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How “Limited” is Pennsylvania’s Limited Liability Company Act?

INTRODUCTION

On December 7, 1994, Pennsylvania joined the growing list of states that have enacted limited liability company (“LLC”) acts. LLCs have been in existence since 1977, but only recently has the LLC attracted attention as a viable business entity alternative. This attention is primarily due to the LLC’s combination of the most favorable aspects of corporations and partnerships.

An LLC provides for limited liability for all its owners, but is designed to be taxed as a partnership for federal income tax purposes. The owners of the LLC, who are called members, have the same limited liability as shareholders of a corporation. Unlike corporations, however, LLCs can be structured to receive flow-through tax treatment under federal law.

An LLC, as a non-corporate business, is not subject to the mandatory provisions of corporate statutes that require boards of directors, officers and related corporate formalities. In addition, LLCs have a flexible capital structure and profit/loss allocation, similar to general partnerships. The members of the LLC, in contrast with the limited partners of a limited partnership,

1. 1994 Pa. Laws 106 (to be codified at 15 PA. CONS. STAT. §§ 8901-98) [hereinafter citations to the Pennsylvania LLC Act will be to the codified statute only]. The effective date of the Act was February 5, 1995. Id.
2. See, e.g., 15 PA. CONS. STAT. § 8915 (“[t]he provisions of this chapter are intended to permit a limited liability company to qualify for taxation as an entity that is not an association taxable as an entity under the Internal Revenue Code”).
3. See, e.g., 15 PA. CONS. STAT. § 8922.
4. See, e.g., 15 PA. CONS. STAT. §§ 1721, 1732.
are not restricted from participating in the management and control of the business. Thus the LLC is a hybrid entity.

The most substantive limitation on the flexibility of LLCs results from the preconditions essential to the preservation of their tax status as a flow-through entity. In particular, the statutes must ensure that the LLC lacks certain basic corporate characteristics. The need to meet these federal tax preconditions imposes at least a modest constraint on the ability to plan for problems of duration and termination.

The LLC entity is likely to be of particular interest to two groups: those small, closely held corporations that would choose to be S Corporations, but fail to meet one of the requirements; and professional corporations that would like flow-through tax treatment, or professional partnerships that would like a degree of limited liability. For these and other businesses considering the LLC, an understanding of the entity's limitations, as well as its benefits, is essential.

This comment provides a general introduction to limited liability companies and the enabling legislation in states nationwide. Issues relating to the formation, operation and dissolution of an LLC are addressed, as well as tax and securities considerations. This comment also compares LLCs to other business forms and suggests the situations in which an LLC might be the preferred entity.

Finally, the recently enacted Pennsylvania Limited Liability Company Act (the "Act") is discussed and analyzed. The various features of the Act, including those relating to formation, management, mergers and professional LLCs are examined. The Pennsylvania Act's failure to provide favorable state tax treatment to LLCs is also discussed. This significant disincentive limits the possibility that this new form of business entity will attract new business to the Commonwealth.

5. These limitations are a result of the Internal Revenue Service's requirements for an entity to be taxed as a partnership, rather than as a corporation. See Treas. Reg. § 301.7701 (as amended in 1993).
7. An S corporation is a corporation that elects to be taxed in a manner similar to partnerships at the federal level. See I.R.C. §§ 1361-78.
8. Generally, professional corporations provide some limitation on the liability of the members; the cost, however, is corporate tax treatment. Professionals who are organized as partnerships have the benefit of flow-through taxation, but there is no limitation on the liability of one partner for the other partner's misdeeds. A professional LLC combines the liability limitation of a professional corporation with the flow-through taxation of a partnership.
LIMITED LIABILITY COMPANIES — A BROAD OVERVIEW

The first LLC statute was enacted by the state of Wyoming in 1977.\(^9\) Over the next ten years, only one other state, Florida, enacted LLC legislation.\(^10\) Other states were not only unfamiliar with this new form of business association, but were also unsure of the viability of the entity because of questions as to how the Internal Revenue Service (the "IRS") would classify an LLC for federal income tax purposes.\(^11\) In 1988, the IRS made the LLC attractive by determining that an LLC organized under the Wyoming LLC Act would be classified as a partnership for purposes of the federal income tax.\(^12\) Following that ruling, nearly every state has ridden the LLC bandwagon.\(^13\)

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11. See Richard M. Horwood and Jeffrey A. Hechtman, The ABC's of LLC's, 40 No. 6 Prac. Law 65 (September 1994). It was not certain if the IRS would treat LLCs as partnerships or as corporations. Id.
Limited liability companies are a hybrid form of business organization, blending characteristics of both partnerships and corporations. Different state statutes use varying language to define LLCs.\textsuperscript{14} Because it is a distinct business form, some states have chosen to include a specific statement that the LLC is a business entity.\textsuperscript{15}

**FORMATION**

All current LLC statutes require the filing of the articles of organization before an LLC may be formed.\textsuperscript{16} These articles must be filed with the Secretary of State, and must include the LLC's name and period of duration.\textsuperscript{17} Generally, an LLC is deemed to be organized either upon the members' endorsement of the articles,\textsuperscript{6} upon filing of the articles,\textsuperscript{9} or upon the issuance by the Secretary of State of a certificate of organization.\textsuperscript{18}

Similar to statutory rules for naming a corporation, LLCs must conform their names to specific guidelines. The name must contain the words “Limited Liability Company” or “Limited


Hawaii, Massachusetts and Vermont have legislation pending that would allow for the creation of limited liability companies.


Company" or the abbreviation "L.C." or "L.L.C." In some states failure to include the designated words in the name of the entity may result in the personal liability of its members.²¹ There are varying restrictions as to the distinguishable characteristics of the name themselves. Some state statutes permit the name to be reserved in advance of the LLC's inception.²² Each state's guidelines are determinative and are designed to ensure that those parties dealing with an LLC are aware of its limited liability feature.

Most LLC statutes require that at least two persons form the LLC.²³ However, some state statutes allow organization by a single person.²⁴ Some statutes permit organization by one person, but require that the LLC have two or more members at formation.²⁵ Because of this distinction, a single member LLC may not be entitled to limited liability under these statutes, although that individual technically complied with the formation requirements.²⁶ Further an LLC with only one member may not be entitled to partnership tax classification for federal tax purposes.²⁷

In most states, an LLC may be formed for any lawful purpose²⁸ but in a few states banking and insurance industries are excepted²⁹ and other states do not permit businesses that provide professional services to organize as LLCs.³⁰ Other statutes limit the purposes for which LLCs may be organized to those purposes that are permitted for partnerships and corpora-

22. See, e.g., NEV. REV. STAT. § 86.171(2); WYO. STAT. ANN. § 17-15-105(b).
26. Compare COLO. REV. STAT. ANN. § 7-80-203 (permitting one or more persons to organize LLC) with COLO. REV. STAT. ANN. § 7-80-203(2) (requiring two or more members at the time of formation).
28. In a recently issued revenue procedure, the IRS indicated that it would not consider advanced ruling requests for LLCs with only one member. See Rev. Proc. 95-10, 1995-3 I.R.B. 20.
30. See CAL. CORP. CODE § 17002 (West Supp. 1994); WYO. STAT. ANN. § 1715-103.
In any case, most of the LLC statutes have defined "purpose" broadly to allow for flexibility.

Similar to the purpose provisions, the state LLC statutes grant broad powers to the LLCs. The general powers contained in LLC acts allow the organization to sue and be sued; deal in property; lend money for proper purposes; deal in interests, shares or obligations of other LLCs, corporations, partnerships, the United States government or any nation; make contracts and incur liabilities; conduct its business in any state of the United States; elect or appoint managers and agents, dispose of its property or assets and to exercise all powers necessary or convenient to effect any of the purposes for which the company is organized. Other states have added supplemental powers to the general ones listed above.

MEMBERS AND MANAGEMENT

The LLC is comprised of members. The interests of these members are characterized as personal property in the LLC. The members are authorized to enter into an operating agreement to regulate the affairs of the LLC, the conduct of its business and the relations of its members. This operating agreement may be written or oral and the agreement is subject to amendment. The operating agreement generally includes the following: 1) capital contribution obligations and remedies for default; 2) management authority and compensation; 3) allocations and distributions to its members; 4) transferability of interests; and 5) dissolution provisions.

32. See, e.g., COLO. REV. STAT. ANN. § 7-80-103; KAN. STAT. ANN. § 17-7603.
33. See, e.g., ARIZ. REV. STAT. ANN. § 29-610; CAL. CORP. CODE § 17003; FLA. STAT. ANN. § 608.404; NEV. REV. STAT. § 86.281. Some states provide that the LLC has the same powers of an individual to do all things necessary to carry out the LLC's general purpose, business and affairs. See, e.g., GA. CODE ANN. § 14-11-202; VA. CODE ANN. § 13.1-1011(C).
34. See, e.g., ILL. ANN. STAT. ch. 805 para. 180/1-30(12) (Smith-Hurd Supp. 1994) (power to donate to charities); NEV. REV. STAT. ANN. § 86.281(4) (power to lend money to assist members); OKLA. STAT. ANN. tit. 18, § 2003 (Supp. 1995) (power to indemnify); VA. CODE ANN. §§ 13.1-1009(12), (13) (power to pay compensation and the power to insure).
35. See, e.g., ALA. CODE § 10-12-6 (1994); UTAH CODE ANN. § 48-2b-103; VA. CODE ANN. § 13.1-1038.
37. See, e.g., ARIZ. REV. STAT. ANN. § 29-601(11); OKLA. STAT. ANN. tit. 18, § 2001(17). Some states require that the articles must be written. See DEL. CODE ANN. tit. 6, § 18-1011(6); N.H. REV. STAT. ANN. § 304-C:1(IV) (Supp. 1993).
There are two basic forms of management provisions in the LLC acts. The basic form, which appears in the majority of the states, simply states three general propositions. First, unless the articles vest management in managers, management is vested in the members.\(^{39}\) If the members choose to give up management power they still will control who will have the management power by electing the managers to their position.\(^{40}\) Second, unless otherwise provided for by the articles, management powers are vested in the members of the LLC in proportion to their contributions to capital.\(^{41}\) This differs from the typical partnership statute which provides that all partners should receive equal voting and management power. Finally, the managers derive their responsibilities from the members as delineated in the operating agreement.\(^{42}\) In this fashion, the members control the extent of power that the managers will have.

