.* § 1705.25(B).

66. Rickert, *supra* note 44, at 2.7.

management to its members and the operating agreement does not state otherwise, the role of the managers is comparable to the role of the directors of a corporation.[67] Under both management schemes, traditional agency rules apply to the members or managers, respectively,[68] of the LLC.[69] If the management of the LLC is not reserved to its members, the managers' standard of care is substantially similar to that applicable to directors of Ohio corporations.[70]

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67. *Id.*

68. As used in this section, the phrase "members or managers, respectively," refers to members if the LLC reserves its management in the members and managers if the LLC elects or designates managers.

69. OHIO REV. CODE ANN. § 1705.25. If a LLC is managed by non-member managers, the following rules may be altered by the operating agreement. *Id.* § 1705.25(B). First, every member or manager is an agent of the LLC for the purposes of its business activities. *Id.* § 1705.25(A)(1), (B)(1). Members or managers, may bind the LLC if the member or manager, is carrying on the business of the company in the usual way. *Id.* The member or manager, however, may not bind a LLC if the member or manager, respectively, has no authority to act for the company in the particular manner, and the person with whom he is dealing has actual knowledge of the member's or manager's lack of authority. *Id.* § 1705.25(A)(1)-(2), (B)(1)-(2). When management is reserved to the members, unless authorized by the other members or unless the other members have abandoned the business, unanimity is required for the members to perform certain specified actions. *Id.* § 1705.25(A)(3)(a)-(e). Also, when management is not reserved to the members, unless authorized by all the members or the LLC has dissolved, unanimity is required for the members to perform certain specified actions, and managers have no authority to engage in these actions. *Id.* § 1705.25(A)(3)(a)-(e), (B)(3). The specified actions include:

> (a) [a]ssign[ing] the property of the company in trust for creditors or on the assignee's promise to pay the debts of the company; (b) [d]ispos[ing] of the good will of the business of the company; (c) [d]o[ing] any other act that would make it impossible to carry on the ordinary business of the company; (d) [c]onfess[ing] a judgment; [or] (e) [s]ubmit[ting] a claim or liability of the company to arbitration or reference.

Id. § 1705(A)(3)(a)-(e). If a person is both a manager and member, that person, unless otherwise provided in the operating agreement, has the rights and powers of both a member and manager. *Id.* § 1705.25(C). Accordingly, that member-manager is subject to the restrictions and liabilities of both members and managers in that person's respective capacity. *Id.*

70. *Compare id.* § 1705.29(B) (standard of care applicable to managers of LLCs) *with id.* § 1701.59(B) (standard of care applicable for directors of corporations). The manager of a LLC must "perform his duties as a manager in good faith, in a manner he reasonably believes to be in or not opposed to the best interest of the company, and with the care that an ordinarily prudent person in similar position would use under similar circumstances." *Id.* § 1705.29(B). A manager will be found to have violated this statutory standard of care by a clear and convincing showing of evidence. *Id.* § 1705.29(C)(1). The clear and convincing evidence standard applies to "any action brought against the manager, including, but not limited to, an action involving or affecting a termination or potential termination of his service to the company as a manager or his service in any other position or relationship with the company." *Id.*

Additionally, a manager will be not considered to be acting in good faith "if he has knowledge concerning a particular matter that would cause reliance on information, opinions, reports, or statements that are prepared or presented by . . . persons . . . to be unwarranted." *Id.* § 1705.29(C)(2). The term persons includes members, managers, officers, or employees of the LLC and counsel, public accountants or other third parties that the member or manager believes are reliable and competent. *Id.* § 1705.30. A manager is liable for damages only if it is proven by clear and convincing evidence that "his action or failure to act involved an act or omission undertaken with deliberate intent to cause injury to the company or undertaken with reckless disregard for the best interests of the company." *Id.* § 1705.29(D). These provisions are based on Ohio corporate law. *See id.* § 1701.59(C)-(D). These provisions apply to the LLC unless the articles of organization or the operating agreement state by specific reference to section 1705.29 of the Ohio Revised Code that its provisions do not apply to the LLC. *Id.* § 1705.29(D).

Finally, a LLC will be dissolved upon the occurrence of any of the following events:

> (1) the expiration of the period fixed by the operating agreement for the duration of the company or, if an expiration period is not fixed by the operating agreement, from the date of the formation of the company;
> (2) one or more of the events specified in writing in the operating agreement as causing the dissolution of the company;
> (3) the unanimous written agreement of all members to dissolve the company;
> (4) the withdrawal of a member of the company,[71] unless the business of the company is continued by the consent of all of the remaining members or under a right to continue the company that is stated in writing in the agreement;
> (5) at any time when there are less than two members;
> (6) upon entry of a decree of judicial dissolution under section 1705.47 of the Ohio Revised Code.[72]

Following the occurrence of one of the above events, a certificate of dissolution must be filed with the Secretary of State.[73] Upon dissolution, the affairs of a LLC may be wound up.[74] The winding up of affairs, though, does not halt the existence of a LLC. Rather, a dissolved LLC continues its existence until the winding up of its affairs is completed. During this period, the persons[75] winding up a LLC's affairs may perform specified actions.[76]

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71. A member ceases to be a member of the LLC, and therefore is deemed to have withdrawn, if the member dies or is adjudicated an incompetent, files a voluntary bankruptcy petition or is adjudicated a bankrupt, resigns or withdraws, or is removed or expelled. *Id.* § 1705.15(A) (resignation or withdrawal); *id.* § 1705.15(B) (removal or expulsion); *id.* § 1705.15(C)(2)-(3) (bankruptcy); *id.* § 1705.15(E) (death or incompetency).

