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Disappointing Diogenes: The LLC Debate That Never Was

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DISAPPOINTING DIOGENES: THE LLC DEBATE THAT NEVER WAS

ALLAN W. VESTAL* & THOMAS E. RUTLEDGE**

INTRODUCTION

> *Like Diogenes wandering the streets of Athens, lantern in hand, searching for the honest man, anyone seeking evidence of a debate among lawmakers over the wisdom of limited liability or the cost-shifting consequences of LLCs and LLPs is destined for disappointment.*[1]

> *[T]he collective wisdom over time of fifty-one legislatures and bar drafting committees must be far greater than that of one uniform or model law drafting organization. . . . As Hayek has said, "if left free, men will often achieve more than individual human reason could design or foresee."*[2]

Professors Hillman and Ribstein provide us two polar views of the legislative process leading to creation of the still relatively new limited liability company and limited liability partnership forms. Were state legislators in this process Hillman's negligent actors, completely unmindful of the policy choices and tradeoffs inherent in their acts? Or were they Ribstein's deliberative yeoman legislators, crafting with care and creativity the legislative products of human enlightenment?

We look at the history, for the first time, of the legislative deliberations on each jurisdiction's laws enabling the formation of the limited liability company (LLC) and, to a lesser extent, the limited liability partnership (LLP). Or, to be more accurate, we look at the sparse record of those deliberations; a sparseness of both the records kept and, more disturbing, a sparseness in the deliberations held.

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1. Robert W. Hillman, *New Forms and New Balances: Organizing the External Relations of the Unincorporated Firm*, 54 WASH. & LEE L. REV. 613, 613 (1997).

2. Larry E. Ribstein & Bruce H. Kobayashi, *Uniform Laws, Model Laws and Limited Liability Companies*, 66 U. COL. L. REV. 947, 951–52 (1995).

The creation of the limited liability company and limited liability partnership forms was one of the most sweeping changes in business organization law in our history.[3] Combining limited liability and the ability to participate in management while enjoying flow-through taxation, the LLC and LLP forms allowed participants to have an essentially unprecedented mix of desirable attributes.[4] This important change is even more notable because of the speed with which it was accomplished and the comprehensive nature of the adoptions—in eight years we went from having the LLC form moribund, having been adopted in only two fairly insignificant states and not having received the imprimatur of the IRS, to having the LLC form adopted in every state of the Union and being accepted by the IRS.[5]

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3. *See generally* Thomas E. Geu, *Understanding the Limited Liability Company: A Basic Comparative Primer (Pt. 1)*, 37 S.D. L. REV. 44 (1992); Robert R. Keatinge et al., *The Limited Liability Company: A Study of the Emerging Entity*, 47 BUS. LAW. 375 (1992) (discussing the LLC as an emerging entity); Larry E. Ribstein, *The Emergence of the Limited Liability Company,* 51 BUS. LAW. 1 (1995) (discussing the rapid growth and acceptance of LLCs); Thomas E. Rutledge & Lady E. Booth, *The Limited Liability Company Act: Understanding Kentucky's New Organizational Option*, 83 KY. L.J. 1 at 6–9 (1995).

4. While the corporate form with a so-called "S-election" provides for nearly equivalent tax treatment, management, and liability attributes, the availability of the form is limited. For example, originally an S-corporation was limited to ten shareholders. *See* 26 U.S.C. § 1371(a)(1) (1958) (amended 1976). The threshold increased to fifteen with conditions in 1976 and fifteen generally in 1978. *See* 26 U.S.C. § 1371(e)(1) (1976); Revenue Act of 1978, Pub. L. No. 95-600, § 341, 92 Stat. 2763 (1978). In 1981 the limit was raised to twenty-five, and in 1982 to thirty-five. *See* 26 U.S.C. § 1361(b)(1)(A) (1982); Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 233, 95 Stat. 172 (1981). In 1996 that limit was increased to seventy-five by the Small Business Job Protection Act of 1996. Pub. L. No. 104-188, § 1301, 110 Stat. 1777 (1996). The limit was raised again to one hundred and the method of counting the number of shareholders was radically liberalized by the American Jobs Creation Act of 2004. Pub. L. No. 108-357, §§ 231–232, 118 Stat. 1433 (2004). The Small Business Job Protection Act also provided for the Electing Small Business Trust and charitable organizations as permissible shareholders of an S-corporation. Pub. L. No. 104-188, §§ 1302(a), 1316(a), 110 Stat. 1785 (1996). Other limitations on S-corporation status include the restriction to a single class of stock, a prohibition of non-resident alien shareholders, and limits on trusts and estates as shareholders. Recently, certain commentators have questioned the perhaps unreasoned expansion in the availability of limited liability. *See, e.g.*, J. William Callison, *Federalism, Regulatory Competition, and the Limited Liability Movement*: *The Coyote Howled and the Herd Stampeded*, 26 J. CORP. L. 951 (2001); Allan W. Vestal, *"Real Partnerships" and Real Problems: Conforming Business Entity Law to Fiscal Realities and Popular Conceptions*, 28 DEL. J. CORP. L. 877 (2003). However, the issue is in no manner of recent vintage. *See, e.g.*, I. MAURICE WORMSER, DISREGARD OF THE CORPORATE FICTION AND ALLIED CORPORATION PROBLEMS 14 (Baker, Voorhis & Company eds., T. Morey & Son 1929) (1927) ("Whether the legislators have not been unduly liberal in [granting limited liability], particularly in the case of one-man companies where dummies are used for incorporating purposes, is a very grave problem, far beyond the scope of this paper.").

5. *See infra* notes 44–47 and accompanying text. This article will focus on the rise of LLCs, and put the rise of the LLP form to one side. This is done because the record is more clearly seen on the LLC side—where the form was created from whole cloth and not against the

Such a sea-change in the law of business ventures should have been widely and carefully debated. The policy implications of the marriage of limited liability, unlimited management participation, and favorable tax treatment should have been examined. The fiscal implications of creating new business forms that would, under the preexisting rules, be exempt from taxation at the entity level should have been estimated with care and an analysis undertaken as to whether the tax treatment should have been linked to a corresponding benefit.[6] At issue were matters of elemental fairness, such as leaving potential tort claimants with no practical recovery, horizontal equity (equivalent taxation of ventures irrespective of organizational structure), and revenue stability, such as removing from the states significant sources of tax collections. These were not insignificant questions.

Professor Hillman had it right; the legislative debate over the broader implications of the LLC and LLP forms never took place. A close review of the legislative record reveals that in state after state the serious policy and fiscal implications of these new forms were not even addressed, much less seriously discussed. In state after state the advocates of the new forms made arguments which, to put it charitably, are at best irrelevant and at worst simply untrue. It was, as commentator Bill Callison has described it, a stampede.[7]

I. THE RISE OF THE LLC IN A *KINTNER* CLASSIFICATION WORLD

The LLC (and just as equally the LLP) is a construct; a need was identified and something was devised to satisfy that need. Now, to the extent that its aim is the ordering of society, all law is a construct. But the LLC is a particularly acute example of the linkage between the objective and the means. The objective: a business structure that would be taxed as a partnership under subchapter K and that would provide its owners limited liability unconditioned on the degree of involvement in management. The means: the drafting and adoption of LLC legislation in the states and IRS confirmation of the tax treatment of the entities so created.

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background of a pre-existing form which was being changed. There is no reason to believe, however, that the history of the legislative treatment of the LLP form would be different except in detail from that of the LLC form.

6. This question necessarily presupposes that entity level taxation is an appropriate "rent seeking" in return for organizational flexibility and limited liability. Reasonable arguments may and have been made on either side of the position, and the authors in fact disagree on the "correct" answer. *See, e.g.*, Thomas E. Rutledge & Allan W. Vestal, *Making the Obvious Choice Malpractice: LLPs and the Lawyer Liability Time Bomb in Kentucky's 2005 Tax Modernization,* 94 KY. L. J. 17, 33–34 (2005); GEORGE K. YIN & DAVID J. SHAKOW, AM. L. INSTIT., FEDERAL INCOME TAX PROJECT—TAXATION OF PRIVATE BUSINESS ENTERPRISES 54 (1999).

7. *See* Callison, *supra* note 4, at 960.

The first LLC statute was considered, and in turn rejected, by the Alaska Legislature in 1975.[8] Two years later, Wyoming adopted the first LLC statute.[9] The development of the LLC was shortly thereafter dealt a near-death blow when the Service, in 1980, announced proposed amendments to the *Kintner* regulations[10] that would have classified as a corporation any entity in which no member would be personally liable for debts of the organization.[11] These proposed regulations were published only one day before the release of a private letter ruling stating that a particular Wyoming LLC would be classified as a partnership.[12] Florida passed the second LLC statute in 1982.[13]

8. S.B. 354, 9th Leg., 1st Reg. Sess. (Alaska 1975). The primary reason for support of the Alaska LLC bill was to generate filing fees from LLCs organized in Alaska with the desire that Alaska become the "Delaware of limited liability companies." *Limited Liability Company Act: Hearings on S.B. 354 Before Alaska Senate Judiciary Committee*, 9th Leg., 2d Sess., at 2 (Feb. 3, 1976) (statement of Mr. Schlosberg, Director of Banking, Securities, and Corporations).

9. Wyoming Limited Liability Company Act, 1977 Wyo. Sess. Laws 537–549 (effective Mar. 4, 1977) (current version at WYO. STAT. ANN. §§ 17-15-101–17-15-144 (1999)). The proponents of the Wyoming LLC bill were those who had been unsuccessful in Alaska. *See* Geu, *supra* note 3, at 48.