Managers and members alike are responsible for general fiduciary duties that arise out of the agency relationship. In addition, some statutes require the managers of the LLC to act in good faith\(^{43}\) or without gross negligence;\(^{44}\) while other statutes do not address the requisite standard of conduct.\(^{45}\)

Members acquire an interest in an LLC by contributing capital.\(^{46}\) The LLC statutes contain no rules governing the issuance of ownership interests, the creation of classes or series of interests, or the allocation of equity contributions to stated capital or surplus accounts. There are also no statutory rules concerning differential treatment of holders of the same class or series of

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40. ALASKA STAT. § 10.50.115 (Supp. 1994); KAN. STAT. ANN. § 17-7612; ME. REV. STAT. ANN. § 651(1) (West 1994); UTAH CODE ANN. § 48-2b-125; WYO. STAT. ANN. § 17-16-116.
42. N.C. GEN. STAT. § 57C-3-21 (1993). Some states require that management powers are presumed to be vested in managers unless the members opt out of the provision. See, e.g., COLO. REV. STAT. ANN. § 7-80-401; VA. CODE ANN. § 13.1-1024. Other statutes require an election of "governors," who serve a function similar to that served by directors of a corporation. See, e.g., N.D. CENT. CODE § 10-32-69 (Supp. 1993).
45. DEL. CODE ANN. tit 6, §§ 18-306, 18-405. The Delaware statute authorizes the operating agreement to provide that a member or manager who fails to comply with the operating agreement shall be subject to specified penalties or consequences. Id.
46. See, e.g., VA. CODE ANN. § 13.1-1027(A). The Virginia contribution provision, typical among LLC acts permits contributions of cash, property or services. See VA. CODE ANN. § 13.1-1027(a). In addition, a contribution may be in the form of a promissory note or other obligation to contribute cash or property or services. Id.
interest as there are under the corporation statutes. The capital structure is determined by the parties in their operating agreement and, because of its flexibility, makes LLCs attractive to investors. The means for allocating profits and losses varies among the different state statutes. Distribution to the members is usually determined by the proportionate share of membership ownership or equally among the members.

LIMITED LIABILITY

The prospect of obtaining limited liability for all of the owners of the business is one of the primary motivations behind the growth of the LLC. Limited liability for the owners of a business entity is granted by statute and is a feature of every LLC act. When the owners of an entity have limited liability, creditors may look only to the entity's assets rather than to the owners' personal assets. The owners' liability for the debts of the entity is restricted to their investment in the entity.

SECURITIES LAW CONSIDERATIONS

Membership interests in a limited liability company may be considered securities under state and federal securities law.

48. See, e.g., GA. CODE ANN. § 14-11-403 (providing for equal allocation of profits and losses if not otherwise stated); ARIZ. REV. STAT. ANN. § 29-709 (allocating profits and losses in proportion to capital contributions).
49. Alaska's state statute requires that members be repaid their capital contribution first, then profits are shared between the members after all other liabilities are satisfied. ALASKA STAT. § 10.50.290.
50. See, e.g., ALA. CODE § 10-12-20; IND. CODE ANN. § 23-18-3-3; WIS. STAT. ANN. § 183.0304.
52. Id.
53. See 15 U.S.C. § 77b (1988). The definition of "security" in the Securities Act of 1933 is clearly broad enough to include interests in LLCs. That definition is: The term "security" means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, reorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a "security," or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.
Unless either the security or the transaction is exempt, the offer and sale of securities require registration with the federal and state securities commission. Some states have amended the statutory definition of security to include interests in LLCs. Whether amended or not, the statutory definition of security in every state will be sufficiently broad to cover interests in LLCs. Therefore, the determination of whether the offer or sale of an LLC interest must be registered will be based upon the exclusions and exemptions from state securities law.

The offer and sale of interests in a limited liability company may be exempt from state registration pursuant to statute or...
regulation of the state securities commission, or pursuant to an individual exemption. Some statutes have excluded from the definition of security interests in LLCs where the number of members are limited or management is vested in the members. In addition to statutory exemptions, interests in an LLC may be exempt from registration under state securities laws pursuant to rules or orders of the state securities commission. Finally, those offering interests in an LLC may apply for an exemption from state registration requirements. Most statutes give the state securities commission discretion to provide additional exemptions from registration.

The rulings of state securities commissions on requests for exemption from registration indicate that the primary focus of state securities regulations is whether the members will actively

59. See, e.g., WIS. STAT. ANN. § 551.02(13)(c) ("Security' is not presumed to include an interest in a limited liability company . . . . if the aggregate number of members in the limited liability company, after the interest is sold, does not exceed 35 and the right to manage the limited liability company is vested in its members."); IND. CODE ANN. § 23-2-1-1(k) ("Security does not include . . . (iii) an interest in a limited liability company if the person claiming that the interest is not a security can prove that all of the members of the limited liability company are actively engaged in the management of the limited liability company.").

60. For example, the Michigan Securities Commission has promulgated an exemption for certain professional limited liability companies. Exemption Order, Michigan Corporations and Securities Bureau, 2 Blue Sky L. Rep. (CCH) 32,630 (March 24, 1994). The Order provides:

[A]ny transaction involving the offer and sale of a membership interest in a professional limited liability company formed under the Michigan Limited Liability Company Act, and to provide professional services, as specifically described in Section 902(b) [which section includes accountants, chiropractors, dentists, optometrists, veterinarians, physicians, engineers and attorneys] of the LLC Act is exempt from the registration provisions of the [Michigan Securities] Act.

61. See, e.g., In re Anne Arundel Physicians' Cooperative LLC, No-Action Letter, 1994 WL 385059 (Md. Sec. Div. March 8, 1994). In Physicians' Cooperative, the members of the LLC were all physicians, would all participate in the management of the LLC, and each member would have the authority to bind the LLC, as a general partner has the authority to bind a partnership. Physicians' Cooperative, 1994 WL 385059 at *2-3. In addition, the interests were not transferable, and the members were not entitled to dividends. Id. Based on these factors, the Maryland Securities Division indicated that no action would be pursued against the LLC for failing to register the offer and sale of the interests with the Securities Division. Id. at *6.

62. See, e.g., PA. STAT. ANN. tit. 70, § 1-203(r) (permitting the commission to exempt from registration, "[a]ny transaction or class of transactions as to which the commission by regulation or order finds that registration is not necessary or appropriate for the protection of investors").
participate in the management of the LLC.\textsuperscript{63} This focus is in accord with the \textit{Howey} test.\textsuperscript{64} If members do not participate in the management of the LLC, their profits are derived from the significant efforts of others.

The classification of a membership interest in an LLC as a security is likely where that interest is not accompanied by management rights. A membership interest, without management, is tantamount to a shareholder's interest in a corporation. In this situation an interest in a limited liability company would satisfy the definition of securities.

If an interest in an LLC is considered to be a security and does not qualify for an exemption, registration with the state securities agency will be required prior to sale of those interests. The availability of exemptions varies from state to state. Because each state's statute will likely apply to any offer or sale within the state, the organizers of an LLC will have to comply with the statutory requirements of every state in which an offer or sale of an interest is made.

When Pennsylvania enacted its Limited Liability Company Act, it also amended its securities statute.\textsuperscript{65} The definition of security was amended to include a "membership interest in a limited liability company."\textsuperscript{66} At the same time, an exclusion for interests in LLCs whose members managed the LLC was enacted.\textsuperscript{67} In addition, an exemption was enacted for membership

\textsuperscript{63} See Request for Interpretive Opinion Orchards Drug, L.C., Kansas Securities Commission 1991 Kan. Sec. No-Act. LEXIS 1, *6 (Kan. Sec. Comm. May 1, 1991) (noting that "if members elect managing members on an annual basis, who manage the business affairs on an ongoing basis in a manner similar to a corporate board, or otherwise delegate management authority to a select group, the interests would be securities"); In re Amici Pecuniarius, L.C., 1992 Okla. Sec. LEXIS 2 (Okla. Sec. Comm. August 28, 1992) (indicating that the Oklahoma Securities Commission would take no action for nonregistration by an LLC whose members had management authority pursuant to the operating agreement).


\textsuperscript{65} 1994 Pa. Laws 126, § 2 (to be codified at PA. STAT. ANN. tit. .70, § 1-102(t)).

\textsuperscript{66} PA. STAT. ANN. tit. 70, § 1-102(t).

\textsuperscript{67} PA. STAT. ANN. tit. 70, § 1-102(t)(v). The exclusion provided that the definition of security did not include:

A membership interest in a limited liability company where all of the following conditions are satisfied:

(A) The membership interest is in a company that is not managed by managers;

(B) The purchaser of the membership interest enters into a written commitment to be engaged actively and directly in the management of the company; and

(C) The purchaser of the membership interest, in fact, does participate actively and directly in the management of the company.
interests in professional LLCs. Apart from these recent amendments, the Pennsylvania Securities Act provides an exemption for any transaction "which the commission by regulation or order finds that registration is not necessary or appropriate for the protection of investors." Pursuant to this statute, the Pennsylvania Securities Commission has promulgated a Small Issuer Exemption. This exemption applies to an issuer who has neither sold securities to more than ten persons nor made offers to more than ninety persons. While this is certainly a limited exemption, it may apply to a small LLC where one or more members will not participate in management.

**TAX CONSIDERATIONS**

*Federal Taxation*

For federal tax purposes, business entities are primarily classified as either corporations or partnerships. Limited liability companies, depending on the provisions of the operating agreement, may be classified as either corporations or partnerships. A corporation pays income tax on its earnings, and its shareholders are taxed on distributions from the corporation. Partnerships are not taxed on income; the income is taxed directly to the partners, and distributions from the partnership are not subject to tax.

The Internal Revenue Code defines a partnership as an entity "which is not, within the meaning of this title, a trust or estate

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68. Id. § 202. The exemption applied to "[a]ny membership interest in a limited liability company that renders one or more professional services." Id.
71. Id. The sales and offers include those made to persons within and outside of Pennsylvania. Id.
72. See Treas. Reg. § 301.7701-1(b) (as amended in 1977). Entities may also be classified as trusts. Id.
74. See I.R.C. §§ 11, 301. S corporations are the exception to this general rule. See I.R.C. §§ 1361-78. S corporations, like partnerships, do not pay tax at the entity level, but rather the income is passed through to the shareholders. Id. §§ 1363, 1366. The availability of the S election is restricted to domestic corporations having only one class of stock, no more than 35 shareholders, all of whom must be United States residents. Id. § 1361.
75. See I.R.C. §§ 701, 731. Distribution of money to partners are only taxable when the amount distributed exceeds the partner's basis in the partnership. I.R.C. § 731(a)(1).
or a corporation." Therefore, the classification of an entity as a partnership requires a determination that it is not a corporation. In determining whether an entity is a corporation for federal tax purposes the IRS looks to the characteristics of the entity rather than its designation. The IRS has promulgated regulations for determining whether an entity is a corporation or a partnership (the "Association Regulations"). The Association Regulations focus on the characteristics of a corporation. The IRS has determined that there are six corporate characteristics, four of which distinguish corporations from partnerships: continuity of life, centralized management, limited liability and free transferability of interests. The Association Regulations provide that an unincorporated business entity will only be classified as a corporation if it has more corporate characteristics than non-corporate characteristics.