72. *Id.* § 1705.47. If it is not reasonably practicable for a LLC to carry on its business in conformity with the articles of organization and the operating agreement and if a member of the LLC applies for a judicial dissolution of the LLC, the court of common pleas may decree a judicial dissolution of the LLC. *Id.*

73. *Id.* § 1705.43(B). The certificate of dissolution must be filed on Form LDS and contain the name of the LLC and the effective date of the LLC's dissolution. *Id.* Dissolution does not result in the transfer of LLC assets or termination of the authority of the statutory agent of the LLC. *Id.* § 1705.45(B)(1), (4). Furthermore, unless otherwise provided in the operating agreement, dissolution does not result in the termination of the authority of any other manager, officer, or other agent of the company, or termination of any contractual rights or obligations of the LLC. *Id.* § 1705.45(B)(5)-(6). Finally, dissolution does not prevent commencement of a suit by or against a LLC, nor abate or suspend a pending proceeding by or against a LLC. *Id.* § 1705.45(B)(2)-(3).

74. *Id.* § 1705.44.

75. Persons who may wind up the affairs of the LLC include: members who have not wrongfully dissolved the LLC; a liquidating trustee selected by those members; or, if the LLC is under management, the managers, unless the operating agreement otherwise provides. *Id.* Alternatively, the court of common pleas may wind up the affairs of the company or allow a court-appointed liquidating trustee to wind up the company's affairs. *Id.*

76. *Id.* § 1705.45(A)(1)-(6). These specified acts include:

> (1) [i]f authorized by the operating agreement, continu[ing] the business of the company in order to maximize its value as a going concern for eventual sale; (2) [c]ollect[ing] the assets of the company and gradually settl[ing] and clos[ing] its business; (3) [d]ispos[ing] of and convey[ing] the property of the company that will not be distributed in kind to its members; (4) [d]ischarg[ing] or mak[ing] reasonable provision for the liabilities of the company; (5) [d]istribut[ing] to the members any remaining assets of the company; (6) [d]o[ing] every other act necessary to wind up and liquidate the business and affairs of the company.

Id.

B. Historical Development of the Classification Criteria

The classification of an organization as a partnership or a corporation for federal taxation purposes can have profound consequences. The exact nature of these consequences, however, has varied with the changes in tax laws. The classification dilemma began in 1935 with the Supreme Court case *Morrissey v. Commissioner.*[77]

In *Morrissey*, the IRS argued that a trust set up by the taxpayers to develop land and to construct and to operate a golf course should be taxed as a corporation, not a partnership.[78] The taxpayers argued that a prerequisite for corporate taxation was organization under a state corporation statute.[79] The Court, in its seminal ruling, rejected the taxpayers' argument and held that a resemblance to a corporation is determinative, not organization under a state corporation statute.[80]

The Court identified five characteristics common to all corporations.[81] The characteristics include the organization's ability to limit the liability of its investors, the ability to transfer ownership interests, the ability of the organization to hold title, the centralization of management, and the continuation of the entity despite the investors death.[82] The Court, after applying these factors to the trust, held that the trust more closely resembled a corporation than a partnership.[83] The Court based its decision on the fact that: (1) the trustees had broad management powers;[84] (2) the beneficial interests of the trust were evidenced by transferable certificates; (3) the trust was not terminated by the death of the trustee; and (4) liability was limited to the trust's assets.[85] The Court, therefore, concluded that the trust possessed the characteristics of centralized management, free transferability of interest, continuity of life, and limited liability.

The Service's success in *Morrissey* proved to be a double edged sword. At the time of the *Morrissey* decision, state law prohibited professionals from incorporating. This prohibition on incorporation prevented professionals from obtaining tax benefits from qualified pension and profit sharing plans.[86] The

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77. 296 U.S. 344 (1935).

78. *See id.*

79. *Id.*

80. *Id.* at 357-58. The Court reasoned that because the Code's definition of a corporation included "association," Congress did not intend for classification to per se depend on organization under a state statute. *Id.* at 349, 357-58.

81. *Id.*

82. *Id.* at 359-60. These characteristics are the basis of the characteristics the IRS adopted in the Treasury Regulations and Revenue Procedure 95-10.

83. *Id.* at 360-61.

84. The trustees were authorized to construct and to operate the golf course and clubhouse, to buy, to sell, to lease, and to operate the land, and to make loans and investments. *Id.*

85. *Id.*

86. A qualified retirement plan generally works as follows. An employer makes contributions on behalf

tax benefits of the qualified pension and profit sharing plans outweighed the double taxation disadvantage. The professionals, therefore, saw the *Morrissey* decision as an avenue for being classified as a corporation for federal taxation purposes without incorporating under state law.

Doctors and other professionals formed organizations possessing the *Morrissey* characteristics. The Service then argued that such organizations

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of the employees who are participating in the plan. Depending on the plan type, the participants may also make contributions to the plan for their benefit. The employer will receive a deduction for the contributions the employer makes to the plan, and the employees do not have to report as income the employer's contribution made on that employee's behalf until distribution from the plan. I.R.C. §§ 402(a)(1), 404 (1988). Depending on the plan, the employees' contributions may or may not be made with pre-tax dollars. The contributions are then placed in a trust and/or account where the funds are held until distribution. The income earned on the contributions is earned tax free. *Id.* § 61. Distributions from the plan occur once the participant is eligible for such distributions. Participants usually are not eligible for distributions from the plan until termination of service or the attainment of normal retirement age. Distributions from the plan may be in the form of lump sum distributions, installment payments over a number of years, or annuity payments over the life of the participant and the life of the participant's spouse.

The following example illustrates the significant tax advantages of a qualified retirement plan by comparing $1,000 investments made in a qualified retirement plan, in an after-tax individual retirement account (IRA), and in a normal investment account. Column (6) indicates how much a $1,000 initial investment would grow over time assuming no retirement plan was used. Assuming a 10% pre-tax and a 7.2% after tax rate of return, and all interest is reinvested, the accumulation over thirty years is $8,051. Columns (2) and (3) indicate the accumulations under a qualified retirement plan that allows a deduction for the initial contribution and allows tax free earnings on the contributions. Column (2) indicates accumulations before taking out taxes when the funds are distributed. Column (3) indicates accumulations after such taxes are deducted. Columns (4) and (5) indicate accumulations when the initial investment is made with after-tax dollars, but earnings on the contributions are tax free (e.g., an after-tax IRA). The qualified retirement plan will accumulate significantly more wealth than the other plans. A qualified retirement plan will accumulate $22,335 before tax on distributions, and $16,081 after tax on distributions. The after-tax IRA will accumulate $17,449 before tax on distribution and $12,843 after the tax on distribution. The investment without a retirement plan will only accumulate $8,051.