10. *See* 26 C.F.R. § 301.7701-2 (1996) (repealed Jan. 1, 1997). The *Kintner* classification regulations grew out of the decision rendered in *United States v. Kintner*, 216 F.2d 418 (9th Cir. 1954), and were an effort by the Service to provide greater rigidity to the classification test set forth in *Morrissey v. Comm'r*, 296 U.S. 344 (1935), with the objective of making it more difficult for unincorporated business organizations to be classified as corporations. *Id*. This weighing of the test against corporate classification (and therefore in favor of partnership classification) was done by restricting the characteristics upon which classification would be determined to four (limited liability, continuity of life, free transferability of interests, and centralized management), one of which, limited liability, exists only as a sovereign grant and not by private ordering, and by providing that a majority of the equally weighted factors was required for corporate classification. *See* Larson v. Comm'r, 66 T.C. 159, 187 (1976) (Dawson, J., concurring); *see also* I.R.S. Tech. Adv. Mem. 7951006 (Aug. 21, 1979) ("It is not possible to obtain limited liability by agreement among the parties; it must be bestowed on the organization by the State."); Larry E. Ribstein, *Limited Liability and Theories of the Corporation*, 50 MD. L. REV. 80, 90 (1991) ("Of all the principal 'corporate' features, only limited liability is not explicitly made available by agreement to partnerships."). In the event of a tie—the presence of two factors and the absence of two factors—the entity would be classified as a partnership. *Id.*

11. *See* Prop. Treas. Reg. § 301.7701-2(a), 45 Fed. Reg. 75709 (Nov. 17, 1980). The proposed regulations failed to note that refusing partnership classification solely on the basis of limited liability had been rejected by the Board of Tax Appeals in *Glensder Textile Co. v. Comm'r*, 46 B.T.A. 176 (1942). This principle, however, is consistent with certain early classification efforts. *See, e.g.*, Susan P. Hamill, *The Origins Behind the Limited Liability Company*, 59 OHIO ST. L.J. 1459, 1504 (1999) (noting that the first definition of "associations" promulgated by Treasury Register 33 in 1914 "stated without exception that all limited partnerships would be taxed as corporations").

12. I.R.S. Priv. Ltr. Rul. 81-06-082 (Nov. 18, 1980). Indicating further uncertainty within the Service on the classification of LLCs, General Counsel Memorandum 38,281, which was prepared in response to a request to clarify the basis upon which the Service could classify an LLC as an association taxable as a corporation, discusses a draft revenue ruling that would have classified a Wyoming LLC as a partnership. I.R.S. Gen. Couns. Mem. 38,281 (Feb. 15, 1980).

After several announced postponements of the effective date of the amended regulations proposed in 1980,[14] the Service bowed to negative comments[15] and in 1983 withdrew the proposed changes.[16] At the same time, the Service began a study of the criteria applied in the classification of non-corporate entities.[17] The further adoption of LLC statutes languished until the Service issued Revenue Ruling 88-76,[18] which classified a Wyoming LLC as a partnership for federal income tax purposes. With the federal tax classification somewhat clarified, other states moved to adopt LLC statutes.[19] After a delay of several

That memorandum reviewed whether an LLC could be classified as an association taxable as a corporation on the grounds that it bore the "other factor" of being afforded entity treatment, as evidenced by its ability to own property and to sue and be sued in its own name. *Id.* "Wyoming law treats a limited liability company exclusively as an entity separate from its owners. We believe that such entity treatment is a corporate characteristic that can be considered significant within the meaning of Treas. Reg. § 301.7701-2(a)(1)." *Id.* The memorandum concluded, however, that partnership classification was in that instance proper. *Id.*

13. FLA. STAT. ANN. §§ 608.401–471 (2001) (several sections have since been repealed). Uncertainty as to the viability of the LLC not only impacted the adoption of additional LLC statutes but also apparently dissuaded the use of the statutes in place. As of February 22, 1988, only twenty-six Wyoming LLCs and sixty-three Florida LLCs had been formed. *See* Ernest A. Seemann, *The Florida Limited Liability Company: An Update*, 14 NOVA L. REV. 901, 903 (1989-1990).

14. *See* I.R.S. Announcement 82-140, 1982-45 I.R.B. 30; I.R.S. Announcement 82-60, 1982-17 I.R.B. 23; I.R.S. Announcement 81-166, 1981-43 I.R.B. 21.

15. *See, e.g.*, *Proposed Regulations on "Limited Liability Companies" Are Criticized as Contrary to Congressional Intent and Detrimental to Overseas Investment*, 15 TAX NOTES 187 (Apr. 19, 1982).

16. I.R.S. Announcement 83-4, 1983-2 I.R.B. 31. Additional amendments to the *Kintner* regulations were made in 1983. The 1983 amendments related to the classification of limited partnerships, the power of limited partners to remove a general partner, and limitations on the liability of a general partner. *See generally* T.D. 7889, 1983-1 C.B. 362; 48 Fed. Reg. 18802 (Apr. 26, 1983).

17. *See* I.R.S. Announcement 83-4, 1983-2 I.R.B. 31. This study focused on the Service's acquiescence in *Larson v. Comm'r*, 66 T.C. 159 (1976), *acq.*, I.R.S. Announcement 1979-2 C.B. 2, in which it was held that each of the four corporate characteristics would be given equal weight in distinguishing partnerships from associations taxed as corporations. The Service also announced it would not issue further private letter rulings on the classification of LLCs until the completion of the study. *See* Rev. Proc. 83-15, 1983-1 C.B. 676. Prior to the withdrawal of the proposed regulations, the Service released I.R.S. Priv. Ltr. Rul. 83-04-138 (Oct. 29, 1982), classifying an LLC as an association taxable as a corporation because it possessed limited liability, centralized management, and continuity of life.

18. Rev. Rul. 88-76, 1988-2 C.B. 360. I.R.S. Announcement 88-118, 1988-38 I.R.B. 25, released with Revenue Rul. 88-76, announced, albeit cryptically, the results of the study discussed in Announcement 83-4, including the continued acquiescence in *Larson*, as well as the Service's intention to review its procedures for the granting of advance rulings to entities seeking partnership classification and the possible application of minimum net worth standards to certain entities classified as partnerships. This study led to the promulgation of Rev. Proc. 89-12, 1989-1 C.B. 798.

19. *See infra* notes 44–46 and accompanying text.

years in publishing further binding pronouncements on the classification of LLCs, beginning in early 1993 the Service issued a series of additional revenue rulings addressing LLCs formed pursuant to the various states.[20] The Service also issued numerous private letter rulings indicating whether or not particular LLCs qualified for partnership classification.[21]

Meanwhile, belatedly and with little apparent enthusiasm, Congress indicated an interest in reviewing the issue and possibly addressing it through legislation. On February 2, 1993, the Subcommittee on Select Revenue Measures of the Ways & Means Committee of the United States House of Representatives announced that it would schedule a hearing to "review the revenue impact of [the] LLC, and [its] effect on the two-tier corporate tax structure and the adequacies of the current classification analysis."[22] Those

20. *See* Rev. Rul. 93-5, 1993-1 C.B. 227 (addressing the classification of LLCs in Virginia); Rev. Rul. 93-6, 1993-1 C.B. 229 (addressing the classification of LLCs in Colorado); Rev. Rul. 93-30, 1993-1 C.B. 231 (addressing the classification of LLCs in Nevada); Rev. Rul. 93-38, 1993-1 C.B. 233 (addressing the classification of LLCs in Delaware); Rev. Rul. 93-49, 1993-2 C.B. 308 (addressing the classification of LLCs in Illinois); Rev. Rul. 93-50, 1993-2 C.B. 310 (addressing the classification of LLCs in West Virginia); Rev. Rul. 93-53, 1993-2 C.B. 312 (addressing the classification of LLCs in Florida); Rev. Rul. 93-81. 1993-2 C.B. 314 (addressing the classification of LLCs in Rhode Island); Rev. Rul. 93-91, 1993-2 C.B. 316 (addressing the classification of LLCs in Utah); Rev. Rul. 93-92, 1993-2 C.B. 318 (addressing the classification of LLCs in Oklahoma); Rev. Rul. 93-93, 1993-2 C.B. 321 (addressing the classification of LLCs in Arizona); Rev. Rul. 94-5, 1994-1 C.B. 312 (addressing the classification of LLCs in Louisiana); Rev. Rul. 94-6, 1994-1 C.B. 314 (addressing the classification of LLCs in Alabama); Rev. Rul. 94-30, 1994-1 C.B. 316 (addressing the classification of LLCs in Kansas); Rev. Rul. 94-51, 1994-2 C.B. 407 (addressing the classification of LLCs in New Jersey).

21. *See, e.g.*, I.R.S. Priv. Ltr. Rul. 94-33-008 (May 6, 1994); I.R.S. Priv. Ltr. Rul. 94-07-030 (Nov. 24, 1993); I.R.S. Priv. Ltr. Rul. 94-04-021 (Nov. 1, 1993); I.R.S. Priv. Ltr. Rul. 93-50-013 (Sept. 15, 1993); I.R.S. Priv. Ltr. Rul. 93-35-063 (June 11, 1993); I.R.S. Priv. Ltr. Rul. 93-35-062 (June 11, 1993); I.R.S. Priv. Ltr. Rul. 93-35-032 (June 4, 1993); I.R.S. Priv. Ltr. Rul. 93-33-032 (May 24, 1993); I.R.S. Priv. Ltr. Rul. 93-31-010 (May 5, 1993); I.R.S. Priv. Ltr. Rul. 93-25-048 (Mar. 30, 1993); I.R.S. Priv. Ltr. Rul. 93-25-039 (Mar. 26, 1993); I.R.S. Priv. Ltr. Rul. 93-21-070 (Mar. 3, 1993); I.R.S. Priv. Ltr. Rul. 93-21-047 (Feb. 25, 1993); I.R.S. Priv. Ltr. Rul. 93-20-045 (Feb. 24, 1993); I.R.S. Priv. Ltr. Rul. 93-20-019 (Feb. 18, 1993); I.R.S. Priv. Ltr. Rul. 93-18-011 (Feb. 3, 1993); I.R.S. Priv. Ltr. Rul. 93-13-009 (Dec. 17, 1992); I.R.S. Priv. Ltr. Rul. 92-10-019 (Dec. 6, 1991); I.R.S. Priv. Ltr. Rul. 93-08-039 (Dec. 2, 1992); I.R.S. Priv. Ltr. Rul. 93-08-027 (Nov. 27, 1992); I.R.S. Priv. Ltr. Rul. 92-42-025 (July 22, 1992); I.R.S. Priv. Ltr. Rul. 92-27-033 (Apr. 8, 1992); I.R.S. Priv. Ltr. Rul. 92-26-035 (Mar. 26, 1992); I.R.S. Priv. Ltr. Rul. 92-18-078 (Jan. 31, 1992); I.R.S. Priv. Ltr. Rul. 91-47-017 (Aug. 12, 1991); I.R.S. Priv. Ltr. Rul. 91-19-029 (Feb. 7, 1991); I.R.S. Priv. Ltr. Rul. 90-52-039 (Oct. 2, 1990); I.R.S. Priv. Ltr. Rul. 90-30-013 (Apr. 25, 1990); I.R.S. Priv. Ltr. Rul. 90-29-019 (Apr. 19, 1990); I.R.S. Priv. Ltr. Rul. 90-10-027 (Dec. 7, 1989); I.R.S. Priv. Ltr. Rul. 89-37-010 (June 16, 1989); I.R.S. Priv. Ltr. Rul. 83-04-138 (Oct. 29, 1982). Private Letter Rulings 8304138 and 9433008 held that particular LLCs would not receive partnership classification. *See* I.R.S. Priv. Ltr. Rul. 94-33-008 (May 6, 1994); I.R.S. Priv. Ltr. Rul. 83-04-138 (Oct. 29 1982).