The first corporate characteristic is continuity of life. An organization lacks continuity of life if the "death, insanity, retirement, resignation or expulsion of any member will cause a dissolution of the organization." The regulations indicate that dissolution is based on the legal relationship between the members of the organization under state law and occurs when the dissociation of a member alters the identity of the organization. In addition, an agreement to continue the business not-

76. I.R.C. § 7701(a).
77. See Treas. Reg. §§ 301.7701-1(b), (c).
79. Id.
80. Id. § 301.7701-2(a)(1). The Association Regulations provide:
[S]ince associates and an objective to carry on business and divide the gains therefrom are generally common to both corporations and partnerships, the determination of whether an organization which has such characteristics is to be treated for tax purposes as a partnership or as an association depends on whether there exists centralization of management, continuity of life, free transferability of interests, and limited liability.
81. Treas. Reg. § 301.7701-2(a)(3). In Larson v. Commissioner, the Tax Court held that the language of the regulations did not allow for any of the characteristics to be weighed more heavily than others; therefore, the application of the Association Regulations simply required counting the number of corporate versus non-corporate characteristics. Larson v. Commissioner, 66 T.C. 159, 185 (1976), acq. 1979-1 C.B. 1. Thereafter, the IRS clarified that it would not consider characteristics other than those set forth in the Association Regulations in determining the classification of an entity. Rev. Rul. 79-106, 1979-1 C.B. 448.
82. See Treas. Reg. § 301.7701-2(b).
83. Id. These occurrences are commonly referred to as events of dissociation.
84. Id. § 301.7701-2(b)(2). By contrast, the Association Regulations note that, "[t]he death, insanity, or bankruptcy of a shareholder or the sale of a shareholder's
withstanding the dissolution of the entity does not establish continuity of life provided that the entity is still considered to be dissolved under state law.85

The Association Regulations indicate that the corporate characteristic of centralized management exists where the management of the entity is not vested in all of the members, but rather in a person or group of persons.86 The characteristic of limited liability will be found where no member of an organization is personally liable for the debts of or claims against the organization pursuant to state law.87

Free transferability of interests exists if a member can transfer all of the attributes of membership to another person without the consent of the other members.88 Free transferability does not exist if the member can assign only the right to share in profits and losses but not the right to participate in the management of the business.89 In addition, if state law provides that the transfer of an interest causes a dissolution of the entity, free transferability does not exist.90

In 1988, the Internal Revenue Service issued the first Revenue Ruling regarding the classification of limited liability companies for federal tax purposes.91 This Ruling examined the Wyoming Limited Liability Company Act92 and determined that a limited liability company organized pursuant to that statute did not possess a majority of corporate characteristics and would therefore be considered a partnership for federal tax purposes.93

In its analysis of the Wyoming statute, the IRS determined that the corporate characteristics of centralized management and limited liability were present.94 The IRS noted that be-

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interest has no effect upon the identity of the corporation, and therefore, does not work a dissolution of the organization." Id.

85. Id.
86. Treas. Reg. § 301.7701-2(c). The regulations indicate that centralized management requires "a concentration of continuing exclusive authority to make independent business decisions on behalf of the organization which do not require ratification by members of such organization." Id.
89. Id.
90. Id.
93. Rev. Rul. 88-76.
94. Id. The IRS first indicated that the LLC had associates and was organized to carry on a business. Id. The IRS based its analysis on an LLC organized pursuant to the Wyoming statute that was engaged in the real estate business. Id. The facts indicated that the LLC had 25 members and that three of its members were the designated managers. Id.
because the Wyoming statute allowed an LLC to be managed either by managers or members, the characteristic of centralized management would exist where the LLC was managed by managers.\textsuperscript{95} The corporate characteristic of limited liability was present because, under the Wyoming statute, there was no member who was personally liable for the LLC's debts.\textsuperscript{96}

Although the two corporate characteristics of limited liability and centralized management were present, the IRS concluded that a Wyoming LLC would not be taxed as a corporation because the corporate characteristics of continuity of life and free transferability of interests were lacking.\textsuperscript{97} Continuity of life was not present because the LLC would be dissolved upon the dissociation of a member, unless all the remaining members consented to continue the business.\textsuperscript{98} The corporate characteristic of free transferability of interests was not present because under the Wyoming statute an assignee or transferee of an interest would only be considered a member upon unanimous consent of all the remaining members.\textsuperscript{99}

After its ruling on the Wyoming statute, the IRS did not publicly rule on the federal tax classification of any other state LLC statute until early 1993.\textsuperscript{100} In January 1993, two revenue rulings were issued, analyzing the LLC statutes of Virginia\textsuperscript{101} and

\textsuperscript{95} Id.; see WYO. STAT. ANN. § 17-15-7. The IRS explained that under the Association Regulations, centralized management was present, "if any person (or group of persons that does not include all the members) has continuing exclusive authority to make management decisions necessary to the conduct of the business for which the organization was formed." Rev. Rul. 88-76 (citing Treas. Reg. § 301.7701-2(c)(1) (as amended in 1993)).

\textsuperscript{96} Rev. Rul. 88-76; see WYO. STAT. ANN. § 17-15-7.

\textsuperscript{97} Rev. Rul. 88-76.

\textsuperscript{98} Id. Under the Wyoming Act, dissolution would occur upon any event of dissociation, including the death, retirement, bankruptcy or expulsion of any member. WYO. STAT. ANN. § 17-15-123. The IRS noted that the Association Regulations provided that continuity of life did not exist where dissolution was caused by events of dissociation. Rev. Rul. 88-76 (citing Treas. Reg. § 301.7701-2(b)(1)). In addition, the IRS noted that even if the members could agree to continue the business, so long as statutory dissolution occurred upon an event of dissociation, continuity of life would not exist. Rev. Rul. 88-76; (citing Treas. Reg. § 301.7701-2(b)(2)).

\textsuperscript{99} Rev. Rul. 88-76; see WYO. STAT. ANN. § 17-15-122. The IRS noted that under the Association Regulations free transferability existed where a member could transfer membership and all membership attributes to a non-member without the consent of the other members. Rev. Rul. 88-76 (citing Treas. Reg. § 301.7701-2(e)(1)).

\textsuperscript{100} The IRS did issue private letter rulings regarding the tax classification of LLCs during this time period. See, e.g., Priv. Ltr. Rul. 92-18-078 (January 31, 1992) (ruling that an LLC organized pursuant to the Texas Limited Liability Company Act would be classified as a partnership); Priv. Ltr. Rul. 92-10-019 (December 6, 1991) (ruling that a Texas limited partnership that converted into a Texas LLC would continue to be classified as a partnership).

\textsuperscript{101} Rev. Rul. 93-5, 1993-1 C.B. 227.
Colorado. In April 1993, Nevada's LLC statute was the subject of a revenue ruling. In each of these rulings, the IRS determined that an LLC organized pursuant to the state statute would be classified as a partnership for federal tax purposes.

On May 24, 1993, the IRS first publicly addressed the classification of an LLC under a state statute that did not automatically qualify the LLC for partnership tax treatment. Based on the provisions of the Delaware Limited Liability Company Act, the IRS concluded that, "depending on the provisions of the LLC [operating] agreement, a Delaware LLC can assume the characteristics either of a corporation or of a partnership for federal tax purposes." Unlike the statutes analyzed in earlier revenue rulings, the Delaware LLC Act did not include the necessary statutory provisions so that any LLC organized pursuant

104. See Rev. Rul. 93-5; Rev. Rul. 93-6; Rev. Rul. 93-30. In each of these rulings the IRS determined that the LLCs would possess the corporate characteristics of centralized management and limited liability, but lacked continuity of life and free transferability of interests. See Rev. Rul. 93-5; Rev. Rul. 93-6; Rev. Rul. 93-30.

The Virginia Limited Liability Company Act required the unanimous consent of the remaining members before an assignee would become a member. VA. CODE. ANN. § 13.1-1040 (Michie 1993 & Supp. 1994). The Virginia statute also provided for dissolution upon the event of dissociation of a member, unless the remaining members unanimously agreed to continue the business. VA. CODE. ANN. § 13.1-1046.

The Colorado Limited Liability Company Act provided that a transferee of an interest would not be a member without the unanimous written consent of the members. COLO. REV. STAT. § 7-80-702(1) (Supp. 1994). With regard to continuity of life, the Colorado statute provided for dissolution upon dissociation of a member. COLO. REV. STAT. § 7-80-801. The statute further provided that the business could be continued upon the unanimous agreement of the remaining members, pursuant to a right to continue included in the articles of organization. Id.

The Nevada Limited Liability Act also required unanimous written consent of the members before a transferee of an interest could become a member. NEV. REV. STAT. ANN. § 86.351(1) (Michie 1991). The dissolution provisions of the Nevada statute were also similar to the Colorado provisions. Dissociation of a member would cause dissolution, unless the remaining members consented pursuant to a right to continue the business set forth in the articles of organization. NEV. REV. STAT. ANN. § 86.491.

107. Rev. Rul. 93-38. In the Ruling, the IRS analyzed two hypothetical LLCs to demonstrate the impact that the provisions of the operating agreement would have on the classification of the LLC. Id. LLC M, which the IRS determined would be classified as a partnership: (1) was managed by its members; (2) allowed an assignee to become a member only upon the unanimous consent of the remaining members; and (3) dissolved upon the event of dissociation of a member. Id. Conversely, LLC N, which the IRS determined would be classified as a corporation: (1) was managed by managers; (2) allowed an assignee to become a member upon notice to the members; and (3) included in the operating agreement a right to continue the business upon dissociation of a member. Id.
to the statute would qualify as a partnership for federal tax purposes.\textsuperscript{108}

The statute permitted an LLC operating agreement to include provisions that would permit the transfer of interests without the consent of the members,\textsuperscript{109} and would allow the LLC to continue to operate after the dissociation of a member without the consent of the members.\textsuperscript{110} The IRS ruled that a Delaware LLC whose operating agreement included these provisions would possess the corporate characteristics of continuity of life and free transferability of interests and therefore would be classified as a corporation for federal tax purposes.\textsuperscript{111} Conversely, a Delaware LLC whose operating agreement required the consent of the members to continue the business and to admit new members would be classified as a partnership for federal tax purposes.\textsuperscript{112}

Following its ruling on the Delaware Limited Liability Company Act, as of January, 1995, the IRS has publicly ruled on the LLC statutes of thirteen additional states: West Virginia,\textsuperscript{113} Illinois,\textsuperscript{114} Florida,\textsuperscript{115} Rhode Island,\textsuperscript{116} Utah,\textsuperscript{117} Arizona,\textsuperscript{118} Oklahoma,\textsuperscript{119} Louisiana,\textsuperscript{120} Alabama,\textsuperscript{121} Kansas,\textsuperscript{122} New Jersey,\textsuperscript{123} Connecticut\textsuperscript{124} and South Dako-

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\textsuperscript{108} As with the other statutes, the Delaware statute provided for limited liability for all members of the LLC, and allowed the LLC to be managed by members or managers. See Del. Code Ann. tit. 6, \$ 18-303 (limited liability); \$ 18-402 (management). The statute's provisions regarding continuity of life and transferability of interests did not automatically fail the Association Regulations test for corporate characteristics. See \$ 18-801 (dissolution); \$ 18-704 (transferability); see also Treas. Reg. \$ 301.7701-2 (as amended in 1993).

\textsuperscript{109} Del. Code Ann. tit. 6, \$ 18-801.

\textsuperscript{110} Id. \$ 18-801.