Assumptions: Funds earn a pre-tax return of 10%
Marginal tax rate is 28%
Marginal tax rate does not change over time

(1)	(2)	(3)	(4)	(5)	(6)
	Situation one		Situation two		Situation three
Year	Before tax on Withdrawals	After tax on Withdrawals	Before tax on Withdrawals	After tax on Withdrawals	
0	$1,280	$ 922	$1,000	$1,000	$ 1,000
1	1,408	1,014	1,100	1,072	1,072
2	1,540	1,109	1,210	1,151	1,149
3	1,704	1,227	1,331	1,238	1,232
⋮					
10	3,320	2,390	2,594	2,147	2,004
⋮					
20	8,611	6,200	6,728	5,124	4,007
⋮					
30	22,335	16,081	17,449	12,843	8,051

BERNARD J. WINGER & RALPH R. FRASCA, INVESTMENTS: INTRODUCTION TO ANALYSIS AND PLANNING 603-04 (2d ed. 1991).

should not be treated as corporations for federal taxation purposes.[87] In *United States v. Kintner*,[88] a group of doctors organized a limited partnership that was structured so that the organization possessed the *Morissey* characteristics.[89] The Ninth Circuit, after examining whether the limited partnership had the *Morrissey* characteristics, held that the limited partnership qualified as a corporation for federal taxation purposes.[90] The *Kintner* court, therefore, rejected the Service's attempt to classify an organization on the taxpayer's organizational motivation, rather than the organization's resemblance to a corporation.

After the *Kintner* decision, the Service codified the *Morrissey* characteristics by enacting section 301.7701-2 of the Treasury Regulations.[91] Pursuant to section 301.7701-2, the IRS, on a case-by-case basis, considers six criteria that are present in a "pure corporation" to determine whether an organization will be taxed as an association or as a partnership.[92] The six characteristics of a pure corporation are: (1) the presence of associates; (2) an objective to carry on business and divide gains; (3) continuity of life; (4) centralization of management; (5) limited liability; and (6) free transferability of interest.[93] An organization will receive pass-through tax treatment if the organization more closely resembles a partnership than a corporation.[94] Since the presence of associates and "an objective to carry on business for joint profit" generally are characteristics common to both corporations and partnerships, the IRS does not evaluate these two characteristics when attempting to distinguish between the two types of organizations.[95] The organization, therefore, must not possess two of the four remaining characteristics of continuity of life, centralization of management, limited liability, and free transferability of interest if the organization desires to receive pass-through tax treatment.[96]

The Service soon realized, however, that section 301.7701-2, like the *Morrissey* decision, was also a double-edged sword. Tax planners devised

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87. The professionals were subject to double taxation if their organization was treated as a corporation for tax purposes. The professionals, however, could avoid the double taxation by distributing all of the organization's net income as salary to the professionals. The organization would have no net income, and pay no corporate income tax.

88. 216 F.2d 418 (9th Cir. 1954).

89. *Id.* at 420-21.

90. *Id.*

91. Treas. Reg. § 301.7701-2 (as amended in 1993). The Service drafted the section in a manner that favored partnership classification. The Treasury Regulations are informative and explanative announcements of the Internal Revenue Code. The Secretary of the Treasury is given general authority to "prescribe all needful rules and regulations for the enforcement" of the Code. I.R.C. § 7805(a) (1988). The Treasury Regulations are presumed to be valid, and courts have accorded regulations force of law status. *See, e.g.*, Bingler v. Johnson, 394 U.S. 741 (1969); Crane v. Commissioner, 331 U.S. 1 (1947); Helvering v. Winmill, 305 U.S. 79 (1938).

92. Treas. Reg. § 301.7701-2(a)(1).

93. *Id.*

94. *Id.*

95. *Id.*

96. *Id.* § 301.7701-2(a)(3).

methods that allowed investors to form limited partnerships that closely resembled corporations, but would be treated as partnerships for federal income taxation purposes. These limited partnerships were set up as tax shelters for the limited partners. The limited partners were able to take their share of the limited partnership's losses to offset income from other sources. The Service once again unsuccessfully argued that these limited partnerships were corporations and not partnerships. The courts refused to accept the Service's arguments to recharacterize organizations that lacked at least two of the *Morrissey* characteristics as corporations.[97]

Today, the motivation for partnership classification is the avoidance of double taxation. Obtaining taxation as a partnership for federal income taxation purposes is one of the critical advantages of the LLC.[98] Under Ohio's flexible LLC statute,[99] a LLC may be taxed as either a partnership or a corporation.[100] Partnership taxation allows the LLC to obtain pass-through treatment for income tax purposes and legally avoid double taxation.[101]

In January 1995, the IRS issued Revenue Procedure 95-10.[102] Revenue Procedure 95-10 provides the factors and conditions the IRS uses to determine whether a LLC should be taxed as a partnership for federal income taxation purposes.[103] Revenue Procedure 95-10 applies to all LLCs formed in Ohio,

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97. *See* Zuckman v. United States, 524 F.2d 729 (Ct. Cl. 1975); Larson v. Commissioner, 66 T.C. 159 (1976). Congress, in the Tax Reform Act of 1986, greatly restricted these tax shelter investments by passive loss limitations. *See* I.R.C. § 469 (1988). The association versus limited partnership classification issue in the tax shelter arena, therefore, is not of much importance today.

