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The Story of LLCs: Combining the Best Features of a Flawed Business Tax Structure

Introduction

On March 4, 1977, the Wyoming legislature enacted a statute authorizing the first domestic limited liability company.¹ Until the creation of the Wyoming LLC, the corporation was the only domestic business organization that offered direct statutory limited liability.² The limited liability protection offered by the corporate form came at a cost. Then, as now, business organizations formed as corporations faced a double tax on profits unless they qualified as S corporations. Although S corporations enjoy only one owner-level of tax similar to partnerships they are subject to a number of other restrictions not applicable to partnerships and other unincorporated business entities.³ The LLC promised the best of both worlds—the limited liability

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¹ See Wyoming Limited Liability Company Act, ch. 158, 1977 Wyo. Sess. Laws 577 (enacted Mar. 4, 1977).

² See generally Susan Pace Hamill, *The Limited Liability Company: A Possible Choice For Doing Business?*, 41 Fla. L. Rev. 721, 722-23 & n.9 (1989) (discussing domestic limited partnership associations offering corporate limited liability enacted by a few states that were seldom used because of restrictions requiring the principal place of business or principal office to be in the state of organization and limiting the number of partners). I first became interested in limited liability companies in 1988 shortly after the IRS released the Wyoming revenue ruling and published the above article in 1989 hoping to build a client base in the private practice of law. Instead this article led me to government service. In 1990 I joined the Pass-throughs & Special Industries Division of the Chief Counsel's Office of the Internal Revenue Service, the area with technical jurisdiction over partnerships and S corporations and the source of the Wyoming revenue ruling, and quickly became acquainted with Barbara Spudis, Bob Keatinge and many others as they worked towards developing and perfecting the LLC. Because during my government service from 1990 through 1994 I either participated in or had first hand knowledge of virtually all of the activity between the proponents of LLCs and the IRS, my discussion of that portion of the LLC's story recounted in "*The Inside Story Behind the Rise of LLCs in the 1990s*" has elements of memoir as well as history. My interest in LLCs continued after I joined the faculty at the University of Alabama School of Law. From 1994 until 2000 I completed four major and four minor articles, which explore tax policy and business policy issues raised by LLCs and trace and explain the historical background of LLCs. Most of the citations for this story comes from these articles.

³ The literature exploring the different tax treatment of partnerships and S corporations, with most of the advantages enjoyed by partnerships, is too numerous to list here. For an early article laying out the most fundamental differences, written by one of the most distinguished tax law experts, especially in area of corporate taxation, see James S. Eustice, *Subchapter S Corporations and Partnerships: A Search for the Pass Through Paradigm (Some Preliminary Proposals)*, 39 Tax L. Rev. 345 (1984).

of corporations and the favorable tax treatment of partnerships. But securing this double benefit required not only an accommodating state legislature, but also compliance with complex federal tax regulations concerning the classification of business entities. This chapter relates the “story” behind the remarkable rise of the LLC over the past quarter century. As we shall see, it is a story of taxpayer ingenuity, adept political lobbying, and entrepreneurial innovation. The story of the LLC also illustrates the dynamic interplay between state law developments and federal regulatory responses. While the final outcome can hardly be described as ideal, the story of how we arrived at that outcome offers important insights to the fluid mechanics that underlay legal innovation in the world of U.S. business taxation.

The Conventional Legal Story of the LLC

At the time the Wyoming LLC was created, the partnership classification regulations determined which unincorporated business organizations would be taxed as partnerships and which would be taxed as corporations by applying a corporate resemblance test based on four classic corporate characteristics—free transferability of interests, continuity of life, centralized management and limited liability. Under the technical language of these regulations, if any two of these four corporate characteristics were absent the unincorporated business organization would be taxed as a partnership. If three or more of these corporate characteristics were present then the unincorporated business organization would be taxed as a corporation.⁴

Despite the fact that the Wyoming LLC defeated the corporate characteristics of free transferability of interests and continuity of life, the Internal Revenue Service took until late 1980, over three years, to issue a private letter ruling confirming that the Wyoming LLC would be taxed as a partnership.⁵ Contemporaneously, the IRS displayed hostility towards LLCs by proposing regulations that would have conclusively taxed all business organizations offering limited liability under the applicable state or local law as corporations.⁶ However, the IRS withdrew the proposed regulations in 1983 after receiving much criticism and announced that they would study the effect of limited liability on the taxation of business entities.⁷ For a decade the Wyoming LLC predictably went nowhere. Less than one hundred businesses actually filed as LLCs⁸ and only Florida followed suit by enacting a LLC statute in 1982.⁹

On September 2, 1988, the IRS issued Revenue Ruling 88-76, stating that Wyoming LLCs would be taxed as partnerships despite possessing the corporate characteristic of limited liability. The revenue ruling clearly stated that the four cor-

⁴ Treas. Reg. § 301.7701-2 (as amended in 1993).

⁵ See Priv. Ltr. Rul. 81-06-082 (Nov. 18, 1980).

⁶ See 45 Fed. Reg. 75, 710 (1980) (codified at 26 C.F.R. pt. 301).

⁷ See Announcement 83-4, 1983-2 I.R.B. 30.

⁸ See Susan Pace Hamill, *The Limited Liability Company: A Catalyst Exposing the Corporate Integration Question*, 95 Mich. L. Rev. 393, 402 & n.46 (1996).

⁹ See Florida Limited Liability Company Act, 1982 Fla. Laws ch. 82-177 (enacted Apr. 21, 1982).

porate characteristics set out in the partnership classification regulations each have equal weight and that if any two of those four were absent the entity would be taxed as a partnership.¹⁰ Wyoming LLCs would always meet the standard for partnership taxation under these regulations because the relevant statutory provisions at that time defeating the corporate characteristics of free transferability of interests and continuity of life strongly resembled the classic general partnership.¹¹

After the IRS recognized that LLCs were eligible to be taxed as a partnerships other states slowly and cautiously began to enact legislation allowing for the formation of LLCs under their laws. It took until 1990—the year Colorado and Kansas both passed LLC statutes—for any state to step forward in light of the Wyoming revenue ruling. In 1991, LLC legislation only modestly increased, with Virginia, Utah, Texas and Nevada enacting LLC legislation. By 1992, and through 1996, LLC legislation swept across the country. In 1992, ten additional states, including Delaware, passed LLC legislation, bringing the total of states recognizing LLCs to eighteen. In 1993, the year showing the greatest number of LLC enactments, eighteen additional states passed LLC legislation, bringing the total to thirty-six. By the end of 1994, twelve additional states, including New York and California, authorized the formation of LLCs under their laws. By the close of 1996, the last three states, Hawaii, Vermont and Massachusetts, enacted LLC legislation, establishing the LLC as a choice for doing business in all fifty states.¹²

The rise in the number business organizations filing to operate as LLCs mirrored the meteoric pace of the state statutes. Starting in 1991, the number of LLC filings substantially increased each year, with the number of LLCs well into six figures by 1995.¹³ By the close of the twentieth century and throughout the early years of the twenty-first century, it became obvious that the LLC had taken its place in the mainstream alongside the corporation and the various types of partnership forms, typically in the business areas of finance, insurance, real estate, rental and leasing as well as the professional and business service sectors. During the second half of the 1990s, the number of LLCs continued to grow substantially each year, with almost 600,000 businesses operating as LLCs in 1999. In 2000 and 2001, this pattern continued with the number of LLCs in 2001 climbing to more than 800,000 of the just over two million partnerships showing numbers more than double that of the number

¹⁰ Rev. Rul. 88-76, 1988-2 C.B. 360.

¹¹ See Susan Pace Hamill, *The Origins Behind the Limited Liability Company*, 59 Ohio St. L. J. 1459, 1469-1470 (1998).

¹² See *id.* at 1470 & n.43, 1473-77 & nn. 59 & 72-75.