\textsuperscript{111} Rev. Rul. 93-38. The IRS noted that under the Delaware statute, an LLC could possess all four corporate characteristics. Id. Under the Association Regulations, a majority of corporate characteristics will result in classification of a corporation. See Treas. Reg. \$ 301.7701-2(a)(3). By definition, all LLCs will possess limited liability. In addition, centralized management will often exist. Therefore, an LLC's classification will virtually always turn on the presence or absence of continuity of life and free transferability of interests.


\textsuperscript{120} Rev. Rul. 94-5, 1994-1 C.B. 312.

\textsuperscript{121} Rev. Rul. 94-6, 1994-1 C.B. 314.

\textsuperscript{122} Rev. Rul. 94-30, 1994-1 C.B. 316.


In each of these rulings, the IRS analyzed the state LLC statute assuming the same facts about the LLC; namely that the LLC had twenty-five members, was authorized to engage in any lawful business, and was managed by three of its members. In addition, the hypothetical LLC always included in the articles of organization or operating agreement the provisions necessary to lack the corporate characteristics of continuity of life and free transferability of interests.

Based either on the statutory provisions or those adopted by the LLC, the LLC in each of these rulings was classified as a partnership for federal tax purposes. In reviewing the rulings, however, it is clear that, in most states, the provisions adopted by the LLC in its operating agreement or articles of organization will determine whether the LLC is classified as a corporation or a partnership for federal tax purposes. Because of the flexibility afforded by most LLC statutes, compliance with the statutory provisions will not guarantee that the LLC will be taxed as a partnership.

126. See, e.g., Rev. Rul. 95-9, 1995-3 I.R.B. 17 (analyzing the classification of the hypothetical LLC under the South Dakota statute).
127. See, e.g., Rev. Rul. 94-79, 1994-51 I.R.B. 7 (indicating that although the Connecticut statute allowed an LLC to include in its operating agreement provisions that would permit continuity of life and free transferability of interests, the LLC in the Revenue Ruling did not include those provisions in its operating agreement).
128. Of those 13 rulings, only LLCs organized under two statutes were held to qualify automatically as partnerships for federal tax purposes. See Rev. Rul. 95-9, 1995-3 I.R.B. 17 (holding that an LLC organized pursuant to the South Dakota LLC Act would be classified as a partnership); Rev. Rul. 93-50, 1993-2 C.B. 310 (West Virginia).

In each of the other 11 rulings, the IRS determined that the classification of an LLC organized pursuant to that state's statute would depend on the provisions adopted in the articles of organization or operating agreement, because the statute allowed flexibility as to one or more corporate characteristics. See Rev. Rul. 94-79, 1994-51 I.R.B. 7 (Connecticut; statute allowed LLC to provide for continuity of life and free transferability); Rev. Rul. 94-51, 1994-32 I.R.B. 11 (New Jersey; statute allowed LLC to provide for continuity of life and free transferability); Rev. Rul. 94-30, 1994-1 C.B. 316 (Kansas; statute allowed LLC to provide for continuity of life); Rev. Rul. 94-6, 1994-1 C.B. 314 (Alabama; statute allowed LLC to provide for free transferability of interests); Rev. Rul. 94-5, 1994-1 C.B. 312 (Louisiana; statute allowed LLC to provide for continuity of life and free transferability); Rev. Rul. 93-92, 1993-2 C.B. 318 (Oklahoma; statute allowed LLC to provide for continuity of life and free transferability); Rev. Rul. 93-93, 1993-2 C.B. 321 (Arizona; statute allowed LLC to provide for continuity of life and free transferability); Rev. Rul. 93-91, 1993-2 C.B. 316 (Utah; statute allowed LLC to provide for continuity of life); Rev. Rul. 93-81, 1993-2 C.B. 314 (Rhode Island; statute allowed LLC to provide for continuity of life and free transferability); Rev. Rul. 93-53, 1993-2 C.B. 312 (Florida; statute allowed LLC to provide for continuity of life); Rev. Rul. 93-49, 1993-2 C.B. 308 (Illinois; statute allowed LLC to provide for continuity of life and free transferability).
On January 17, 1995, the Internal Revenue Service issued Revenue Procedure 95-10 (the "Revenue Procedure")\(^{129}\) that outlined the circumstances under which an LLC would receive an advance ruling that it would qualify as a partnership for federal tax purposes.\(^{130}\) The Revenue Procedure sets forth the documents and information that an LLC must submit to the IRS for a determination of its federal tax status.\(^{131}\) This Procedure provides general rules for profit and loss interests and capital account balances and provides ruling guidelines for determining whether the corporate characteristics of continuity of life, centralized management and free transferability of interests exist.\(^{132}\)

The Revenue Procedure establishes minimum profits and losses interests for member-managers of LLCs that seek a ruling that the LLC lacks either of the corporate characteristics of continuity of life or free transferability of interests.\(^{133}\) The operating agreement must provide that the member-managers own, "at least a [one] percent interest in each material item of the LLC's income, gain, loss, deduction, or credit during the entire existence of the LLC."\(^{134}\)

\(^{129}\) Rev. Proc. 95-10, 1995-3 I.R.B. 20. A revenue procedure is issued by the Internal Revenue Service to outline a procedure that will be employed in the administration of provisions of the Internal Revenue Code or treasury regulations. BLACK'S LAW DICTIONARY 1319 (6th ed. 1990).

\(^{130}\) Rev. Proc. 95-10. The Revenue Procedure is effective for all ruling requests filed on or after January 17, 1995. Id. The IRS indicated that once Revenue Procedure 95-10 became effective, Revenue Procedure 89-12 would no longer apply to LLCs. Id.

\(^{131}\) Rev. Proc. 95-10. The information that must be provided includes: the name, business, and state whose laws govern the LLC; information about capital contributions, participation of members and managers in profits and losses, and the management relationship of members and managers; a description of why the LLC does not satisfy the necessary corporate characteristics; and the application of any revenue ruling regarding that state's LLC statute to the LLC in question. Id. In addition, copies of the following documents must be submitted: the articles of organization and operating agreement, any state or federal securities registration; the state LLC statute, and any materials to be used in connection with the sale of membership interests in the LLC. Id.

\(^{132}\) Id. The Procedure also notes that no ruling will be considered for an LLC that has only one member. Id.

\(^{133}\) Id. If the management of the LLC is vested in all of the members, the requirements for capital account balances and profits and losses interests will necessarily be satisfied.

\(^{134}\) Id. The percentage interest is lower for LLCs whose total contributions exceed $50 million. Id. The member-managers of those LLCs must, pursuant to the terms of the operating agreement, maintain an interest "of at least 1% divided by the ratio of total contributions to $50 million." Id. There is also an exception for al-
In addition, the member-managers of LLCs seeking a ruling that either continuity of life or free transferability of interests is lacking must satisfy minimum capital account requirements. The member-managers must maintain positive capital account balances of one percent of the total capital account balances or $500,000, whichever is less. The Revenue Procedure provides that the operating agreement must require the member-managers to make an additional capital contribution whenever the contribution of a non-managing member causes the capital account balances of the managing members to fall below the minimum requirement. There is an exception to the minimum capital account balance requirement if one or more of the member-managers will contribute “substantial services” to the LLC. The minimum capital requirements and minimum profits and losses interest set forth in this Revenue Procedure parallel the requirements for a limited partnership to obtain a ruling that it will be classified as a partnership for federal tax purposes.

The Revenue Procedure also discusses the circumstances under which each of the four corporate characteristics — continuity of life, free transferability of interests, centralized management and limited liability — will be determined to be lacking. The IRS notes that the corporate characteristic of continuity of life will be absent if either the statute or the LLC’s operating agree-
ment provides for dissolution upon "the death, insanity, bankruptcy, retirement, resignation or expulsion" of a member, if the LLC is managed by all the members, or a member-manager, if it is managed by member-managers.\textsuperscript{141} The statute or the operating agreement may provide that the majority in interest of the remaining members may vote to continue the business.\textsuperscript{142} Finally, the IRS notes that if the events of dissociation do not include all of the events set forth above, the IRS will not rule that the LLC lacks continuity of life unless those events that will trigger dissolution "provide a meaningful possibility of dissolution."\textsuperscript{9143}

The Revenue Procedure establishes that free transferability of interests will not exist if the consent of a majority of the members is required to transfer a membership interest.\textsuperscript{144} The same requirement applies to LLCs managed by all members and those managed by member-managers.\textsuperscript{145} The IRS notes that, for purposes of this factor, a majority may be determined by interest or per capita.\textsuperscript{146}

Where management of the LLC is vested in all the members solely in their capacity as members, the Revenue Procedure indicates that the corporate characteristic of centralized management will not be present.\textsuperscript{147} Where management is vested in member-managers, the LLC may still lack centralized management if the aggregate ownership of the member-managers equals twenty percent or more of the total ownership interests in the LLC.\textsuperscript{148}

With regard to the corporate characteristic of limited liability,

\begin{itemize}
\item \textsuperscript{141} Id.
\item \textsuperscript{142} Id.
\item \textsuperscript{143} Id.
\item \textsuperscript{144} Id. The Revenue Procedure also indicates that free transferability will not exist if the consent of the majority of members is necessary to transfer a membership interest held by "those members owning more than 20 percent of all interests in the LLC's capital, income, gain, loss, deduction, and credit." \textit{Id.} The IRS notes that the member's ability to refuse to agree to a transfer of another member's interest must constitute a "meaningful restriction on the transfer of the interests." \textit{Id.} Therefore, if the statute or the operating agreement provides that consent to a transfer cannot be unreasonable withheld, the LLC would not lack the corporate characteristic of free transferability. \textit{Id.}
\item \textsuperscript{145} Rev. Proc. 95-10.
\item \textsuperscript{146} Id.
\item \textsuperscript{147} Id.
\item \textsuperscript{148} Id. The IRS indicates that if the member-managers possess the requisite ownership, the IRS will examine the "relevant facts and circumstances" to determine whether centralized management exists. \textit{Id.} If the member-managers are elected periodically or can be removed by the members, centralized management will exist. \textit{Id.}
\end{itemize}
the Revenue Procedure indicates that an LLC will possess this characteristic unless one or more members is personally liable for all of the obligations of the LLC. Because limited liability is the essence of an LLC, few, if any LLCs would fail to possess this characteristic.

An LLC will be classified as a partnership for federal tax purposes if it lacks two of the four corporate characteristics. The two characteristics that most LLCs will seek to avoid are continuity of life and free transferability of interests. This Revenue Procedure, together with the revenue rulings previously issued by the IRS provide sound guidance for an LLC that desires to be classified as a partnership for federal tax purposes.

**State Taxation**

Although it is possible to structure the LLC to avoid the double taxation of a corporation on the federal level, taxation on the state level does not necessarily follow federal tax treatment. The majority of states tax LLCs as partnerships rather than as corporations. The statutes typically provide that if the LLC is classified as a partnership for federal tax purposes, it will be treated as a partnership for state tax purposes. However some states do impose a tax on the LLC itself. For example, Florida applies its corporate income tax to LLCs, and LLCs in Texas are subject to a corporate franchise tax.