98. The classification of a LLC for state income taxation purposes will depend on the federal income tax classification of the LLC. OHIO REV. CODE ANN. § 5733.01(F) (Anderson 1991). If a LLC is taxed as a partnership for federal income tax purposes, the LLC will be exempt from Ohio corporation franchise tax. *Id.* Members of a LLC who are Ohio residents, however, are subject to Ohio personal income tax. *Id.* § 5747.08(D).

Pass-through taxation has one disadvantage. The members will have to pay tax on the LLC's income even if the LLC does not actually distribute the income. Thomas Earl Geu, *Understanding the Limited Liability Company: A Basic Comparative Primer (Part Two)*, 37 S.D. L. REV. 467, 470 (1992). Thus, the member's individual tax bills may increase even though no cash or property was distributed to them. *Id.* at 471.

99. *See supra* notes 35-45 and accompanying text.

100. A LLC will be classified as a partnership if the default provisions are not modified. *See infra* notes 107-54 and accompanying text.

101. Pass-through taxation means that the LLC's income, gains, losses, deductions, and credits are calculated at the LLC level and then passed through to its members for use on their personal tax returns. *See* I.R.C. § 701 (1988). The members, and not the LLC, are subject to income tax on their personal returns. In contrast, corporations, which are "taxable entities," not pass-through entities, are subject to double taxation. *See id.* § 11. Double taxation occurs because corporate income is generally taxed once at the corporate level and a second time when the corporation distributes dividends to shareholders. *Id.* §§ 11, 61(a)(7). General partnerships, limited partnerships, Subchapter S corporations and certain types of trusts are also pass-through entities.

102. Rev. Proc. 95-10, 1995-3 I.R.B. 20.

103. *Id.* at 20. Revenue Procedure 95-10 modifies Revenue Procedure 89-12. *Id.* Revenue Procedure 89-12 provided the factors and conditions under which the IRS will issue a ruling as to whether an organization would be taxed as a partnership. *Id.* Revenue Procedure 89-12 no longer applies to LLCs, but now only applies to organizations formed as partnerships and other organizations seeking partnership classification. *Id.*

unless a LLC is publicly traded and treated as a corporation under section 7704 of the Internal Revenue Code.[104] Revenue Procedure 95-10 generally adopts the standards that the Treasury Regulations provide for determining whether an organization will be taxed as a partnership or an association.[105] Accordingly, the IRS generally will issue a ruling that a LLC will obtain pass-through tax treatment if a LLC has no more than two of the four corporate characteristics of limited liability, free transferability of interest, centralized management, and continuity of life.[106]

III. ANALYSIS

It is critical that the organizers of a LLC understand the organizational characteristics the IRS considers in determining a LLC's tax status. Under the Ohio LLC Act, all LLCs formed in Ohio will possess the characteristic of limited liability.[107] Consequently, to ensure partnership treatment a LLC must lack two of the remaining three corporate characteristics: continuity of life, free transferability of interest, or centralized management.[108] This Note now examines how a planner can organize a LLC that technically possesses continuity of life, free transferability of interest, and possibly centralized management, as defined in Revenue Procedure 95-10, while maximizing the flexibility of the LLC.

A. Continuity of Life

Revenue Procedure 95-10 provides identical guidelines regarding continuity of life for LLC's that designate or elect managers and for LLC's that reserve management in all the members.[109] Under either management scheme, the IRS will apply a two-part test to determine if the LLC lacks the corporate characteristic of continuity of life. First, the controlling statute or the operating

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104. *Id.*

105. Section 5.01 of Revenue Procedure 95-10 relates to the corporate characteristic of continuity of life described in § 301.7701-2(b) of the Treasury Regulations. *Id.* at 23. Section 5.02 relates to the corporate characteristic of free transferability of interest described in Treasury Regulation § 301.7701-2(e). *Id.* Section 5.03 relates to the corporate characteristic of centralized management described in Treasury Regulation § 301.7701-2(c). *Id.* at 23-24. Finally, § 5.04 relates to the corporate characteristic of limited liability described in Treasury Regulation § 301.7701-2(d). *Id.* at 24.

106. A LLC must also satisfy the ownership tests contained in section 4 of Revenue Procedure 95-10. Generally, a LLC satisfies the ownership tests if the LLC has at least two members, meets minimum profit and loss interests, and maintains minimum capital account balances. *Id.* at 21-23. The minimum profit and loss interests and the minimum capital account balances differ depending on a LLC's corporate characteristics, and various exceptions may apply. *Id.*

107. *See supra* notes 59-63 and accompanying text.

108. These four corporate characteristics must be weighed equally. Larson v. Commissioner, 66 T.C. 159 (1976).

109. *See* Rev. Proc. 95-10, 1995-3 I.R.B. 20, 23.

agreement must provide that the "death, insanity, bankruptcy, retirement, resignation, or expulsion" of any manager or member, respectively,[110] dissolves[111] the LLC.[112] Second, the LLC cannot be continued by less than a "majority in interest"[113] of the remaining members.[114] If both prongs of the test are satisfied, the IRS will rule that the LLC lacks continuity of life.[115]

The default provisions of the Ohio LLC Act eliminate continuity of life for a LLC organized in Ohio if the members do not alter the default provisions in the operating agreement. The default provisions relating to the duration of a LLC either: (1) establish a default life of perpetuity;[116] (2) establish a default life of thirty (30) years;[117] or (3) allow the operating agreement to specify a stated life for the LLC.[118] These are not the provisions that cause a LLC formed under the default provisions of the LLC Act to lack continuity of life. The Treasury Regulations provide that an organization's agreement to operate for a stated period or until the completion of some stated transaction does not cause the organization to lack continuity of life so long as no member has the power to dissolve the corporation in contravention of the agreement.[119] The default provisions that establish a default life of perpetuity or a default life of thirty years, therefore, will not prevent the organization from possessing the corporate characteristic of continuity of life, because no member has the power to dissolve the LLC in contravention of the agreement.