22. *Ways and Means Select Revenues Subcommittee Report on Referred Tax Issues*, TAX NOTES TODAY, Feb. 2, 1993. The full text of the announcement, as it relates to LLCs, reads:

PURPOSE

The hearing would focus on so-called "limited liability companies," which have been utilized as an alternative to doing business as a partnership. These companies represent a relatively new and unique business structure, and concerns have been raised that one purpose of the entity is to avoid the corporate income tax while providing economic benefits of doing business as an entity. Because of the unique structure of limited liability companies, a review of current law and possible modifications would be considered as part of the hearing.

ISSUE

Limited liability companies have evolved within the past five to six years as a new form of doing business. These companies originate from State law, with each state statute that allows for the creation of such entities being slightly different. The structure of these entities generally resembles a hybrid between a partnership and a corporation, incorporating certain aspects of a partnership such as pass-through treatment for tax purposes, flexibility regarding [the] number of, and who can be, owners, and the use of the entity's debt to increase the basis of the owner's interest. At the same time, limited liability companies retain unique characteristics of a corporation such as continuity of life of the entity, operation of the day-to-day business like a corporation, and absence of personal liability of owners.

Because of the structure of these companies, there has been growing concern that the test currently used to determine whether an entity is a corporation or a partnership, for tax purposes, is inadequate. At the very heart of the dispute are Treasury regulations that were issued in the 1960s for purposes totally unrelated to testing limited liability companies but which are used for such purpose. The regulations, which were drafted to discourage the use of the corporate form as a means of abusing the pension rules, generally establish[ed] a four-factor-test that favors the finding of a partnership entity. When this test is applied to limited liability companies, the result, for tax purposes, may not accurately reflect the true nature of the entity.

Limited liability companies appear to be structured to take advantage of the tax benefits of a particular "business form" without the corresponding burdens or limitations. Although the growth of these entities is relatively new, if left unchecked, there is some concern that these companies could be a sanctioned way to undercut the two-tier system of corporate taxation.

Id. In her article, Barbara Kichheimer states:

On a related note, Weinberger [tax counsel to Senator Danforth] said it is time for Congress to "wake up and at least look at" the issue of limited liability companies. While the IRS has basically deemed these entities worthy of being subjected to only a single level of tax, Congress has legislated rules at the federal level requiring corporations to meet all the requirements of subchapter S. "You have the Treasury Department, the IRS, going with limited liability companies as the model of integration," Weinberger said. These companies, however, have no congressional oversight. He suggested Congress at least hold hearings and look into whether these companies cause a revenue drain, and are bad policy, or whether LLCs should replace S corporations.

Barbara Kirchheimer, *Revenue Constraints and Lack of Momentum May Hinder S Corp Reform, Danforth Aide Says*, TAX NOTES TODAY, Dec. 22, 1993; *see also Congress May Examine IRS' Position on LLCs in Future*; *Subchapter S Bill Gains Speed*, DAILY TAX REP. (BNA) No. 72, at G-7 (Apr. 15, 1994); *LLCs Status May Be Subject to Congressional Scrutiny*, 1 J. LIMITED LIABILITY COMAPANIES 47 (1994); *Surge in Limited Liability Co. Laws Seen Driving Move to* hearings were never scheduled.[23] Still the tidal wave of the LLC advanced across the country, until at last Hawaii embraced the LLC form in 1997.[24]

Nonetheless, the *Kintner* classification regulations did impose certain limits on the use of the LLC form, and continuing uncertainties over the tax classification of a single member LLC[25] effectively precluded the use of the structure. However, in order to avail themselves of the perceived benefits of classification as a partnership, rather than as an association taxable as a corporation, taxpayers needlessly expended significant time, money, and effort to eliminate "corporate characteristics" from organizational documents. For those organizations with sufficient resources to retain qualified legal and accounting professionals, this expense was simply a cost of doing business. However, for smaller business organizations with neither the time nor money to spare, the *Kintner* classification regulations inevitably became a barrier to business. Furthermore, the Service found itself expending more and more resources by responding to requests for private letter rulings on particular fact patterns and in drafting classification revenue rulings and revenue procedures. Recognizing the inequities of this system and the fact that developments in

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Corporate Integration, DAILY TAX REP. (BNA) No. 100, at G-2 (May 26, 1993); *Tax Aide Discusses LLCs, S Corporations, and Health Care*, TAX NOTES TODAY, Apr. 15, 1994;

23. Telephone interview with Gloria Bryant, House Ways and Means Committee (Sept. 30, 1994). As observed by one commentator:

> Here is what should have happened. Prior to the issuance of Revenue Ruling 88-76, the IRS should have alerted congressional staff members that it was about to issue a revenue ruling treating Wyoming limited liability companies as partnerships rather than as corporations under the Kintner Regulations. With the experience of master limited partnerships fresh in everyone's mind, both the congressional staff and the IRS would have known that, once the private sector digested the information about limited liability companies, it would flock to that type of entity to circumvent the problems associated with other forms of business associations, especially S corporations. Congress should then have decided whether or not to permit this circumvention of the Subchapter S rules. It would have been most sensible to engage in a full-scale review of conduits and to rewrite the rules so that they made more sense. Congress, of course, has numerous pressing matters before it and may have lacked the time necessary to complete such a major project. Still, Congress could have adopted stop-gap legislation, e.g., by making limited liability companies meet the Subchapter S standards as a prerequisite to being treated as conduits, until it had time to engage in a fuller review. Instead, Congress remained inert, allowing virtually all of the states to pass legislation. It may now be hard to put the bull back in the barn.

William J. Rands, *Passthrough Entities and Their Unprincipled Differences Under Federal Tax Law*, 49 SMU L. REV. 15, 32–33 (1995).

24. *See* Uniform Limited Liability Company Act, 1996 Haw. Sess. Laws 181–225 (effective Apr. 1, 1997) (current version at HAW. REV. STAT. ANN. §§ 428-101–428-1302 (LexisNexis 2004 & Supp. 2005)).

25. While Rev. Proc. 95–10, 1995–1 C.B. 501, § 4.01 acknowledged that single member LLCs could be formed under certain statutes, it also provided that such an entity could not request an advance classification ruling. Rev. Proc. 95-10, 1995-1 C.B. 501.

organizational law had overtaken the *Kintner* regulations, the Service proposed and enacted a new tax classification regimen under which the classification of unincorporated associations would be governed by the voluntary election of the owners.

II. CHECK-THE-BOX, OR HOW THE STRUCTURAL LIMITS ON LLCS WERE ABANDONED

In April, 1995, the Service raised the possibility of revising the classification regulations to provide for an elective regimen, and requested comments upon the feasibility and desirability of such a system.[26]

The comments received on the simplification concept set forth in Notice 95-14 were almost without exception favorable. As set forth in the notice, domestic unincorporated associations would be allowed to elect their classification without regard to the presence or absence of the *Kintner* regulations. Of particular import was the request in the notice for comments on the proper treatment of unincorporated, single-member organizations. A hearing on these points was held on July 20, 1995.[27]

26. I.R.S. Notice 95–14, 1995–1 C.B. 297; *see also* Thomas E. Rutledge, *IRS Considers End to* Kintner *Analysis of Unincorporated Associations*, 18 LLC ADVISOR 4 (1995). In I.R.S. Notice 95–14, the Service stated:

> The existing classification regulations are based on the historical differences under local law between partnerships and corporations. However, many states recently have revised their statutes to provide that partnerships and other unincorporated organizations may possess characteristics that have traditionally been associated with corporations, thereby narrowing considerably the traditional distinctions between corporations and partnerships. For example, some partnership statutes have been modified to provide that no partner is unconditionally liable for all of the debts of the partnership. Similarly, almost all states have enacted statutes allowing the formation of limited liability companies. These entities are designed to provide liability protection to all members and to otherwise resemble corporations, while generally qualifying as partnerships for federal tax purposes. . . . One consequence of the narrowing of the differences under local law between corporations and partnerships is that taxpayers can achieve partnership tax classification for a non-publicly traded organization that, in all meaningful respects, is virtually indistinguishable from a corporation. Taxpayers and the Service, however, continue to expend considerable resources in determining the proper classification of domestic unincorporated business organizations. . . . In addition, small unincorporated organizations may not have sufficient resources and expertise to apply the current classification regulations to achieve the tax classification they desire.

I.R.S. Notice 95–14, 1995–1 C.B. 297

27. *See, e.g.*, *ABA Tax Lawyers Embrace Check-the-Box Proposal and Say Extend it to Foreign Organizations*, TAX NOTES TODAY, July 26, 1995; *AICPA Strongly Supports Check-the-Box Proposal for Domestic and Foreign Entities*, TAX NOTES TODAY, July 28, 1995; *IRS Approval of Simplified Business Classification System Urged at Hearing*, DAILY TAX REPORT, July 21, 1995.

In May, 1996, the Service released proposed entity classification rules incorporating an elective regimen for both domestic and foreign entities which also addressed the classification of single member unincorporated organizations.[28] The comments received on the proposed regulations were almost without exception supportive of the general check-the-box strategy, suggesting only minor revisions. The one exception to the unanimity of support was the California Franchise Tax Board, which objected to the proposed regulations on the basis that California would treat all single member entities as corporations and that if Check-the-Box were adopted there would be different classifications under federal and state law.[29]

The final Check-the-Box regulations were released on December 18, 1996 with an effective date of January 1, 1997[30] and generally adopted the elective system contained in the proposed regulations.[31] Breaking important new

28. Simplification of Entity Classification Rules, 61 Fed. Reg. 21989 (May 13, 1996). Those proposed regulations provided: (i) an elective regimen between partnership and corporate classification for domestic unincorporated associations with two or more members and a default classification as a partnership; (ii) an elective regimen regarding the classification of domestic single member unincorporated associations between sole proprietorships/branches and corporations with a default classification as a sole proprietorship/ branch; (iii) the designation of certain foreign organizations as *per se* corporations; and (iv) an elective regimen for all other foreign organizations with default classification being dependent upon the number of members and the presence or absence of limited liability for all owners with the opportunity to elect a contrary classification. *Id.*; *see also* Roger F. Pillow, John G. Schmalz & Samuel P. Starr, *Check-the-Box Proposed Regs. Simplify the Entity Classification Process*, 85 J. TAX'N 72, 73 (1996); Thomas E. Rutledge & James B. Martin, Jr., *The Proposed Check-the-Box Classification Regulations: What Might They Mean For You*, 1 LLC ADVISOR 4 (1996).