¹³ See Hamill, *supra* note 8, at 404-05 & nn.56-59, 440-46 & nn.215-16. In 1995, during the research phase of this article, compilations under *Statistics of Income* of the numbers of corporations and partnerships filing tax returns were only available up through the year 1992 (typically for any given year compilations come out at least three years later) and it was not until 1993 that *Statistics of Income* started explicitly keeping track of LLC filings. The research team conducted telephone interviews with representatives in state filing offices and estimated that total LLC filings approximated 210,000 by 1995. Because this method was only able to track new filings and was not able to account for liquidations, shell LLCs or mergers it was bound to be a high estimate. According to now available compilations under *Statistics of Income*, LLC filings for the years 1993, 1994 and 1995 equaled 17,000, 48,000, and 119,000, respectively. See Bill Pratt & Maureen Parsons, *Partnership Returns, 2001, Statistics of Income Bulletin* 46, 54 (Fall 2003) available at <http://www.irs.gov/pub/irs-soi/01partnr.pdf>.

of limited partnerships. This steady growth of LLCs clearly indicates that the number of LLCs either already has or likely will reach the one million mark.¹⁴

The Inside Story of the Push by Hamilton Brothers Oil Company to Create the First LLC Statute

The inside story explaining the conventional legal story of the LLC is a fascinating tale of two different groups of entrepreneurial individuals pursuing legal innovations to meet the needs of their clients. The lawyers and accountants representing Hamilton Brothers Oil Company, an independent oil explorer headquartered in Denver, were responsible for the creation of the first domestic limited liability company statute. Since the late 1960s, Hamilton Brothers Oil Company had conducted international oil exploration activities organized as unincorporated foreign business entities. These foreign entities, especially the Panamanian *limitada*, qualified for partnership taxation even though they provided direct corporate style limited liability under the applicable foreign law. However, by the early 1970s, these foreign entities became unsuitable due to capital and quota participation limitations imposed by foreign law as well as increasing concerns that the U.S. courts would be reluctant to recognize the foreign based limited liability shield. Consequently, Hamilton Brothers Oil Company needed to come up with an alternative business entity that provided more certainty of limited liability protection while still qualifying for partnership taxation under U.S. law.¹⁵

Hamilton Brothers Oil Company's board members wanted to conduct their oil exploration activities in a business entity organized under U.S. law and they could have opted for the limited partnership form. Although under state law only the limited partners enjoyed direct limited liability protection, with the general partner technically bearing personal liability for all debts of the limited partnership, at that time limited partnerships commonly achieved substantive limited liability by setting up a corporate general partner. As long as the corporate general partner satisfied certain net worth requirements specified by the IRS, the limited partnership could safely be treated as defeating the corporate characteristic of limited liability and qualify for partnership taxation, usually by also defeating the corporate characteristic of continuity of life.¹⁶

¹⁴ See Pratt & Parsons, *supra* note 13, at 53-54. The compilations under *Statistics of Income* show an unmistakable trend upward in LLC filings at the dawn of the 21st century. In 1999 and 2000, 589,000 and 718,000 businesses, respectively, filed as LLCs. In 2001 the number of LLC filings totaled 809,000 out of 2,132,000 partnerships, 369,000 of which are limited partnerships. *Id.* Business organizations continue to file as corporations in the greatest numbers with the compilations under *Statistics of Income* showing 5,135,591 (of which 2,860,478 elected subchapter S taxation) corporate filings in 2001. See *Statistics of Income*, Table 13, Corporation Income Tax Returns: Balance Sheet, Income Statement and Tax Items for Specified Years, 1985-2001, available at <http://www.irs.gov/pub/irs-soi/01col3bs.xls>.

¹⁵ See Hamill, *supra* note 11, at 1463-64 & nn. 14-16.

¹⁶ See Susan Pace Hamill, *The Taxation of Domestic Limited Liability Companies and Limited Partnerships: A Case for Eliminating the Partnership Classification Regulations*, 73 Wash. U. L.Q. 565, 585-87 & nn.94-97, 581-85 & nn. 68 & 70-76 (1995).

Instead of recommending the limited partnership form, Frank M. Burke, Jr.¹⁷, who at that time was advising Hamilton Brothers Oil Company, created a new business organization form—he drafted the first LLC proposal—and with the help of others approached the Alaska legislature to get the proposal enacted. Although the Alaska bills were discussed extensively and enjoyed substantial legislative support (due to the hope that the IRS would recognize the LLCs’ right to be taxed as a partnership, thereby bringing considerable fees into Alaska for filings), two attempts, in 1975 and in 1976, failed, apparently for political reasons unrelated to the proposals. Shortly thereafter, proponents of Burke’s Alaska LLC Proposal took an identical LLC proposal to the Wyoming legislature, which was very receptive and promptly enacted the first domestic LLC statute without any struggle.¹⁸

The more than three year process endured by Hamilton Brothers Oil Company and Wyoming’s governor and Secretary of State as the IRS debated the merits of the private letter ruling request to recognize the Wyoming LLC as a partnership for tax purposes proved to be a very frustrating experience. Internal correspondence among government officials reveals that the IRS initially reacted quite pessimistically to the Wyoming LLC. Representative comments such as “obviously the normal channels do not provide us an adequate means of expediting the ruling”, “no justification for two-year delay”, “proposed revenue ruling not receiving priority attention”, “virtually all issues resolved but no indication of outcome”, and “reasons for delay include the usual buck passing” provide an idea of what it was like for the first group of LLC proponents.¹⁹ Although the proposed regulations of 1980 that would have taxed all entities offering limited liability as corporations were clearly devastating to the Wyoming LLC, the firestorm of scathing criticism that erupted attacking these regulations was far removed from the pioneering efforts of the original inventors of the Wyoming LLC. Most of the numerous comments, over sixty of them, came from organizations like the Tax Section of the American Bar Association, the New York State Bar Association and large prestigious New York City based law firms representing equipment leasing trusts and U.S. persons participating in foreign enterprises.²⁰

The Inside Story Behind the Rise of LLCs in the 1990s

Ultimately the LLC’s original creators and proponents never enjoyed the opportunity to actually use the LLC. By 1988, when the IRS recognized the partnership tax status of Wyoming LLCs, the business market for massive independent oil ex-

¹⁷ Frank M. Burke, Jr. is currently the chairman and managing general partner of Burke, Mayborn Company Ltd., a private investment company in Dallas. Mr. Burke is a friend of John Dzienkowski, a member of the law faculty at the University of Texas, and, a friend of mine who helped guide me through the tenure process. Through my connection with John Dzienkowski I was able to secure from Mr. Burke copies of his files documenting all the unpublished letters, memos and other information, providing an inside picture of the LLC’s creation and the first battle with the IRS. I thank both of them for making it possible for me to tell the inside story of the LLC’s first phase of development.

¹⁸ Hamill, *supra* note 11, at 1463-65 & nn. 14-23.

¹⁹ *Id.* at 1466-67 & n. 28.

²⁰ *Id.* at 1468 & n.35.

ploration efforts and the ability to syndicate tax losses in other investment activities had passed from the scene.²¹ In July of 1990, as the early states slowly started to pass LLC statutes, two individuals, Barbara Spudis²² and Bob Keatinge²³, established subcommittees on LLCs in the Tax and Business Sections of the American Bar Association. In their capacities as the chair of these subcommittees (Barbara Spudis chaired the LLC Tax Section Subcommittee, which later became the Task Force on Limited Liability Companies, and Bob Keatinge chaired the LLC Business Section Subcommittee) they led efforts to study the LLC, plan strategies on how to further approach the IRS for clarification on open questions regarding the LLC's ability to be taxed as a partnership, organize a clearinghouse of information to encourage and assist state LLC drafting committees, and convince the National Conference of Commissioners on Uniform State Laws to produce a uniform LLC statute.²⁴

In the early 1990s, published comments such as “[the LLC] was shown around at this year’s Tax Section meeting like a new fighter plane at the Paris Air Show . . .”, “[Minnesota’s law] slid so smoothly through the House and Senate that . . . one legislator described it as a ‘bipartisan love fest’”, and “LLCs are an easy sell” indicated that LLCs had sparked enormous enthusiasm.²⁵ As early as 1991, the *Washington Post*, after noting that the LLC “is exciting lawyers around the country” predicted that the LLC “is likely to grow in importance over the next few years.”²⁶ The editor of the *Business Lawyer* offered up an even bolder (yet ultimately prophetic) prediction: “[The LLC is] one of the most important developments in business law today. . . . While to date only a handful of states have adopted legislation providing for limited liability companies, the train is out of the station. Years from now, this may be viewed as the dawn of a new era in business entities.”²⁷

Vigorous and tenacious behind-the-scenes efforts to promote LLCs continued through 1996, showing a high degree of intensity and commitment normally found only in movements for social change. For example, a working group of ten volunteers met every Saturday morning by conference call for two years in order to produce a prototype limited liability company act.²⁸ While hundreds of lawyers and

²¹ *Id.* at 1517.