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110. As used in this section, the phrase "members or managers, respectively," refers to members if the LLC reserves its management in the members and managers if the LLC elects or designates managers.

111. Dissolution occurs when there is an alteration of the identity of an organization by reason of a change, under local law, in the relationship between its members. Treas. Reg. § 301.7701-2(b)(2) (as amended in 1993).

112. Rev. Proc. 95-10, 1995-3 I.R.B. 20, 23. The Revenue Procedure makes it clear that all of the managers or members, respectively, must be subject to the specified dissolution events. It is not sufficient that only a specified number of the managers or members, respectively, are subject to the dissolution events.

113. *See* Rev. Proc. 94-46, 1994-28 I.R.B. 129 (defining "majority in interest").

114. Rev. Proc. 95-10, 1995-3 I.R.B. 20, 23.

115. This test is very similar to the Treasury Regulations' provisions regarding the corporate characteristic of continuity of life. Under the regulations, an organization possesses the corporate characteristic of continuity of life when the original business organization does not dissolve upon a member's death, insanity, bankruptcy, retirement, resignation, or expulsion. Treas. Reg. § 301.7701-2(b)(1). The Treasury Regulations create absolute rules for general partnerships and corporations regarding continuity of life. General partnerships always lack continuity of life because any event which entails the withdrawal of a general partner dissolves the partnership. *Id.* In contrast, corporations always possess continuity of life because corporations have a continuing identity which is detached from the relationship between its shareholders. *Id.* No similar rules, however, exist for LLCs. It, therefore, is necessary to examine the Ohio LLC Act and the operating agreement of a LLC to determine the presence or absence of continuity of life in a LLC.

116. OHIO REV. CODE ANN. § 1705.04(B) (Anderson Supp. 1994).

117. *Id.* § 1705.43(A)(1).

118. *Id.* §§ 1705.04(B), 1705.43(A)(1). The statute appears on its face to contain conflicting provisions on this issue. While section 1705.04(B) of the Ohio Revised Code provides that the duration will be perpetual if the operating agreement does not provide a period of duration, section 1705.43(A)(1) of the Ohio Revised Code provides for a default life of 30 years. *Id.* Thus, if the operating agreement is silent regarding a LLC's duration, it is unclear whether the LLC will have a perpetual life or a default life of 30 years.

119. Treas. Reg. § 301.7701-2(b)(3) (as amended in 1993).

The default provisions that cause a LLC to lack the characteristic of continuity of life relate to the dissolution of a LLC. These provisions provide that a LLC dissolves upon, among other events, the withdrawal of a member.[120] A member is deemed to have withdrawn if the member is adjudicated an incompetent or dies,[121] files a voluntary bankruptcy petition or is adjudicated a bankrupt,[122] withdraws or resigns,[123] or is expelled or removed.[124] The LLC Act, however, permits the LLC to continue doing business upon a member's withdrawal if the business is continued either by "consent of all the remaining members or under a right to continue" as provided in the operating agreement.[125]

The Treasury Regulations provide that an organizational agreement:

> [M]ay provide that the business will be continued by the remaining members in the event of the death or withdrawal of any member, but such agreement does not establish continuity of life if under local law the death or withdrawal of any member causes a dissolution of the organization.[126]

If the operating agreement does not provide for any right to continue and a member subsequently withdraws, the continuity of the LLC is not assured because all remaining members must agree to continue the business. Consequently, a LLC will lack the characteristic of continuity of life if the members do not alter, in the operating agreement, the Act's provisions concerning dissolution of the LLC.

If, however, the operating agreement contains, in writing, a business continuation right, and this right denies the members of the power to dissolve the LLC, the LLC will possess the characteristic of continuity of life.[127] Continuity of life exists because the LLC continues to exist under all circumstances without the approval or consent of any member. Accordingly, if the operating agreement contains business continuation language, the business planner must make sure that the LLC lacks free transferability of interest and centralized management. Otherwise, the planner risks forfeiting pass-through tax treatment for the LLC.

A planner, however, can increase the life and stability of a LLC without causing the LLC to possess the characteristic of continuity of life. The planner

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120. OHIO REV. CODE ANN. § 1705.43(A)(4).
121. *Id.* § 1705.15(E).
122. *Id.* § 1705.15(C)(2)-(3).
123. *Id.* § 1705.15(A).
124. *Id.* § 1705.15(B).
125. *Id.* § 1705.43(A)(4).
126. Treas. Reg. § 301.7701-2(b)(2) (as amended in 1993).
127. In Revenue Ruling 93-38, the IRS determined that a LLC, organized under the Delaware LLC Act, in which the members agreed in writing that the entity would continue, without approval or consent of any member, following the death, retirement, resignation, expulsion, bankruptcy, or dissolution of a member, or the occurrence of any event that terminates the continued membership of a member, possessed continuity of life. Rev. Rul. 93-38, 1993-1 C.B. 233. The Delaware LLC Act, like the Ohio LLC Act, is a flexible statute, thus, presumably the IRS would apply the same reasoning in Ohio.

can accomplish this by providing in the operating agreement that less than all of the dissolution events provided in section 5.01 of Revenue Procedure 95-10 dissolves the LLC.[128] As long as the dissolution event or events selected provide "a meaningful possibility of dissolution," the IRS should not rule that the LLC possesses continuity of life.[129] For example, the operating agreement could provide that the only dissolution event is the retirement of a member. If the retirement of a member provides a meaningful possibility of dissolution, then the LLC should lack continuity of life.

If the LLC has designated one or more members as managers, it is possible for the planner to further increase the life and stability of the LLC. Section 5.01 of Revenue Procedure 95-10 provides that the IRS will rule that a LLC lacks continuity of life if the dissolution event or events relate only to the member-managers, as long as, the events relate to all of the member-managers.[130] Thus, the planner can provide in the operating agreement that the dissolution event or events relate solely to the member-managers. Again, less than all of the events in section 5.01 of Revenue Procedure 95-10 may be specified as the dissolution event or events.[131] For example, the operating agreement can provide that the only dissolution event is the death of a member-manager, and the IRS should rule that the LLC lacks continuity of life because the death of a member-manager should constitute a meaningful possibility of dissolution.

