A GUIDE TO THE IOWA LIMITED LIABILITY COMPANY ACT

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I. INTRODUCTION

Imagine a business entity with the operating characteristics of a general partnership, including its tax status, but with liability protections equivalent to corporate shareholders for all of its owners. The limited liability company (LLC), a recent innovation in business law, is such an entity. Such companies have the tax characteristics of partnerships, with the limited liability aspects of corporations for all investors, called members. At least thirty states now permit limited liability companies (LLCs) to be organized, and every other state in the Union has shown interest in LLC legislation.[1]

1. The states that have adopted LLC legislation are Alabama, Arizona, Colorado, Delaware, Florida, Georgia, Idaho, Illinois, Indiana, Iowa, Kansas, Louisiana, Maryland, Michigan, Minnesota, Missouri, Montana, Nebraska, Nevada, New Hampshire, New Mexico, North Dakota, Oklahoma, Rhode Island, South Dakota, Texas, Utah, Virginia, West Virginia, and Wyoming. See the Appendix for a state by state comparison. In Mississippi foreign LLCs

The Iowa Limited Liability Company Act (Act or Iowa Act) was effective July 1, 1992, and was codified as Iowa Code Chapter 490A.[2]

Although LLCs have been common internationally for many years, it was not until 1977 that Wyoming adopted the first Limited Liability Company Act in the United States.[3] The Wyoming Act was special legislation for a Texas mineral concern.[4] Florida followed suit in 1982 on the assumption Latin American LLCs might be encouraged to do business in Florida.[5] Businesspersons were reluctant to use LLCs, however, until its tax status was resolved.

It was 1988 before the Internal Revenue Service (IRS) ruled on the tax status of LLCs. In Revenue Ruling 88-76, the IRS ruled LLCs would be taxed as partnerships so long as they failed two of the four key tests distinguishing partnerships from associations.[6] Failing these tests is the *sine qua non* of LLCs, but is also an important drawback to such entities, as discussed later in this Article.[7]

LLCs have become popular as an alternative to S corporations[8] and partnerships. LLCs are ideally suited for small businesses and entrepreneurs without the restrictions imposed on S corporations.[9] In addition, large or widely-held corporations may use such entities as subsidiaries or as joint-venture vehicles, an area once dominated by partnerships.

II. ADVANTAGES OF LLCS OVER S CORPORATIONS AND LIMITED PARTNERSHIPS

LLCs have the advantages of S corporations and partnerships without the disadvantages inherent in both. LLCs and S corporations provide limited liability to their owners and the pass-through of income and losses to them. LLCs, however, have the following advantages over S corporations:

1. Any type of entity or person can be a member of a LLC, including entities prohibited from owning stock in an S corporation, such as

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are able to register to do business, but domestic LLCs cannot be organized. LLC legislation has been introduced in California, Connecticut, Hawaii, Maine, Massachusetts, New Jersey, New York, North Carolina, Ohio, Oregon, Pennsylvania, Tennessee and Washington. *See* Barbara C. Spudis, *Limited Liability Companies*, 5 J. S CORP. TAX'N 183 (Fall 1993).

2. Iowa H.F. 2369, 74th G.A., 2d Sess. (1992) (codified at IOWA CODE §§ 490A.100-.1601 (1993)).

3. WYO. STAT. §§ 17-15-101 to -15-136 (1977).

4. Based on conversations the author had with those involved in the development of LLCs.

5. FLA. STAT. ANN. §§ 608.401-.471 (West 1993).

6. Rev. Rul. 88-76, 1988-2 C.B. 360.

7. *See infra* text accompanying notes 201-76.

8. A S corporation is a corporation that has elected pass-through tax status. *See* I.R.C. §§ 1361-1366 (1988).

9. *See infra* text accompanying notes 10-17.

corporations, partnerships, nonresident aliens, Employee Stock Ownership Plans (ESOPs), and charities.[10]

2. LLCs may have an unlimited number of members whereas an S corporation is limited to no more than thirty-five shareholders.[11]
3. LLCs may make disproportionate distributions and allocations among their members, but S corporations are limited to a single class of stock, making special distributions of cash flows or allocations of income or loss impossible.[12]
4. LLCs' liabilities can increase the members' bases in their LLC interests.[13] The liabilities incurred by S corporations do not increase the "outside bases" of the shareholders' stock.[14]
5. LLCs will not recognize gain upon the distribution of appreciated property; however, S corporations will recognize gain upon the distribution of appreciated property.[15]
6. LLCs cannot inadvertently lose their pass-through tax status as can an S corporation.[16]
7. Unlike members of S corporations, members of LLCs are allowed to contribute appreciated property to the LLC in exchange for a membership interest without having to recognize gain on the transfer regardless of whether the member owns eighty percent or more of the LLC.[17]

LLCs share the same tax advantages found in limited partnerships. LLCs, like limited partnerships (and S corporations), have pass-through tax advantages so there is only tax at the investor level.[18] Because they are taxed as partnerships, members of LLCs also enjoy such tax advantages as increased basis adjustments for company liabilities and stepped-up bases in their assets upon the sale or transfer of a membership interest.[19] LLCs can also allocate income and tax liabilities freely among their members, just like a partnership, to fit the members' needs.[20]

In addition, LLCs have significant advantages over limited partnerships:

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10. I.R.C. § 1361(b)(1)(B), (c)(2) (1988).
11. *Id.* § 1361 (b)(1)(A).
12. *Id.* §§ 1361(b)(1)(D), 1377(a)(1).
13. *Id.* § 754.
14. Rev. Rul. 71-288, 1971-2 C.B. 319.
15. I.R.C. § 311(b) (1988).
16. *Id.* § 1362(d)(2).
17. *Id.* § 351(b). The IRS recognized the applicability of § 351 to S corporations in Gen. Couns. Mem. 38,969 (March 11, 1983).
18. This presupposes the LLC will be deemed a partnership for tax purposes. *See infra* text accompanying notes 201-76.
19. *See generally* I.R.C. §§ 705, 742 (1988).
20. *See id.* § 704.

1. All members of a LLC have the benefit of limited liability regardless of their involvement in the management of the company. No member of a LLC is liable for the debts of the company.[21]
2. Limited partners in a limited partnership run the risk of losing their limited liability status if they become too involved in the business of the partnership.[22] The ability of investors in a LLC to participate actively in management without losing their limited liability status may also permit them to convert what are known as "passive" tax losses to "active" tax losses, which could have a favorable tax result for them.[23]
3. Moreover, using a LLC avoids the need for a general partner and, in the case of a corporate general partner, compliance with the capital and other requirements imposed by the IRS.[24]

III. CREATION, ORGANIZATION, AND OPERATION OF A LLC

A. *Commencement of Existence*

A LLC is created by filing articles of organization with the Iowa Secretary of State.[25] Once a LLC files articles of organization, it comes into legal existence.[26] The articles of organization set forth the name of the LLC (the Iowa Act requires the words "Limited Company" or the abbreviation "L.C.");[27] its period of duration, which in Iowa shall not be perpetual;[28] the name and address of the registered agent;[29] and the name and address of the LLC's principal office.[30] The Secretary of State's certificate of organization is conclusive evidence the articles of organization have been filed.[31] One or more persons, including third parties, may sign and file articles of organization,[32] just as an incorporator may file articles of incorporation under the Iowa Business Corporation Act.[33] A LLC must have at least two members from the moment of its formation, however.[34]

The need for two members is not only a requirement of the Act, but is also important from a tax law standpoint. When structuring a LLC, the tax implications of the identity of the members are critical. For example, for tax

21. IOWA CODE § 490A.601 (1993).
22. *Id.* § 487.303.
23. I.R.C. § 469 (1988).
24. Rev. Proc. 89-12, 1989-1 C.B. 798.
25. IOWA CODE §§ 490A.122, .301 (1993).
26. *Id.* § 490A.301.
27. *Id.* § 490A.401(1).
28. *Id.* § 490A.303(1)(d).
29. *Id.* § 490A.303(1)(b).
30. *Id.* § 490A.303(1)(c).
31. *Id.* § 490A.127.
32. *Id.* § 490A.301.
33. *Id.* § 490.201.
34. *See id.* § 490A.102(13).

purposes a husband and wife can be partners.[35] The IRS has analyzed five factors to determine whether a partnership, particularly between spouses, exists: (1) the agreement between the parties and their conduct in carrying out its terms, (2) the contributions by each party to the venture, (3) the control over the income and capital of the venture and the right of each party to make withdrawals, (4) whether the parties share in the profits and the losses, and (5) whether the venture is carried on in the name of both parties and presented as a partnership.[36] Application of the IRS's "single economic interest" theory may, however, make it difficult for a shell corporation and its owner to form a LLC.[37] The single economic interest theory provides the identity of separate entities will be disregarded if a common person controls such entities.[38] Once the distinction between the owners is disregarded, a LLC would not be able to satisfy the transferability of interests tests for establishing the LLC as a partnership for tax purposes.[39]

B. *Filing the Articles of Organization*

The articles must contain the information required by Section 303 of the Act,[40] and must be accompanied by a filing fee of $50.[41] The information requirements for the articles of organization are similar to those for corporate articles of incorporation:

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35. Commissioner v. Tower, 327 U.S. 280, 290 (1946) (holding a wife may be a general or limited partner with her husband); *see* Commissioner v. Culbertson, 337 U.S. 733 (1949); Beulah H. Nichols, 32 T.C. 1322 (1959), *acq.*, 1960-2 C.B. 6 (holding a partnership for federal income tax purposes existed between a physician and his nondoctor spouse); Rev. Rul. 77-332, 1977-2 C.B. 484; Rev. Rul. 58-243, 1958-1 C.B. 255.

36. Treas. Reg. § 1.704-1(e)(2) (1992); Luna v. Commissioner, 42 T.C. 1067 (1964) (holding insurance agent was employee of insurer, not a partner or joint venturer); Priv. Ltr. Rul. 90-07-013 (Nov. 15, 1989) (holding harbor pilot association was a partnership when the 15 members contributed all their revenue to the association, from which expenses of association and wages of members were paid); Priv. Ltr. Rul. 87-42-007 (June 26, 1987) (holding husband and wife were not partners in a hog, cattle, and grain operation).

37. *See* Rev. Rul. 93-4, 1993-3 I.R.B. 5 (modifying Rev. Rul. 77-214, 1977-1 C.B. 408 by ruling a German LLC, a GmbH, was taxable as a corporation because its two members were subsidiaries of the same United States parent). *But see* Rev. Rul. 75-19, 1975-1 C.B. 382 (ruling a general partnership comprised of four corporate partners all wholly-owned subsidiaries of a domestic corporation was a partnership for tax purposes); Priv. Ltr. Rul. 92-39-014 (June 25, 1992) (holding a limited partnership made up of a husband and wife as the limited partners and a corporate general partner owned by the husband would be taxed as a partnership).

38. Rev. Rul. 77-214, 1977-1 C.B. 408.

39. *Id. See infra* text accompanying notes 201-08.

40. IOWA CODE § 490A.303 (1993).

41. *Id.* § 490A.124(1)(a).