29. *See California Franchise Tax Board Opposes Single-Member Business Entity Election*, TAX NOTES TODAY, August 21, 1996.

30. Simplification of Entity Classification Rules, 61 Fed. Reg. 66584 (Dec. 18, 1996). The validity of the regulations was recently confirmed in *Littriello v. United States*, No. Civ.A. 3:04CV–143–H, 2005 WL 1173277, at *3 (W.D. Ky. May 18, 2005).

31. Reviews of the Check-the-Box classification regulations include WILLIAM S. MCKEE, WILLIAM F. NELSON & ROBERT L. WHITMIRE, FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS ¶ 3.08[1]–[5] (Warren, Gorham & Lamont eds. 2006) (3d ed. 1997); *see* Barbara C. Spudis, *The "Check-the-Box" Regulations: Effective Entity Classification Under Section 7701*, TAX STRATEGIES FOR CORPORATE ACQUISITIONS, DISPOSITIONS, SPIN-OFFS, JOINT VENTURES, FINANCING, REORGANIZATIONS AND RESTRUCTURINGS, Oct.-Nov. 1997. For a discussion of certain pit-falls and ambiguities in the Check-the-Box regulations, see, for example, Hugh M. Dougan et al., *Check the Box—Looking Under the Lid*, May 27, 1997. In addition to simplifying entity classification, by de-linking state law organizational characteristics and tax classification, Check-the-Box had the salutary benefit of eliminating the drive to create an ever increasing menu of entities, entities which have been oft proposed to address perceived gaps in the weave of available organizations. *See, e.g.*, George W. Coleman & Robert R. Keatinge, *Universal [Contractual] Organization Act*, Aug. 7, 1995 (paper presented to the ABA Section of Business Law, Committees on Taxation and Partnerships and Unincorporated Business Organizations introducing the so-called UNICORN); Mitchell F. Crusto, *Extending the Veil to Solo Entrepreneurs: A Limited Liability Sole Proprietorship Act (LLSP)*, 2001 COLUM. BUS. L. REV.

ground, the Check-the-Box regulations addressed the classification of single member unincorporated associations. The appropriate classification of such entities was an oft debated and never solved question under the *Kintner* regulations.[32]

Under Check-the-Box, single member LLCs have the option of either being classified as corporations or, in the alternative, treated as either a sole proprietorship, where the sole member is an individual, or as a branch/division, where the owner is a corporation or other business entity.[33] Unless classification as a corporation is elected, the separate entity, while existing for purposes of state law, will be afforded no separate tax identity.[34] Under the default rule, a single member unincorporated entity is treated as having no separate tax identity.[35] As such, in parallel with the system applied to unincorporated associations with more than one member, an affirmative election is required to have the domestic single member unincorporated association taxed as a corporation.

It is doubtful that it is possible to overstate the importance of the Service's effort in this area. While Revenue Ruling 88-76[36] signified the acceptance of the LLC as a viable business structure with a predictable tax classification, the Check-the-Box regulations initiated the practical use of the single member LLC. One common application of this structure is to provide limited liability for businesses that would otherwise operate as a sole proprietorship because of the disadvantages and complexities of either C or S corporation status. Another common application has been in the creation of wholly owned LLCs to serve as joint venture vehicles or as baskets in which to hold particular assets. In addition, there are international and state tax planning opportunities.[37] Keep in mind, however, that Check-the-Box addresses only

381, 383 (2001); John H. Matheson & Brent A. Olson, *A Call for a Unified Business Organization Law*, 65 GEO. WASH. L. REV. 1, 29 (1996); Dale A. Oesterle & Wayne M. Gazur, *What's In a Name?: An Argument for a Small Business "Limited Liability Entity" Statute (With Three Subsets of Default Rules)*, 32 WAKE FOREST L. REV. 101, 114 (1997); Larry E. Ribstein, *The Loneliest Number: The Unincorporated Limited Liability Sole Proprietorship*, J. ASSET PROTECTION 46, 46–47 (May-June 1996).

32. *See, e.g.*, Francis J. Wirtz & Kenneth L. Harris, *Tax Classification of the One-Member Limited Liability Company*, TAX NOTES TODAY, June 28, 1993.

33. 26 C.F.R. § 301.7701-3(a) (2006); *see also* 26 C.F.R. § 301.7701-2(c)(2) (2006). Such organizations will be referred to as "Tax-Nothings" for the balance of this article.

34. 26 C.F.R. § 301.7701-2(a) (2006).

35. 26 C.F.R. § 301.7701-3(b)(ii) (2006).

36. Rev. Rul. 88-76, 1988-2 C.B. 360. In Rev. Rul. 88-76, the Service determined that a Wyoming LLC would be classified as a partnership. *Id*.

37. For discussions of the single member unincorporated entity with no tax identity and its use in various situations, *see* Christopher Barton, *Much Ado About a Nothing: The Taxation of Disregarded Entities*, TAX NOTES TODAY, June 30, 1997; David S. Miller, *The Tax Nothing,* TAX NOTES TODAY, Feb. 3, 1997; William S. McKee et al., *Issues Relating to Choice of Entity, Entity*

the *federal* tax classification of single member LLCs; the individual states neither were nor are bound to follow that classification.[38]

III. STATE ADOPTIONS OF FEDERAL CLASSIFICATION, OR HOW GOING ALONG PUT THE STATE FISC AT RISK

None of the states are bound by the federal tax classification of a business structure. Rather, for purposes of its tax code, a state may classify business entities as it sees fit. Most states have followed the rule of conformity, but there are noteworthy exceptions.[39] As an example, our home state of Kentucky

Characterization and Partnership Anti-Abuse Rules, *in* TAX PLANNING FOR DOMESTIC AND FOREIGN PARTNERSHIPS, LLCS, JOINT VENTURES, AND OTHER STRATEGIC ALLIANCES (PLI Tax Law and Estate Planning Handbook Series) (1997). In I.R.S. Notice 98-11, 1998-6 I.R.B., the Service announced that it would be proposing regulations intended to combat the use of hybrid Tax Nothings (Tax Nothing treatment for purposes of US taxation while treatment as an entity for foreign tax purposes) in situations which are considered abusive because they are structured to avoid foreign tax while at the same time avoiding Subpart F income treatment. *See also* Steven Grodnitzsky, *Notice 98–11 Not Intended to Attack Check-the-Box Regs. Treasury Says*, TAX NOTES TODAY, Jan. 26, 1998; *IRS To Issue Regs on Hybrid Branches Used to Circumvent Subpart F*, TAX NOTES TODAY, Jan. 20, 1998; Lee A. Sheppard, *IRS Talks About Foreign Hybrid Notice*, TAX NOTES TODAY, Jan. 22, 1998.

38. *See generally* Amy Hamilton, *Check-the-Box Chaos? The State Tax Treatment Factor*, TAX NOTES TODAY, May 29, 1997; Scott D. Smith, *What Are States Doing on the Check-the-Box Regs?*, TAX NOTES TODAY, Aug. 18, 1997; *see also States Must Address Business Entity Issue Following IRS Check-the-Box Rules*, 22 DAILY TAX REPORT G-8, Feb. 3, 1997; *California Groups Discussing Conforming to Federal Entity Classification Rules*, DAILY TAX REPORT, Feb. 24, 1997. As most states "couple" their tax codes to the Internal Revenue Code, changes in federal tax law take effect, except to the degree that the states "decouple" state revenues. For an exploration of this effect, see, for example, Michael H. Lippman & Sharlene E. Amitay, *How Will the American Jobs Creation Act of 2004 Affect State and Local Taxes?*, 102 J. TAX'N 161 (2005).

39. *See* Bruce P. Ely, *State Taxation of Subchapter S and Subchapter K Entities and Their Owners—An Overview*, ALI-ABA Continuing Legal Education Presentation, Choice of Entity—2006: Selecting Legal Form and Structure for Closely-Held Businesses and Ventures (Feb. 2, 2006). According to Ely:

> In most states, the decision to conform to the Check-the-Box regulations for income tax purposes was not controversial. Almost all states that impose a corporate income tax, or its equivalent, have enacted legislation or announced in formal or informal guidance that they will classify an LLC in the same manner as it is classified for federal tax purposes.

Id. at 322. *See generally* Michael W. McLoughlin & Walter Hellerstein, *State Tax Treatment of Foreign Corporate Partners and LLC Members After Check-the-Box*, 8 STATE AND LOCAL TAX LAWYER 1, 3 (2003) ("For the most part, states follow the federal tax treatment of partnerships and treats them as pass-through entities."). Other state laws imposing an entity-level tax on business structures that, for federal tax purposes, are pass-through entities include: ALA. CODE § 40-14A-22(a) (2003) (imposing net worth based "business privilege" tax on LLCs); CAL. REV. & TAX. CODE §§ 17941, 17942 (2006, 2004) (imposing entity-level franchise tax); 35 ILL. COMP. STAT. 5/205(b), 5/201(d) (2004) (imposing 1.5% personal property replacement tax based on net income); KY. REV. STAT. ANN. §§ 141.010(24), 141.040(5) (LexisNexis 2003 & Supp. 2005) (classifying LLCs as corporations and subject to the greater of corporate or alternative minimum was typical in following the Federal classification scheme.[40] It was also typical, as we shall see, in not appreciating revenue implications of conforming to the Federal scheme[41] and in reacting when revenue shortfalls occurred, although not in the specifics of its reaction.[42]

calculation tax); Mich. Dept. of Treasury Revenue Admin. Bulletin 1999–9, *available at* http://www.michigan.gov/documents/rab99-9_109073_7.pdf (Michigan Single Business Tax); N.H. REV. STAT. ANN. §§ 77–A:2, 77–E:2 (2002) (subjecting LLCs that do business in the state to a 5% tax on dividends and interest, an 8.5% business profits tax, and the 0.75% business enterprise tax); N.J. STAT. ANN. § 54:10A-15.11 (2002) (obligating partnerships to pay 6.37% of New Jersey net income allocated to nonresident, noncorporate partners and 9.00% for all nonresident corporate partners); OHIO REV. CODE ANN. §§ 5733.06, 5733.40, 5733.401 (2005) (imposing an 8.5% entity-level tax except where all owners give written consent to state tax jurisdiction); 15 PA. CONS. STAT. ANN. § 8925 (2006) (subjecting LLCs, except certain professional LLCs, to 0.699% capital stock and franchise taxes); TENN. CODE ANN. §§ 67-4-2007, 67-4-2105(a), 67-4-2106(a)) (2006) (applying excise tax of 6.5% of net earnings and franchise tax of $0.25 per $100 of net worth to LLCs, LLPs, and LPs); TEX. TAX CODE ANN. § 171.001 (2005) (taxing LLCs as though they are corporations for tax years ending prior to Jan. 1, 2007, but not treating LPs, LLPs, or LLLPs in the same manner); WASH. REV. CODE ANN. §§ 25.05.500–25.05.570, 25.15.005–25.15.902 (2006) (subjecting all entities to business & occupations tax). *See generally* Ely, *supra* note 39, at Appendices B & C; ROBERT R. KEATINGE & ANN E. CONAWAY, KEATINGE AND CONAWAY ON CHOICE OF BUSINESS ENTITY 373, 430 (2006). With respect to the changes in the Texas taxation of LLCs, as well as LLPs and limited partnerships for tax years ending on or after January 1, 2007, see generally Ira A. Lipstet, *Franchise Tax Reformed: The New Texas Margin Tax*, presented at 2006 Partnerships, Limited Partnerships, and LLCs at Austin, Texas (July 21, 2006).