**DISSOLUTION**

Dissolution provisions in the majority of LLC statutes resemble the dissolution of a general partnership under the Uniform Partnership Act. Most statutes have provisions for non-judicial dissolution specified in the articles or the operating agreement. On application by or for a member, a court may decree

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149. Id. The governing statute must expressly authorize members to have personal liability for all of the debts of the LLC. Id. The personally liable member or members must have net worth equal to 10% of all of the contributions to the LLC, and this net worth must be expected to continue throughout the life of the LLC. Id.


152. Fla. Stat. Ann. § 608-471.51. A distribution is deemed a dividend under Section 316 of the Internal Revenue Code as defined under the Florida Code. Id. § 608-471.52.


dissolution of an LLC if it is not reasonably practicable to carry on the business in conformity with the articles or the operating agreement.\textsuperscript{155} Wind-up and the distribution of assets upon dissolution is governed by the individual state statute, similar to the wind-up of a general partnership.\textsuperscript{156} Some states require filing notice of dissolution or cancellation.\textsuperscript{157}

**CHOICE OF ENTITY — WHY THE LLC?**

When choosing a business entity, there are two factors that most business owners consider to be fundamental — limited liability and flow-through taxation. Limited liability, with few exceptions, ensures that the investors in the business will not be liable for the debts of the business beyond their investment. Limited liability is determined by reference to state law, and is conferred upon business associations pursuant to statute.

Flow-through taxation, \textit{i.e.}, taxation as a partnership, allows investors to avoid double taxation on the profits of the business\textsuperscript{158} and at the same time deduct directly the losses of the business. Whether a business is entitled to flow-through tax treatment is determined by the Internal Revenue Code, and the Treasury Regulations.\textsuperscript{159}

A limited partnership is formed in accordance with the Revised Uniform Limited Partnership Act or some related act.\textsuperscript{160} The limited partnership offers limited liability for the limited partners.\textsuperscript{161} The downside to this entity is that limited partners cannot perform any management or control function in the


\textsuperscript{158} A corporation pays income tax. See I.R.C. § 11. Generally, money flows out of the corporation in the form of dividends, which are taxable to the shareholders. I.R.C. § 301. A partnership, however, does not pay tax on its income. \textit{Id.} § 701. Rather, the partners pay tax on their proportionate share of the partnership’s income. \textit{Id.} Distributions from the partnership to the partners are tax-free to the extent of the partner’s basis in the partnership. \textit{Id.} § 731.

\textsuperscript{159} The Internal Revenue Code provides for flow-through tax treatment of partnerships, pursuant to Subchapter K (I.R.C. §§ 701-61) and S corporations, pursuant to Subchapter S (I.R.C. §§ 1361-78). The Internal Revenue Service has plainly indicated that it is not bound by the state law determination or characterization of an entity in determining how the entity will be taxed at the federal level. See Treas. Reg. § 301.7701-1(c).


\textsuperscript{161} See, \textit{e.g.}, 15 Pa. Cons. Stat. § 8523.
business. Limited partners must operate with at least one general partner, who will manage the business. This general partner will be exposed to unlimited personal liability.

The LLC has two distinct advantages over the limited partnership. First, the members of the LLC have management capabilities that a limited partner cannot enjoy. The members of the LLC not only can manage the company but also enjoy limited liability. Second, limited partnerships often utilize a corporation as a general partner to manage the partnership. The limited partnership achieves its goal to protect limited liability, however the corporate general partner is subject to the double tax disadvantage, thus ruining the flow-through characteristic that is desired of the partnership. The LLC’s limit of liability and management capabilities of its members makes it the preferred alternative to a limited partnership.

Another choice of business entity that offers limited liability and management capability is the S Corporation. An S Corporation is a corporation under state law, that elects to be treated for federal tax purposes as a partnership. However, the S Corporation is subject to restrictive requirements. There can be no more than thirty-five shareholders. The S Corporation may have only one class of stock. There are additional restrictions on other entities as shareholders and restrictions on the S Corporation’s accumulation of earnings.

The LLC is a much more flexible entity than the S Corp. There is no restriction on the number of members, allowing LLCs to engage in larger, more lucrative businesses that require more capital. There is no limitation on foreign ownership, thus encouraging more competitive world markets and a more diverse source of capital. LLCs have a more flexible capital structure because they are not limited to one class of stock. There is no restraint on the accumulated earnings of the LLC and the LLC may have subsidiaries. Finally, the S Corp is an elected status; therefore any violation of an IRS regulation will cause a revocation of that status. The LLC status is not an elected feature and therefore can be considered less risky. Overall the LLC is a much more flexible entity than the S Corporation.

162. See I.R.C. §§ 1361-78. The name S Corporation is derived from the subchapter of the Internal Revenue Code that governs the taxation of this entity.
164. Id. § 1361(b)(1)(D).
165. See generally I.R.C. § 1361.
166. See I.R.C. § 1362(d).
Formation

On December 7, 1994, the Pennsylvania legislature passed the Limited Liability Company Act (the "Act"). The formation process in Pennsylvania is similar to that of other states. The name of the LLC must satisfy the same standards as the corporate name selection. Therefore, an LLC established in Pennsylvania must not reserve a "confusingly similar" name. The Act provides that the name should include the term "Company", "Limited" or "Limited Liability Company".

In order to become a limited liability company, a certificate of election must be filed with the Department of State. Once the certificate of election is filed, the association is granted limited liability company status.

The LLC may be formed for any lawful business purpose, with the exception of banking or insurance. The Act also provides that the LLC may engage in any type of business activity that a general or limited partnerships may undertake. In addition, the LLC has the legal capacity to act as an individual. The Act provides that a Pennsylvania LLC has the capacity to sue and to be sued. Both members and managers are permitted to bring suit on behalf of the LLC provided that the interest to be litigated is not adverse to the company's interest.

The Act permits organization of the LLC by one or more persons. All persons that participate in organizing the LLC

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187. 15 PA. CONS. STAT. §§ 8901-98.
188. 15 PA. CONS. STAT. § 8905(b).
189. Id. Virginia's LLC act provides that the name must be "distinguishable" only from the name of other LLCs. VA. CODE ANN. § 13.1-1012(C) (Michie 1993).
170. 15 PA. CONS. STAT. § 8905(a)(3). Abbreviations of the words are permitted.
171. Id. § 8908(b). The certificate must be executed by all who wish to elect LLC status and must include the name of the LLC, the county where the articles or association were filed, a statement that the associates consent to abide by the rules of the Act, and provisions dealing with the certificate of organization. Id.
172. Id. § 8908(c).
173. Id. § 8911(a).
174. Id. § 8921(b). The Act does not include an express powers provision.
175. 15 PA. CONS. STAT. § 8921(a).
176. Id. § 8991(a). Suit is not brought under the individual member's name but under the name of the LLC except in situations where that member is personally liable. Id. § 8991(b).
177. Id. § 8992.
178. Id. § 8912. Members may acquire an interest in an LLC in exchange for "cash, tangible or intangible property, services rendered or a promissory note or
must sign a certificate of organization.\textsuperscript{179} This certificate must include the initial registered office of the LLC.\textsuperscript{180} The place of the registered office must be in the Commonwealth.\textsuperscript{181} The certificate must also contain statements as to who the members are, how management is to be effectuated, whether the company is to operate as a restricted professional company and when the certificate will take effect.\textsuperscript{182} The LLC is officially organized when the certificate is filed with the Department of State.\textsuperscript{183} The certificate may be modified by agreement\textsuperscript{184} or may be amended upon the proper filing of a certificate of amendment with the Department of State.\textsuperscript{185}

\textbf{Members and Management}

Members of the LLC are authorized to enter into an operating agreement to govern the internal affairs of the business and the relationship of its members.\textsuperscript{186} Because there is no need to file the operating agreement as a public record, the members can use it to address issues which they do not wish to disclose publicly. The terms of the agreement must be consistent with the LLC’s articles of organization and the applicable LLC statute.\textsuperscript{187}

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\textsuperscript{179} \textit{Id.} § 8931(a). The note or obligation needs to be in writing to be enforceable. \textit{Id.} § 8931(b).

\textsuperscript{180} \textit{Id.} § 8913.

\textsuperscript{181} 15 PA. CONS. STAT. § 8913(2). The names and addresses of all organizers of the LLC must also be included. \textit{Id.} § 8913(3).

\textsuperscript{182} \textit{Id.} § 8906. Unlike the case of a corporation where advertising of the filing of the articles of incorporation is mandatory, advertising of the filing of a certificate of organization is not required.

\textsuperscript{183} \textit{Id.} § 8913 (4)-(7). The Act also provides:

Any other provision, whether or not specifically authorized by or in contravention of this chapter, that the members elect to set out in the certificate of organization for the regulation of internal affairs of the company. . . . A provision included in the certificate of organization under this paragraph shall be deemed to be a provision of the operating agreement for purposes of any provision of this chapter that refers to a rule as set forth in the operating agreement.

\textit{Id.} § 8913(8).

\textsuperscript{184} \textit{Id.} § 8914. The certificate of organization may stipulate a later date that would constitute the effective date of organization. \textit{Id.}

\textsuperscript{185} \textit{Id.} § 8915.

\textsuperscript{186} 15 PA. CONS. STAT. § 8951.

\textsuperscript{187} The Act defines the operating agreement as:

Any agreement of the members as to the affairs of a limited liability company and the conduct of its business. The operating agreement need not be in writing except where this chapter refers to a written provision of the operating agreement. The operating agreement may contain any provision for the regulation of the internal affairs of the company agreed to by the members. . . .

\textit{Id.} § 8903.

\textsuperscript{188} See 15 PA. CONS. STAT. § 8903. The operating agreement should address
Except to the extent that the certificate of organization or operating agreement provides for management by managers, management is vested in the members. If the business is to be managed by the members, the Act provides that the members be treated as general partners for the purposes of decision making authority. If either the certificate or the operating agreement provides that managers will manage the business, the members will be treated as limited partners for management purposes and the managers will be responsible for the day-to-day operation of the business. If the members act as general partners, each member has the duty as a trustee and must account directly to the LLC for any profits. If the company has managers to run the business, they are held to a similar standard as officers and directors of a corporation. Decisions and matters that need to be addressed by the business must be agreed upon by a majority vote of the members or the managers. A unanimous vote by the members or managers is required to amend the certificate of organization, amend the operating agreement or authorize an agent to act on behalf of the company. Either the certificate of organization or the operating agreement may provide for additional voting provisions. Generally, members and managers of an LLC are not personally liable for the debts, obligations and liabilities of the LLC regardless of the degree to which they participate in the management of the business. The members’ liability is limited to the amount of their capital contribution plus agreed to but unpaid contributions. Accordingly, creditors of an LLC may not

188. 15 PA. CONS. STAT. § 8941(a), (b).
189. Id. § 8904(a)(1).
190. Id. §§ 8904(a)(2)(i), (ii). Managers will be selected according to the operating agreement. Id. § 8941(c). Managers are limited to a one year term unless otherwise stated by the agreement. Id. § 8941(c)(2). Managers may resign at any time. Id. § 8947.
191. Id. § 8943(a).
192. Id. § 8943(b)(1). This standard of care is similar to the business judgment rule that applies to corporate officers. A member who acts as a limited partner has no duties to the company other than his general duties as a member. Id. § 8943(b)(2).
193. 15 PA. CONS. STAT. § 8942.
194. Id. § 8942(b)(1), (2).
195. Id. § 8942(e).
196. Id. § 8922(a).
197. Id. § 8931(c). The one exception to the rule of limited liability is in the case of an LLC conducting business as a professional practice, where the members will be personally liable for malpractice in which they are involved. Id. § 8922(b).
recover from a member if the LLC's assets are insufficient to satisfy the claim.