1. *Name Requirements*

(a) The name must contain the words "Limited Company" or the abbreviation "L.C."[42]
(b) The name cannot contain the words "Corporation," "Incorporated," or "Limited Partnership," or the abbreviations "Corp.," "Inc.," or "L.P."[43]
(c) With certain exceptions, the name must be distinguishable upon the records of the Secretary of State from the names, fictitious or actual, of other LLCs, limited partnerships, corporations, and nonprofit corporations (domestic or foreign) in use or reserved for use in Iowa.[44]
(d) Names of proposed LLCs are to be reserved for 120 days, and the owner of a reserved name may transfer the reservation to another person by delivering a notice of the transfer to the Secretary of State.[45]

2. *Registered Office and Agent*

The requirements for the registered agent and registered office[46] parallel those found in the Iowa Business Corporation Act.[47] A registered agent must be either an individual who is a resident of Iowa,[48] a domestic corporation,[49] nonprofit corporation or a LLC,[50] a foreign corporation,[51] a foreign nonprofit corporation,[52] or a foreign LLC registered to do business in Iowa.[53] The agent's business office must be identical with its registered office.[54] A LLC may change its registered office or registered agent, or both, by filing a statement of change of registered agent or office.[55] If a registered agent changes his business address, he must change the address of the registered office of any LLC of which he is a registered agent.[56] A registered agent may resign as a LLC's agent by signing and filing with the Secretary of State a statement of resignation and two copies of the same. The agency of the regis-

42. *Id.* § 490A.401(1).
43. *Id.* § 490A.401(2)(a).
44. *Id.* § 490A.401(3).
45. *Id.* § 490A.402.
46. *Id.* § 490A.501.
47. *See id.* § 490.501.
48. *Id.* § 490A.501(2)(a).
49. *Id.* § 490A.501(2)(b).
50. *Id.*
51. *Id.* § 490A.501(2)(c).
52. *Id.*
53. *Id.*
54. *Id.* § 490A.501(2)(a).
55. *Id.* § 490A.502(1). A statement of change must be filed by a LLC "forthwith" upon the death, resignation, or failure to satisfy the conditions of § 501 of the Act by any registered agent. *Id.* § 490A.502(2). The Act does not provide a definition of "forthwith."
56. *Id.* § 490A.502(3). The change may be made by filing a statement for each LLC or a single statement that identifies each LLC for which the person is the registered agent. *Id.*

tered agent is terminated on the thirty-first day after the date on which the statement is filed.[57]

3. *Principal Office*

The principal office is the address at which the LLC must keep the minimum records required to be maintained by Section 709 of the Act. It need not be within the State of Iowa.[58] The principal office may be the same as the registered office.[59]

4. *Duration*

The period of the LLC's duration, which cannot be perpetual, must be indicated.[60] This requirement of limited duration distinguishes LLCs from corporations.

5. *Other Matters*

The articles of organization may also include any other matter permitted to be set forth in an operating agreement.[61] Several sections of the Act require certain optional matters be contained either in the articles or in an operating agreement, otherwise the "default" rules established by the Act will apply.[62] Attorneys should consider three such additional provisions mandatory. These provisions are: (1) a provision that the LLC has a written operating agreement rendering oral understandings without force or effect, the equivalent of an integration clause; (2) a provision declaring whether or not the LLC is managed by managers and the members' authority, or lack thereof, to bind the LLC; and (3) a limitation of liability of managers or members (if the LLC is member-managed), for monetary damages for breach of fiduciary duty as a manager. This excludes a limit on liability for breach of the duty of loyalty, acts or omissions not in good faith or those involving intentional misconduct or a knowing violation of law, transactions from which a manager derives an improper personal benefit, or a wrongful distribution pursuant to Section 807 of the Act.[63]

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57. *Id.* § 490A.503.
58. *Id.* § 490A.303(1)(c).
59. *Id.*
60. *Id.* § 490A.303(1)(d).
61. *Id.* § 490A.303(2).
62. *See, e.g., id.* §§ 490A.701, .702, .705(4)-(8).
63. *Id.* § 490A.707.

C. *Purpose and Powers*

A LLC may engage in any lawful business except as otherwise provided by law, or as restricted by the articles of organization.[64] The Act was amended in 1993 to permit LLCs to own agricultural land subject to the same restrictions imposed on corporations.[65] A LLC has the powers of an individual to do "all things necessary or convenient to carry out its business and affairs."[66] The Act includes a nonexclusive list of powers that parallels the list included in the Iowa Business Corporation Act.[67] These powers do not need to be enumerated in the articles of organization.[68]

D. *Management of a LLC: Member or Manager?*

The owners, or members, may participate directly in the LLC's management or they may vest the management in one or more managers elected by the members.[69] If all of the members are entitled to manage the business, any member can bind the LLC in dealing with third parties unless specifically limited in the articles of organization.[70] If a LLC is to be manager-managed, the articles of organization or an operating agreement must specify this choice.[71] If not specified otherwise, the LLC will be deemed to be member-managed.[72] In a member-managed LLC, the members of a LLC will vote (unless the articles or an operating agreement provide otherwise) on the basis of their contributions to the LLC, as adjusted to reflect additional contributions or withdrawals.[73] Alternatively, the members could choose a per capita voting rule.[74] Although the Act provides for majority or unanimous voting rules in certain situations,[75] the Act does not specify a voting rule for general decision making in a member-managed LLC. Although members of a LLC can include such a voting rule in an operating agreement (which must be

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64. *Id.* § 490A.201. It has been suggested if "business" connotes a pecuniary purpose, LLCs cannot be organized for other uses such as charitable activities or estate planning; but "business" does not require a profit motive. BLACK'S LAW DICTIONARY 198 (6th ed. 1990).

65. 1993 Iowa Acts ch. 39, §§ 1-2 (amending IOWA CODE § 9H).

66. IOWA CODE § 490A.202 (1993).

67. *Id.* §§ 490A.202, 490.202.

68. *Id.* § 490A.303(3).

69. *Id.* § 490A.702 (as amended by 1993 Iowa Acts ch. 39, § 25).

70. *Id.* The Act declares if the LLC is managed by all of its members, then each member is an agent of the LLC unless otherwise provided in the articles of organization. *Id.* § 490A.702(2) (as amended by 1993 Iowa Acts ch. 39, § 25). If a LLC is managed by managers, then a member, solely in her capacity as a member, is not an agent of the LLC. *Id.* § 490A.702(3)(a) (as amended by 1993 Iowa Acts ch. 39, § 25).

71. *Id.* § 490A.702.

72. *Id.*

73. *Id.* § 490A.701(1).

74. *See generally id.* § 490A.701(1) (1993) (allowing alternative voting schemes if provided in articles of organization or operating agreement).

75. *See, e.g., id.* § 490A.701.

agreed to by all the members),[76] the Act should probably be amended to contain a default rule providing for majority voting on all matters for which a greater voting majority is not required under the Act or by agreement. In the absence of such a default rule, unanimous consent is arguably required for all decisions for which the Act, the articles of organization, or an operating agreement do not specify a different rule.

There is a presumption in the Act that LLCs will be managed by a manager or managers. This presumption is found in Sections 706,[77] 707,[78] and 708[79] of the Act. These provisions of the Act provide protections to managers, but not necessarily to members who are managing a LLC. In order to allow member-managers to take advantage of the protections afforded managers in Sections 706 through 708 of the Act, it would be good practice to name the members as managers in the operating agreement even though all of the members will manage the LLC.[80] Section 707 of the Act permits a LLC to limit the liability of its managers or members if management of the LLC is vested in its members.[81]

The articles of organization or an operating agreement may specify that a LLC will be managed by one or more managers.[82] A manager may be any person as defined in the Iowa Code.[83] Thus, a corporation or another LLC could be retained to manage a LLC. Managers are elected and vacancies filled by majority vote of the members, much like the directors and officers of a business corporation, unless the articles of organization or the LLC's operating agreement provides otherwise.[84] Managers may be removed in the manner provided in the articles or an operating agreement, but if no such provision is made, they may be removed with or without cause by a majority vote of the members.[85]

The Act does not specifically permit members in a manager-managed LLC to reserve certain management decisions to the members. This option should be available to members, however, by indicating an appropriate provision in the operating agreement or, perhaps more importantly, in the articles of organization.

The manager-managed form offers tremendous flexibility in structuring the operation of a LLC. An operating agreement, or the articles of organiza-

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76. *Id.* § 490A.701(1).
77. *Id.* § 490A.706 (providing safe harbor standards of conduct).
78. *Id.* § 490A.707 (limiting liability of managers).
79. *Id.* § 490A .708 (providing conflict of interest rules).
80. Business transactions of a manager with a LLC are not voidable if the material facts are disclosed to either the other managers or members and the transaction is authorized, approved, or ratified or if the transaction was fair to the LLC. *Id.* This provision is borrowed from the Iowa Business Corporation Act. *See id.* § 490.831.
81. *Id.* § 490A.707 (as amended by 1993 Iowa Acts ch. 39, § 27).
82. *Id.* § 490A.705.
83. *Id.* §§ 4.1(13), 490A.102(15).
84. *Id.* § 490A.705(4)-(5).
85. *Id.* § 490A.705(6).

tion, could implement a variety of alternatives involving the responsibilities and voting power of managers. The Act imposes virtually no restrictions on the management structure of a LLC. The owners are free to design the management format that best suits the needs of the business. Thus, a single manager can have autocratic powers or a team of managers can share functions in a LLC. The managers can be subject to annual election or serve at the will of the members. Under some circumstances, organizers might wish to set up two manager classes that would be equivalent to the functions of corporate officers and directors.

Managers must discharge their duties in accordance with their good faith business judgment of the best interests of the LLC.[86] This provision parallels the standard of care established for corporate directors in the Iowa Business Corporation Act.[87] In discharging their duties, managers may rely on information, reports, and statements prepared or presented by other managers, attorneys, certified public accountants, or other professionals.[88]

E. *Decisions Reserved to Members*

> Unless otherwise provided in the articles of organization or an operating agreement, a majority vote [of the members] shall be required to approve the following matters:
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> a. The dissolution and winding up the [LLC].
> b. The sale, exchange, lease, mortgage, pledge, or other transfer of all or substantially all of the assets of the [LLC] other than in the ordinary course of business.
> c. Merger of the [LLC] with another entity.[89]

The operating agreement can only be amended by the approval of all members, unless otherwise provided in the articles of organization or in an operating agreement.[90] The members may adjust this voting requirement to a simple majority, a super-majority, or any other voting requirement fitting their needs. To avoid the tyranny of the minority, consideration should be given to lowering the unanimity requirement.