40. Prior to the adoption of "tax modernization" in 2005, Kentucky income tax classification conformed itself to the federal tax classification. KY. REV. STAT. ANN. § 141.208 (1994) originally provided:

> (2) Any limited liability company which is treated as a partnership for federal income tax purposes shall be treated as a partnership in accordance with the provisions of KRS § 141.206 for Kentucky income tax purposes.
>
> (3)Any limited liability company which is treated as a corporation for federal income tax purposes shall be treated as a corporation in accordance with the provisions of KRS § 141.040 for Kentucky income tax purposes.

Subsequent to Check-the-Box, the 1998 General Assembly amended KRS § 141.208 by deleting the above referenced subsections (2) and (3) and replacing them with a new subsection (2) which provided:

> (2) Any limited liability company shall be treated for Kentucky income tax purposes in the same manner as its tax treatment for federal income tax purposes.

H.B. 666, § 1(2), Gen. Assem., Reg. Sess. (Ky. 1998) (subsequently modified by H.B. 272, § 19, Gen. Assem., Reg. Sess. (Ky. 2005)). Speaking specifically to the case of Kentucky but applying to some degree to all states whose revenue decline has been laid at the feet of the LLC, it may be that this was the point "that the wheels came off." The Kentucky General Assembly deleted the requirement that LLCs have at least two members, thereby enabling the SMLLC and its treatment as a Tax Nothing, a "tax planning opportunity" of exceptional utility, without an appreciation of its consequences.

41. As observed by Governor Fletcher in his 2005 State of the Commonwealth address:

IV. THE DEBATE THAT NEVER WAS

The speed with which the various states adopted the LLC form was notable. In 1988 there were statutes in place in two states, Wyoming and Florida, neither of which would be characterized as leading commercial centers.[43] In 1990 there were two statutory adoptions,[44] four in 1991,[45] and ten in 1992.[46] As observed by Susan Pace Hamill:

> After the Internal Revenue Service (IRS) formally recognized the LLCs ability to be taxed as a partnership in 1988, interest in LLCs grew exponentially. By the close of 1996, all fifty states and the District of Columbia had passed statutes allowing formation of LLCS within their jurisdictions. In less than twenty years—a meteoric pace unprecedented in the development of business organizations—this new business form grew from obscurity to a viable new alternative for doing business.[47]

As contrasted with the voluminous records maintained of federal legislative (and administrative) deliberations, the various states maintain relatively limited records of their deliberations. As such, our criticism is of the

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> In 1994 [the General Assembly] passed a good law for small businesses that allowed the formation of limited liability companies. The law never anticipated that large out of state companies would use that structure as a way of avoiding corporate tax. These loopholes are neither fair nor responsible.

Governor Ernie Fletcher, State of the Commonwealth Address at the House Chambers of the State Capitol (Feb. 1, 2005).

42. Subsequent years saw budget shortfalls in the state budget, and the blame for the missing revenue was in substantial part placed upon the LLC. In 2005, Kentucky adopted a substantial "modernization" of its income tax code, imposing a new regimen under which LLCs, including SMLLCs, LLPs, LPs, and a variety of other structures traditionally treated as flow-through, are subject to an entity level tax. H.B. 272, Reg. Sess. (Ky. 2005). Certain aspects of this legislation are reviewed in Rutledge & Vestal, *supra* note 6, at 26–29.

43. Florida adopted its LLC act in 1982 in an effort to attract to that state businesses organized in Central and South America in the form of a *limitada*, an analogous form. *See* Geu, *supra* note 3, at 49. Still, even at that early date, the debate was no more robust than it would be in the wave of 1990s adoptions. Richard Johnson, *Limited Liability Company Act*, 11 FLA. ST. U. L. REV. 387 (1984). Johnson states that "The purpose behind the legislation's enactment was to lure capital to the state in order to add to the economic base of Florida." *Id*. at 387. Florida hoped to attract foreign investment by having a familiar business organization. *Id*. In addition to attracting international investment, it was also thought that the LLC would encourage businesses to move to Florida. *Id*. "The committee reports were very optimistic as to the impact which the new entity would have on the business community. One report even expected a 'deluge of filings.'" *Id*. at 387–88.

44. These states were Colorado and Kansas. LARRY E. RIBSTEIN & ROBERT R. KEATINGE, RIBSTEIN & KEATINGE ON LIMITED LIABILITY COMPANIES § 1:2, at 1-7 (2d ed., 2004).

45. These states were Nevada, Texas, Utah, and Virginia. *Id.*

46. The 1992 adoptions were Arizona, Delaware, Illinois, Iowa, Louisiana, Maryland, Minnesota, Oklahoma, Rhode Island, and West Virginia. *Id*.

47. Susan Pace Hamill, *The Origins Behind the Limited Liability Company*, 59 OHIO ST. L.J. 1459, 1460–61 (1998).

lack of debate reflected in an, charitably speaking, incomplete record. Still, based on the feebleness of the available records, we have no reason to think a robust, but unrecorded, debate took place in other states or in other settings. The records that are available reflect a debate held at best first order generalities: the LLC is good for business;[48] the LLC is needed to keep business formation fees in the state;[49] the LLC is an uncomplicated alternative to the corporation;[50] the LLC is good for in-state economic development;[51] the

48. For example, in North Dakota, Sen. Wayne Stenehjem, Sponsor, testified in support that LLC legislation saying that they "represent an innovative and potentially very useful business tool for the citizens of North Dakota." *Hearing on S.B. 2222 Before the S. Comm. on Judiciary*, 1993 Leg., 53d Reg. Sess., at 1 (N.D., Jan. 25, 1993). Sen. Karen Krebsbach, co-sponsor, testified that "anything we can do to induce and entice business is what we need to do, and this is a good vehicle to do that." *Id*. at 3.

Likewise, in Montana, Sen. Waterman, the bill's sponsor, opened the hearing by stating, "S.B. 146 creates an exciting and innovating business entity in the state. . . . S.B. 146 will enhance Montana's ability to attract and promote businesses throughout the state." *Hearing on S.B. 146 Before the S. Comm. on Judiciary*, 1993 Leg., 53d Reg. Sess., at 3 (Mont., Jan. 21, 1993). David Owen, Montana Chamber of Commerce, stated that "S.B. 146 is a concept that is advantageous for small and family businesses, and professional service organizations." *Id*. at 4. Tom Morrison, a tax lawyer, testified that "Limited Liability Companies will help small businesses and that S.B. 146 would place Montana with the rest of the progressive states that feel Limited Liability Companies are helpful to small businesses." *Id*. at 4. Additionally, Steven Bahls testified on his own behalf that LLC

> legislation will facilitate a welcome improvement in Montana's business images. LLCs are pro-economic development, at virtually no cost. And as Montana strives to be a leader not a follower in providing for small business, it makes great sense that Montana seize this opportunity now. If Montana wishes to compete for small business with surrounding states, LLC legislation is a practical necessity and a step toward the future.

Id. at 7.

49. Sen. Chuck Blanchard, sponsor for Arizona's LLC legislation, "explained it [S.B. 1084] had [been] very carefully drafted and present[ed] an exciting opportunity for Arizona to get on the 'band wagon' early in creating a new business structure that is more flexible and more workable for smaller businesses." *Hearing on S.B. 1084 Before the S. Comm. on Commerce and Labor*, 40th Leg., 2d Reg. Sess., at 5 (Ariz., Feb. 12, 1992). He also said it "would save accounting and attorney's fees and would give Arizona a modest advantage for economic development in the 1990s." *Id.*

50. For instance, Sen. Blanchard supported Arizona's legislation partially on the basis of this generality. *See id*.

When LLC legislation was introduced in California, the California Chamber of Commerce testified in favor of the bill:

> LLCs offer business owners and investors the ability to achieve limited liability and avoid double taxation, without the necessity of meeting the many procedural requirements to qualify as a corporation. California should quickly adopt this bill so that it will be competitive with 35 other states which have adopted LLCs, and the number is rapidly increasing.

Hearing on S.B. 469 Before the Assemb. Comm. on Ways and Means, Reg. Sess., at 4 (Cal., Aug. 29, 1994).

In Idaho, supporter Mike Brassey of the Idaho State Bar Association presented the bill to the Committee and remarked, "The ability to organized LLCs in Idaho will provide substantial organizational flexibility and operational advantages to businesses currently organized as partnerships." *Limited Liability Companies Created: Hearing on H.B. 381 Before the H. Bus. Comm. on the Judiciary*, 1993 Leg., 52d Reg. Sess., at 1 (Idaho, Mar. 5, 1993). Ken Pursley of the Corporate Securities Section of the Idaho State Bar testified that LLCs would "work very well in Idaho enabling some to do business who can't now. It is the ideal business form for small business." *Id*.

51. For example, in Alaska's hearings on LLC legislation, the record indicates support was offered for the LLCs economic benefits:

> Representative Mulder stated that he didn't understand all the specifics of HB 420, but felt it was a good move towards promoting economic development. . . . [Brian Durrell, Attorney and CPA,] championed the bill as being very good for business in Alaska. He said it would help streamline and stimulate business activity in Alaska. . . . [Mr. Bob Manley, attorney,] express[ed] concern that Alaskans would lose business to other states from individuals desiring the formation of LLCs.

Comm. Hearing and Analysis of H.B. 420, Before the H. Labor and Commerce Standing Comm., 18th Leg., 2d Reg. Sess. (Alaska, Mar. 8, 1994).

Likewise, in Arizona Sen. Blanchard emphasized that LLC legislation "would give Arizona a modest advantage for economic development in the 1990s." *Hearing on S.B. 1084 Before the S. Comm. on Commerce and Labor*, 40th Leg., 2d Reg. Sess., at 5 (Ariz., Feb. 12, 1992).