²² Barbara Spudis (who now goes by Barbara Spudis de Marigny) is currently a shareholder at the law firm of Oppenheimer, Blend, Harrison & Tate in San Antonio, Texas. I thank her for sharing her substantial files, which made it possible for me to write the inside story of the LLC during the first half of the 1990s.

²³ Bob Keatinge is currently of Counsel at the law firm of Holland & Hart in Denver, Colorado. I thank him for sharing his substantial files, which made it possible for me to write the inside story of the LLC during the first half of the 1990s.

²⁴ Hamill, *supra* note 11, at 1470-72 & n. 44.

²⁵ See Charles Briggs Davenport, Jr., et al., *LLC Boosters Blitz, Pass-through Sessions*, 37 Tax Notes 1019 (1992); Josephine Marcotty, *State To Allow Business Hybrid That Combines the Advantages of Corporate and Tax Worlds*, *Star Trib.*, (Minneapolis-St. Paul) Apr. 30, 1992; and Jeffery A. Tannenbaum, *Forming as a Limited Liability Company Offers Best of Both Worlds*, *Wall St. J.*, May 14, 1991, at B2.

²⁶ Daniel B. Moskowitz, *New Way to Organize Business is Gaining Wider Acceptance*, *Wash. Post*, Nov. 4, 1991, at F14.

²⁷ Richard M. Phillips, *From the Editor*, 47 *Bus. Law.* at xiii (1992).

²⁸ Hamill, *supra* note 11, at 1471 & n. 46.

other professionals worked hard and contributed a great deal towards advancing the development of LLCs, Barbara Spudis and Bob Keatinge provided crucial leadership for the LLC movement by coordinating these massive efforts going on at the same time across the county. No two individuals are more responsible for the rise of the LLC during the 1990s than Barbara Spudis and Bob Keatinge.²⁹

Throughout the period from 1990 through 1996, questions concerning how the partnership classification regulations applied to LLCs dominated the efforts of the LLC's proponents. To minimize controversy regarding the corporate characteristics of free transferability of interests and continuity of life, drafters of Wyoming LLC statute had written the transferability and dissolution provisions to closely resemble the classic general partnership. Moreover these provisions were immutable, sometimes called "bullet proof", meaning they could not be changed. Regardless of how the members actually wanted the operating agreement to address the important business issues of transferability of interests and dissolution consequences, all members had to agree to a complete transfer of a LLC interest and all members had to agree to thwart a dissolution and continue the business if a member died, retired, resigned or suffered bankruptcy, insanity or expulsion.³⁰ Behind-the-scenes correspondence shows that members of both the tax and business LLC subcommittees recognized early on that the practical use of LLCs would be limited to small, closely held businesses and joint ventures as long as interests in a LLC remained very difficult to transfer and the LLC itself highly dissolvable. For example, as one commentator explained, "several members of the subcommittee suggested that until the transferability issue is resolved, limited liability companies will not be of much use." Another observed that "[i]f the IRS rules that an LLC lacks continuity of life when events of dissolution are tied to only one member, this will greatly increase our practical ability to use LLCs".³¹

A great deal of strategic discussion, as evidenced by comments such as "the committee should reevaluate the issue list in order to avoid prompting the IRS to reevaluate its position on LLCs", occurred as subcommittee members debated how to approach the IRS.³² Barbara Spudis, Bob Keatinge and others from both LLC subcommittees met with IRS attorneys several times over this period, urging that LLCs be allowed to enjoy the more flexible partnership classification rules regarding transferability and dissolution applicable to limited partnerships so that larger, more widely-held business ventures could choose to operate as LLCs.³³ Under the IRS's

²⁹ *Id.* at 1470-84 & nn.44-52, 61-71 & 79-110 (virtually all unpublished letters and memos documenting the behind-the-scenes efforts to promote LLCs in the 1990s are authored by, or at least mention, Barbara Spudis and Bob Keatinge).

³⁰ *Id.* at 1470, 1473-74, 1478-79 & nn. 41-42.

³¹ *Id.* at 1472, 1475 & nn.49 & 69.

³² *Id.* at 1472 & n. 50.

³³ *Id.* at 1473, 1478 & nn.51-52 & 79-82. LLC proponents also argued that LLCs should be able to enjoy the flexible standards accorded limited partnerships lacking centralized management if the LLC has managers (three of the twenty-five members featured in the LLC analyzed in the Wyoming revenue ruling were designated as managers and the ruling stated, without identifying the equity share owned by the managers, that the LLC possessed centralized management); and that the LLC should be able to lack limited liability if some or all of the members assume the LLC's liabilities. *Id.*

standards at the time, limited partnerships could defeat the corporate characteristics of free transferability of interests and continuity of life if a majority of the limited partners or the general partners consented to the transfer or agreed to continue the business upon a dissolution event. Moreover a vote to continue the business only had to be triggered upon one of the dissolution events, commonly the bankruptcy of a corporate general partner set up solely to manage the particular limited partnership.³⁴ In 1992 and 1993, these subcommittees produced written comments articulating their recommendations, which officially came to the IRS from the Tax Section of the American Bar Association.³⁵

Throughout this period, as LLC proponents endlessly lobbied the IRS, the relationship between the two remained cooperative and professional. IRS attorneys appeared in numerous public discussions and subcommittee meetings and assured LLC proponents that state-by-state revenue rulings and a revenue procedure would be issued to provide further guidance on how far LLCs could deviate from the stringent requirements of Revenue Ruling 88-76 and still be classified as a partnership for tax purposes.³⁶ The IRS also provided significant informal guidance “encouraging everyone working on LLC statutes to call in and get advice” on the theory that “it’s better to draft a statute properly and get the tax aspects correct than have to go back and amend or deal with a possible unfavorable ruling.”³⁷ In 1992, when the National Conference of Commissioners on Uniform State Laws appointed a committee to draft a Uniform LLC Act, IRS attorneys attended the drafting sessions, and in 1993 the IRS provided a non-binding informal opinion letter analyzing the partnership classification consequences of the draft Uniform LLC Act.³⁸

As the number of states enacting LLC statutes rapidly increased, the classification issues raised by LLCs finally came to a head. On December 29, 1994, the IRS issued Revenue Procedure 95-10, essentially allowing LLCs to enjoy the same flexible standards as limited partnerships when applying the classification regulations.³⁹ Three months later, the IRS issued a notice, announcing a forthcoming proposal to eliminate the partnership classification rules and followed up a year later with proposed regulations that were enthusiastically supported.⁴⁰ Commentators at the time

³⁴ Hamill, *supra*, note 16 at 581-583, 587-589. Under the IRS’s standards at the time, limited partnerships also could defeat the corporate characteristic of centralized management despite the presence of general partners vested with the statutory authority to manage the business if the general partner owned more than 20% of the equity interests of the partnership (and if a number of other conditions were met); and could defeat the corporate characteristic of limited liability despite the presence of a corporate general partner if the general partner satisfied detailed net worth (as well as certain other) requirements. *Id.* at 583-587.

³⁵ Hamill, *supra* note 11, at 1474, 1478 & nn.63-67 & 84-86.

³⁶ *Id.* at 1479-80 & nn.87-90.

