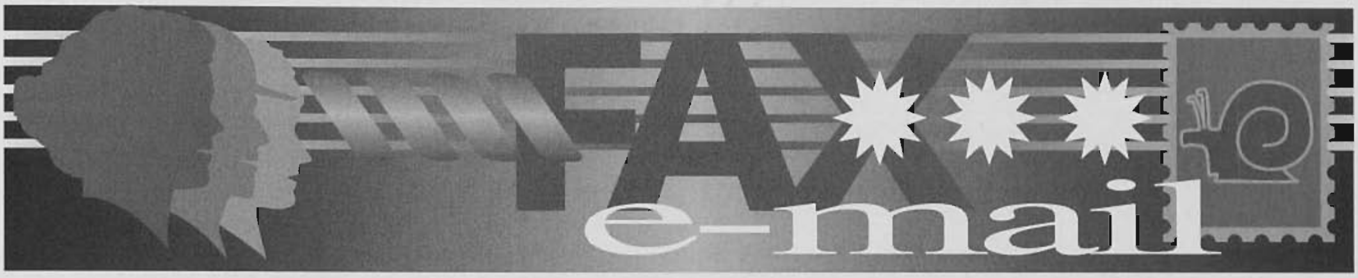
Letters



Limited Liability Companies

New rules

■ House's article on Limited Liability Companies (*Choices*, Fourth Quarter 1997) does not reflect a major change in public policy concerning LLCs. The author apparently studied the topic and wrote the article long before it was published in *Choices*. This change increases the appeal of LLCs to rural residents and other small agribusiness owners and operators.

The first section of the article, "Tax Implications," summarizes the Internal Revenue Service's (IRS) former "corporate characteristics" test (also referred to as the Kintner regulations) for determining whether an unincorporated business should be taxed as a partnership or a corporation. However, as of 1 January 1997, IRS abandoned the "corporate characteristics" test. The new rules are commonly called the "check-the-box" regulations because they permit most unincorporated businesses, including LLCs, to choose whether to be taxed as a partnership or corporation. Most don't even have to make a choice. They are automatically assigned the status they prefer. If a business wants to change its classification, it does so by filing IRS form 8832. (Treas. Reg. § 301.7701-1 to § 301.7701-3, released as Treas. Dec. 8697 [Dec. 17, 1996]).

Like other business entities, LLCs are usually formed under state, not federal, laws. Many states enacted so-called "bullet proof" LLC laws, meaning an LLC had to qualify for partnership tax treatment under the Kintner regulations (and therefore could not be "shot down" by an IRS auditor) to be recognized as a separate legal entity, a prerequisite to limiting liability of owners to their investment in the venture. In response to the check-the-box regulations, numerous state legislatures are removing such restrictions on LLCs. Soon most LLCs will be able to provide owners with limited liability and have continuity of life, free transferability of interests, centralized management, and access to partnership tax treatment.

Some other statements by the author should also be clarified. In the first paragraph, House suggests that in 1988 the IRS "ruled to allow a Wyoming LLC." Actually, IRS said that limited liability was not such a dominant corporate characteristic that, by itself, it prevented an LLC from qualifying for partnership tax treatment. This permitted an LLC with limited liability to avoid federal income taxation at the entity level, so long as it had no more than one of the other corporate characteristics (Rev. Rul. 88-76, 1988-2 C.B. 360). It was still up to Wyoming and the other states to decide whether to permit people to organize businesses as LLCs. Also regarding the first paragraph, all states, including Hawaii, now have statutes authorizing LLCs.

Table 1 contains some notations that are somewhat dated. Most states have authorized, or are in the process of authorizing, one-member LLCs. This is consistent with a portion of the IRS's check-the-box regulations that permits the owner of a one-member LLC to choose to have the entity taxed as either a sole proprietorship or a corporation. Also, readers should be aware that the Small Business Job Protection Act of 1996 (P.L. 104-188) changed some rules concerning Subchapter S corporations. One such change, not reflected in table 1 of this article, increases the maximum number of permissible shareholders from 35 to 75.

While LLCs are an attractive tool for organizing businesses, they are only another option to be added to sole proprietorships, partnerships, cooperatives, and general business corporations. Each has its pluses and minuses. When forming a new business, readers should consult with an attorney who understands the special rules for each option under the laws of their state.

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