Distributions by the LLC are also provided for by the Act. The general rule is that distributions of profits or allocations of losses to the members of the company are to be per capita. The operating agreement may provide an alternative method of distribution. No member or manager has the right to demand a distribution in a form other than in cash from the LLC. The member-manager may not be compelled to accept any distribution which exceeds his or her per capita share in the company.

**Federal Tax Considerations**

Whether limited liability companies organized pursuant to the Pennsylvania Limited Liability Company Act will be classified as partnerships for federal tax purposes will depend upon the provisions of the certificate of organization and the operating agreement of the LLC. A Pennsylvania LLC will be deemed to possess the corporate characteristic of limited liability, and may possess centralized management, depending on whether it elects to be managed by all members or by managers.

The determination of whether the LLC lacks free transferability of interests will depend upon the provisions set forth in the operating agreement. The Pennsylvania statute permits the operating agreement to provide for free transferability. If the

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199. *Id.* § 8932.
200. *Id.* § 8934(a).
201. *Id.* § 8934(b).
202. The Pennsylvania LLC Act provides:

> Neither the members of a limited liability company nor the managers of a company managed by one or more managers are liable, solely by reason of being a member or a manager, under an order of a court or in any other manner for a debt, obligation or liability of the company of any kind or for the acts or omissions of any other member, manager, agent or employee of the company.

*Id.* § 8922.

203. The Pennsylvania statute provides that management of the LLC may be vested in one or more managers. 15 PA. CONS. STAT. § 8941(a). The statute further provides that the managers need not be members. *Id.* § 8941(b). In light of the IRS's minimum capital requirements and profit/loss interests for managers, it is unclear whether an LLC with non-member managers could be classified as a partnership for federal tax purposes. *See Rev. Proc.* 95-10. See notes 129-49 and accompanying text for a discussion of these minimum requirements as set forth in the Revenue Procedure.

204. 15 PA. CONS. STAT. § 8924. The statute provides:

> Unless otherwise provided in writing in the operating agreement, if all of the
operating agreement includes no provision regarding transfer of interest, the statutory provision will apply, and the unanimous consent of the members will be necessary to transfer the attributes of membership.205

Similarly, the operating agreement will determine whether the LLC lacks the corporate characteristic of continuity of life. The Pennsylvania statute provides for dissolution upon an event of dissociation, unless the operating agreement includes a right to continue the business.206 Therefore, if the operating agreement is silent, the statutory provisions should satisfy the IRS's guidelines for failing to possess continuity of life.207

A limited liability company organized pursuant to Pennsylvania law that adopts the default provisions of the Pennsylvania statute should be classified as a partnership for federal tax purposes.208 Under the default provisions, the LLC will lack the corporate characteristics of continuity of life and free transferability of interests. An LLC that does not possess these two characteristics may be managed by either members or mem-

other members of the company other than the member proposing to dispose of his interest do not approve of the proposed transfer or assignment by unanimous written consent, the transferee of the interest of the member shall have no right to participate in the management of the business and affairs of the company or to become a member.

Id. (emphasis added). A similar provision of the Delaware LLC statute was the subject of a revenue ruling. See Rev. Rul. 93-38, 1993-21 I.R.B. 4. The IRS ruled that because the LLC's operating agreement, as permitted under the statute, allowed the transferee to become a member upon written notice of the transfer, the LLC possessed the corporate characteristic of free transferability. Id.

205. Id.

206. 15 PA. CONS. STAT. § 8971(a)(4). This section provides: Upon a member becoming a bankrupt or executing an assignment for the benefit of creditors, or the death, retirement, resignation, expulsion or dissolution of a member, or the occurrence of any other event that terminates the continued membership of a member in the company, unless the business of the company is continued by the consent of all the remaining members given within 90 days following such event or under a right to do so stated in the operating agreement.

Id. (emphasis added). A similar provision of the Delaware LLC statute was examined in a revenue ruling. See Rev. Rul. 93-38, 1993-21 I.R.B. 4. The IRS held that where, pursuant to the statute, the operating agreement provided for the continuation of the business upon the dissociation of a member, the corporate characteristic of continuity of life was present. Id.

207. Although the events of dissolution set forth in the Pennsylvania statute are not exactly the same as those listed in the Revenue Procedure (Pennsylvania's statute does not provide for dissolution upon the insanity of a member), those events included in the Pennsylvania statute clearly "provide a meaningful possibility of dissolution." See Rev. Proc. 95-10.

208. However, a Pennsylvania LLC with only one member, although permissible under the Pennsylvania statute, may not be classified as a partnership for federal tax purposes. See 15 PA. CONS. STAT. § 8912; see also Rev. Proc. 95-10.
ber-managers without affecting its federal tax classification.\textsuperscript{209} If the managers of the LLC are not members, however, the LLC will not meet the requirements outlined by the IRS in Revenue Procedure 95-10 for obtaining an advanced ruling of its classification.\textsuperscript{210}

An LLC organized pursuant to the Pennsylvania LLC Act that does not adopt the Act's default provisions can also qualify for treatment as a partnership for federal tax purposes. The operating agreement should be drafted to comply with the provisions of Revenue Procedure 95-10 and the IRS's prior revenue rulings regarding the classification of LLCs.\textsuperscript{211} Finally, the Pennsylvania Act includes a provision that allows modification of the certificate of organization or operating agreement if necessary for a Pennsylvania LLC to be classified as a partnership for federal tax purposes.\textsuperscript{212}

\textit{State Tax Considerations}

For state tax purposes, the Pennsylvania Limited Liability Company Act provides that all LLCs, except restricted professional LLCs, are treated as corporations, and their members are treated as shareholders.\textsuperscript{213} LLCs that satisfy the statutory requirements may elect Pennsylvania S corporation status.\textsuperscript{214} However, even LLCs that elect to be treated as Pennsylvania S

\textsuperscript{209} The Association Regulations provide that an unincorporated association will be taxed as a corporation if it possess more corporate characteristics than non-corporate characteristics. Treas. Reg. \textsection 301.7701-2(a)(3) (as amended in 1993). Because four characteristics are considered, if two are lacking the entity cannot possess a majority of corporate characteristics.

\textsuperscript{210} As indicated previously, the Pennsylvania statute allows non-members to manage the LLC. See 15 PA. CONS. STAT. \textsection 8941(c)(1). This does not comply with the IRS's capitalization and profit/loss interest requirements for managers. See Rev. Proc. 95-10.

\textsuperscript{211} In particular, the revenue ruling involving the Delaware LLC should be carefully examined, as it provides examples of provisions that lack corporate characteristics and provisions that possess corporate characteristics. See Rev. Rul. 93-38, 1993-21 I.R.B. 4. This Revenue Ruling is also significant because the provisions of the Delaware statute appear to be substantially similar to the provisions of the Pennsylvania Act.

\textsuperscript{212} 15 PA. CONS. STAT. \textsection 8915. This section provides:

The provisions of this chapter are intended to permit a limited liability company to qualify for taxation as an entity that is not an association taxable as a corporation under the Internal Revenue Code. . . . the certificate of organization and operating agreement may effect any change in the form of organization of the company, in addition to or in contravention of the provisions of this chapter, that may be necessary to accomplish that purpose.

\textit{Id.}

\textsuperscript{213} \textit{Id.} \textsection 8925(a).

\textsuperscript{214} \textit{Id.}
corporations will be subject to the corporate net income tax and the capital stock-franchise tax. 215

The Pennsylvania Act's failure to provide favorable tax treatment for LLCs at the state level could significantly limit the number of entities that organize as LLCs in Pennsylvania. Because the overwhelming majority of states provide favorable tax treatment to LLCs at the state level, this provision is a significant disincentive. If the legislature intended to attract new business to the Commonwealth through the Limited Liability Company Act, it should have drafted a statute that was at least as favorable to businesses as LLC acts in other states.

Mergers

The Pennsylvania Limited Liability Company Act permits mergers and consolidations between domestic and foreign LLCs, as well as between domestic and foreign LLCs and other business entities. 216 The Act requires that a plan of merger or consolidation be prepared and adopted by either the members or the managers. 217 The plan must include the terms, conditions of the merger or consolidation and the mechanism for converting the ownership interests in the existing entity into interests in the resulting entity. 218 Where the resulting entity will be a Pennsylvania LLC, the plan must also set forth the changes to, including any restatement of, the certificate of organization and the operating agreement. 219

The Act provides that a plan of merger or consolidation can be adopted by either the managers or the members. 220 Adoption by the members occurs when the plan is approved by the majority of the votes cast. 221 The statute further provides, however, that a plan of merger or consolidation for an LLC that is managed by managers must also be approved by the managers. 222

215. Id. See PA. STAT. ANN. tit. 72, § 7602 (1990 & Supp. 1994) (Pennsylvania Capital Stock-Franchise Tax). The Act further provides that the ability of a municipality to collect taxes or fees from a company that elects LLC status is not affected by the statute. 15 PA. CONS. STAT. § 8925(a).

216. 15 PA. CONS. STAT. § 8956. Foreign LLCs may participate in a merger with Pennsylvania LLCs if permitted by the statute governing the foreign LLC. Id. § 8956(a).

217. Id. § 8957.

218. Id. § 8957(a). Additional provisions may be included. Id.

219. Id. § 8957(a)(2).

220. Id. § 8957(g), (h).

221. 15 PA. CONS. STAT. § 8957(g).

222. Id. The statute provides:

A proposed plan of merger of consolidation shall not be deemed to have been adopted by a company that is managed by one or more members unless it has
A plan of merger or consolidation may be adopted by the managers alone. The Act allows for adoption by the managers where the plan will not alter the provisions of the LLC’s certificate of organization or operating agreement, and each member’s interest in the resulting entity will be identical to the interest held in the existing entity.

Once a plan of merger or consolidation is adopted, a certificate of merger (or consolidation) must be filed with the Department of State. This certificate must include information relating to the entities involved in the merger or consolidation, the effective date, how the plan was adopted, and a copy of the plan. Upon completion of a merger or consolidation, the resulting company shall hold title to all property and be obligated for all liabilities of the merged or consolidated companies.