³⁷ See Catherine Hubbard & Lee Sheppard, *Guidance Forthcoming on LLC Classification, Practitioners Told*, 58 Tax Notes 824 (1993) and Hamill, *supra* note 16, at 590 & n.117.

³⁸ Hamill, *supra* note 11, at 1480-82 & nn.92-99.

³⁹ Rev. Proc. 95-10, 1995-1 C.B. 501.

⁴⁰ See I.R.S. Notice 95-14, 1995-1 I.R.B. (Mar. 30, 1995) and Prop. Treas. Reg. §§ 301.7701-2-4 (proposed May, 13 1996); Hamill, *supra* note 11, at 1480, 1482-83 & nn.103 and 106.

credited the rise of the LLC with the demise of the partnership classification regulations.⁴¹

On December 17, 1996, shortly after the last holdout states had passed LLC statutes, the IRS issued final regulations, dubbed the “Check-the-Box” regulations, permanently eliminating all partnership classification concerns for LLCs and all other domestic unincorporated entities. Under these regulations, which continue in effect today, all LLCs and other domestic unincorporated business entities are automatically taxed as partnerships as long as they are not publicly traded.⁴² With this new flexibility, business participants choosing LLCs are now able to craft the dissolution, transferability and management provisions of the LLC to satisfy business goals alone.⁴³

The Earliest Origins of the LLC

The opportunity to create and develop the LLC was a direct result of the individual states rather than Congress enjoying primary jurisdiction over the creation of business organizations. Had the initial creation of LLCs required congressional approval, the LLC undoubtedly never would have achieved legitimacy because, at least on the surface, LLCs appear to provide a new way to avoid the double tax on corporate profits.⁴⁴ Because the states have the power to enact business organization statutes, the first group of LLC proponents only had to convince the legislature of one state to enact their proposal. As LLC statutes stamped across the country in the early 1990s, the second group of LLC proponents were able to build on the momentum as more and more states enacted LLC statutes. The earliest origins of the LLC can be traced to the point in America’s past when the power to authorize corporations vested under state rather than federal control, which led to the states assuming the general authority to create new business organizations.⁴⁵

Unlike the classic general partnership, which is automatically created when at least two persons act together as co-proprietors in a manner that shows they intend to combine their efforts and share profits, corporations have always been creatures of statute, requiring formal recognition by a sovereign person or government.⁴⁶ In

⁴¹ See Rod Garcia and Nancy Loube, *LLCs or How the Government Got to Check-the-Box Classification*, 67 Tax Notes 1139 (1995) (“Three years ago...sponsors of the limited liability company structure peddled their product at several committee sessions....Now its 1995, and times have indeed changed. Almost every state in the nation has a statute dealing with LLCs...The IRS has set up guidelines for assuring that an LLC is classified as a partnership and not as a corporation for federal income tax purposes....With Notice 95-14...the government proposed to throw in the towel on trying to define the lines that distinguish partnerships from corporations....[N]o single entity is more responsible for Notice 95-14 than the LLC, which just a few years ago was a new idea to many practitioners.”) *id.*

⁴² Treas. Reg. §§ 301.7701-1-4 (1996). Sponsors of LLCs and all other domestic unincorporated business organizations can follow certain procedures and affirmatively elect for the entity to be taxed as a corporation. *Id.*

⁴³ Hamill, *supra* note 11, at 1483.

⁴⁴ Hamill, *supra* note 8, at 397 & n.22.

⁴⁵ Hamill, *supra* note 11, at 1484-85.

⁴⁶ *Id.* at 1484-85 & n.109.

America's colonial days, there were no general incorporation laws. Corporate charters were issued privately, either directly by the King of England or by the colonial assemblies under the implicit authority of the King of England. Although after the American Revolution the Founding Fathers debated whether the new U.S. Constitution authorized Congress to issue corporate charters for large projects such as the first national bank, they never contemplated whether Congress had the general authority to issue corporate charters nor did they explicitly confer this power to the states. This is not surprising. During America's colonial period through the end of the eighteenth century corporations were very uncommon. During this time only public purpose endeavors such as municipalities, religious and educational institutions, cemeteries and charitable organizations that required the ability to exist beyond the natural life of the original sponsors and pool capital typically needed a corporate charter. Almost all business activities were conducted either by sole proprietors or in general partnerships.⁴⁷

The best historical evidence indicates that after the American Revolution the state legislatures simply followed the precedent of the colonial assemblies and assumed the power to grant special charters by default.⁴⁸ The sponsors of the early American corporations issued by special charter followed vastly different procedures for incorporating than the procedures set out by the general state laws in operation today. A special charter required the state legislature to create each corporation individually through a private bill that outlined all terms and conditions, including special privileges, applicable to that corporation.⁴⁹

The practical question of whether it made sense for state legislatures to issue corporate charters came up in the first few decades of the nineteenth century when hundreds of corporate charters were being issued by different states for banks and transportation projects, two areas that raise classic interstate commerce concerns and are now regulated by federal law. Because of concerns regarding the extent of congressional powers and the states-rights oriented climate that punctuated the Jacksonian period and continued through the Civil War, the idea of empowering Congress to issue corporate charters, even for projects clearly involving interstate commerce, never took root. Instead, prominent Jacksonian Democrats pushed for the enactment of state general corporation laws in order to allow all potential corporate sponsors who met the statutory requirements the right to use a corporation without securing a special charter from the state legislature.⁵⁰

From the 1830s through 1875, state general incorporation laws spread across the country.⁵¹ On an almost parallel course, at least as far as the timing of state statu-

⁴⁷ See Susan Pace Hamill, *From Special Privilege to General Utility: A Continuation of Willard Hurst's Study of Corporations*, 49 Am. U. L. Rev. 81, 88-99 & nn.23-46 (1999).

⁴⁸ *Id.* at 91 & nn.39 & 41.

⁴⁹ *Id.* at 84 & nn.5-6.

⁵⁰ *Id.* at 93-101 & nn.47-78. The availability of general incorporation laws in almost all the states by 1875 did not result in the end of the practice of corporate sponsors seeking a special charter from state legislatures. From 1875 through the late 20th century state legislatures issued almost 20,000 special charters despite the availability of general incorporation laws and special charters remained an important part of the corporate landscape through the early decades of the 20th century. *Id.* at 122-168, 177-179 & nn. 165-317.

⁵¹ *Id.* at 101-02, 104-05, 178 & nn.79-87 & 94-95.

tory enactments, the first limited partnership statute emerged in the early 1800s and state general laws authorizing limited partnerships also became more common.⁵² Throughout the nineteenth century, as business grew beyond the ability of the states to regulate, federal law was never contemplated as the more efficient vehicle for issuing corporate charters, even during the Reconstruction years which showed unprecedented federal activism in a number of other areas.⁵³

In the early decades of the twentieth century, the primary power of the states over the legitimacy of corporations proved to be irreversibly entrenched. At the end of the nineteenth century, New Jersey enacted the first liberal general incorporation law that catered to the needs of corporate managers controlling the largest, vertically integrated corporations. This started a heated competition among the rest of the states to also enact liberal general incorporation laws in order to attract filing and other fees for their state. It was during this competition, known in later literature as the “race-to-the-bottom” because the new laws imposed few restraints on potential corporate abuses, that Delaware established itself as the favorite state for incorporation. By the 1930s, liberal general incorporation laws had emerged as a pattern across the nation.⁵⁴

The proliferation of liberal general incorporation laws across the country did not go unnoticed. In response to heavy criticism of corporate abuses, the administrations under four presidents supported federal proposals which would have taken the authority over corporations away from the states and placed it under federal control. These proposals all failed, however, because the longstanding tradition empowering the states to charter corporations and the popularity of liberal general incorporation laws proved to be too powerful for Congress to overcome. Instead, Congress responded to corporate abuses by enacting laws directly addressing corporate conduct, the 1933 and 1934 Securities Acts being the most well known. These developments established the current landscape for regulating corporations and other business organizations as a two-tier system of state and federal law existing together and occupying separate spheres of power. The primary power of state law over the legitimacy of corporations never again faced serious challenge leaving in place the state law

⁵² *Id.* at 172-75 & nn.327-35. Unlike the corporation, which by the 1830s was the dominate form for doing business, it took until the 20th century for the limited partnership to emerge as a reasonable and practical choice for a substantial number of businesses. *Id.* at 174-175 & nn.333-35.