F. *Operating Agreement*

The key LLC document is the operating agreement. Although the articles of organization are essentially a notice filing, the operating agreement is the nuts and bolts of the LLC. The members of a LLC will enter into an operating agreement to provide for the capitalization of the company, the

86. *Id.* § 490A.706(1).
87. *Id.* § 490.830.
88. *Id.* § 490A.706(2).
89. *Id.* § 490A.701(2).
90. *Id.* § 490A.701(3) (as amended by 1993 Iowa Acts ch. 39, § 24).

allocation of its profits and losses, and the management of the business, among other matters. An operating agreement may contain any provisions regarding the affairs or business of a LLC that are not inconsistent with the articles of organization or law.[91] Practitioners will find a typical operating agreement to be a blend of partnership agreements and corporate bylaws, with an emphasis on partnership characteristics. Special tax considerations should also be contained in the operating agreement, including a qualified income offset provision,[92] a minimum gain chargeback[93] provision, and identification of the tax matters member.[94]

An operating agreement need not be in writing, but must initially be agreed to by all the members.[95] Unless a lesser vote is permitted under the operating agreement, the agreement may be amended only by unanimous consent.[96] A court may enforce an operating agreement through injunctive or other equitable relief.[97]

G. *Business Records of a LLC*

A LLC must maintain at its principal office certain business records similar to those required to be maintained by limited partnerships.[98] The required records include a list of all members and their last known business address,[99] copies of organizational documents,[100] copies of all tax returns and financial statements for the last three years,[101] and a copy of any written operating agreement.[102] If not contained in a written operating agreement, the LLC must also maintain at its principal office a writing describing the members' contributions, certain other matters with respect to contributions,[103] and a description of any agreed upon events whose occurrence will result in the dissolution and winding up of the LLC.[104]

Each member of a LLC has the right, upon reasonable request and subject to reasonable standards set forth in an operating agreement, to inspect and copy any of the LLC records required to be maintained, and to

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91. *Id.* § 490A.703(1).
92. *See, e.g.*, I.R.C. § 704(b)(2) (1988); Treas. Reg. § 1.704-1(b)(2)(ii)(d) (as amended in 1991).
93. *See, e.g.*, Treas. Reg. § 1.704-2 (1991).
94. *See* I.R.C. § 704 (1988); *see also infra* text accompanying notes 313-15.
95. IOWA CODE § 490A.703(2) (1993).
96. *Id.* § 490A.701(2).
97. *Id.* § 490A.703(3).
98. *Id.* § 490A.709.
99. *Id.* § 490A.709(1)(a).
100. *Id.* § 490A.709(1)(b).
101. *Id.* § 490A.709(1)(c).
102. *Id.* § 490A.709(1)(d).
103. *Id.* § 490A.709(1)(e)(1)-(3).
104. *Id.* § 490A.709(1)(e)(4).

obtain other reasonable information regarding the LLC.[105] Such reasonable information is identified in the Act as "true and full information" regarding the financial condition of the LLC, a copy of the most recent tax returns, and "other information regarding the affairs of the [LLC] that is just and reasonable."[106]

H. *Liability of LLC Members*

A member or manager of a LLC is not personally liable for the contractual or tort liabilities of a LLC by reason of being a member or manager of a LLC except as otherwise provided by the Act.[107] The articles of organization can provide for personal liability on the part of members or managers.[108] Furthermore, members and managers remain responsible for their own acts and for activities undertaken in an individual capacity on behalf of the LLC[109] (such as loan guaranties), as well as for the performance of their contractual undertakings with the LLC (such as contributions of cash, other property, or services).[110] In addition, members and managers are not relieved of liability otherwise imposed by law (such as the liability of "responsible persons" for unpaid taxes).[111] As a corollary to the general limitation of liability, a member of a LLC is not a proper party to a proceeding by or against a LLC, except in connection with a derivative action[112] or in a case involving the enforcement of a member's right against or liability to the LLC. [113]

I. *Financial Matters*

Members may make contributions to a LLC in the form of cash, property, or services rendered, and may contribute promissory notes or enter into other binding obligations to contribute cash or property or to perform services.[114] Unless otherwise provided in the articles of organization or operating agreement, a written obligation to contribute cash or property, or to perform services, is enforceable by the LLC even if the member is unable to perform because of death, disability, or any other reason.[115] The LLC also has the option to require a member who has not made a required contribution of

105. *Id.* § 490A.709(2).
106. *Id.* § 490A.709(2)(b)(1), (3).
107. *Id.* § 490A.601.
108. *Id.*
109. *Id.* § 490A.602(1).
110. *Id.* § 490A.801(2).
111. *Id.* § 421.26.
112. *Id.* § 490A.602(2).
113. *Id.* § 490A.602(1).
114. *Id.* § 490A.801(1).
115. *Id.* § 490A.801(2).

property or services to contribute cash equal to the value (as stated in the LLC's records) of the promised contribution.[116]

Unless otherwise provided in the articles of organization or operating agreement, a written obligation of a member to contribute money or property to the LLC, or to return to the LLC money or property paid or distributed in violation of the Act, may be compromised only by the consent of all the members.[117] A creditor who extends credit or otherwise acts in reliance on the original obligation of the member can enforce the obligation notwithstanding such a compromise.[118]

J. Profits, Losses, and Distributions

The profits and losses of a LLC, and distributions of cash or other assets of a LLC, are allocated on the basis of the value of the members' respective contributions.[119] Members may, however, provide for another method of allocation in writing in the articles of organization or in an operating agreement.[120] The articles of organization or an operating agreement may provide for a member's entitlement to receive interim distributions.[121] Unless otherwise provided in the articles of organization or an operating agreement, a member has no right to demand and receive a distribution in any form other than cash, and cannot be compelled to accept a distribution in kind that is disproportionate to his membership interest.[122]

A LLC may not make a distribution if, after giving effect to the distribution, the LLC would not be able to pay its debts as they became due in the usual course of business (equity test), or if the LLC's total assets would be less than the sum of its total liabilities (balance sheet test).[123] Under the balance sheet test, prior to making a distribution the LLC must also have available the amount needed to satisfy any preferential dissolution rights of members that are superior to the rights of the members who will receive the distribution, unless the articles of organization or the operating agreement permit otherwise.[124] The LLC may determine whether a distribution is permitted by relying on financial statements prepared on the basis of accounting practices and principles that are reasonable under the circumstances, or on a fair valuation or other method that is reasonable under the circumstances.[125]

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116. *Id.*
117. *Id.* § 490A.801(3).
118. *Id.*
119. *Id.* §§ 490A.802-.803.
120. *Id.*
121. *Id.* § 490A.804.
122. *Id.* § 490A.806.
123. *Id.* § 490A.807(1).
124. *Id.*
125. *Id.* § 490A.807(2).

The effect of a distribution is measured as of the date the distribution is authorized, or if the distribution is made more than 120 days after authorization, as of the date payment is made.[126] A LLC's indebtedness to a member arising from the declaration of a distribution is at parity with the indebtedness of the LLC to general unsecured creditors, except to the extent subordinated by agreement.[127] A member who receives a distribution in violation of Section 807 of the Act, the articles of organization, or an operating agreement, is liable to the LLC for a period of five years after the distribution for the amount of the distribution wrongfully made.[128]

K. *Distributions upon Withdrawal*

A member may resign from the LLC upon written notice to each member, not less than six months prior to the resignation, unless the articles or an operating agreement specify in writing the time or events upon whose occurrence a member may resign, or a definite time for the dissolution and winding up of the LLC.[129] A resigning member is entitled to receive any distribution provided for the member under the articles of organization or an operating agreement.[130] If those documents do not provide for such distributions, the member is entitled to receive, within a reasonable time after resignation, the fair value of his membership interest as of the date of his resignation.[131] Although the Act allows the members to prohibit withdrawal,[132] it also allows restrictions to be placed on the manner of withdrawal and the method of payment to accomplish an ersatz prohibition.[133] Certain types of businesses should consider restrictions on withdrawals. For example, a LLC engaged in a real estate development should restrict withdrawals to avoid a liquidity crunch when the only asset is a heavily-leveraged plot of land. A LLC could allow members to withdraw and thereby disassociate themselves from the company, but defer payment of their distributive shares until the LLC has the funds available.

L. *Membership Interests and Their Assignment*

A membership interest in a LLC is personal property.[134] Although a member's personal property interest in the LLC is assignable, except as otherwise provided in the articles or in an operating agreement, the assign-

126. *Id.* § 490A.807(3).
127. *Id.* § 490A.807(4).
128. *Id.* § 490A.808.
129. *Id.* § 490A.704.
130. *Id.* § 490A.805.
131. *Id.*
132. *Id.* § 490A.704.
133. *Id.* § 490A.704 (as amended by 1993 Iowa Acts ch. 39, § 26).
134. *Id.* § 490A.901.

ment of an interest does not entitle the assignee to participate in the management and affairs of the LLC, to become a member, or to exercise any rights of a member.[135] The assignment merely entitles the assignee to receive distributions to which the assignor would be entitled.[136] The assignor is no longer a member either.[137] In order for an assignee of a membership interest to become a member, the other members must give their unanimous consent.[138] The pledge or grant of a security interest in or against a membership interest does not cause the member to cease to be a member or deprive the member of any rights or powers of a member.[139] Generally, in order to avoid free transferability of ownership interests, a key ingredient in order to be taxed as a partnership, an assignee can have no right to participate in the management and affairs of the LLC unless all of the remaining members consent to the assignee's inclusion as a member.[140] Three recent IRS private letter rulings have, however, undermined this "general rule."[141] The private letter rulings have found free transferability lacking when: (1) just the manager or a majority interest (if the manager is not a member or is the assignor), approves the assignee as a member;[142] (2) only two-thirds of the remaining interests approve the assignee as a member;[143] and (3) only a simple majority of the remaining interests consent to the assignee as a member.[144]

Revenue Procedure 92-33 provides that in the case of partnerships the IRS will find free transferability of interests lacking if throughout the life of the partnership the free transferability of more than twenty percent of all interests is restricted.[145] In essence, seventy-nine percent of the interests may be freely transferable. Presumably, organizers of a LLC could combine the concepts illustrated in the private letter rulings with the safe harbor provision of Revenue Procedure 92-33 to create one class of membership interest that is freely transferable and one class that requires majority consent for an assignee to become a member. Although private letter rulings may not be cited as precedent and Revenue Procedure 92-33 only relates to partnerships, attorneys can take some comfort when organizing LLCs having less than

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135. *Id.* § 490A.902. The impact this would have on a creditor who forecloses on a membership interest has not been tested. The creditor would have no right to vote. Thus, in the case of a majority interest the creditor could not reduce the interest to cash by dissolving the LLC.

136. *Id.*

137. *Id.*

138. *Id.* § 490A.903(1).

139. *Id.* § 490A.902.

140. *See infra* text accompanying notes 255-68.

141. Priv. Ltr. Rul. 92-19-022 (Feb. 6, 1992); Priv. Ltr. Rul. 92-18-078 (Jan. 31, 1992); Priv. Ltr. Rul. 92-10-019 (Dec. 6, 1991); *see also* Rev. Proc. 92-33, 1992-1 C.B. 782.

142. Priv. Ltr. Rul. 92-10-019 (Dec. 6, 1991). It is not clear from the ruling if it is only the admittance as a member that requires approval or the transfer of the interest.

143. Priv. Ltr. Rul. 92-18-078 (Jan. 31, 1992).

144. Priv. Ltr. Rul. 92-19-022 (Feb. 6, 1992).

145. Rev. Proc. 92-33, 1992-1 C.B. 782.

unanimous consent provisions for assignees to become members and can be more sanguine about the outcome of a ruling request putting forth such provisions.