A LLC, therefore, can technically lack the corporate characteristic of continuity of life while minimizing the possibility of dissolution. The planner can easily provide a long life for the LLC by carefully selecting the dissolution event or events and to whom the dissolution event or events relate. This flexibility allows a LLC significant stability while technically lacking the corporate characteristic of continuity of life.

B. Free Transferability of Interest

Revenue Procedure 95-10 also permits LLCs to have minimal transferability restrictions while technically lacking free transferability of interest. Revenue Procedure 95-10 provides identical guidelines regarding free

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128. Section 5.01 of Revenue Procedure 95-10 provides that the death, insanity, bankruptcy, retirement, resignation or expulsion of any member-manager dissolves a LLC, if a LLC that designates or elects one or more members as managers, or of any member if the LLC does not designate or elect one or more members as managers. Rev. Proc. 95-10, 1995-3 I.R.B. 20, 23.

129. *Id.* at 23. Revenue Procedure 95-10 does not define a "meaningful possibility of dissolution." The IRS, when informally explaining the revenue procedure, however, stated that a legal possibility should be sufficient, and that the taxpayer would not be required to establish the factual possibility of the dissolution event or events. *See* Susan Pace Hamill, *The Taxation of Domestic Limited Liability Companies and Limited Partnerships: A Case for Eliminating the Partnership Classification Regulations*, 73 WASH. U. L.Q. 565, 592 (1995).

130. Rev. Proc. 95-10, 1995-3 I.R.B. 20.

131. *See supra* note 128.

transferability of interest for LLCs that designate or elect managers and for LLCs that reserve management in all the members.[132] Under either management scheme, the IRS will generally rule that a LLC lacks free transferability of interest if each member or those members owning more than twenty percent of all interests in the LLC's capital, income, gain, loss, deduction, and credit cannot transfer to a non-member all the attributes of the member's interest without the consent[133] of at least a majority[134] of the non-transferring managers or members, respectively.[135] This standard is substantially similar to the Treasury Regulations' rule regarding free transferability of interest.[136]

The default provisions of the Ohio LLC Act cause a LLC to lack the characteristic of free transferability of interest. The Ohio LLC Act provides that membership interests are assignable, except as provided in the operating agreement.[137] An assignee, however, only acquires the economic interests to which the assignor was entitled.[138] An assignee does not acquire the right to participate in management decisions, unless all of the other members consent or the operating agreement provides authority for the assignor to give an assignee the right to become a member.[139] If the planner does not alter the default provisions of a LLC Act, the LLC, therefore, will lack free transferability of interest.[140]

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132. Rev. Proc. 95-10, 1995-3 I.R.B. 20.

133. The power to withhold consent must "constitute[] a meaningful restriction on the transfer of the interests." *Id.* at 23. For example, the IRS does not consider consent to be a meaningful restriction on the transfer if the consent may not be unreasonably withheld. *Id.*

134. "[C]onsent of a majority includes either a majority in interest . . . a majority of either the capital or profits interests in the LLC, or a majority determined on a per capita basis." *Id.*; *see* Rev. Proc. 94-96, 1994-28 I.R.B. 129 (defining a "majority in interest").

135. As used in this section, the phrase "members or managers, respectively," refers to members if the LLC reserves its management in the members and managers if the LLC elects or designates managers.

136. Under the Treasury Regulations, an organization possesses the corporate characteristic of "free transferability of interests" if each of the organization's members or those members owning "substantially all" of the interest in the organization have the power to transfer all of their attributes of membership to another person without the consent of the other members. Treas. Reg. § 301.7701-2(e)(1) (as amended in 1993). The characteristic of free transferability of interest does not exist when each member can assign his right to share in profits without the consent of other members, but cannot assign his right to participate in the management of the organization. *Id.*

137. OHIO REV. CODE ANN. § 1705.18 (Anderson Supp. 1994); *see supra* notes 53-58 and accompanying text.

138. OHIO REV. CODE ANN. § 1705.18; *see supra* notes 53-58 and accompanying text.

139. OHIO REV. CODE ANN. § 1705.20; *see supra* notes 53-58 and accompanying text.

140. The IRS has determined that LLCs organized under statutes with similar provisions to those in section 1705.20 of the Ohio Revised Code do not possess the corporate characteristic of free transferability of interest. *See* Rev. Rul. 95-9, 1995-3 I.R.B. 17 (S.D.; holding that a LLC lacks the corporate characteristic of free transferability of interest when an assignee does not become a substitute member and does not acquire all of the attributes of the member's interests in the LLC unless the remaining members unanimously approve of the assignment); Rev. Rul. 94-51, 1994-32 I.R.B. 11 (N.J.; same); Rev. Rul. 94-30, 1994-19 I.R.B. 6 (Kan.; same); Rev. Rul. 94-6, 1994-3 I.R.B. 11 (Ala.; same); Rev. Rul. 94-5, 1994-2 I.R.B. 21 (La.; same); Rev. Rul. 93-93, 1993-42 I.R.B. 13 (Ariz.; same); Rev. Rul. 93-92, 1993-42 I.R.B. 11 (Okla.; same); Rev. Rul. 93-81, 1993-38 I.R.B. 7 (R.I.; same); Rev. Rul. 93-53, 1993-26 I.R.B. 7 (Fla.; same); Rev. Rul. 93-49, 1993-25 I.R.B. 11 (Ill.; same); Rev. Rul. 93-38, 1993-21 I.R.B. 4 (Del. (situation 1); same); Rev. Rul. 93-6, 1993-1 C.B. 229 (Colo.; same); Rev. Rul. 93-5, 1993-1 C.B. 227 (Va.; same); Rev. Rul. 88-76, 1988-2 C.B. 360 (Wyo.; same).