⁵³ *Id.* at 107-16 & nn.100-44. During the Reconstruction-era the Radical Republicans and the Moderate Republicans hotly debated the amount of federal oversight needed to ensure that the southern states would comply with Reconstruction policies, with the Radicals favoring far more federal oversight and greater rights for the newly freed slaves. Neither the Radicals nor the Moderates considered the possibility of using federal law to coordinate the rapidly growing railroad system or tame the increasingly powerful business corporation. The Radical leaders, who were otherwise years ahead of their time, enjoyed no understanding of the basic underpinnings of business and corporations and were not able to see that sound business practices would help nurture a healthy economy which in turn would bring increased economic opportunities that would help the newly freed slaves. The Moderates, many of whom understood how business and corporations operated, still trusted the state and local free market to provide the proper level of regulations and therefore, never would have considered pushing for increased federal oversight and control over corporations. *Id.* at 112-113 & nn.126-27.

⁵⁴ *Id.* at 118-19 & nn.154-58.

forum for creating new business organizations, which made the LLC's invention possible approximately fifty years later.⁵⁵

Conditions of the 20th Century that Spawned LLCs

If the LLC's earliest origins are found in special charters issued by state legislatures and early general incorporation statutes, its more direct roots can be traced to the first modern income tax enacted in 1913 as a result of the Sixteenth Amendment.⁵⁶ The critical provision, which in substance still applies today, taxes the net income of "every corporation, . . . or association . . . organized in the United States . . . not including partnerships."⁵⁷ By imposing an entity level tax on all state law corporations and on at least some unincorporated forms but not on partnerships, the Revenue Act of 1913 laid the foundations of the business tax structure that would eventually lead to the birth of the LLC more than a half century later.⁵⁸

Despite the theoretical possibility of the LLC emerging earlier, the IRS actively discouraged the states from creating LLCs before 1960, and, through its own regulations, set the legal stage for the LLC's invention after 1960. Before 1960, the partnership classification regulations relied upon various techniques to identify the presence of limited liability as a marker mandating corporate taxation.⁵⁹ In 1960, however the IRS changed these regulations in a way that would enable the LLC's invention less than twenty years later. In order to restrict access to the favorable tax rules for pension benefits, which at that time were only available to entities taxed as corporations, the IRS overhauled the partnership classification regulations to make it more difficult for unincorporated business organizations to be classified as associations, thereby conferring partnership tax status if two of the four corporate characteristics were absent.⁶⁰

⁵⁵ *Id.* at 119-122, 175-76 & nn.159-64 & 336-39; Hamill, *supra* note 11, at 1496, 1500-1501, 1518-1519, 1520.

⁵⁶ U.S. Const. Sixteenth Amendment (creating broad congressional powers to tax).

⁵⁷ See Revenue Act of 1913, ch. 16, 38 Stat. 114. 26 U.S.C. §11 (2004).

⁵⁸ The drafters of the Revenue Act of 1913 apparently saw no need to define corporation when imposing *per se* the corporate tax on all state law corporations, without regard to the particular business characteristics of the corporation. Undoubtedly due to the long history of corporations being formed by special charter and the current debates at that time over what to do about corporate abuses in the face of liberal incorporation laws, Congress believed that state and local law adequately defined corporations for tax purposes. Hamill, *supra* note 16, at 571 & n.24; Hamill, *supra*, note 11 at 1503 & nn.195-98; Hamill, *supra*, note 47 at 119 & nn.159-60.

⁵⁹ Hamill, *supra*, note 11 at 1504-08 & nn.199-215. From 1914 until 1940, a time when some state limited partnership laws provided direct limited liability for general as well as limited partners, the presence of corporate limited liability created a strong presumption that a limited partnership would be classified as an association taxable as a corporation. From 1940 to 1960 although the presence of corporate limited liability no longer directly mandated corporate status for limited partnerships (because by then limited partnership statutes had evolved to requiring the general partner to bear personal liability for the debts of the partnership) the presence of limited liability nevertheless served as a dividing line because state law partnership associations, which did provide direct limited liability, were automatically deemed to be associations. *Id.*

⁶⁰ Hamill, *supra*, note 16 at 573 & nn.32-34; Hamill, *supra* note 11, at 1508 & nn.216-17.

Understanding the dynamics behind the invention of the LLC after 1960 requires examining two key factors—i.e., the relative tax cost of doing business in the corporate and partnership forms and the general business climate. As we shall see, these factors help explain the motivations of the particular client—the Hamilton Brothers Oil Company—that ultimately invested the substantial time and effort necessary to invent the LLC. Until the Tax Reform Act of 1986, the combination of lower corporate tax rates, the preferential treatment of capital gains as well as other corporate preferences, resulted in a lower effective income tax burden on business profits for C corporations than for partnerships or S corporations. Consequently, from a tax perspective until 1986, business interests needing the ability to pass through start-up losses, which would otherwise be suspended in both the S and C corporation forms, had far more motivation to invent the LLC than business interests expected to show profits relatively quickly.⁶¹

The general business climate of the late 1960s and early 1970s, which features a heavy increase in the demand for crude oil discovered by independent oil explorers—like the Hamilton Brothers Oil Company—sheds further light on why the LLC was born during the 1970s. Until the late 1960s, most of the major oil producers either drilled for their own crude oil, or, especially after the 1940s, secured their supply from foreign sources, which at that time offered very inexpensive crude oil. However, once relationships with Middle Eastern governments began to deteriorate in the late 1960s, culminating in the oil embargo crisis of 1973, the supply of foreign oil dried up rapidly. These developments created a market for crude oil from independent oil explorers, with the result that the number of business ventures formed to conduct independent oil exploration activity exploded to new levels during these years. During the 1970s shares of these business ventures set up to explore and drill for new sources of crude oil were the most popular partnership syndication investments on the securities markets, offering investors flow-through tax losses up-front and the potential of substantial profits if oil was discovered.⁶²

Although the rise of independent oil explorers during the late 1960s and early 1970s best explains the invention of the LLC and lines up nicely with the actual facts, theoretically a number of other business interests could have invented the LLC. By the late 1970s and early 1980s, other business activities, for example the development of real estate, assumed a significant share in the market offering the syndication of partnership interests promising the flow-through of tax losses in the early years of operation. Had Hamilton Brothers Oil Company or some other independent oil explorer not invented the LLC, it is possible that the real estate syndication or some other industry might have. However because the LLC's ability to be taxed as a partnership remained highly uncertain until the IRS issued the Wyoming revenue ruling in 1988, LLCs played no role in the explosion of partnership syndications formed almost exclusively to market flow-through tax losses. By the late 1970s

⁶¹ Hamill, *supra* note 11, at 1509-12, 1521-22 & nn.218-30. Even if the other numerous restrictions imposed by the rules for taxing S corporations posed no problems, the rules denying the shareholders of S corporations an increase in stock basis for shares of the corporation's third party debt rendered S corporations unsuitable for any business venture where the ability to pass-through early losses was an important part of the deal. *Id.* at 1509 & n.218.