An assignee who becomes a member has the rights and powers and is subject to the restrictions and liabilities of a member under the articles, any operating agreement, and the Act.[146] An assignee also assumes the assignor's obligations to make and return contributions.[147] The assignee does not have such obligations, however, with respect to liabilities that are unknown to the assignee at the time he became a member.[148] The assignor is not released from his obligations with respect to wrongful distributions or contributions not made.[149] Upon the assignment of an entire interest, the assigning member ceases to be a member.[150] The assignment does not itself dissolve the LLC.[151]

A judgment creditor of a member may charge the interest of a member in the LLC with payment of the unsatisfied amount of the judgment with interest.[152] A judgment creditor will have only the rights that an assignee of the interest would have.[153]

M. *Derivative Actions*

A member of a LLC is entitled to bring an action in the right of the LLC[154] to the same extent a shareholder can bring a derivative action under the Iowa Business Corporation Act,[155] provided the LLC is managed by a manger or managers, or management is reserved to the members and the plaintiff does not have the authority to cause the LLC to sue in its own right.[156] Further, a demand for the LLC to sue must be made and the members or managers with the authority to do so must have either wrongfully refused to bring the action or failed to respond to the demand.[157] There is no "demand would be futile" exception to this requirement. The plaintiff in the derivative action must fairly and adequately represent the interests of the members and the LLC.[158]

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146. IOWA CODE § 490A.903(2) (1993).
147. *Id.*
148. *Id.*
149. *Id.* § 490A.903(3).
150. *Id.* § 490A.902.
151. *Id.*
152. *Id.* § 490A.904.
153. *Id.*
154. *Id.* § 490A.1001.
155. *Id.* § 490.740.
156. *Id.* § 490A.1001(1).
157. *Id.* § 490A.1001(2)-(3).
158. *Id.* § 490A.1001(5).

The plaintiff in a derivative action must be a member at the time the action is brought.[159] In addition, the plaintiff must have been a member at the time of the transaction forming the basis of the claim, or membership must have devolved upon the plaintiff pursuant to the terms of the articles of organization or an operating agreement from a person who was a member at the time of the transaction.[160]

N. *Mergers*

One or more LLCs may merge with or into one or more LLCs, limited partnerships, or corporations.[161] No member, as a result of a merger, will become personally liable for the liabilities or obligations of another person unless the member approves the plan of merger or otherwise consents to become personally liable.[162] This subchapter of the Act directly parallels the merger provisions of the Iowa Business Corporation Act.[163] It was designed primarily to facilitate inter-entity mergers and will have little effect until Iowa Code Chapters 490 and 487 are amended to permit corporations and partnerships to participate in inter-entity mergers.[164] The LLC merger procedure will be familiar to anyone who has merged corporations. Each entity must enter into a plan of merger that must be approved by the owners of each entity.[165] The plan of merger must identify: (1) each constituent entity and the surviving entity; (2) the terms and conditions of the merger; (3) the manner and basis for converting each constituent entity's interests "into interests, shares, or other securities or obligations of the surviving entity, or . . . into cash or other property"; (4) any necessary amendments to the governing documents of the surviving entity; and (5) any other necessary or desirable provisions.[166] Once a plan of merger is approved, it cannot be abandoned except by the unanimous consent of the members of a LLC, unless the articles of organization or an operating agreement provide otherwise.[167] Articles of

159. *Id.* § 490A.1001(4).
160. *Id.*
161. *Id.* § 490A.1201.
162. *Id.*
163. *Id.* §§ 490.1101-.1108.
164. Whether Chapters 490 and 487 need to be amended to allow inter-entity mergers has fueled a minor debate. At least one merger between a corporation and a LLC has occurred in Iowa. The Iowa Secretary of State will accept articles of merger between entities. Based on the author's review of the first 30 LLC filings with the Iowa Secretary of State. The author believes Chapter 490A does not itself authorize corporations and limited partnerships to merge with LLCs.
165. IOWA CODE § 490A.1202(1) (1993).
166. *Id.* § 490A.1202(2).
167. *Id.* § 490A.1203(2)(a).

merger are filed to reflect the consummation of the merger.[168] Mergers with foreign entities are also permitted.[169]

In a merger, the LLC considered to have contributed the greater dollar value of assets will be considered for tax purposes to be the resulting LLC, and the other LLC will be considered terminated.[170]

O. *Dissolution of a LLC*

There are two kinds of dissolutions: nonjudicial and judicial. In a nonjudicial dissolution, a LLC is dissolved, and its affairs will be wound up, upon the occurrence of the following: (1) events specified in the Act, the articles of organization, or an operating agreement; (2) "the unanimous written consent of the members"; (3) the death, resignation, expulsion, bankruptcy, or dissolution of a member, unless the business of the LLC "is continued by the consent of the remaining members in the manner stated in the articles of organization or an operating agreement or if not so stated, by the unanimous consent of the remaining members."[171] The third event of dissolution is a statutory recognition of the IRS requirement that a LLC lack the corporate characteristic of continuity of life. As will be discussed, lacking continuity of life is an essential element for a LLC to be taxed as a partnership.[172] In a judicial dissolution, the district court in the county in which the registered office of the LLC is located may, on request, decree dissolution of the LLC if it is not reasonably practicable to carry on the business of the LLC in conformity with the articles and an operating agreement.[173]

Unless otherwise provided in the articles or in an operating agreement, members who have not wrongfully dissolved the LLC may wind up the LLC's affairs.[174] However, on cause shown and the application of a member, the member's legal representative, or assignee, the district court in the county in which the registered office of the LLC is located may wind up the LLC's affairs.[175] Upon the winding up of a LLC, its assets will be distributed in the following order: (1) to creditors (including member-creditors) in satisfaction of liabilities of the LLC other than for distributions to members;[176] (2) to members and former members in satisfaction of liabilities for distributions;[177]

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168. *Id.* § 490A.1204.
169. *Id.* § 490A.1206.
170. I.R.C. § 708(b)(2)(A) (1988); Treas. Reg. § 1.708-1(b)(2) (1992); Rev. Rul. 68-289, 1968-1 C.B. 314. *See* LARRY E. RIBSTEIN & ROBERT R. KEATINGE, LIMITED LIABILITY COMPANIES § 17.13 (1992).
171. IOWA CODE § 490A.1301(1)-(3) (1993) (as amended by 1993 Iowa Acts ch. 39, §§ 31-32).
172. *See infra* text accompanying notes 209-54.
173. IOWA CODE § 490A.1302 (1993).
174. *Id.* § 490A.1303.
175. *Id.*
176. *Id.* § 490A.1304(1).
177. *Id.* § 490A.1304(2).

and (3) to members generally.[178] Unless otherwise provided in the articles or in an operating agreement, distributions to members will be made first, for the return of their contributions, and second, in proportion to the manner in which they share in distributions generally.[179] Upon completion of the winding up of the LLC, articles of dissolution are to be filed with the Secretary of State.[180] The Act sets forth provisions for disposing of known and unknown claims,[181] which are substantially identical to provisions found in the Iowa Business Corporation Act.[182]

P. *Registration of Foreign LLCs*

A foreign LLC may register to do business in Iowa, and upon registration, the laws of the state of its organization will govern its internal affairs.[183] A foreign LLC shall have no greater rights and privileges than a domestic LLC or exercise any powers forbidden to a domestic LLC.[184] The registration of a foreign LLC must include: (1) the name of the foreign LLC;[185] (2) the state or other jurisdiction and date of its formation;[186] (3) the street address of the LLC's registered office in Iowa and the name of the LLC's registered agent in Iowa;[187] (4) the address of the LLC's office of record in the jurisdiction of its formation, or if no office is required, the address of its principal office;[188] and (5) a copy of the LLC's articles of organization in the jurisdiction of its formation.[189] A foreign LLC may cancel its certificate of registration by delivering to the Secretary of State a certificate of cancellation.[190]

A foreign LLC transacting business in Iowa cannot maintain any action, suit, or proceeding until it is registered.[191] The failure to register does not, however, impair the validity of any contract or act of the LLC or prevent the LLC from defending itself in an Iowa court.[192] A foreign LLC transacting business without registration is subject to a $1000 fine.[193]

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178. *Id.* § 490A.1304(3).
179. *Id.*
180. *Id.* § 490A.1305.
181. *Id.* §§ 490A.1306-.1307.
182. *See id.* §§ 490.1406-.1407.
183. *Id.* § 490A.1401.
184. *Id.*
185. *Id.* § 490A.1402(1). If the foreign LLC's name does not satisfy the requirements of the Iowa Act, the LLC may add the words "Limited Company" or the abbreviation "L.C." to its name for use in Iowa, or may use an available fictitious name when its real name is not available. *Id.* § 490A.1404.
186. *Id.* § 490A.1402(2).
187. *Id.* § 490A.1402(3).
188. *Id.* § 490A.1402(4).
189. *Id.* § 490A.1402(5).
190. *Id.* § 490A.1406.
191. *Id.* § 490A.1408.
192. *Id.*
193. *Id.*

Foreign LLCs, like foreign corporations, are permitted to engage in certain activities in Iowa without being considered as doing business in the state.[194] Among the permissible activities enumerated by the Act are: (1) maintaining, defending, or settling any legal proceeding; (2) holding meetings in the state; (3) selling through independent contractors; (4) soliciting or obtaining orders that require acceptance outside the state; (5) creating or acquiring indebtedness, mortgages, and security interests in real or personal property; (6) securing, collecting, or enforcing mortgages or security interests; (7) "owning, without more, real or personal property"; and (8) "conducting an isolated transaction that is completed within thirty days and that is not one in the course of repeated transactions of a like nature."[195]

Q. Professional LLCs

The Act permits professionals, such as attorneys and accountants, to organize as LLCs.[196] This section of the Act was borrowed almost verbatim from the Iowa Professional Corporation Act.[197] As of January 2, 1993, Iowa lawyers were permitted by the Iowa Supreme Court to organize as LLCs.[198] The availability of the LLC format to lawyers should cause many law partnerships to convert to LLCs. As discussed more fully later in this Article, the conversion of a partnership to a LLC can be accomplished tax-free.[199] A quirk in the Internal Revenue Code, however, could require professional LLCs to use the accrual method rather than the cash method of accounting, a nasty consequence.[200] With LLCs, lawyers can insulate their personal assets from the malpractice of their colleagues and still maintain the financial flexibility of operating as a partnership.

IV. CLASSIFICATION OF A LLC AS A PARTNERSHIP FOR TAX PURPOSES

The use of LLCs as a business tool emerged after the issuance of Revenue Ruling 88-76.[201] Prior to 1988, the existence of a proposed IRS regulation that would have denied partnership tax status to any entity with

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194. *Id.* § 490A.1407.

195. *Id.*

196. *See id.* §§ 490A.1501-.1519. Accountants are also permitted to organize as professional partnerships or corporations. *Id.* § 542C.18 (as amended by 1993 Iowa Acts ch. 19, § 4).

197. *Id.* §§ 496C.1-.22.

198. *See* IOWA CODE OF PROFESSIONAL RESPONSIBILITY EC 2-13, DR 2-102(B)-(C) (as amended Oct. 23, 1992).

199. *See infra* text accompanying notes 277-81.

200. *See infra* text accompanying notes 296-312. *But see* Priv. Ltr. Rul. 93-21-047 (Feb. 25, 1993) (permitting a law partnership that was converting to a LLC to use the cash method of accounting).

201. Rev. Rul. 88-76, 1988-2 C.B. 360.

limited liability for all of its owners stymied the development of LLCs.[202] The proposed regulation was withdrawn in 1982 when the IRS announced a study project to ascertain the proper tax treatment of LLCs.[203] In 1988, the IRS determined limited liability would not preclude partnership status.[204] In any event, Iowa LLCs will be treated as partnerships for state income tax purposes.[205]

A. *General Rules*

IRS regulations provide a corporation has a number of characteristics that distinguish such entities from other organizations. These characteristics are: (1) the presence of associates; (2) an objective to carry on business for profit; (3) continuity of life; (4) centralized management; (5) limited liability; and (6) free transferability of ownership interests.[206] An "unincorporated organization," such as a LLC or a partnership, will not be classified as an association for tax purposes unless it has more corporate characteristics than noncorporate characteristics, excluding characteristics common to both partnerships and corporations.[207] The characteristics of having associates and a profit objective are common in both partnerships and corporations and are therefore disregarded.[208] Because LLCs should always have limited liability, the key tests are continuity of life, free transferability of membership interests, and to a lesser extent centralized management.