While the provisions of the Pennsylvania Limited Liability Company Act provide an easy mechanism for converting an existing business into a limited liability company, the federal tax consequences of converting a corporation into an LLC may prevent these provisions from being employed. The conversion from a partnership to an LLC that is classified as a partnership for federal tax purposes should be tax free. The IRS has previously ruled that the conversion of a general partnership to a limited partnership is a tax-free transfer. If an LLC is considered a partnership, the same principle should apply upon the

also been approved by the managers, regardless of the fact that the managers have directed or suffered the submission of the plan to the members for action.

Id.

223. Id. §8957(h). The operating agreement may provide for adoption by members in all instances. Id.

224. Id. § 8957(h)(1). Changes to the certificate of organization or operating agreement that do not require the approval of the members are permissible. Id.

225. Id.

226. 15 PA. CONS. STAT. § 8958.

227. Id. § 8958(a). The copy of the plan may be omitted if it is on file and available at the place of business of the surviving entity. Id. § 8958(b).

228. Id. § 8959(b). Any unpaid taxes of the merged or consolidated companies also become the responsibility of the surviving or new company. Id. § 8959(c).

229. In a revenue ruling, the IRS determined that the conversion of a general partnership into a limited partnership was an exchange pursuant to section 721 of the Internal Revenue Code, and therefore was a non-recognition transaction. See Rev. Rul. 84-52, 1984-1 C.B. 157. Section 721 of the Internal Revenue Code provides that, “[n]o gain or loss shall be recognized to a partnership or to any of its partners in the case of a contribution to the partnership in exchange for an interest in the partnership.” I.R.C. § 721(a). Because the surviving entity was also a partnership and because that entity carried on the partnership business, the IRS determined that the partnership was not terminated. Rev. Rul. 84-52; see I.R.C. § 708(b).

conversion of a partnership to an LLC. 231

There is no parallel provision for converting a corporation to an LLC in a tax-free event. While the contribution of assets to the LLC would not be taxable, 232 getting the assets out of the corporation will require recognition of gain based on the appreciation of the value of the corporation. 233 If a corporation does liquidate, and distributes the assets to its shareholders who then contribute the assets to the LLC, the corporation and the shareholders will recognize gain on the liquidation. 234 The shareholders/members would not recognize gain or loss on contribution of the assets to the LLC; 235 the member's basis in the LLC would equal the basis in the assets transferred; 236 the LLC's basis in the assets transferred would also equal the member's basis in those assets. 237

The cost of conversion will largely depend on the inherent gain in the corporation's assets. Even if there is substantial appreciation in those assets, corporations with high levels of income could still save money by eliminating one layer of taxation. For many corporations considering converting to an LLC, the decision may turn on whether the tax savings of partnership tax treatment outweigh the costs of immediate recognition of

231. In a number of private letter rulings, the IRS has concluded that the conversion of a partnership to an LLC was not a taxable event. See Priv. Ltr. Rul. 95-01-033 (October 5, 1994) (ruling that the conversion of a Maryland general partnership of lawyers to an LLC would be a continuation of the partnership, provided that the LLC qualified for partnership treatment and there were no changes in the partners' shares of the liabilities); Priv. Ltr. Rul. 94-52-024 (September 29, 1994) (ruling that the conversion of a general partnership of physicians to an LLC was a continuation of the partnership and therefore could be effected without recognizing gain or loss on the conversion); Priv. Ltr. Rul. 94-43-024 (July 26, 1994) (ruling that the conversion of a Utah limited partnership to an LLC was a continuation of the partnership and therefore did not trigger recognition of gain or loss).

232. See I.R.C. § 721(a).

233. If the assets are distributed to the shareholders, the corporation will recognize gain to the extent the fair market value of the assets exceeds the corporation's basis in those assets. See I.R.C. §§ 311(b), 336(a). In addition, the shareholder will recognize gain to the extent the value of the property received exceeds the shareholder's basis in the stock. See I.R.C. § 331.

A conversion of an S corporation to an LLC will also cause recognition of gain; that gain, however, will only be recognized at the shareholder level, rather than by both the corporation and the shareholder. See I.R.C. §§ 1366, 1368.

234. See I.R.C. §§ 331(a), 336(a).

235. See I.R.C. § 721(a).

236. See I.R.C. § 722. The basis would now equal the fair market value of the assets, due to the gain recognized on liquidation of the corporation. The member's basis would be adjusted for the member's share of liabilities of the LLC. See I.R.C. § 752.

237. See I.R.C. § 723. Again, because of the recognition of gain on liquidation of the corporation, the basis would now equal the fair market value of the property transferred.
gain at both the corporate and shareholder level.

**Disassociation and Dissolution**

Disassociation of a member may be limited by the operating agreement. The Pennsylvania Act provides that a member may be precluded from voluntarily disassociating from the LLC before the dissolution of the company. Dissolution of the LLC is similar to the dissolving of a general partnership. In Pennsylvania, nonjudicial dissolution of an LLC may occur in a number of ways. Dissolution may be avoided by the consent of a majority of the members. The LLC may also be judicially dissolved. The Act also provides for the winding-up and distribution of the assets upon dissolution. After the winding-up process, the company will prepare a certificate of dissolution and upon the filing of the certificate, the existence of the company will cease.

**Choice of Business Entity in Pennsylvania**

The LLC joins the growing list of business entities to choose from in the Commonwealth. These entities differ with regard to tax treatment, limitations on liability and organizational structure.

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238. 15 PA. CONS. STAT. § 8948.
239. Id. § 8971. The Act provides that dissolution of an LLC occurs upon the happening of one of the following events:
   1. At the time or upon the happening of events specified in the certificate of organization.
   2. At the time or upon the happening of events specified in writing in the operating agreement.
   3. By the unanimous written agreement or consent of all members.
   4. Upon a member becoming bankrupt or [on] the death, retirement, resignation, expulsion or dissolution of a member, or the occurrence of any other event that terminates the continued membership of a member in the company.

Id.

240. Id. § 8103(c).
241. Id. § 8972.
242. Id. § 8973.
243. 15 PA. CONS. STAT. § 8974. The Act designates the order of settling accounts after dissolution. The order is as follows: creditors of the LLC, satisfaction of debts and liabilities to members, return of the members contribution of capital, and finally the members share of the remaining profits. Id.
244. Id. §§ 8975, 8976.
Corporations

Pennsylvania offers the corporate form of business.\textsuperscript{245} Organization under this form provides that the shareholders are not personally liable for the debts of the corporation.\textsuperscript{246} The risk is limited to the investment in the business. A corporation is taxed as a separate entity unless "S" status is elected.\textsuperscript{247} In addition, corporations must comply with statutory requirements regarding annual meetings, boards of directors, officers and filings with the Secretary of State.

An S corporation will not be taxed at the federal level, but rather treated as a flow-through entity.\textsuperscript{248} Regardless of other tax status, all corporations are subject to the Pennsylvania capital stock-franchise tax.\textsuperscript{249} Professional corporations are treated as corporations for tax purposes, but shareholders are personally liable for malpractice in which they are involved.\textsuperscript{250}

Partnerships

Partnerships are another form of business entity available in Pennsylvania. In a general partnership, the partners are personally liable for the debts of the business.\textsuperscript{251} Income and other tax items flow through to the partners, resulting in no tax at the entity level.\textsuperscript{252} The partnership form of business also offers the advantages of informal management and the absence of statutory requirements. Limited partnerships provide limited partners with limited liability for the debts of the business.\textsuperscript{253} At least one general partner must have the liabilities of a partner in a general partnership. Limited partners are not permitted to man-

\textsuperscript{246} 15 PA. CONS. STAT. § 1526 (1992).
\textsuperscript{248} See I.R.C. §§ 1361-78. In Pennsylvania, a corporation electing to be treated as an S Corporation is also not taxed at the corporate level. PA. STAT. ANN. tit. 72, § 7307.5 (1990). The S election in Pennsylvania is generally available to corporations that qualify under Subchapter S of the Internal Revenue Code. Id. §§ 7307.1, 7301(a.2).
\textsuperscript{249} PA. STAT. ANN. tit. 72, § 7602 (1990 & Supp. 1994).
\textsuperscript{250} See 15 PA. CONS. STAT. § 2925(b). The shareholder is also responsible for the acts of any individual under his supervision. Id.
\textsuperscript{251} See 15 PA. CONS. STAT. § 8327 (1992). Partners are jointly and severally liable for the torts of other partners. Id. Partners are jointly liable for all other debts of the partnership. Id.
\textsuperscript{252} See I.R.C. § 701.
\textsuperscript{253} 15 PA. CONS. STAT. § 8523 (1992).
age or participate in the control of the business. The limited partnership is normally taxed as a flow-through entity.

**Limited Liability Company**

The LLC combines the desirable features of corporations and partnerships. The LLC offers limited liability to all its members, as does a corporation. However, the LLC is not taxed at the entity level for federal purposes and is not required to maintain corporate formalities. The LLC takes from the partnership entity the pass-through tax feature, the simplified management style and leaves behind the unlimited liability. For small businesses seeking the management benefits of a partnership and the liability protection of a corporation, the LLC merits serious consideration. Pennsylvania LLCs, however, will not be treated as partnerships at the state level, but rather will be subject to the double taxation of corporations.

**Limited Liability Partnership**

Along with the enactment of the LLC Act, Pennsylvania passed the Limited Liability Partnership (“LLP”) Act. The effect of becoming an LLP is to provide general partners with protection from personal liability. First, general partners will not be personally liable for torts in which they are not involved. To ensure protection from the tort liability of other partners, the LLP must carry insurance as provided by the statute. Furthermore, a general partner who disassociates from the partnership may cut off his or her personal liability for debts of the partnership by making a filing with the Department of State that provides notice of the termination of the person's interest as general partner.

LLP status will not affect the tax status of the partnership.
under either federal or Pennsylvania law. An LLP will pay an annual fee equal to two-hundred dollars per Pennsylvania partner. The liability protection provided by LLP status is significantly more limited than that provided by a corporation or an LLC, but LLP status is attractive to existing partnerships because it is easy to implement. Unlike reorganizing as a corporation or an LLC, which requires organizing an entirely new entity under different provisions of law, becoming an LLP does not require any change in a partnership's form of organization or its partnership agreement.

**Business Trust**

Pennsylvania also offers an entity known as a business trust. A business trust is an unincorporated association. As a trust, property is held by trustees and managed for the benefit of beneficiaries or holders of trust certificates. In operation, a business trust looks like a corporation. The owners, who are termed beneficiaries, are not personally liable for the debts of the business.

Due to the preponderance of corporate characteristics, a business trust readily can be characterized as a corporation for federal tax purposes. Business trusts were not subject to the Pennsylvania corporate net income tax or the capital stock-franchise tax. Effective January 1, 1995, however, the exemption for business trusts from the Pennsylvania capital stock-franchise tax and corporate net income tax ended. However, Pennsylvania business trusts that are classified as partnerships for federal income tax purposes will not be affected and will remain exempt from those taxes.

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259. Id. § 8221. The fee is less than the fee for LLCs because the liability protection provided by an LLP is less. See 15 PA. CONS. STAT. § 8996(b) (providing that professional LLC's will pay an annual fee equal to three-hundred dollars per Pennsylvania member).