The planner, however, in the operating agreement, can minimize the transferability restrictions of the default provisions and satisfy Revenue Procedure 95-10. First, all of the membership interests are not necessarily subject to the consent requirement. Rather, only members that own twenty percent of all interests in the LLC's capital, income, gain, loss, deduction, and credit are subject to the consent requirement.[141] Almost eighty percent of the membership interests, therefore, can avoid the consent requirement.

Second, if the LLC has designated or elected member-managers, a majority of the member-managers may provide the consent for the transfer, instead of a majority of the members.[142] The only requirement that must be satisfied is that the power to withhold consent must constitute a "meaningful restriction."[143] A LLC allowing transfers with the consent of less than all of the remaining members, therefore, may lack the corporate characteristic of free transferability of interest.

Third, a LLC should lack free transferability of interest if the operating agreement provides that the non-transferring members who are entitled to receive a majority of the non-transferring profits consent to the transfer before the transferee acquires all the transferring member's interest in the LLC.[144] The planner, therefore, can provide the members with minimal transferability restrictions while the LLC lacks the corporate characteristic of free transferability of interest.

C. Centralized Management

Four possible management schemes may exist in a LLC. First, a LLC could be managed exclusively by the members in their membership capacity. Second, a LLC could designate one or more persons who are not members as managers of the LLC. Third, a LLC could designate or elect one or more members as managers of the LLC. Finally, a LLC could designate or elect both one or more members and one or more persons who are not members of the LLC as managers of the LLC.

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141. Rev. Proc. 95-10, 1995-3 I.R.B. 20, 23. This confirms several private letter rulings in which the IRS indicated that when the operating agreement provides for a majority consent requirement, a LLC may lack free transferability of interest if the operating agreement provides that an assignee cannot become a substituted member unless the members holding a majority of the capital assets consent to the transfer. *See* Priv. Ltr. Rul. 92-19-022 (Feb. 6, 1992); Priv. Ltr. Rul. 92-10-019 (Dec. 6, 1991). Since private letter rulings only apply to the taxpayer who obtained the ruling, the rulings only provide for the possible treatment by the IRS on this issue. Thus, planners considering modifying the LLC Act's provisions in this respect should consider obtaining a private letter ruling.

142. Rev. Proc. 95-10, 1995-3 I.R.B. 20, 23.

143. *Id.* "For example, a power to withhold consent to a transfer is not a meaningful restriction if the consent may not be unreasonably withheld." *Id.*

144. *See* Rev. Rul. 93-91, 1993-2 C.B. 316 (determining that a LLC organized under the Utah LLC Act, which provides for a transfer of all membership interests with the consent of less than all the non-transferring members, lacks the corporate characteristic of free transferability of interest if the non-transferring members entitled to receive a majority of the non-transferred profits of the LLC must consent to the proposed transfer before the transferee acquires all of the membership attributes of the transferor).

A LLC that adopts the first management scheme will clearly lack the characteristic of centralized management. Revenue Procedure 95-10 provides that if a LLC is managed by the members exclusively in their membership capacity, the IRS will rule that the LLC lacks centralized management.[145] The Ohio LLC Act's default provisions provide that management of a LLC is vested in all the members, unless otherwise provided in the operating agreement.[146] If the operating agreement does not alter the default provisions of the LLC Act, the LLC will lack the corporate characteristic of centralization of management.[147]

Additionally, if a LLC has the second management structure, electing or designating non-members as managers, it is clear that the IRS will rule that the LLC has centralized management. Revenue Procedure 95-10 provides that if a LLC elects or designates managers, the Service will not rule that the LLC lacks centralized management unless the managers own in the aggregate twenty percent of the total interests in the LLC.[148] The twenty percent ownership exception obviously will not be met because non-member managers have no membership interest in the LLC.

Under the two management schemes where the LLC designates or elects member-managers and/or non-member managers, the determination of whether the IRS will rule that a LLC lacks centralized management is not clear. Prior to Revenue Procedure 95-10, the IRS seemed to have adopted a per se rule that the use of managers in a LLC causes the LLC to possess centralized management.[149] Revenue Procedure 95-10, however, provides that if the elected or

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145. Rev. Proc. 95-10, 1995-3 I.R.B. 20, 23. This standard is similar to the rule the regulations provide for determining if an organization possesses the characteristic of centralized management. Under the regulations, an organization possesses the corporate characteristic of centralized management if any person, or any group of persons not including all of the members of the entity, has the "continuing exclusive authority" to make the entity's management decisions. Treas. Reg. § 301.7701-2(c)(1) (as amended in 1993). The "persons who are vested with such management authority," will possess similar responsibility and authority as directors of a corporation. *Id.* For centralization of management to exist, managers must have "sole authority" to make decisions that do not require ratification by members of the organization. *Id.* § 301.7701-2(c)(3) to (4). Thus, centralization of management will not exist "when the centralized authority is merely to perform ministerial acts as an agent at the direction of a principal." *Id.* § 301.7701-2(c)(3).

146. OHIO REV. CODE ANN. § 1705.24 (Anderson Supp. 1994); *see supra* notes 64-70 and accompanying text.

147. The IRS has determined that LLCs organized under statutes with provisions similar to those in section 1705.24 of the Ohio Revised Code do not possess the corporate characteristic of centralized management. *See* Rev. Rul. 95-9, 1995-3 I.R.B. 17 (S.D.; determining that a LLC lacks the corporate characteristic of centralization of management when management is vested in all of its members); Rev. Rul. 94-51, 1994-2 C.B. 407 (N.J.; same); Rev. Rul. 94-30, 1994-1 C.B. 316 (Kan.; same); Rev. Rul. 94-6, 1994-1 C.B. 314 (Ala.; same); Rev. Rul. 94-5, 1994-1 C.B. 312 (La.; same); Rev. Rul. 93-93, 1993-2 C.B. 321 (Ariz.; same); Rev. Rul. 93-92, 1993-2 C.B. 318 (Okla.; same); Rev. Rul. 93-81, 1993-2 C.B. 314 (R.I.; same); Rev. Rul. 93-53, 1993-2 C.B. 312 (Fla.; same); Rev. Rul. 93-49, 1993-2 C.B. 308 (Ill.; same); Rev. Rul. 93-38, 1993-1 C.B. 233 (Del. (situation 1); same); Rev. Rul. 93-6, 1993-1 C.B. 229 (Colo.; same); Rev. Rul. 93-5, 1993-1 C.B. 227 (Va.; same); Rev. Rul. 88-76, 1988-2 C.B. 360 (Wyo.; same).