1. *Continuity of Life*

The IRS regulations provide a limited partnership does not have continuity of life "if the retirement, death, or insanity of a general partner . . . causes a dissolution of the partnership, unless the remaining general partners agree to continue the partnership or unless all remaining members

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202. Prop. Treas. Reg. § 301.7701-2, 45 Fed. Reg. 75,709 (1980). This proposed regulation rendered moot a private letter ruling granting partnership status to a Wyoming LLC. Priv. Ltr. Rul. 81-06-082 (Nov. 18, 1980).

203. I.R.S. News Release IR-82-145 (Dec. 16, 1982) (announcing Study Project).

204. Announcement 88-118 (Sept. 2, 1988); 1988-38 I.R.B. 25 (Sept. 19, 1988); *see also* Gen. Couns. Mem. 39,798 (Oct. 18, 1989).

205. IOWA CODE § 422.32(1) (1993).

206. Treas. Reg. § 301.7701-2(a)(1) (1992); *see* Morrissey v. Commissioner, 296 U.S. 344, 359 (1935).

207. Treas. Reg. § 301.7701-2(a)(3) (1992). The regulations define a "partnership" as "a syndicate, group, pool, joint venture, or other unincorporated organization" carrying on a business, financial operation, or venture that is not a corporation or a trust under the Code. *Id.* § 301.7701-3(a).

208. *Id.* § 301.7701-2(a)(3).

agree to continue the partnership."[209] The same regulations also provide "[a]n organization has continuity of life if the death, insanity, bankruptcy, retirement, resignation, or expulsion of any member will not cause a dissolution of the organization."[210] In Revenue Ruling 88-76, the IRS ruled, for federal income tax purposes, a Wyoming LLC would be taxed as a partnership.[211] The Wyoming LLC Act requires a LLC to be dissolved upon the death, retirement, resignation, expulsion, bankruptcy, or dissolution of a member unless the business of the LLC is continued by the consent of all of the remaining members.[212] Based on this provision, the IRS concluded the LLC lacked continuity of life.[213]

As a result of this ruling, it appeared that in order to assure a LLC lacked continuity of life, the LLC had to dissolve upon the occurrence of a triggering event unless the remaining members unanimously consented to continue the business. The provision in the Wyoming Act limiting the life of a LLC to a maximum of thirty years might also be necessary to assure the lack of continuity of life even though the IRS never mentioned this provision in Revenue Ruling 88-76 and it is not supported by the Treasury regulations.[214] About the time of the Wyoming revenue ruling, a private letter ruling was issued regarding a Florida LLC.[215] Like the Wyoming LLC, the Florida LLC was granted partnership tax status because unanimous consent was required to continue the business upon the occurrence of any event terminating a member's continued membership including death, retirement, resignation, expulsion, bankruptcy, or dissolution of a member.[216] The LLC therefore lacked the continuity of life characteristic of a corporation.[217] Although these early rulings required unanimous consent if any member left the LLC, the Treasury regulations support a less severe consequence.[218] The list of calamities in the Treasury regulations ends in a disjunctive, suggesting every one need not apply.[219] Equally important, the Treasury regulations associate the occurrence of an event to "any" member, suggesting that limit-

209. *Id.* § 301.7701-2(b)(1). The Internal Revenue Code and the Treasury regulations do not mention limited liability companies. Application of the Code and the regulations must be by analogy to partnerships.

210. *Id.*

211. Rev. Rul. 88-76, 1988-2 C.B. 360.

212. WYO. STAT. § 17-15-123 (1990).

213. Rev. Rul. 88-76, 1988-2 C.B. 360, 361.

214. *See* WYO. STAT. § 17-15-107(a)(ii) (1989); Treas. Reg. § 301.7701-2(b)(3) (as amended in 1983). *See* Priv. Ltr. Rul. 93-31-010 (May 5, 1993) (opining a LLC having a life of 75 years was a partnership for federal tax purposes).

215. Priv. Ltr. Rul. 89-37-010 (June 16, 1989).

216. *Id.*

217. *Id.*

218. Treas. Reg. § 301.7701-2(b)(1) (1992).

219. *Id.*

ing the occurrence of an event to just one member would satisfy the Treasury regulations.[220]

Recently, the IRS has relaxed this stringent standard of unanimity. A LLC formed to own and operate a kidney dialysis facility was determined to lack the corporate characteristic of continuity of life because its operating agreement required that if at least a majority in interest of the remaining members voted to continue the business in the event of the death, retirement, resignation, expulsion, bankruptcy, or dissolution of a member, then all remaining members shall consent to the continuation of the LLC.[221] Similarly, a LLC was deemed to lack continuity of life when approval of the continuation of the LLC by all remaining members meant written acceptance by two-thirds in number of all members.[222]

A Delaware LLC was found to lack continuity of life because its operating agreement permitted the business of the LLC to continue upon the occurrence of a dissolution event if a majority of the managing directors and a majority (in number and voting interest) of the remaining members consented to its continuation.[223]

The operating agreement of a Texas LLC provided if *M*, the corporate member-manager, ever went bankrupt the LLC would dissolve unless all of the remaining members agreed to continue the business.[224] The IRS found this LLC lacked continuity of life even though the triggering event was limited to one type of event (bankruptcy) occurring to one pre-identified member (the corporate member-manager).[225] If the corporate member-manager was simply a shell operating entity, then this LLC had an almost unlimited life expectancy, subject only to the period of duration listed in the articles of organization.[226]

The operating agreement of a Utah LLC provided that the LLC would dissolve upon the death, retirement, resignation, expulsion, bankruptcy, or dissolution of any member unless all of the member-managers on the Executive Committee and a majority of the other members (in number and voting interest) agreed to continue the business of the LLC.[227] The IRS concluded this LLC lacked continuity of life.[228]

In another recent development, the IRS stated it would not conclude a limited partnership has continuity of life "[i]f under local law and the part-

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220. *Id.*

221. Priv. Ltr. Rul. 93-31-010 (May 5, 1993). It should be noted, however, the LLC had only two members. *Id.*

222. Priv. Ltr. Rul. 93-25-039 (Mar. 26, 1993).

223. Priv. Ltr. Rul. 93-08-027 (Nov. 27, 1992).

224. Priv. Ltr. Rul. 92-10-019 (Dec. 6, 1991).

225. *Id.*

226. *Id.*

227. *Id.*

228. *Id.* Note the parallel to limited partnerships in Treas. Reg. § 301.7701-2(b)(1) (as amended in 1993).

nership agreement the bankruptcy or removal of a general partner" causes dissolution "unless the remaining general partners or at least a majority in interest of all remaining partners agree to continue the partnership."[229]

As further evidence of the relaxing of this standard, on June 14, 1993, the IRS amended the Section 7701 regulations to lower the standard for determining whether a limited partnership possessed continuity of life from unanimous consent to the consent of at least a majority in interest of its remaining partners.[230]

Five recent revenue rulings reaffirm the ability of LLCs to be taxed as partnerships for federal income tax purposes.[231] Of the five rulings, three put to rest the debate over whether a state LLC statute has to be "bulletproof" rather than "flexible" in order for LLCs organized under the statute to be treated as partnerships for federal income tax purposes. A bulletproof statute is one requiring the unanimous consent of a LLC's members to transfer a membership interest and to continue the business upon an event of dissolution. A flexible statute permits organizers of a LLC to deviate from the "default" rules of the statute, which usually require unanimous consent similar to bulletproof statutes. The Iowa Act is a flexible statute. Ever since the issuance of Revenue Ruling 88-76 regarding a Wyoming LLC (the Wyoming LLC statute is bulletproof), purists and overly cautious tax practitioners have considered only LLCs organized under bulletproof state statutes to be safe from tax treatment as an association. In Revenue Ruling 93-53, the IRS considered whether a LLC organized under a flexible LLC statute in Florida could be treated as a partnership for federal income tax purposes.[232] The LLC had twenty-five members, three of whom were managers.[233] The transfer of a membership interest and continuation of the business required unanimous consent under the operating agreement.[234] The IRS expressed the view that under the Florida LLC statute a LLC can be classified as a partnership or as an association depending on the provisions of the LLC's articles of organization or operating agreement. The IRS held the LLC would be classified as a partnership.[235] The IRS had previously addressed the identical issue with regard to an Illinois LLC in Revenue Ruling 93-49.[236] The factual circumstances of the Illinois case were identical to those of the Florida case.[237] The IRS classified the Illinois LLC as a partnership.[238]

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229. Rev. Proc. 92-35, 1992-1 C.B. 790.
230. Treas. Reg. § 301.7701-2(b)(1) (as amended in 1993).
231. *See infra* text accompanying notes 232-52.
232. Rev. Rul. 93-53, 1993-26 I.R.B. 7.
233. *Id.* This ownership and management structure can also be found in Revenue Ruling 88-76. *See* Rev. Rul. 88-76, 1988-2 C.B. 392.
234. Rev. Rul. 93-53, 1993-26 I.R.B. 7.
235. *Id.*
236. Rev. Rul. 93-49, 1993-25 I.R.B. 11.
237. *See id.*
238. *Id.*

In perhaps the most significant ruling ending the flexible versus bulletproof debate, the IRS considered two situations under the flexible Delaware LLC statute.[239] In the first situation, the LLC operating agreement provided unanimous consent was required for transfers of interests and continuation of the LLC.[240] Additionally, the management of the LLC was vested in all twenty-five members.[241] Based on these facts, the IRS ruled the LLC was classified as a partnership for federal income tax purposes.[242]

In the second situation, the LLC was managed by three of the twenty-five members, a transferee of a membership interest became a member upon providing written notice of the transfer, and the death, retirement, resignation, expulsion, bankruptcy, or dissolution of a member did not dissolve the LLC.[243] Under this scenario, the IRS concluded the LLC had the corporate characteristics of centralized management, free transferability of membership interests, and continuity of life.[244] Thus, it was taxable as an association.[245]

Although the impact of these decisions on the Iowa Act is favorable, the most intriguing aspect of these rulings is in each case the requesting party did not take advantage of the flexible nature of the LLC statute in seeking a ruling. The operating agreements considered by the IRS were themselves "bulletproof." Even so, because the Iowa Act is a flexible statute, organizers of Iowa LLCs can take comfort in knowing LLCs organized under flexible statutes in other states have been determined to be partnerships for federal income tax purposes.

The IRS also recently considered the tax status of two other LLCs formed under bulletproof statutes. In Revenue Ruling 93-5, the IRS ruled a Virginia LLC would be taxed as a partnership because it lacked the corporate characteristics of continuity of life and free transferability of ownership interest.[246] In Revenue Ruling 93-5, the LLC had twenty-five members, three of whom were the managers.[247] Like the Iowa Act, the Virginia Liability Company Act does not mandate a specific term for the duration of a LLC, but merely requires the articles of organization to state "the latest date on which the [LLC] is to be dissolved and its affairs wound up."[248] By law a Virginia

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239. Rev. Rul. 93-38, 1993-21 I.R.B. 4.
240. *Id.*
241. *Id.*
242. *Id.*
243. *Id.*
244. *Id.*
245. *Id.*
246. Rev. Rul. 93-5, 1993-3 I.R.B. 6.
247. *Id.*
248. VA. CODE ANN. § 13.1-1011(4) (Michie 1992). *See* IOWA CODE § 490A.303(1)(d) (1993).