In California, the Committee on Revenue and Taxation's comments on California's legislation stated:

> The purpose of this bill is to allow the formation of limited liability companies (LLCs) in California. Proponents argue that California must recognize limited liability companies in order to remain competitive with other states. In the absence of a state LLC law, proponents argue, businesses organized as LLCs will conduct their business outside of California, resulting in a loss of jobs and business activity.

Authorizes Formation of Limited Liability Companies, Hearing on S.B. 469 Before the Assemb. Comm. on Revenue and Tax'n, Reg. Sess., at 3 (Cal., Aug. 15, 1994). Additionally, the sponsors of the bill argued that the availability of LLC status would improve California's business climate by facilitating the formation of new businesses in California. *Corporation Tax: Limited Liability Companies*, Hearing on S.B. 469 Before the Assemb. Comm. on Revenue and Tax'n, Reg. Sess., at 4 (Cal., Jan. 5, 1994). The bill's sponsors further expressed concern that without LLC legislation, the status of activities conducted by foreign LLCs would be unclear, thereby reducing their enthusiasm for doing business in California. *Id.*; *see* Timothy M. Harris, *Review of Selected 1994 California Legislation*, 26 PAC. L.J. 281, 309–10 (1994) ("Chapter 1200 was enacted to make California a more competitive business environment. . . . Proponents of Chapter 1200 expect the flexibility LLCs offer will attract new businesses and create jobs in California.").

In Hawaii, Rep. Yohiniga testified in support of Senate Bill 2723:

> Economic revitalization is vital to the improvement of the State's current economic condition. Encouragement of capital investment, proactive rather than reactive state response to federal changes, fostering of well-paying jobs, fairness and equity in the impact of taxes and competing nationally and internationally in the business climate are a few of the grievous motives for the state to explore . . .

J. OF THE H.R. OF THE STATE OF HAWAII, 18th Leg., Reg. Sess., at 802 (1996).

Regarding Montana's LLC bill, Sen. Mignon Waterman, its sponsor, presented written testimony in support of the bill:

LLC is needed to create the perception that the state has progressive business laws;[52] and the LLC is needed to avoid being the odd-state-out not having an

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> The Montana Legislature has an opportunity to promote business development and improve its business climate through [LLC] legislation prepared by a State Bar of Montana committee. If Montana is to be competitive with other states seeking business development it needs this modern and flexible business alternative.

Hearing on S.B. 146 Before the H. Comm. on the Judiciary, 1993 Leg., 53d Reg. Sess., at Exhibit 2 (Mont., Feb. 4, 1993). Steven Bahls, Associate Dean and Professor at the University of Montana School of Law, presented a letter from the then-Governor of Montana Marc Racicot, dated January 11, 1993, which pledged support for the bill: "The Internal Revenue Services' approval of Limited Liability Companies certainly requires that Montana adopt this type of business entity in order to remain competitive with surrounding states." *Id*. at Exhibit 4.

Additionally, when legislation was introduced in Nebraska, Sen. Kristensen, the bill's sponsor, testified the following on the Senate floor:

> I think rarely does the Legislature get a chance to create a new business entity that will benefit such a large number of our citizen and also give us such great opportunities for new businesses, but also give us a very competitive edge to keep existing businesses in the State of Nebraska.

J. OF THE S. OF THE STATE OF NEB., 93rd Leg., 1st Sess., at 3399 (1993). The Senator went on to state:

> We've had people from economic development begin to embrace this as an opportunity to lure additional businesses into Nebraska. When we have new businesses come and look at the state, one of the new questions that they ask are, do you have limited liability companies? We've not been able to say yes, up to this point. And particularly we lose business to other states.

Id. at 3406. Jerry Sestak, a partner with the Omaha firm Seim, Johnson, Sestak & Quist and president-elect of the Nebraska Society of Certified Public Accountants, testified:

> It is our opinion that the State of Nebraska must continue to offer incentives to invite new businesses to locate within the State of Nebraska in order for the state to continue to prosper and grow. I firmly believe that one of the incentives that will be considered by prospective future businesses, is whether the state has limited liability company legislation.

Introducer's Statement of Intent L.B. 121 Before the Comm. of Banking, Commerce and Ins., 1993 Leg., 93d 1st Sess., at 24–25 (Neb., Jan. 26, 1993).

Also, regarding North Dakota's legislation, Rep. Don Shide testified that passage of this LLC legislation will do a lot economically for the State of North Dakota. *Hearing on S.B. 2222 Before the H. Comm. on the Judiciary*, 1993 Leg., 53d Reg. Sess. 1 (N.D., Jan. 25, 1993).

52. J. OF THE H.R. OF THE STATE OF HAWAII, 18th Leg., Reg. Sess., at 582 (1996) (Rep. Yoshinaga remarked "[a]s in other areas, Hawaii lags behind other states in enacting a progressive business law. This limited liability act will do much to improve the perception that this State is unfriendly to businesses.").

These sentiments were conveyed during the hearings on Montana's LLC legislation by Sen. Waterman and Prof. Steven Bahls. *See Hearing on S.B. 146*, *supra* note 51, at Exhibits 2, 4.

Also, consider Sen Kristensen's statements in support of Nebraska's legislation. J. OF THE S. OF THE STATE OF NEB., *supra* note 51, at 3399, 3406. Sen. Kristensen also testified:

> [Limited Liability Companies will be] a very helpful tool for Nebraska. We could become a leader in the country instead of being one of the last to do it. Certainly with surrounding states all having limited liability companies by the end of this year we'll. . .we'll be at a competitive disadvantage by not having this business entity.

LLC act.[53] The failure to debate the merits of the LLC concept, beyond the first order generalities that the LLC form would be "good for business"[54] or that adoption of the LLC form was required to maintain competitive posture of the various states *inter se*, masked three separate policy matters that should have been thoroughly vetted: first, the policy implications incumbent in creating a structure that would be utilized by those who would have previously used the partnership or limited partnership forms with attendant joint and several liability to creditors; second, the fiscal implications of extending pass-through taxation to firms that, not related to the previous organizational forms, might have chosen the corporation and entity-level taxation;[55] and, third, the

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Introducer's Statement of Intent L.B. 121 Before the Comm. of Banking, Commerce and Ins., 1993 Leg., 93d 1st Sess., at 9–10 (Neb. 1993). Additionally, Robert Berkshire of the Nebraska State Bar Association testified: "Certainly the Nebraska State Bar Association feels that this is a constructive legislation that keeps Nebraska competitive, as far as creating a business climate for business organizations." *Id*. at 21.

In a letter from the State of New York Executive Chamber dated July 26th, 1994, former Governor Mario M. Cuomo wrote:

> The bill [S. 7511–A], is part of our continuing effort to be aggressively hospitable to business. . . .The bill will help attract business to New York State. . . . Adoption of LLC legislation in New York is a significant step in promoting New York as a competitive location for conducting and establishing business enterprises . . . . [S. 7511–A] will provide the resources and tools to enable businesses to create more jobs, right now!

1994 N.Y. Sess. Laws 2985 (McKinney). The New York State Executive Department also indicated its support of the bill in a memorandum:

> The bill will attract businesses to New York State . . . The bill provides an attractive alternative to partnerships, corporations and trusts and should be particularly desirable for foreign investors and entrepreneurs. Adoption of LLC legislation in New York will be a significant step in promoting New York as a competitive location for conducting and establishing business enterprises.

Id. at 2773.

53. In hearings regarding Nebraska's legislation, Sen. Kristensen and Robert Berkshire conveyed this generality in their remarks. *See Introducer's Statement of Intent*, *supra* note 52, 93 Leg., at 9, 10, 21, 24–25. In a telephone interview, Doug Williams, Deputy Fiscal Officer, Vermont Joint Fiscal Office, indicated that when Vermont's LLC legislation (H. 112) was proposed it was presented as a "housekeeping detail." Telephone interview with Doug Williams (June 11, 2003). "The general sentiment was that if Vermont was to remain competitive with other states in attracting and keeping businesses, then this bill must be passed." *Id*.

54. *Hearing on A.B. 655, Before the Assemb. Comm. on the Judiciary*, 1991 Leg., 66th Sess., at 19 (Nev., May 20, 1991) (where testimony was given to the effect that after reviewing A.B. 655 and limited liability companies, lawmakers felt it would help bring more diversified companies to Nevada).

55. Noteworthy exceptions to the lack of analysis were California and New York. *See, e.g.*, CALIFORNIA FRANCHISE TAX BOARD-RESEARCH BUREAU, ASSESSING THE STATE REVENUE IMPLICATIONS OF LIMITED LIABILITY COMPANY LEGISLATION (Mar. 1993); Marilis Carson, *Tax Revenues Will Suffer, But Limited Liability Companies May Be Here to Stay*, 3 STATE TAX NOTES 802 (1992); F.R. Nagle, *California FTB Members Explain Revenue Consequences of LLC Bill*, TAX NOTES TODAY, Nov. 17, 1993; Kevin Sack, *New Type of Company Stirs Tax Worry in*

social implications of moving business entity law in directions (perhaps) inconsistent with popular conceptions.

The policy, fiscal, and social issues inherent in the adoption of the LLC form were not debated much at all in the various state legislatures, a failure noted by other analysts.[56] As to the LLC debates, Bill Callison has observed:

> . . . legislators failed to consider the public policy aspects of expansive limited liability protection before they acted, and the expansion of limited liability protection occurred for pragmatic rather than theoretical or normative reasons. In a sense, the limited liability movement was unchallenged and its success came too easily.[57]

With respect to the LLP statutes, Bob Hamilton has been clear in his indictment: the expansion of limited liability to the general partnership was the product of "gross overreaching by members of the legal profession."[58] He also noted the lack of a clear public discussion of the implications of the statutory change:

Albany, N.Y. TIMES, June 20, 1992, at 36 ("State lawmakers said this week that efforts to create a new kind of business entity in New York had been seriously wounded by new projections showing that the businesses could mean the state would lose up to $65 million a year in revenue."); Lee A. Sheppard, *New York Contemplates Cost of Partnership Treatment for Limited Liability Companies,* TAX NOTES TODAY, Dec. 7, 1992 (as amended by Lee A. Sheppard, *Correction: New York Limited Liability Companies*, TAX NOTES TODAY, Dec. 8, 1992). California imposes an entity level franchise tax on LLCs. CAL. REV. & TAX CODE § 17942 (2004). As this levy is not subject to apportionment based upon the state or states in which the LLC's income is earned, it has been declared unconstitutional under the Due Process and Commerce Clauses of the U.S. Constitution. *Northwest Energetic Services, LLC v. Calif. Franchise Tax Board*, No. CGC-05-437721 (San Francisco Sup. Ct. Mar. 3, 2006). The potential revenue impact in New York was addressed in a memorandum transmitted March 20, 1992 in support of the New York LLC Act, it being recognized that there could be a loss in revenue from "a decline in the use of corporations," but with offsetting fee revenue and increased individual tax revenues. Memorandum reproduced in N.Y. LLC FORMS AND PRACTICE MANUAL (2004); s*ee also supra* note 41.