148. Rev. Proc. 95-10, 1995-3 I.R.B. 20, 23-24.

149. The Service ruled in all of the Revenue Rulings that concerned the classification of LLCs with designated or elected managers and were issued prior to Revenue Procedure 95-10 that these types of LLCs possess the corporate characteristic of centralized management. *See* Rev. Rul. 95-9, 1995-3 I.R.B. 17 (S.D.;

designated managers in the aggregate own at least twenty percent of the total interest in the LLC, the IRS will not apply the per se rule.[150] Instead, the IRS will "consider all the relevant facts and circumstances, including, particularly, member control of the member-managers (whether direct or indirect), in determining whether the LLC lacks centralized management."[151] If the member managers are subject to periodic elections by the members or the non-managing members have an unrestricted power to remove the member managers, then the IRS will rule that the LLC has centralized management.[152]

Under these management schemes, to satisfy the twenty percent ownership exception, the members that have been designated managers must initially own, in the aggregate, at least twenty percent of the total interests in the LLC.[153] If the twenty percent ownership test is satisfied, the IRS will still consider facts and circumstances to ensure that the non-managing members do not control the managers. At the very least, the managers cannot be subject to periodic elections and the non-managing members cannot have an unrestricted power to remove the managers.[154] The foregoing indicates a lack of certainty on the IRS's position regarding centralized management, or lack thereof, when a LLC either designates member-managers or a combination of member-managers and non-member managers as managers. Thus, a planner must proceed with caution if the LLC is going to be managed by member-managers or a combination of member-managers and non-member managers.

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finding that a LLC comprised of 25 members which elected three members to be managers of the LLC possessed the corporate characteristic of centralized management); Rev. Rul. 94-51, 1994-2 C.B. 407 (N.J.; same); Rev. Rul. 94-30, 1994-1 C.B. 316 (Kan.; same); Rev. Rul. 94-6, 1994-1 C.B. 314 (Ala.; same); Rev. Rul. 94-5, 1994-1 C.B. 312 (La.; same); Rev. Rul. 93-93, 1993-2 C.B. 321 (Ariz.; same); Rev. Rul. 93-92, 1993-2 C.B. 318 (Okla.; same); Rev. Rul. 93-91, 1993-2 C.B. 316 (Utah; same); Rev. Rul. 93-81, 1993-2 C.B. 314 (R.I.; same); Rev. Rul. 93-53, 1993-2 C.B. 312 (Fla.; same); Rev. Rul. 93-50, 1993-2 C.B. 310 (W. Va.; same); Rev. Rul. 93-49, 1993-2 C.B. 308 (Ill.; same); Rev. Rul. 93-38, 1993-1 C.B. 233 (Del. (situation 2); same); Rev. Rul. 93-30, 1993-1 C.B. 231 (Nev.; same); Rev. Rul. 93-5, 1993-1 C.B. 227 (Va.; same); Rev. Rul. 88-76, 1988-2 C.B. 360 (Wyo.; same); *see also* Rev. Rul. 93-6, 1993-1 C.B. 229 (Colo.; finding that a LLC comprised of five members of which each member was elected to be a manager of the LLC possessed the corporate characteristic of centralized management due to the fact that management was delegated).

150. Rev. Proc. 95-10, 1995-3 I.R.B. 20, 23-24. This standard is similar to the factors in Revenue Procedure 89-12 provides that the IRS considers in determining if an organization will be classified as a partnership for federal tax purposes. *Id.* at 20. Revenue Procedure 95-10, however, modified Revenue Procedure 89-12 so that Revenue Procedure 89-12 no longer applies to LLCs. *Id.* In Revenue Procedure 89-12, the IRS provided that a limited partnership will lack centralized management if the general partners own at least 20% of the partnership. Rev. Proc. 89-12, 1989-1 C.B. 798, 801. This rationale, however, had never been applied to LLCs before Revenue Procedure 95-10.

151. Rev. Proc. 95-10, 1995-3 I.R.B. 20, 24.

152. *Id.*

153. *Id.* The 20% ownership test does not require that all of the managers have an ownership interest in the LLC. The ownership test only requires is that all of the manager's membership interests, if any, total 20%. Thus, if the management of the LLC consists of some member managers and some non-member managers, the test can be satisfied if the member-managers ownership interests total 20% of the LLC's total membership interests.

154. *Id.* at 24.

IV. CONCLUSION

Ohio business planners have long awaited an entity that allows broad flexibility in management structures, avoids double taxation, and limits the owner's liability. The Ohio LLC is such an entity. In order for an Ohio LLC to obtain pass-through tax treatment, the LLC must lack at least two of the four corporate characteristics of limited liability, centralized management, free transferability of interest, and continuity of life, as defined in Revenue Procedure 95-10. A LLC formed under the default provisions of the Ohio LLC Act will lack all of these characteristics and, therefore, avoid double taxation.

A planner, however, in the operating agreement, can alter the default provisions of the Ohio LLC Act and structure the LLC to meet the specific needs and desires of the members. A planner can structure the LLC so that the LLC technically lacks continuity of life, free transferability of interest, and possibly centralized management, while the LLC, for practical purposes, retains these characteristics. With this flexibility, business planners will find little use for partnerships and Subchapter S corporations, and the LLC will become the entity of choice.

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