LLC must require unanimous consent of its members to continue the business of the LLC upon the occurrence of a dissolution event.[249]

A Colorado LLC was also found to be a partnership for federal income tax purposes in Revenue Ruling 93-6.[250] Similar to the Virginia LLC in Revenue Ruling 93-5, the Colorado LLC would terminate upon the occurrence of a dissolution event unless all of the remaining members agreed to continue the business.[251] Also similar to the Virginia Act, this termination provision is mandated by Colorado law.[252]

Although the Iowa Act is a flexible statute allowing less than unanimous consent to continue the business as a result of a dissolution event, lowering a dissolution vote to something less than unanimous is not without risk.[253] Most private letter rulings and recent revenue rulings concern LLCs that require unanimous consent of the remaining members to continue the business of the LLC. Only one recent private letter ruling has permitted majority consent to meet the continuity of life test.[254] Because applicants typically withdraw private ruling requests that the IRS has indicated will be adverse to the applicant, this dearth of rulings could be a sign the IRS is tightening the rein on such developments.

2. *Free Transferability of Membership Interest*

The IRS regulations provide the free transferability of an organization exists "if each of its members or those members owning substantially all of the interests in the organization have the power, without the consent of the other members, to substitute for themselves . . . a person who is not a member."[255] The characteristic of free transferability does not exist if a member can, "without the consent of other members, assign only his right to share in the profits but cannot so assign his rights to participate in the management of the organization."[256]

In Revenue Ruling 88-76, the IRS found the characteristic of free transferability of membership interest did not exist for the Wyoming LLC because the Wyoming LLC Act and the LLC's operating agreement required unani-

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249. VA. CODE ANN. § 13.1-1046(3) (Michie 1992).

250. Rev. Rul. 93-6, 1993-3 I.R.B. 8.

251. *Id.*

252. COLO. REV. STAT. ANN. § 7-80-801 (West 1992). Unlike the Virginia LLC Act and the Iowa Act, the Colorado LLC Act limits the life of a LLC to 30 years. *Id.* § 7-80-204(1)(b); *see also* Rev. Rul. 93-50, 1993-25 I.R.B. 13 (ruling a LLC would be classified as a partnership under a bulletproof statute).

253. *See* Priv. Ltr. Rul. 90-35-041 (Oct. 2, 1990) (withdrawing Priv. Ltr. Rul. 90-10-028 (Dec. 7, 1989), which had allowed 85% consent); Priv. Ltr. Rul. 90-10-027 (Dec. 7, 1989) (opining a LLC possessed continuity of life when majority consent continued the entity).

254. Priv. Ltr. Rul. 93-31-010 (May 5, 1993). On the other hand, no recent private letter ruling has denied partnership status because of a less than unanimous consent requirement.

255. Treas. Reg. § 301.7701-2(e) (as amended in 1983).

256. *Id.*

mous consent of the members to admit a substitute member into the organization, although no consent was required to transfer a right to profits.[257] The IRS reaffirmed the unanimous consent requirement in recent revenue rulings.[258] This unanimous consent requirement has become the safe harbor even though the regulations speak of "consent of the other members," not "the members" or "all members." This safe harbor is not, however, without an undercurrent. The IRS has ruled a German GmbH, the equivalent of a LLC, could not fail the free transferability test, even if unanimous consent was needed to transfer an interest, and would therefore be taxed as an association because its two corporate members were owned and controlled by the same corporate parent.[259]

As with the continuity of life test, the IRS has occasionally liberalized the unanimous consent requirement. Less than unanimous consent to transfer ownership was permitted in two private letter rulings concerning LLCs.[260] In Private Letter Ruling 92-18-078, the consent of the manger or two-thirds of the other members was required.[261] It must be noted, however, this LLC had only three members.[262] In Private Letter Ruling 92-19-022 only majority consent was required, but again the LLC had only three members.[263] Consent of only a manager or a majority of the remaining members was permitted in Private Letter Ruling 92-10-019.[264] This is similar to a limited partnership in which only the consent of the general partner is necessary.[265] In Revenue Procedure 92-33, the IRS ruled a limited partnership will lack free transferability of ownership if more than twenty percent of the interests are restricted.[266] Thus, if Revenue Procedure 92-33 is applied to LLCs, seventy-nine percent of a LLC's interests could be freely transferable.[267]

The Iowa Act has the flexibility to permit an Iowa LLC to structure its transferability clauses along any of the lines described above.[268]

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257. Rev. Rul. 88-76, 1988-2 C.B. 360.

258. *See* Rev. Rul. 93-53, 1993-26 I.R.B. 7; Rev. Rul. 93-50, 1993-25 I.R.B. 13; Rev. Rul. 93-49, 1993-25 I.R.B. 11; Rev. Rul. 93-38, 1993-21 I.R.B. 4; Rev. Rul. 93-6, 1993-3 I.R.B. 9; Rev. Rul. 93-5, 1993-3 I.R.B. 6.

259. Rev. Rul. 93-4, 1993-3 I.R.B. 5 (ruling the GmbH also possessed the corporate characteristics of limited liability and centralized management).

260. *See* Priv. Ltr. Rul. 92-19-022 (Feb. 6, 1992); Priv. Ltr. Rul. 92-18-078 (Jan. 31, 1992).

261. Priv. Ltr. Rul. 92-18-078 (Jan. 31, 1992).

262. *Id.*

263. Priv. Ltr. Rul. 92-19-022 (Feb. 6, 1992).

264. Priv. Ltr. Rul. 92-10-019 (Dec. 6, 1991).

265. Treas. Reg. § 301.7701-3(b)(2) (Ex. 1) (as amended in 1983).

266. Rev. Proc. 92-33, 1992-17 C.B. 142.

267. *Id.*

268. IOWA CODE § 490A.902 (1993).

3. *Centralized Management*

The Treasury regulations define centralized management to be present if one or more persons, but not all of the members of the organization, have the exclusive authority to make management decisions.[269] In the case of limited partnerships, the IRS focuses on the extent of the ownership interests of the limited partners. If "substantially all" of the interests in the limited partnership are owned by the limited partners, then centralized management does exist.[270] For ruling purposes, the IRS requires the limited partners to own less than eighty percent of the partnership otherwise the IRS will not rule the limited partnership lacks centralized management.[271] Arguably, if a manager of a LLC owns twenty percent or more of the LLC interests, then the LLC should lack centralized management. In Revenue Ruling 88-76, however, the IRS ruled the Wyoming LLC in which three of its twenty-five members were managers had the corporate characteristic of centralized management.[272] No mention was made of the member-managers' ownership interests. The issue has not been raised in recent revenue rulings.[273]

In several recent private letter rulings the IRS determined centralized management did not exist when the members had the right to participate in management and bind the LLC even though the authority over the day-to-day operations of each LLC would be held by one of the members pursuant to a management agreement.[274]

In an interesting and stilted ruling, Revenue Ruling 93-6, the IRS concluded that a Colorado LLC possessed the corporate characteristic of centralized management even though all five members were named managers.[275] The Colorado LLC statute requires all Colorado LLCs to be managed by managers.[276] The ruling appears to hinge on the fact members acting in their capacities as members in a Colorado LLC cannot manage a LLC. The members as managers are distinguished from members as members. Although this is not the case under the Iowa Act, it could have implications for an Iowa LLC governed by an operating agreement requiring the LLC to be operated under the direction of managers. Based on the rationale of Revenue Ruling 93-6, such a LLC might possess centralized

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269. Treas. Reg. § 301.7701-2(c)(1) (as amended in 1983).

270. *Id.* The IRS has ruled a LLC managed by all of its members lacks centralized management. Priv. Ltr. Rul. 90-10-027 (Dec. 7, 1989).

271. Rev. Proc. 89-12, 1989-2 C.B. 798.

272. Rev. Rul. 88-76, 1988-2 C.B. 360.

273. Rev. Rul. 93-53, 1993-26 I.R.B. 7; Rev. Rul. 93-50, 1993-25 I.R.B. 13; Rev. Rul. 93-49, 1993-25 I.R.B. 11; Rev. Rul. 93-38, 1993-21 I.R.B. 4; Rev. Rul. 93-6, 1993-3 I.R.B. 9; Rev. Rul. 93-5, 1993-3 I.R.B. 6.

274. Priv. Ltr. Rul. 93-25-048 (Mar. 30, 1993); Priv. Ltr. Rul. 93-21-070 (Mar. 3, 1993); Priv. Ltr. Rul. 93-20-045 (Feb. 24, 1993); Priv. Ltr. Rul. 93-20-019 (Feb. 18, 1993).

275. Rev. Rul. 93-6, 1993-3 I.R.B. 9.

276. COLO. REV. STAT. ANN. § 7-80-401 (West 1993).

management even though all members were named managers because they did not possess management authority by virtue of being members.

V. SPECIAL TAX ISSUES

A. *Conversions*

In Revenue Ruling 84-52, the IRS ruled the conversion of a general partnership to a limited partnership would not cause the termination of the partnership for federal income tax purposes.[277] The IRS has followed this ruling in finding no termination of a general partnership that converted to a LLC,[278] and finding no termination of a limited partnership that converted to a LLC.[279]

The steps, all part of a single simultaneous transaction, to converting a partnership to a LLC are: (1) the LLC is organized; (2) partners contribute their partnership interests to the LLC in exchange for LLC interests; (3) all partners become members and own LLC interests in the same proportion as they owned partnership interests; (4) the partnership dissolves and distributes its assets to the LLC; and (5) the LLC assumes all recourse obligations of the partnership and takes the assets subject to all nonrecourse obligations of the partnership.[280] No gain or loss will be recognized by the members, the LLC, or the partnership except as provided in Internal Revenue Code Section 752.[281]

B. *The Inapplicability of Revenue Procedure 89-12*

Revenue Procedure 89-12 sets out the conditions under which the IRS will rule on whether an entity is taxable as a partnership.[282] This revenue procedure applies to limited partnerships as well as other organizations wishing to be taxed as a partnership.[283] Most private letter rulings concerning LLCs provide "this ruling is subject to the requirements of Rev. Proc. 89-12, 1989-1 C.B. 798, to the extent applicable. If the requirements of Rev. Proc. 89-12 fail to be met at any time, this ruling will have no force or effect."[284]

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277. Rev. Rul. 84-52, 1984-1 C.B. 157.

278. Priv. Ltr. Rul. 90-29-019 (Apr. 19, 1990); Priv. Ltr. Rul. 92-26-035 (Mar. 26, 1992); Priv. Ltr. Rul. 93-21-047 (Feb. 25, 1993) (concerning a law partnership converting to a LLC).

279. Priv. Ltr. Rul. 92-10-019 (Dec. 6, 1991); Priv. Ltr. Rul. 91-19-029 (Feb. 7, 1991); Priv. Ltr. Rul. 90-10-027 (Dec. 7, 1989).

280. Priv. Ltr. Rul. 92-10-019 (Dec. 6, 1991); Priv. Ltr. Rul. 91-19-029 (Feb. 7, 1991); Priv. Ltr. Rul. 90-10-027 (Dec. 7, 1989).