⁶² *Id.* at 1512-16 & nn.231-49.

and early 1980s when these tax shelters proliferated out of control, promoters combined flow-through tax losses under the partnership tax provisions and substantive limited liability by setting up limited partnerships with a minimally capitalized corporate general partner.⁶³

In the second half of the 1980s, significant federal tax legislation probably played a key role towards creating a sufficient comfort zone for the IRS to concede that Wyoming LLCs would be taxed as partnerships. The passive activity loss rules of the Tax Reform Act of 1986 materially limited the ability of most investors to currently deduct flow-through losses and effectively destroyed the market for syndicated tax shelters. A year later, in 1987, Congress added section 7704, automatically taxing all publicly traded partnerships as C corporations, which put to rest widespread fears that massive corporate tax revenues would be lost due to the steady increase, which had started in the early 1980s, of publicly traded partnerships being offered on the securities markets. Despite the fact that LLCs never had the potential to be the cause of the undisputed substantial revenue loss from abusive tax shelters or the arguably imagined revenue loss from publicly traded partnerships, this legislation allowed the IRS to issue Revenue Ruling 88-76 knowing for sure that LLCs would never be a vehicle for tax shelters or publicly traded partnerships.⁶⁴

Major shifts in the effective tax burden imposed on business profits in corporate versus unincorporated business organizations help explain what motivated the numerous LLC proponents in the 1990s to invest significant time and energy to work towards perfecting the LLC. The Tax Reform Act of 1986 materially increased the effective tax burden imposed on corporations. The gap between the tax burden borne as a result of doing business in a C corporation as opposed to a partnership or S corporation peaked in 1990, with substantially lower burdens on business profits taxed at one level at individual rates. Participants in business ventures expecting significant taxable income that wanted to enjoy direct corporate limited liability without being hampered by the many restrictions imposed by the S corporation rules, had, for the first time, strong reasons to support the LLC. On behalf of many clients engaged in profitable business activity, LLC proponents pushed for more flexibility on the partnership classification front and encouraged state legislatures to enact LLC statutes. By 1993 despite changes in the tax rates mitigating the tax burdens faced by C corporations, the race among the states to enact LLC statutes continued to stampede across the country on its own independent momentum, strongly resembling the movement of the states to enact the first general incorporation and limited partnership statutes in the nineteenth century and the competition among the states to produce liberal general incorporation laws in the early twentieth century.⁶⁵

Although the historical developments of the nineteenth century vesting the power to create new business organizations with the relatively accessible channels of state legislatures and the tax and business conditions of the twentieth century both go a long way towards fostering a greater understanding of the LLC phenomenon, the invention and perfection of the LLC cannot be fully explained in a scientific

⁶³ Hamill, *supra* note 16, at 574-75 & nn.37-40.

⁶⁴ Hamill, *supra* note 11, at 1517 & nn.250-53; Hamill, *supra* note 8, at 426-29 & nn.163-71.

⁶⁵ Hamill, *supra* note 11, at 1517-1518 & nn.254-259.

manner by isolating these conditions in a laboratory. Frank M. Burke, Jr. and the first group of LLC proponents in the 1970s, as well as Barbara Spudis and Bob Keatinge and the second group of LLC proponents in the 1990s, could have opted for the well developed limited partnership form and secured for their clients partnership taxation and substantive limited liability protection under the relatively clear tax and business law standards. Instead, they chose the road less traveled and invested an enormous amount of time and energy into a new idea. Ultimately the rise of the LLC resulted from sparks of unpredictable human creativity being ignited—initially by the first group of LLC proponents who instead of settling for the established pattern, created something new and then by the second group of LLC proponents who followed suit and perfected the new business entity instead of returning to the established pattern.

Important Policy Issues Exposed by the Rise of LLCs

Despite the considerable enthusiasm for LLCs, the rise of this new business entity was not greeted with uniform zeal. The title of one commentary, “*The Dark Side of Limited Liability Companies*” along with one critic’s statement “[t]he federal government has opened up a candy store” metaphorically articulated the more directly expressed concerns that LLCs will “open the floodgates to do-it-yourself integration” resulting in “big holes in the federal corporate tax base” that will lead to “a significant revenue loss. . . .”⁶⁶ The question raised—does the LLC offer a new mechanism to achieve corporate integration even though U.S. lawmakers have not yet sanctioned corporate integration in any form—adds more controversy to the important tax policy issue debating whether the two-tier tax on C corporations represents wise tax policy.⁶⁷ During the LLC’s rise this question was not merely a theoretical issue. In 1993 and 1994, the House Ways and Means Select Revenue Measure Subcommittee expressed interest in further exploring the corporate integration issue generally and the increased use of the LLCs particularly.⁶⁸ If the LLC offers a state law back-door around the federally imposed corporate tax, Congress would have strong reasons to amend the Internal Revenue Code and require LLCs to be taxed as corporations.⁶⁹

For at least two reasons, LLCs have little or no potential to drain corporate tax revenues. First, since 1960 businesses using the partnership form have been able to

⁶⁶ Lee A. Sheppard, *The Dark Side of Limited Liability Companies*, 62 Tax Notes Today 1441 (1992); *New York Contemplates Cost of Partnership Tax Treatment for Limited Liability Companies*, 1992 Tax Notes Today 243-10 (quoting from James W. Wetzler, New York State Tax Commissioner of Taxation and Finance); *Use of Limited Liability Companies Seen Not Jeopardizing Corporate Tax Base*, Daily Tax Rep. (BNA) No. 59, at J-1 (Mar. 30, 1993) (quoting Donald Alexander, former IRS Commissioner); *Tax Revenues Will Suffer, But Limited Liability Companies May Be Here To Stay*, 62 Tax Notes Today 233-34 (1992) (quoting Lee Sheppard, Contributing Editor, *Tax Notes*); *New York Official Says Corporate Integration Ignores Revenue Impact on States*, 1993 Tax Notes Today 102-103 (quoting from James W. Wetzler, New York State Tax Commissioner of Taxation and Finance).

⁶⁷ Hamill, *supra* note 8, at 397.

⁶⁸ See Highlights & Documents, Feb. 3, 1993 at 2109; *Congress May Examine IRS Position on LLCs in Future*, Daily Tax Rep. (BNA) No. 72 at G-7 (Apr. 15, 1994).

⁶⁹ Hamill, *supra* note 11, at 1469 & n.37; Hamill, *supra* note 8, at 424.

enjoy substantive limited liability and partnership taxation by using a corporation as the general partner in a limited partnership. Even before the IRS issued the Wyoming revenue ruling, the four factor corporate resemblance test of the partnership classification regulations did not require personal liability exposure as a condition for partnership taxation. As result, the Wyoming revenue ruling, subsequent developments in the partnership classification area allowing LLCs to enjoy the flexible interpretations accorded limited partnerships, and finally the adoption of the Check-the-Box regulations did not themselves create the ability to combine limited liability and partnership taxation—they only provided a more direct and therefore a more transaction cost free route to reach these goals.⁷⁰

Second, LLCs offer little potential to supplant businesses paying significant corporate taxes. Businesses fitting the prototype of a small closely-held firm that choose LLCs will cost the Treasury at most *de minimis* corporate tax revenues. Empirical evidence indicates that small corporations, which have always enjoyed the ability to eliminate the corporate tax by either electing subchapter S or by paying out corporate profits to the shareholders in a deductible fashion, account for a minuscule share of the corporate tax when compared to their gross receipts.⁷¹ LLCs also lack the ability to supplant larger widely-held corporations, even those that are not publicly traded, which do pay significant corporate taxes. This is because the business tax system treats the distributive share of income earned from a LLC as unrelated business taxable income for tax-exempt members or income effectively connected with a U.S. trade or business for foreign members. Dividends on corporate stock, however, are not taxable at all to tax-exempt investors and are usually taxed at significantly lower rates to foreign investors under the applicable treaty. Consequently, growing businesses that find it necessary to raise significant capital from the equity markets generally prefer to incorporate in order to attract these investors, which understandably will not invest in the equity of any business entity taxed as a partnership.⁷²

Although the rise of the LLC does not force Congress to directly confront the corporate integration issue, the addition of the LLC to the mainstream of choices for doing business does bring to the forefront some very troubling aspects of the business tax system. When focusing on business organizations that are not publicly traded, including both closely-held and widely-held firms, the LLC exposes the arbitrary and inequitable consequences of the *per se* taxation of all state law corporations under the corporate tax regime juxtaposed to the partnership tax regime enjoyed by all unincorporated business organizations. Given the historical background of the evolution of corporate law and especially the business and political climate of the early twentieth century as liberal general incorporation laws proliferated across the states, relying on state law to conclusively define corporate status for tax purposes may have made sense in 1913. Nearly a century later, however, those reasons are substantially less compelling because the state law designation of business entities as incorporated or unincorporated no longer carries any meaning towards identi-

⁷⁰ Hamill, *supra* note 16, at 598-607; Hamill, *supra* note 8 at 410, 426-27; Hamill, *supra* note 11, at 1517.