56. *See, e.g.*, Callison, *supra* note 4, at 964 ("Based on the lack of legislative debate and conversation concerning the expansion of limited liability, LLCs were not the product of the public interest model of legislation."). Whether there has been a departure from public expectations is open to debate. *See, e.g*., Rands, *supra* note 23, at 17 ("The private sector frequently desires a form of business organization that will entail limited liability for investors and be treated as a conduit for federal income tax purposes.").

57. *See, e.g*., Callison, *supra* note 4, at 953–54, 961. Callison notes that the expansion of limited liability "resulted from a confluence of evolutionary forces and political power," including the erosion of the strict treatment of unlimited liability and partnership taxation in the 1960s and early 1970s, and the development of other means of avoiding personal liability. *Id*. The third factor Callison cites is that "business lawyers advocated for LLC legislation without organized resistance from the plaintiffs' tort bar or other interested parties." *Id*.

58. Robert W. Hamilton, *Registered Limited Liability Partnerships: Present at the Birth (Nearly)*, 66 U. COLO. L. REV. 1065, 1090–91 (1995).

> The argument that this broadening of limited liability is necessary to make the shield of limited liability against malpractice claims 'more perfect' seems to me to be a pretext for quietly obtaining limited liability for all partners in general partnerships without telling the world about it.[59]

The point is not a subtle one. We are not saying that the debate was inadequate, that surely if there had been just a bit more debate the outcome would have been different (and better). One of us, a self-described old-fashioned liberal, tends to believe that his opinions will prevail if there is adequate debate. The other, a self-described fiscal conservative, wishes there had been informed debate as a resource for preserving the resultant situation. But the reality is that neither can cite what did take place in support of his position. There was not just a bit too little debate; there was effectively none. Zero. Zilch. Nada. Nehil. Τιποτα.

How little debate was there? It is hard to tell. The various state legislatures keep quite varied levels of legislative history. Unfortunately, the norm seems to be that states keep no verbatim record of floor debates and have no printed records of the all-important committee deliberations.

As a first-order approximation, one can go to the legislative voting records. Each of the states does keep a record of the vote on final passage of bills which become law. Below we report the percentage of votes in favor on final passage in each house of the legislature of the initial LLC statute. Where there was only a voice vote recorded, we include it as a unanimous vote, but mark it to indicate that it was a voice vote.

Final Passage of Initial LLC Act				
State	**House**		**Senate**	
	Yea	**Nay**	**Yea**	**Nay**
Alabama[60]	88	0	19	0
Alaska[61]	38	0	15	5
Arizona[62]	53	3	30	0
Arkansas[63]	86	0	33	0
California[64]	78	0	39	0

59. *Id.* at 1091.

60. Alabama Limited Liability Company Act, 1993 Ala. Laws 1425–60 (current version at ALA. CODE §§ 10-12-1–10-12-61 (LexisNexis 1999 & Supp. 2005)).

61. Limited Liability Company Act, 1994 Alaska Sess. Laws 1–55 (current version at ALASKA STAT. §§ 10.50.010–10.50.995 (2004)).

62. Limited Liability Company Act, 1992 Ariz. Sess. Laws 394–424 (current version at ARIZ. REV. STAT. ANN. §§ 29-601–29-857 (1998 & Supp. 2005)).

63. Small Business Entity Tax Pass Through Act, 1993 Ark. Acts 2928–98 (current version at ARK. CODE ANN. §§ 4-32-101–4-32-1401 (2001 & Supp. 2005)).

64. Beverly-Killea Limited Liability Company Act, 1994 Cal. Stat. 7297–7413 (current version at CAL. CORP. CODE §§ 17000–17656 (2006)).

Final Passage of Initial LLC Act				
State	**House**		**Senate**	
	Yea	**Nay**	**Yea**	**Nay**
Colorado[65]	57	6	34	0
Connecticut[66]	142	0	35	0
Delaware[67]	41	0	16	1
District of Columbia[68]	Council: 12 Yeas; 0 Nays			
Florida[69]	108	0	38	0
Georgia[70]	160	1		
Hawaii[71]	51	0	25	0
Idaho[72]	66	0	35	0
Illinois[73]	111	0	57	0
Indiana[74]	99	0	48	0
Iowa[75]	93	2	44	0
Kansas[76]	88	35	39	0
Kentucky[77]	92	0	36	2
Louisiana[78]	98	0	38	1

65. Colorado Limited Liability Company Act, 1990 Colo. Sess. Laws 414–460 (current version at COLO. REV. STAT. §§ 7-80-101–7-80-1101 (2006)).

66. Connecticut Limited Liability Company Act, 1993 Conn. Acts 884–910 (current version at CONN. GEN. STAT. ANN. §§ 34-100–34-242 (2005 & Supp. 2006)).

67. Limited Liability Company Act, 1992 Del. Laws 1329–1359 (current version at DEL. CODE ANN. §§ 18-101–18-1109 (2005)).

68. Limited Liability Company Act of 1994, 41 D.C. Reg. 3010–50 (May 27, 1994) (current version at D.C. CODE §§ 29-1001–29-1075 (LexisNexis 2001 & Supp. 2006)). The Council of the District of Columbia includes 13 members. One council member was absent for this vote.

69. Florida Limited Liability Company Act, 1982 Fla. Laws 580–603 (current version at FLA. STAT. ANN. §§ 608.01–608.77 (West 2001 & Supp. 2006)).

70. Georgia Limited Liability Company Act, 1993 Ga. Laws 123–288 (current version at GA. CODE ANN. §§ 14-11-100–14-11-1109 (2003)). The recorded vote for the Georgia State Senate is unavailable.

71. Uniform Limited Liability Company Act, 1996 Haw. Sess. Laws 181–225 (current version at HAW. REV. STAT. ANN. §§ 428-101–428-1302 (LexisNexis 2004 & Supp. 2005)).

72. Idaho Limited Liability Company Act, 1993 Idaho Sess. Laws 760–90 (current version at IDAHO CODE ANN. §§ 53-601–53-672 (2000 & Supp. 2006)).

73. Limited Liability Company Act, 1992 Ill. Laws 2529–63 (current version at 805 ILL. COMP. STAT. ANN. 180/1-1–60-1 (LexisNexis 2005)).

74. Indiana Business Flexibility Act, 1992 Ind. Acts 1970–2023 (current version at IND. CODE ANN. §§ 23-18-1-1–23-18-13-1 (LexisNexis 1999 & Supp. 2006)).

75. 1992 Iowa Acts 238–69 (current version at IOWA CODE ANN. §§ 490A.100–490A.1601 (West 1999 & Supp. 2006)).

76. Kansas Limited Liability Company Act, 1990 Kan. Sess. Laws 585–610 (current version at KAN. STAT. ANN. §§ 17-7601–17-7656 (2005)).

77. Kentucky Limited Liability Company Act, 1994 Ky. Acts 1087–1132 (current version at KY. REV. STAT. ANN. §§ 275.001–275.455 (LexisNexis 2003 & Supp. 2005)).

Final Passage of Initial LLC Act				
State	**House**		**Senate**	
	Yea	**Nay**	**Yea**	**Nay**
Maine[79]				
Maryland[80]	128	3	44	0
Massachusetts[81]	151	0	37	0
Michigan[82]	102	0	34	0
Minnesota[83]	129	2	57	0
Mississippi[84]	121	0	52	0
Missouri[85]	146	1	31	0
Montana[86]	90	8	47	0
Nebraska[87]	Unicameral Legislature: 43 Yeas, 0 Nays			
Nevada[88]	58	3	24	0
New Hampshire[89]				
New Jersey[90]	76	0	33	0
New Mexico[91]	62	4	34	0

78. Limited Liability Company Law, 1992 La. Acts 2083–2153 (current version at LA. REV. STAT. ANN. §§ 12:1315–1369 (1994 & Supp. 2006)).

79. Maine Limited Liability Company Act, 1993 Me. Laws 2168–2207 (current version at ME. REV. STAT. ANN. tit.31, §§ 601–762 (1996 & Supp. 2005)). The vote is unavailable; an unrecorded voice vote was taken.

80. Maryland Limited Liability Company Act, 1992 Md. Laws 3288–3377 (current version at MD. CODE ANN. [CORPS. & ASS'NS] §§ 4A-101–4A-1103 (LexisNexis 1999 & Supp. 2005)).

81. Massachussetts Limited Liability Company Act, 1995 Mass. Acts 1008–34 (current version at MASS. ANN. LAWS ch. 156C §§ 1–69 (LexisNexis 2005)).

82. Michigan Limited Liability Company Act, 1993 Mich. Pub. Acts 138–171 (current version at MICH. COMP. LAWS SERV. §§ 450.4101–450.5200 (LexisNexis 2001)).

83. Minnesota Limited Liability Company Act, 1992 Minn. Laws 1185–1288 (current version at MINN. STAT. ANN. §§ 322B.01–960 (West 2004)).

84. Mississippi Limited Liability Company Act, 1993 Miss. Laws 215–50 (current version at MISS. CODE. ANN. §§ 79-29-101–79-29-1204 (2001 & Supp. 2006)).

85. Missouri Limited Liability Company Act, 1993 Mo. Laws 965–1011 (current version at MO. ANN. STAT. §§ 347-010–347-740 (West 2001 & Supp. 2006)).

86. Montana Limited Liability Company Act, 1993 Mont. Laws 269–312 (current version at MONT. CODE ANN. §§ 35.8.101–35.8.1307 (2005)).

87. Limited Liability Company Act, 1993 Neb. Laws 333–442 (current version at NEB. REV. STAT. §§ 21-2601–21-2653 (1997)).

88. Nevada Limited Liability Company Act, 1991 Nev. Stat. 1292–1319 (current version at NEV. REV. STAT. §§ 86.011–86.590 (2005)).

89. Limited Liability Company Act, 1993 N.H. Laws 323–65 (current version at N.H. REV. STAT. ANN. §§ 304-C:1–304-C:85 (LexisNexis 2005)). The vote is unavailable; an unrecorded voice vote was taken.