281. Priv. Ltr. Rul. 92-10-019 (Dec. 6, 1991); Priv. Ltr. Rul. 91-19-029 (Feb. 7, 1991); Priv. Ltr. Rul. 90-10-027 (Dec. 7, 1989); I.R.C. §§ 721, 752 (1988); I.R.C. § 731 (1988 & Supp. IV 1992).

282. Rev. Proc. 89-12, 1989-1 C.B. 798.

283. *Id.*

284. *See, e.g.*, Priv. Ltr. Rul. 93-31-010 (May 5, 1993).

This admonition is absent from some recent private letter rulings concerning LLCs[285] and recent revenue rulings,[286] but reappears in other recent private letter rulings.[287]

A section-by-section review of Revenue Procedure 89-12 reveals that little, if any, of it is applicable to LLCs. Sections 4.01 through 4.04 and 4.07 concern the economic substance of a general partner presumably to determine whether the entity lacks limited liability.[288] If this is the case, then the provisions should not apply to LLCs. For example, General Counsel Memorandum 39,798 states the net worth requirements of Section 4.07 do not apply to LLCs.[289]

Sections 4.05 and 4.06 may have some relevance to LLCs. Section 4.05 provides the IRS will not rule an entity lacks continuity of life if less than a majority of the limited partners can elect a general partner to replace a general partner who had been removed.[290] This section is not likely to apply to LLCs when the threshold is unanimity or at least majority. Section 4.06 provides the IRS will not rule an organization lacks centralized management if the limited partners own more than eighty percent of the partnership.[291]

C. *Self-Employment Tax*

Neither the Internal Revenue Code nor the Treasury regulations contemplate LLCs. Merely being classified as a partnership for federal income tax purposes does not resolve the tax treatment of LLCs on many other tax issues. On the contrary, classification as a partnership unleashes a number of questions. Among these issues is the proper treatment of members' distributive shares of any earnings from a LLC. The Internal Revenue Code includes a partner's distributive share of income in the definition of "net earnings from self-employment."[292] It excludes from this definition the distributive share of any item of income to a limited partner, however, unless it represents a guaranteed payment within the meaning of Internal Revenue Code Section 707(c) to a limited partner for services rendered to or on behalf of the partnership.[293] This exclusion was designed to prevent passive in-

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285. *See* Priv. Ltr. Rul. 92-19-022 (Feb. 6, 1992); Priv. Ltr. Rul. 92-10-019 (Dec. 6, 1991); Priv. Ltr. Rul. 90-52-039 (Oct. 2, 1990).

286. *See* Rev. Rul. 93-53, 1993-26 I.R.B. 7; Rev. Rul. 93-50, 1993-25 I.R.B. 13; Rev. Rul. 93-49, 1993-25 I.R.B. 11; Rev. Rul. 93-38, 1993-21 I.R.B. 4.

287. *See* Priv. Ltr. Rul. 93-31-010 (May 5, 1993); Priv. Ltr. Rul. 93-25-048 (Mar. 30, 1993) (declaring § 4 of Rev. Proc. 89-12, 1989-1 C.B. 798 does not apply); Priv. Ltr. Rul. 93-25-039 (Mar. 26, 1993).

288. Rev. Proc. 89-12, 1989-1 C.B. 798.

289. Gen. Couns. Mem. 39,798 (Oct. 18, 1989).

290. Rev. Proc. 89-12, 1989-1 C.B. 798.

291. *Id.*

292. I.R.C. § 1402(a) (1988 & Supp. II 1990).

293. *Id.* § 1402(a)(13).

vestors from generating social security benefits related to purely investment activities.[294]

May a member use the limited partner exclusion to avoid paying self-employment tax? That is, will a member be treated as a limited partner based on the fact a member has limited liability like a limited partner[295] or will the status be determined by the extent of a member's participation in the management of a LLC? In LLCs organized to provide personal services, such as law firms, clearly the tax would be payable. In other organizations, however, the answer is not as clear. This is particularly true when a LLC does not have any managers. In such a situation all of the members would have a say in the management of the company, but it is not clear to what extent or how the IRS would discern the varying levels of participation.

D. *Cash or Accrual Method of Accounting*

The Internal Revenue Code prohibits certain entities from using the cash method of accounting.[296] This prohibition includes entities defined as "tax shelters."[297] The term "tax shelter" includes any "enterprise" or "syndicate."[298] An "enterprise" is an entity whose ownership interests have been offered for sale in a securities offering registered with the Securities and Exchange Commission (SEC) or any other federal or state agency.[299] A "syndicate" includes any partnership or other entity, except a C corporation, if more than thirty-five percent of the losses of the entity are allocable to limited partners or limited entrepreneurs.[300] A "limited entrepreneur" is a person who "(A) has an interest in the enterprise other than as a limited partner and (B) does not actively participate in the management of the enterprise."[301] Thus, a literal reading of the Internal Revenue Code may prohibit LLCs from using the cash method of accounting if more than thirty-five percent of the losses are allocable to nonmanaging members. This result seems unfair because the intent of the statute was to combat abusive tax shelters.[302] It may, however, be possible for a LLC that does not have losses or allocates

294. Of course, those limited partners with an aversion to paying taxes were delighted by the exclusion.

295. Treating a member as a limited partner based on the fact a member has limited liability like a limited partner would make all members limited partners, unless one treats a member that guarantees the debt of a LLC as a "general partner."

296. I.R.C. § 448 (1988).

297. *Id.* § 448(a)(3). *See id.* § 6662(d)(2)(C) (defining a tax shelter).

298. *Id.* § 461(i)(3).

299. *Id.* § 461(i)(3)(A).

300. *Id.* § 1256(e)(3)(B).

301. *Id.* § 464(e)(2).

302. *Id.*

at least sixty-five percent of its losses to members who participate in the management of the LLC to avoid this restriction.[303]

In a private letter ruling important to law partnerships in Iowa considering a conversion to a professional LLC, the IRS held under the facts presented the professional LLC could use the cash method of accounting.[304] In other words, the professional LLC was not a tax shelter.

The law firm avoided the traps described above as follows. On the issue of being an enterprise, the proposed LLC represented it had never sold its securities in a registered offering and never would.[305] Thus, the IRS concluded the professional LLC would not be an enterprise.[306]

On whether the professional LLC would be considered a syndicate, the IRS had to find no more than thirty-five percent of the losses of the LLC would be allocated to limited entrepreneurs. The proposed LLC represented the election of the management committee and the compensation committee would require the vote of *all* members to be effective.[307] Other matters requiring the vote of *all* members included admission of new members, dismissal of a member, amending the operating agreement, dissolution of the LLC, approval of the recommendations of the compensation committee, and other major decisions.[308] The day-to-day management of the law firm was to be in the hands of a five-member management committee.[309]

Based on these representations and the continued practice of law by the members of the professional LLC, the IRS concluded the lawyer-members were not limited entrepreneurs.[310]

Finally, the proposed LLC represented it would not be organized for any federal income tax avoidance motive.[311] Because the LLC was neither an enterprise nor a syndicate and was not organized to avoid taxes, the IRS concluded it was not a tax shelter and could use the cash method of accounting.[312]

E. *Tax-Matters Partner*

The Internal Revenue Code requires each partnership with more than ten partners, a nonresident alien partner, or a partner other than a natural

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303. *See* Priv. Ltr. Rul. 87-53-032 (Oct. 5, 1987). For an excellent discussion of this issue, see RIBSTEIN & KEATINGE, *supra* note 170, § 17.11.

304. Priv. Ltr. Rul. 93-21-047 (Feb. 25, 1993).

305. *Id.*

306. *Id.*

307. *Id.*

308. *Id.*

309. *Id.*

310. *Id.* The law firm also represented it did not expect to have losses. *Id.* Presumably, without losses to allocate to limited entrepreneurs the conclusion would be the entity was not a syndicate. The IRS did not comment on this representation.

311. Priv. Ltr. Rul. 93-21-047 (Feb. 25, 1993).

312. *Id.*

person to identify a tax-matters partner to resolve administrative and judicial disputes concerning partnership items.[313] The tax-matters partner is required to possess authority to act on behalf of the partnership in resolving such disputes.[314] The tax-matters partner is determined as follows: (1) the general partner designated by a majority in interest of the partners; or (2) if a tax-matters partner is not designated, then the tax-matters partner is either (a) the general partner with the largest profits interest or (b), if it is impractical to apply (a), then a general partner selected by the IRS.[315]

Clearly, the rules cannot be easily applied to LLCs. The best the members of a LLC can do is to name either a manager or a member as the tax-matters manager-member. It can be reasonably expected the IRS will honor the designation.

VI. LIMITED LIABILITY COMPANIES AND OUT-OF-STATE TRANSACTIONS

A. *Choice of Law Principles*

One issue more than others stands in the way of widespread use of LLCs in Iowa—the risk a member's limited liability for the debts and obligations of a LLC will not be recognized in a state that does not have a LLC statute. A related and more frequently encountered issue is how an Iowa LLC can qualify to do business and apply for business permits in a state that does not recognize LLCs.[316]

The Restatement (Second) of Conflict of Laws,[317] principles of comity, the Full Faith and Credit Clause,[318] and the Commerce Clause[319] can provide some guidance. No hard and fast rule exists, however. Perhaps the best approach for the practitioner to use when analyzing this issue is to view the impact of choice of laws on LLCs in three discrete parts: (1) internal operations; (2) contract law; and (3) torts. The following analysis relies heavily on the Restatement (Second) of Conflict of Laws in recognition of the secondary

313. I.R.C. § 6231(a)(7) (1988).

314. *Id.*

315. *Id.*

316. It has been suggested a LLC should attempt to qualify as a foreign corporation. It is unlikely a court would recognize clerical acceptance of an administrative filing, however, as dispositive on the issue of liability.

317. RESTATEMENT (SECOND) OF CONFLICTS OF LAWS § 294 (1965).

318. U.S. CONST. art. IV, § 1.

319. *Id.* art. I, § 8. *See* RIBSTEIN & KEATINGE, *supra* note 170, § 13.05; Wayne M. Gazur & Neil M. Goff, *Assessing the Limited Liability Company*, 41 CASE W. RES. L. REV. 387, 430-37 (1991).

role that comity, the Full Faith and Credit Clause, and the Commerce Clause play in this area.[320]

B. *Internal Operations*

Like every other issue outside the provisions of the Act, application of the conflict of law principles to LLCs must be by analogy to partnerships and corporations. The Restatement (Second) of Conflict of Laws is consistent with its treatment of choice of law on the internal workings of partnerships and corporations. With respect to partnerships the state with the most significant relationship to the partners and the transaction at issue will determine the rights and duties owed by partners to each other.[321] The right of shareholders to participate in management of a corporation and receive a share of its profits is to be determined by reference to the state of incorporation or, "in the unusual case," some other state having a more significant relationship to the shareholder and the corporation.[322]

Regardless of whether a court views a LLC similar to a partnership or a corporation, it will likely be compelled to apply Iowa law on issues involving the terms of an Iowa LLC's articles of organization and operating agreement. To aid a court in this decision, the choice of law provisions should become part of a LLC's articles of organization and operating agreement, particularly if the LLC has out-of-state members.[323]

C. *Contracts*

Members of LLCs run the risk a foreign court will not recognize Iowa's limited liability protection and hold the members personally responsible for the LLC's obligations. This fear is exemplified by the hoary case of *Means v. Limpia Royalties*.[324] In *Means*, suit was brought in Texas to rescind the purchase of an interest in a business trust organized in Oklahoma.[325] Oklahoma law provided limited liability protections for owners of business trusts, but Texas did not.[326] The Texas court applied the law of Texas in holding the members of the business trust liable for the rescission damages.[327]

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320. Courts are granted too much discretion in applying these principles for practitioners to rely heavily on them. *See* RIBSTEIN & KEATINGE, *supra* note 170, § 13.05; Gazur & Goff, *supra* note 319, at 427-37.

321. RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 294 (1965).

322. *Id.* § 304.

323. *Id.* § 187.

324. Means v. Limpia Royalties, 115 S.W.2d 468 (Tex. Civ. App. 1938).

325. *Id.* at 469.

326. *Id.* at 475.

327. *Id.* at 477.

If care is taken in the drafting of a LLC's operational documents,[328] the Restatement relieves a great deal of uncertainty with respect to the choice of law to be applied. Each of these documents should contain a choice of law provision similar to the following:

> Governing Law. This agreement shall be governed by and construed in accordance with the laws of the State of Iowa. The parties recognize that _____, L.C. is an Iowa limited liability company and as such its members are not personally liable for the debts and obligations of the limited liability company. The parties are not relying on the ability of any of the members to perform this agreement in the event _____, L.C. defaults.

Such a provision, tailored to meet the requirements of the agreement, should give an Iowa LLC and its members the best protection available under the Restatement's choice of law rules.[329]

In the absence of an effective choice of law provision in an agreement, the contract rights of the parties will be determined by the law of the state that has the "most significant relationship" to the transaction and the parties.[330] The Restatement first directs a court to apply the principles of Section 6 of the Restatement[331] to determine which states have a public policy inter-

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328. Operational documents include, but are not limited to, loan agreements, purchase orders, and employment contracts.

329. RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 187 (1965), provides:

> (1) The law of the state chosen by the parties to govern their contractual rights and duties will be applied if the particular issue is one which the parties could have resolved by an explicit provision in their agreement directed to that issue.
>
> (2) The law of the state chosen by the parties to govern their contractual rights and duties will be applied, even if the particular issue is one which the parties could not have resolved by an explicit provision in their agreement directed to that issue, unless either
>
> (a) the chosen state has no substantial relationship to the parties or the transaction and there is no other reasonable basis for the parties' choice, or
>
> (b) application of the law of the chosen state would be contrary to a fundamental policy of a state which has a materially greater interest than the chosen state in the determination of the particular issue and which, under the rule of § 188, would be the state of the applicable law in the absence of an effective choice of law by the parties.
>
> (3) In the absence of a contrary indication of intention, the reference is to the local law of the state of the chosen law.

330. *Id.* § 188(1).

331. These principles are:

> (a) the needs of the interstate and international systems,
>
> (b) the relevant policies of the forum,
>
> (c) the relevant policies of other interested states and the relative interests of those states in the determination of the particular issue,

est in the application of their laws to the resolution of a dispute. After determining which states have an interest in the dispute, the Restatement directs a court to apply the law of the state with the most significant relationship.[332]

The contacts a court is to consider when determining the most significant state relationship to a contract dispute are: "(a) the place of contracting, (b) the place of negotiation of the contract, (c) the place of performance, (d) the location of the subject matter of the contract, and (e) the domicile, residence, nationality, place of incorporation and place of business of the parties."[333]

The Restatement notes "these contacts are to be evaluated according to their relative importance."[334] If contacts (b) and (c) are in the same state, the Restatement requires that law to apply.[335]

D. *Torts*

Similar to contract issues, when the parties have not selected a choice of law for tort claims the Restatement calls for a court to apply the principles of Section 6,[336] and in so doing consider the following contacts: "(a) the place where the injury occurred, (b) the place where the conduct causing the injury occurred, (c) the domicile, residence, nationality, place of incorporation, and place of business of the parties, and (d) the place where the relationship, if any, between the parties is centered."[337]

If an accident occurs in a foreign state, an Iowa LLC is going to be faced with the application of foreign law that does not recognize the legal existence of LLCs. This is the risk of doing business in a state that does not have a LLC statute. Quite literally, the members of the Iowa LLC will be at the mercy of the foreign court in beseeching it either to treat the LLC as a corporation and apply Restatement Section 307 or apply principles of comity, the Full Faith and Credit Clause, and the Commerce Clause, in favor of applying Iowa law to limit the members' liability.

(d) the protection of justified expectations,
(e) the basic policies underlying the particular field of law,
(f) certainty, predictability and uniformity of result, and
(g) ease in the determination and application of the law to be applied.

Id. § 6.

332. *Id.* § 188(1).

333. *Id.* § 188(2).

334. *Id.*

335. *Id.* § 188(3). This rule is not necessarily applicable in cases of land transfers, chattel, insurance, suretyship, loans, personal service contracts, transportation, issues of capacity, the requirements of a writing, and usury. *Id.*

336. *See supra* note 331.

337. RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 145 (1965).

VII. CONCLUSION

LLCs provide practitioners an important new tool in developing and crafting business arrangements best suited for their clients. Perhaps the best way to demonstrate this advantage is by example.[338]

A. *Example 1: S Corporation Starts New Business*

1. *Background*

Wizard Industries is an S corporation with a record of steady profitability in its core manufacturing business. Its engineers last year developed a new process Wizard believes can be marketed profitably. Wizard believes it is essential to allow the engineers to participate in the profits of the new process to ensure their continued commitment. The Company anticipates the engineers will own up to twenty percent of the new venture. Although Wizard is willing to share the profits of the new venture with the engineers, it has no desire to let them share in the profits of its core business. The new venture is not without risk, and Wizard would like to isolate these risks in a separate entity. The new process has a value of around $500,000 and a tax basis of 0.

2. *Alternatives*

a. *Spin off the New Process into a New S Corporation Owned by Wizard's Shareholders and the Engineers.* This alternative would result in a taxable gain to Wizard of $500,000, as well as potential taxable income to the Wizard shareholders and the engineers. This is because a five year business history is required by the tax law in order to achieve a tax-free spin off.[339]

b. *Incorporate a New Subsidiary to be Owned Eighty Percent by Wizard and Twenty Percent by the Engineers.* This alternative would result in a termination of the S corporation election for Wizard; no S corporation election would be possible for the subsidiary.[340]

c. *Form a Partnership with the Engineers.* This alternative would preserve the S election and pass-through taxation for the new business.[341] However, it would expose the assets of the core business, and those of the engineers, to the potential tort liabilities of the new business.

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338. The author is indebted to Joe Kristan, C.P.A., a member of the Des Moines, Iowa accounting firm of Roth & Company, P.C. for these two illustrations of the advantages of LLCs.

339. I.R.C. § 355(b) (1988).

340. *Id.* § 1361(b)(2)(A).

341. *Id.*

d. *Form a Limited Liability Company.* This is the only available alternative that achieves pass-through taxation while insulating participants from unforeseen risks of the new business. It can be done without causing taxation to Wizard or its current shareholders, and probably with minimal tax consequences to the engineers.

B. *Example 2: LBO Structured to Provide Preferred Allocations*

1. *Background*

Art Welding and Rose Trellis have the opportunity to purchase the asset of the Bacilli subsidiary of the Amoeba Corporation, which has just been purchased by international conglomerate Godzilla, Inc. Riscbedamd Group, a venture capital firm, is interested in providing critical equity financing and subordinated debt for the purchase. Art and Rose, although critical of the operation of the business, have only limited personal equity. A group of local investors would provide additional financing. Due to the nature of the business, all potential investors want to avoid personal liability for corporate tort exposure.

Art and Rose have prepared projections showing initial start-up losses, followed by substantial taxable income. Riscbedamd insists on a preferred return on its investment. It is willing to accept a lower interest rate on its subordinated debt if a way can be found to allocate all start-up losses to Riscbedamd—Riscbedamd's tax posture makes such losses useful to it. No other potential equity investor has the ability to use start-up losses. Riscbedamd is expected to provide about thirty percent of the equity for the purchase.

2. *Alternatives*

a. *Incorporation with Multiple Classes of Stock.* This alternative is deficient for two important reasons. First, it can only be accomplished using a C corporation, which makes double taxation unavoidable.[342] Second, there is no way to allocate any losses to Riscbedamd under this structure—all income and losses would be confined to the Bacilli corporate entity.

b. *Limited Liability Company with Multiple Classes of Interests.* This is the only available alternative that can provide a preferential allocation of losses and cash flow to Riscbedamd. Because they are taxed as partnerships, LLCs provide significant flexibility in the allocation of income and loss items

342. *Id.* § 1361(b)(1)(D).

as long as the allocations reflect economic reality.[343] Because a LLC is taxed as a partnership, the LLC avoids the two-level tax of C corporations.

343. *Id.* § 704(b).

APPENDIX**

State	Ruling	Classification (P)—Partnership (C)—Corporation	Corporate Characteristics***	
			Lacked	Possessed
Alabama	Rev. Rul. 94-6	P	CL FT	LL CM
Arizona	Rev. Rul. 93-93	P	CL FT	LL CM
Colorado	Rev. Rul. 93-6	P	CL FT	LL CM
Delaware	Rev. Rul. 93-38 (Situation 1)	P	CL FT CM	LL
Delaware	Rev. Rul. 93-38 (Situation 2	C		LL CM FT CL
Florida	Rev. Rul. 93-53	P	CL FT	LL CM
Illinois	Rev. Rul. 93-49	P	CL FT	LL CM
Louisiana	Rev. Rul. 94-5	P	CL FT	LL CM
Nevada	Rev. Rul. 93-30	P	CL FT	LL CM
Oklahoma	Rev. Rul. 93-92	P	CL FT	LL CM
Rhode Island	Rev. Rul. 93-81	P	CL FT	LL CM
Utah	Rev. Rul. 93-91	P	CL FT	LL CM
Virginia	Rev. Rul. 93-5	P	CL FT	LL CM
West Virginia	Rev. Rul. 93-50	P	CL FT	LL CM
Wyoming	Rev. Rul. 88-76	P	CL FT	LL CM

** Prepared by ABA Task Force on LLCs Chair, Barbara Spudis, Jan 26, 1994.

*** CL—Continuity of Life; FT—Free Transferability of Membership Interest; LL—Limited Liability; CM—Centralized Management.

State	Bulletproof or Flexible Statute	Interesting Feature
Alabama	Flexible	LL: exposure to personal liability for professional malpractice does not cause lack of limited liability
Arizona	Flexible	CL: majority consent to continue
Colorado	Bulletproof	CM: possessed CM even though all members were appointed managers
Delaware	Flexible	First ruling on flexible statute: handles by illustrating alternatives. Lacked CM by retaining management to members
Delaware	Flexible	
Florida	Flexible	Handles flexibility by referencing Delaware ruling
Illinois	Flexible	Handles flexibility by referencing Delaware ruling
Louisiana	Flexible	Handles flexibility by referencing Delaware ruling
Nevada	Bulletproof	
Oklahoma	Flexible	FT: majority of interests in capital consent to transfer
Rhode Island	Flexible	Handles flexibility by referencing Delaware ruling
Utah	Flexible	CL: majority consent to continue FT: majority of profits interest consent to transfer LL: exposure to personal liability for professional malpractice does not cause lack of limited liability
Virginia	Bulletproof	
West Virginia	Bulletproof	
Wyoming	Bulletproof	The first LLC public ruling