⁷¹ Hamill, *supra* note 8, at 410-18.

⁷² *Id.* at 418-29.

ifying the true business characteristics of the firm and therefore offers no rational policy concerning the appropriate taxation of the firm and its owners.⁷³

The arbitrary and inequitable nature of *per se* corporate taxation of small corporations is especially insidious. The trend of closely-held firms, where owners are actively participating in the firm's business, incorporating to secure direct limited liability, started in the early decades of the twentieth century and quickly gained momentum. Even though these corporations provide direct limited liability they still more closely resemble general partnerships because ownership and control is normally vested with the shareholders. Nevertheless, they must either engage in elaborate planning to eliminate the corporate tax or tolerate the restrictions of subchapter S. Even worse, if the corporation owns significant appreciated assets the shareholders cannot convert the business to a LLC without recognizing the built-in gain because the conversion is treated as a corporate liquidation.⁷⁴ When I teach *Business Tax* I refer to this as the "Hotel California"⁷⁵ phenomena and tell my students "when in doubt don't incorporate".⁷⁶ The rise of the LLC exposes this disparate treatment as unfair because well advised new businesses can choose LLCs while the corporate tax provisions preclude businesses that incorporated years ago from making the same choice.⁷⁷

In the context of large, widely-held, non publicly traded business organizations, where the investors are seeking returns from the efforts of professional managers, the increased use of LLCs adds more light further exposing the irrational side effects caused by the business tax system. The backstops in the law that have always prevented partnerships and continue to prevent LLCs from threatening corporate tax revenues—the characterization of the flow-through income as unrelated business taxable income and income effectively connected with a U.S. trade or business—inappropriately affect investment decisions. These backstops discourage tax-exempt and foreign investors from investing in partnership and LLC equity while encourag-

⁷³ Hamill, *supra* note 16, at 598-608.

⁷⁴ Hamill, *supra* note 8, at 408-09, 415-18. Generally partnerships and LLCs that seek to convert to the corporate form and partnerships and LLCs that seek to change to another unincorporated business form can delay the recognition of the built-in gain of the appreciated assets while maintaining the historic carry-over basis. *Id.*

⁷⁵ This comes from the lyrics of a popular song by the *Eagles* ("you can check out anytime you'd like, but you can never leave") to express the idea that the business participants legally can convert the corporation to a LLC but are precluded from doing so because the acceleration of the tax liability on the built-in gain is too expensive.

⁷⁶ There is one major circumstance where the S corporation rules offer better tax consequences than the partnership tax provisions. If the business expects to earn substantial income within the range of possibly being subject to self employment tax there is a substantial risk, given the uncertainty of the law in this area, that the members and managers of a LLC will be subject to self employment tax on their distributive shares of the LLC's income. See David J. Cartano, *Federal & State Taxation of Limited Liability Companies* (2004 ed.) at 363-368. On the other hand shareholders of S corporations are not subject to self employment tax on their distributive shares of the S corporation's income. See James S. Eustice & Joel D. Kuntz, *Federal Income Taxation of S Corporations* (4th ed. Supp. 2004) at paragraph 7.12. This distinction favoring S corporations has no more rational basis than the many distinctions favoring partnerships and LLCs. I tell my students to carefully explain to their clients, forming new businesses as S corporations to avoid self employment taxes, the long term consequences of "checking in the Hotel California" and to document carefully in the files that this warning was explicitly given and the client chose the S corporation anyway.

⁷⁷ Hamill, *supra* note 8, at 408-09, 429-33.

ing them to invest in the stock of C corporations. At the same time the double tax on corporate profits discourages investors subject to U.S. income tax at regular rates from investing in the stock of C corporations while encouraging such investors to invest in the equity of non publicly traded partnerships and LLCs. Even worse the deductibility of interest encourages all investors in corporations to choose debt over equity. Although these indefensible distinctions between incorporated and unincorporated business organizations existed long before LLCs, the increased use of LLCs has made it much more difficult to ignore them. This is because LLCs enjoy partnership taxation while directly offering limited liability and a structure that separates ownership and control like a classic corporation.⁷⁸

Before the rise of the LLC, it was possible to pretend that the presence or absence of direct state law corporate limited liability provided some measure of substance justifying the differences in the taxation of corporations and partnerships. The rise of the LLC has shattered this myth, highlighting the need for federal policymakers to come up with a rational answer to the corporate integration issue. Congress could respond by taxing all business entities that provide both direct and substantive limited liability as corporations. For a number of reasons, however, that would probably be an unwise decision.⁷⁹ A better approach would be to tax small, closely-held businesses, businesses that tend to vest control over the day-to-day business decisions with the equity owners, only once under the same regime.⁸⁰ In 1995, when the LLC was well on its way to becoming a mainstream business organization form, individual policymakers recognized this basic premise and considered proposals to allow shareholders of S corporations to convert the business to a LLC without recognizing the built-in gain normally triggered in corporate liquidations.⁸¹

In the context of both non publicly traded and publicly traded firms where ownership and control are separated, the rise of the LLC offers no clear solution as to which way the corporate integration issue should be resolved. However, if policymakers determine that some business organizations should bear a separate entity level tax, Congress should clearly set forth substantive standards for imposing the corporate tax and eliminate the conflicting provisions of the law undermining that tax. In 1987, Congress at least partially attempted to do this by treating all publicly traded partnerships as C corporations for tax purposes. However, most of the arbitrary side effects exposed by the rise of the LLC that also undermine the credibility

⁷⁸ *Id.* at 424-29, 434-36.

⁷⁹ *Id.* at 433-34. Imposing the corporate tax regime based the presence of statutory limited liability should be summarily rejected as merely elevating form over substance. Extending the corporate provisions to all business entities offering substantive limited liability as well would require extensive line drawing and would extend the corporate tax provisions to many partnerships that previously have never been subject to the corporate tax. *Id.*

⁸⁰ *Id.* at 429-33.

⁸¹ See Letter from Leslie B. Samuels, Assistant Secretary for Tax Policy, Treasury Dept., to Orrin Hatch, Senator (July 25, 1995) reprinted in *Treasury Expresses Conditional Support for S Corp. Reform Bill*, 95 Tax Notes Today, 150-25 (Aug. 2, 1995). The legislation being discussed in this letter that was ultimately passed, the Small Business Job Protection Act of 1996 contained no provision allowing S corporations to convert to LLCs tax free and no tax free conversion has ever been seriously contemplated since. Hamill, *supra* note 8, at 408-09 & n.82.

of the corporate tax—i.e., the disparate treatment favoring corporate debt over equity for all investors and the double tax on corporate profits discouraging investors paying U.S. tax from investing in C corporations that does not exist for tax-exempt and foreign investors—are still present despite the treatment of publicly traded partnerships as C corporations. Although the rise of the LLC does not even theoretically raise these issues in the publicly traded arena, the LLC is thematically connected because the same backstops that will keep the LLC from draining corporate tax revenues in the widely-held, non-publicly traded arena were put forth by publicly traded partnership proponents as reasons publicly traded partnerships posed no threat to corporate tax revenues.⁸²

While the rise of the LLC has been largely driven by tax considerations, it is important not to lose sight of the business law implications of this new business entity.⁸³ The invention and widespread acceptance of LLCs inspired the creation of even more unincorporated business organization forms, the most important being limited liability partnerships, referred to as LLPs, and limited liability limited partnerships, referred to as LLLPs. LLPs are state law general partnerships and LLLPs are state law limited partnerships where in each the general partners have registered to enjoy limited liability protection.⁸⁴ At the broadest level, this new range of choices is confusing and inefficient, leading scholars to argue that states should merge the different statutes into one unincorporated business organization statute.⁸⁵

In addition to spawning more unincorporated business organization forms, the business provisions of the LLC itself sometimes contain traps for business planners, especially when comparing LLCs and LLPs.⁸⁶ Although LLCs and LLPs appear

⁸² Hamill, *supra* note 8, at 428-29, 437-38. Proponents also argued that publicly traded partnerships had no ability to drain corporate tax revenues because the potential investors were those subject to U.S. income tax at regular rates who would otherwise choose to invest in corporate debt. *Id.*

⁸³ See “LLCs must be rescued from the grasp of the tax lawyers.” *AALS Tax Section Looks at LLCs*, 96 Tax Notes Today 17-H (1996) (quoting Professor Larry Ribstein arguing that LLCs offer independent business advantages) and “Everything is driven by tax and the rest of the world will accommodate...” *id.* (quoting Professor Jerry Kurtz’s response to Professor Ribstein).