261. 15 PA. CONS. STAT. § 9501. A business trust has no relationship to trusts created for estate planning purposes.

262. Id. § 9506. Recovery of such parties are limited to the assets of the business trusts. Id. Limited liability may not exist outside of Pennsylvania. Many states have no clear rules governing foreign business trusts.

263. See Treas. Reg. §§ 301.7701-2(a)(2), (3) (as amended in 1993); Rev. Rul. 72-121, 1972-1 C.B. 403. If desired, it is possible to draft the business trust so that it will be taxed as a partnership for federal income tax purposes. See Rev. Rul. 88-79, 1988-2 C.B. 361.

264. See 15 PA. CONS. STAT. § 9501(c).
The Pennsylvania Limited Liability Act provides for the creation of limited liability companies that render professional services, and restricted professional services. The formation and organizational requirements are the same for professional LLCs as for all other LLCs. The certificate of organization of a restricted professional company must indicate that the LLC is a restricted professional company and must also describe its services.

A restricted professional company is primarily limited to the business of rendering the restricted professional services set forth in the certificate of organization. The Act does permit a restricted professional company to own property for the purpose of carrying out its business, and to invest funds. All members and managers of a restricted professional company must be licensed to provide the restricted professional services, unless the rules or regulations of the profession provide otherwise.

A restricted professional company must register annually with the Department of State. The certificate of annual registra-

265. For purposes of the LLC Act, professional companies are defined as those companies that provide professional services. Id. § 8903.
266. Id. § 8921. Restricted professional services are defined as "[t]he following professional services: chiropractic, dentistry, law, medicine and surgery, optometry, osteopathic medicine and surgery, podiatric medicine, public accounting, psychology or veterinary medicine." Id. § 8903. The statute provides that the provision of public accounting services includes issuing reports on financial statements, financial consulting, tax advising and preparing tax returns. Id. § 8996(d)(1).
267. See 15 Pa. Cons. Stat. §§ 8911-14. Qualified foreign restricted professional companies may register in the same manner as foreign LLCs. Id. § 8981.
268. Id. § 8913(7). A similar requirement is imposed upon qualified foreign restricted professional companies. Id. § 8981(a)(2).
269. Id. § 8996(a). The statute precludes restricted professional service companies from owning any interest in clinical labs, blood banks, health care facilities, ambulatory service facilities and kidney treatment centers. Id. § 8996(d)(2).
270. Id. § 8996(a)(1). A restricted professional company may also be a partner, shareholder or member in a partnership, corporation or restricted professional company. Id. § 8996(a)(2).
271. Id. § 8996(b). The Act also provides that restricted professional services may only be rendered by licensed persons. Id. § 8996(c). Restricted professional companies may, however, employ non-licensed persons, such as clerks, bookkeepers, nurses and technicians "who are not usually and ordinarily considered by law, custom and practice to be rendering the restricted professional service or services for which the restricted professional company was organized." Id. The Act further provides that, "notwithstanding any other provision of law, a restricted professional company may charge for the restricted professional services rendered by it, may collect those charges and may compensate those who render the restricted professional services." Id.
272. 15 Pa. Cons. Stat. § 8998(a). This requirement applies to both domestic
tion, together with the annual registration fee must be filed by April 15th, for the preceding calendar year. The annual registration fee is currently three-hundred dollars per licensed resident member as of the end of the calendar year for which the fee is paid. The Act provides that the fee will be increased every three years, beginning December 31, 1997, based on the increase in the Consumer Price Index for Urban Workers.

The limited liability afforded members and managers of LLCs is modified for members and managers of professional companies. The Act provides that the general rule of limited liability "shall not afford members and managers of a professional company with greater immunity than is available to the officers, shareholders, employees or agents of a professional corporation." In addition, organization of a professional LLC does not shield the company from the jurisdiction or disciplinary powers of any entity regulating the profession.

The tax treatment of a restricted professional services LLC is also different from other LLCs at the state level. The statute excepts a restricted professional company from the provision that treats LLCs as corporations for purpose of state taxes. A restricted professional company is treated as a limited partnership, and its members as limited partners. This tax status will not apply for any year in which the restricted professional company engages in business not permitted under the statute, has only one member, or is a member of an LLC.

The limited liability company form may provide an advantage over the professional corporation for those rendering professional

restricted professional companies and foreign restricted professional companies that are registered to do business in Pennsylvania. The failure to pay the annual fee does not affect the continued existence of the restricted professional company, but constitutes a lien on its assets. Id. § 8998(f).

273. Id. The failure to pay the annual fee does not affect the continued existence of the restricted professional company, but constitutes a lien on its assets. Id. § 8998(b).

274. Id. § 8998(b).

275. Id.

276. See 15 PA. CONS. STAT. § 8922.

277. Id. § 8922(b). Under the Pennsylvania professional corporation statute, shareholders, officers and agents of a professional corporation are personally liable for their own negligence, as well as the negligence of those under their direct supervision. 15 PA. CONS. STAT. § 2925(b).

278. Id. § 8922(c). For example, the Supreme Court of Pennsylvania, and not the legislature, regulates lawyers. See PA. CONST. art. V, § 10(c). Therefore, a conclusive determination of whether lawyers can practice as an LLC would have to come from the court.

279. 15 PA. CONS. STAT. § 8925(a). The reason professional LLCs were made taxable as partnerships is that most of the firms that want to become LLCs are professional practices that are currently organized and taxed as partnerships.

280. Id. § 8997(a).

281. Id. § 8997(b).
services. Namely, the LLC offers the possibility of flow-through tax treatment, while at the same time retaining the limited liability of professional corporations. Therefore, professionals operating within the Commonwealth may choose to organize as a restricted professional company under the Pennsylvania Act.

For professionals who conduct business outside of the state, however, the uncertainty created by the varying statutory provisions regarding professional LLCs is troubling. Some states permit professional LLCs, others prohibit them, and other statutes are silent on the matter. Generally, a state’s treatment of foreign LLCs will be no more generous than that of domestic LLCs. In Pennsylvania, for example, foreign LLCs are recognized, but they are subject to all of the restrictions imposed on domestic LLCs. A state that does not permit domestic professional LLCs is unlikely to recognize the limited liability of a foreign professional LLC.

For a professional corporation whose business is conducted exclusively within the Commonwealth and whose primary con-


285. See 15 Pa. Cons. Stat. § 8981(a). The Pennsylvania statute provides: A qualified foreign limited liability company shall enjoy the same rights and privileges as a domestic limited liability company, but no more, and, except as otherwise provided by law, shall be subject to the same liabilities, restrictions, duties and penalties now in force or hereafter imposed upon domestic limited liability companies to the same extent as if it had been organized under this chapter.

Id. § 8981(a)(3).

286. In light of the ease with which jurisdiction can be obtained, and the uncertain resolution by another jurisdiction of a conflict of law question, the inconsistent recognition of professional LLCs is a significant concern. The Pennsylvania statute includes the following provision:

The personal liability of a member of a company to any person or in any action or proceeding for the debts, obligations or liabilities of the company or for the acts or omissions of other members, managers, employees or agents of the company shall be governed solely and exclusively by this chapter and the laws of this Commonwealth. Whenever a conflict arises between the laws of this Commonwealth and the laws of any other state with regard to the liability of members of a company organized and existing under this chapter for the debts, obligations and liabilities of the company or for the acts or omissions of the other members, managers, employees or agents of the company, the laws of this Commonwealth shall govern in determining such liability.

cern is achieving partnership tax treatment, the Pennsylvania professional LLC — the restricted professional company — may provide the answer. The restricted professional company will maintain the limited liability characteristics of a professional corporation, can be classified as a partnership for federal tax purposes, and will be treated as a limited partnership for state taxation. Whether this combination of factors will lead many professional corporations to convert to professional LLCs will likely depend on the weight given to their inconsistent treatment from jurisdiction to jurisdiction.

CONCLUSION

The limited liability company is an important organizational development for business planners. The LLC offers a variety of advantages over other business entities, including organizational, management, capitalization and tax benefits. The immaturity of an LLC as an entity, however, gives rise to disadvantages. While the recent IRS promulgations with regard to LLCs suggest that this entity is here to stay, its federal tax classification could be altered. The lack of case law addressing potential issues involving LLCs and the absence of uniformity between the state LLC laws leaves planners with a lack of certainty. In this vacuum it is difficult for business planners to weigh the benefits and costs of LLCs.

Pennsylvania's LLC Act highlights these planning concerns. By taxing the LLC as a corporation for the purposes of state taxes, the Pennsylvania Act removes a significant incentive for businesses to organize as LLCs. The substantial cost a corporation may incur in converting to an LLC, coupled with the lack of tax benefits at the state level, will deter many corporations from seeking to become LLCs. Those providing restricted professional services, who may organize as LLCs and be taxed as a partnership at the state level, are the most likely to take advantage of the LLC form of entity.

The Pennsylvania Act's failure to provide a state tax incentive for LLCs limits the possibility that new businesses will enter the

287. For a restricted professional company to obtain federal partnership tax treatment, it must not possess more corporate characteristics than non-corporate characteristics. See Treas. Reg. § 301.7701-2(a)(3) (as amended in 1993). For a discussion of the corporate characteristics as applied to Pennsylvania LLCs see notes 202-12 and accompanying text.

288. Congress could require LLCs to be taxed as corporations rather than partnerships. Such legislation would not be unprecedented. See I.R.C. § 7704 (providing that publicly traded limited partnerships shall be treated as corporations).
Commonwealth to become Pennsylvania LLCs. The vast majority of states offering LLC status provide for partnership tax treatment of LLCs at the state level. While the Pennsylvania General Assembly may have been concerned that corporations would reorganize as LLCs and cost the Commonwealth substantial tax revenues, this concern is unfounded because of the significant federal tax costs of liquidation. The Pennsylvania's LLC Act, coupled with its high corporate tax rates, sends a message to the business community that Pennsylvania is not interested in attracting new businesses. The rush to create an LLC statute in Pennsylvania will not likely be followed by a rush of new businesses into the Commonwealth.

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289. The provision of the Alabama LLC Act is typical in this regard. See ALA. CODE § 10-12-8 (1994). The Alabama statute provides:

The terms "partnership" and "limited partnership," when used in any chapter or title other than this chapter, the Alabama Partnership Act . . . , and the Alabama Limited Partnership Act of 1983 . . . , include a limited liability company organized under this chapter, unless the limited liability company is an association taxable as a corporation for federal income tax purposes, or unless the context requires otherwise.

ALA. CODE § 10-12-8 (citations omitted). Therefore, the state tax treatment of LLCs in Alabama is determined by their federal tax classification.

In addition, Pennsylvania's neighbors, Ohio and West Virginia, both provide favorable state tax treatment to LLCs. See OHIO REV. CODE ANN. § 5733.01(F) (Supp. 1994) (providing that LLCs are only subject to the corporate franchise tax if they are treated as corporations for federal tax purposes); W. VA. CODE § 11-13A-2(b)(8) (including LLCs that are treated as partnerships for federal tax purposes in the definition of partnership for state tax purposes).