⁸⁴ Hamill, *supra* note 11, at 1521. See also Robert W. Hamilton, *Registered Limited Liability Partnerships: Present At The Birth (Nearly)*, 66 Colo. L. Rev. 1065 (1995) (describing the impetus for Texas’ enactment of the first domestic LLP in 1991). The compilations under *Statistics of Income* started keeping track of LLP filings in 1998. From 1998 through 2001 filings for LLPs numbered 26,000, 42,000, 53,000, and 69,000, respectively, clearly showing steady growth but not at the dramatic level seen with LLCs. See Bill Pratt and Maureen Parsons, *Partnership Returns, 2001, Statistics of Income Bulletin* 46, 54 (Fall 2003) available at <http://www.irs.gov/pub/irs-soi/01partnr.pdf>.

⁸⁵ See John H. Matheson & Brent A. Olsen, *A Call For a Unified Business Organization Law*, 65 Geo. Wash. L. Rev. 1 (1996); Dale A. Oesterle & Wayne M. Gazur, *What’s in a Name? An Argument For a Small Business “Limited Liability Entity” Statute (With Three Sets of Default Rules)*, 32 Wake Forest L. Rev. 101 (1997). Even before the rise of the LLC at least one scholar argued for combining the business organization statutes into one. See Harry Haynesworth, *The Need For a Unified Small Business Structure*, 33 Bus. Law. 849 (1978).

⁸⁶ From 1996 to 2000, with independent study students as co-authors, I produced four articles in a series published in the Alabama Law Review exploring legal issues and practical problems raised by LLCs and LLPs. The first three articles were dedicated entirely to issues raised in the business law area. See Mitchel Hampton Boles & Susan Pace Hamill, *Agency Powers and Fiduciary Duties Under the Alabama Limited Liability Act: Suggestions for Future Reform*, 48 Ala. L. Rev. 143 (1996); Laurel Wheeling Farrar & Susan Pace Hamill, *Dissociation From Alabama Limited Liability Companies in the Post Check-the-Box Era*, 49 Ala. L. Rev. 909 (1998); and Fallany O. Stover & Susan Pace Hamill, *The LLC Versus LLP Conundrum: Advice For Busi-*

almost identical, especially when no managers are appointed for the LLC, default and immutable business provisions buried within their respective statutes can produce unintended and undesirable consequences. For example, since the IRS adopted the Check-the-Box regulations, most LLC statutes do not provide for dissociation rights in the statutes, making it necessary to draft corporate-like buy sell agreements to thwart problems of liquidity and issues of the potential oppression of minority owners that have plagued close corporation planners for years. On the other hand, LLPs, being general partnerships, have immutable dissociation rights in the statute.⁸⁷ In addition, many LLC statutes require the operating agreement to be in writing, a feature that is consistent with corporate law, while LLPs, like all general partnerships, will recognize oral agreements if the terms can be proven. This disparity of treatment can cause potentially huge inequities, especially in informally created LLCs without competent legal assistance, if the members make an oral agreement for sharing profits under circumstances where some members contribute mostly capital while others contribute mostly services.⁸⁸

When considering the monumental tax and business policy issues raised by the rise of the LLC and the state of the world of business organizations, both before and after the LLC came on the scene, a fair question can be posed—are the business and tax worlds better or worse off as a result of the LLC? For many years I answered that question by enthusiastically endorsing LLCs, declaring that LLCs improve the business organization legal landscape by allowing small informal business participants who cannot afford expensive legal assistance to directly achieve limited liability and partnership taxation in a cost effective manner.⁸⁹

Now I am not so sure. During the LLC's third phase of development following the Check-the-Box regulations, lawyers providing sophisticated advice for estate plans and other complicated investment ventures successfully convinced most state legislatures to move the LLC closer to a corporate model by eliminating all dissociation rights from the default provisions of the LLC statutes. Although LLCs are now more attractive to those who can afford, and do secure, expensive legal assistance,

nesses Contemplating the Choice, 50 Ala. L. Rev. 813 (1999). The fourth in the series documented how the arguably most complex regulations in the income tax area—the section 704(b) allocation rules—are even more complex when applied to LLCs and LLPs. See Christine Rucinski Strong and Susan Pace Hamill, *Allocations Attributable to Partner Nonrecourse Liabilities: Issues Revealed by LLCs and LLPs*, 51 Ala. L. Rev. 603 (2000).

⁸⁷ Farrar & Hamill, *supra* note 86, at 915-28, 934-38.

⁸⁸ Stover & Hamill, *supra* note 86, at 833-38. A capital contributing member's and service contributing member's oral agreement to share profits equally is arguably not enforceable if the LLC statute requires the operating agreement to be in writing. The default rule for sharing profits in most LLC statutes, consistent with corporate themes, looks to the members' capital accounts, which in the case of the service-contributing member is arguably zero. The LLP statute would recognize the oral agreement, and, even if proof of the terms proved difficult, consistent with general partnership law the LLP default rule provides for equal sharing of profits. *Id.*

⁸⁹ Hamill, *supra* note 8, at 430 (“[t]he increased use of LLCs actually improves the overall fairness of the business tax system...[by]...level[ing] the playing field between sophisticated, well advised small businesses and unsophisticated small businesses”).

these recent statutory developments have also made LLCs more perilous for many informal business arrangements.⁹⁰

Although LLCs no longer offer small, informal firms, which work best within the classic general partnership model, a transaction cost friendly option,⁹¹ the rise of the LLC created no new pitfalls for these businesses. The traps in the business law arena now faced by informal businesses using LLCs were present in the close corporation context years before LLCs were invented.⁹² Therefore my response to the question asking whether the world is better or worse off because of LLCs has changed. I now believe that the business and tax worlds are no better off but are also no worse off as a result of LLCs joining the mainstream of business organization choices. Or stated another way: “The more things change, the more they remain the same.”⁹³

⁹⁰ Farrar & Hamill, *supra* note 86, at 934-938 (dissociation rights eliminated in the LLC’s default provisions to make the LLC a suitable entity for family gift and estate tax planning); *id* at 931 (elimination of dissociation rights in the LLC default provisions is a negative development because LLCs initially provided an alternative to the general partnership for small business).

⁹¹ Stover & Hamill, *supra* note 86, at 838-844, 847 (LLPs, which offer business default provisions mirroring the classic general partnership, are a better choice for small, informal businesses unable or unwilling to shoulder significant transaction costs). Given the explosive growth of LLCs, as compared to the modest but not insignificant growth of LLPs (*see supra* notes 13, 14 & 84), participants in many informal businesses are probably choosing LLCs simply because at this point LLCs are more well known than LLPs.

⁹² Farrar & Hamill, *supra* note 86 at 923-28, 930-31 (discussing the development of close corporations and the problems of oppression of minority shareholders).

⁹³ John Bartlett and Justin Kaplan, editors, *Bartlett’s Familiar Quotations* (16th edition 1992) at 443, paragraph 19 (quoting Alphonse Karr, *Les Guepes* (January 1849)).