90. New Jersey Limited Liability Company Act, 1993 N.J. Laws 1215–52 (current version at N.J. STAT. ANN. §§ 42:2B-1–42:2B-70 (West 2004 & Supp. 2006)).

Final Passage of Initial LLC Act				
State	**House**		**Senate**	
	Yea	**Nay**	**Yea**	**Nay**
New York[92]	146	0	60	0
North Carolina[93]	94	3	40	0
North Dakota[94]	78	3	48	0
Ohio[95]	95	0	33	0
Oklahoma[96]	88	7	44	2
Oregon[97]	47	12	26	3
Pennsylvania[98]	199	0	49	0
Rhode Island[99]	69	0	43	0
South Carolina[100]				
South Dakota[101]	62	2	35	0
Tennessee[102]	91	6	30	0
Texas[103]			31	0
Utah[104]	63	0	24	0

91. Limited Liability Company Act, 1993 N.M. Laws 2753–2860 (current version at N.M. STAT. ANN. §§ 53-19-4–53-19-63 (2003 & Supp. 2005)).

92. New York Limited Liability Company Law, 1994 N.Y. Laws 3240–3324 (current version at N.Y. [LTD. LIAB. CO.] LAW §§ 34-101–34-1403 (McKinney 2006)).

93. North Carolina Limited Liability Company Act, 1993 N.C. Sess. Laws 1080–1147 (current version at N.C. GEN. STAT. ANN. §§ 57C-1-01–57C-10-07 (2005)).

94. Limited Liability Company Act, 1993 N.D. Laws 390–497 (current version at N.D. CENT. CODE §§ 10-32-01–10-32-156 (2005)).

95. Limited Liability Company Act, 1994 Ohio Laws 634–846 (current version at OHIO REV. CODE ANN. §§ 1705.01–1705.58 (West 1994 & Supp. 2006)).

96. Oklahoma Limited Liability Company Act, 1992 Okla. Sess. Laws 483–507 (current version at OKLA. STAT. ANN. tit. 18, §§ 2000–2060 (West 1999 & Supp. 2006)).

97. Oregon Limited Liability Company Act, 1993 Or. Laws 435–60 (current version at OR. REV. STAT. §§ 63.001–63.990 (2005)).

98. Limited Liability Company Act, 1994 Pa. Laws 703–73 (current version at 15 PA. STAT. ANN. §§ 8901–8998 (West 1995 & Supp. 2006)).

99. Rhode Island Limited Liability Company Act, 1992 R.I. Pub. Laws 1108–50 (current version at R.I. GEN. LAWS §§ 7-16-1–7-16-75 (1999 & Supp. 2005)).

100. South Carolina Limited Liability Company Act, 1994 S.C. Acts 4856–4919 (current version at S.C. CODE ANN. §§ 33-44-101–33-44-1208 (2006)). The vote is unavailable; an unrecorded voice vote was taken.

101. Limited Liability Company Act, 1993 S.D. Sess. Laws 535–67 (current version at S.D. CODIFIED LAWS §§ 47-34-1–47-34-59 (2000 & Supp. 2003)).

102. Tennessee Limited Liability Company Act, 1994 Tenn. Pub. Acts 654–754 (current version at TENN. CODE ANN. §§ 48-249-101–48-249-1133 (Supp. 2005)).

103. 1991 Tex. Gen. Laws 3161–3236 (current version at TEX. REV. CIV. STAT. ANN. art. 1528n, §§ 1.01–11.07 (Vernon 2003 & Supp. 2006)). No vote was recorded in the Texas House of Representatives.

Final Passage of Initial LLC Act				
State	**House**		**Senate**	
	Yea	**Nay**	**Yea**	**Nay**
Vermont[105]				
Virginia[106]	96	0	35	1
Washington[107]	91	0	46	3
West Virginia[108]				
Wisconsin[109]	98	0	32	0
Wyoming[110]	58	33	24	0

The results are somewhat astounding. Among the states for which votes were recorded, the average affirmative vote on the initial LLC statute was 97%. Twenty of the states and the District of Columbia had a unanimous vote on the initial LLC statute. In only three states were the total "no" votes in excess of 10%.[111] Of eighty-eight chamber votes for which a recorded roll call is available, there was unanimous approval in sixty-two of the votes, an astonishing rate of 70.5%.

Now it is possible that such lopsided legislative votes could have been the product of an intense debate, over the course of which virtually every mind in each legislative body was convinced of the merit of the proposed legislation. Such is the deliberative model of the legislative process. We would like to think that the legislatures of our states occasionally operate in this classically deliberative manner. But we are in this instance unconvinced that this was such a case. The record simply does not reflect an in-depth consideration of the question presented. Rather, the limited legislative history resources of the

104. Utah Limited Liability Company Act, 1991 Utah Laws 991–1006 (current version at UTAH CODE ANN. §§ 48-2c-101–48-2c-1902 (2002 & Supp. 2006)).

105. 1996 Vt. Acts & Resolves 567–701 (current version at VT. STAT. ANN. tit. 11, §§ 3001–3162 (1997 & Supp. 2005)). The vote is unavailable; an unrecorded voice vote was taken.

106. Virginia Limited Liability Company Act, 1991 Va. Acts 212–28 (current version at VA. CODE ANN. §§ 13.1-1000–13.1-1080 (2006)).

107. 1994 Wash. Sess. Laws 1018–73 (current version at WASH. REV. CODE ANN. §§ 25.15.005–25.15.902 (West 2005 & Supp. 2006)). The Senate amended the Act, and the House concurred at a vote of 87-0.

108. West Virginia Limited Liability Company Act, 1992 W. Va. Acts 305–57 (current version at W. VA. CODE ANN. §§ 31B-1-101–31B-13-1306 (LexisNexis 2003 & Supp. 2006)). The vote is unavailable; an unrecorded voice vote was taken.

109. 1993 Wis. Sess. Laws 708–74 (current version at WIS. STAT. ANN. §§ 183.01–183.1305 (West 2002 & Supp. 2005)).

110. Wyoming Limited Liability Company Act, 1977 Wyo. Sess. Laws 537–49 (current version at WYO. STAT. ANN. §§ 17-15-101–17-15-144 (1999)).

111. Kansas, 78.4% positive vote among two chambers; Oregon, 82.9% positive vote among two chambers; and Wyoming, 71.3% positive vote between two chambers.

states support the conclusion that the debate simply did not happen, not the conjecture that an unrecorded debate occurred and all were convinced.

Given the lack of legislative history resources in the states, the only information we have available is anecdotal. But in this case the anecdotal evidence is telling.

In our home state of Kentucky, the recollections of the participants suggest that no significant debate occurred over the revenue implications of the bill,[112] the committee assignments were inconsistent with a recognition that a discussion was appropriate,[113] and the bill lacked the "fiscal statement" which would have been attached to the record had the bill been perceived as having any revenue or spending implications.[114]

Indeed, the record is silent as to any state having addressed in any meaningful way the revenue implications of its proposed LLC statute. Looking beyond the official record, we made inquiries of various practicing attorneys and academics involved in the process of drafting and seeing through to the adoption of the various LLC acts. As observed by one practitioner from a Midwest state:

> I can confirm that from my perspective as chair of the . . . State Bar Association's LLC Committee, the . . . Legislature neither considered nor appreciated the tax or liability consequences of adopting the . . . LLC Act. The

112. The Republican co-sponsor of the legislation remembers that the revenue implications were discussed. The Democratic co-sponsor does not remember any discussion of the revenue implications of the bill. Jim Jordan, *Limited Liability's Unlimited Appeal*, LEXINGTON HERALD-LEADER, Feb. 5, 2003, at A1. Former Governor Patton, who was the Lieutenant Governor at the time the LLC bill was passed, stated that the LLC bill "sort of slid in under the radar." *Id*.

113. The bill creating the Kentucky LLC was referred to the Committee on Business Organizations and Professions and to the Rules Committee in the Senate, and to the Judiciary Committee in the House. In neither chamber was the bill referred to the respective Committee on Appropriations and Revenue. Kentucky Legislature Homepage, Final Legislative Record, Senate Bill 184 (1994), http://www.lrc.state.ky.us/recarch/94rs/bills/sb184.htm (last visited Nov. 12, 2006). However, measures which have any revenue implications are routinely referred to the Committees on Appropriations and Revenue. KY. HOUSE R. P. 40 (2006), *available at* http://www.lrc.ky.gov/house/hserules06.pdf; KY. SENATE R. P. 40 (2006), *available at* http://www.lrc.ky.gov/senate/senrules06.pdf.

114. Under the rules of the Kentucky Legislature, a proposed statute can be the subject of a fiscal impact statement. KY. HOUSE R. P. 52 (2006) *available at* http://www.lrc.ky.gov/house/hserules06.pdf; KY. SENATE R. P. 52 (2006), *available at* http://www.lrc.ky.gov/senate/senrules06.pdf. This statement is designed to predict the fiscal implications of a change in a statute. A fiscal impact statement is prepared at the request of a sponsor of a bill or the chair of a relevant committee. *Id*. In the case of the LLC bill, a fiscal impact statement was prepared, but it dealt only with the cost of reprogramming computers in the office of the Secretary of State, not with the revenue implications of creating the LLC form.

> . . . Legislature, in order to protect the innocent and the dumb, does not keep a legislative history.[115]

A respected authority in this area from an Atlantic seaboard state, in response to the question "What consideration was given in your state at the time your LLC Act was adopted to the possible revenue implications of the act," said "It was not considered."[116]

V. THE RISK SHIFTING DEBATE THAT WAS BARELY HELD

Notwithstanding occasional protests to the contrary, limited liability does provide societal benefits by promoting capital formation without the supervisory expenses incident to personal liability.[117] Still, the risk shifting possibilities of the creation of new limited liability entities (LLEs) does not appear to have been doubted except within the context of professional, particularly legal, firms.[118] One area in which we have not seen evidence of an unwarranted shift in risk is in the area of tort claims. Tort claimants are almost by definition involuntary creditors, and they do not have the option of selecting between the well-capitalized LLC, the thinly capitalized corporation, or the judgment-proof individual as their debtor. The debates on the adoption of the LLC are silent as to the risk-shifting that could take place with the expanded use of the new structure.[119] We have seen the traditional law of piercing the corporate veil applied to LLCs,[120] and we have seen the expansion of statutory

115. Letter to Thomas E. Rutledge (May 25, 2005) (copy on file with Thomas E. Rutledge). Name of state not included in order to protect the anonymity of the speaker.

116. Telephone Interview with Thomas E. Rutledge (Feb. 17, 2006). Name of authority not included in order to protect the anonymity of the speaker.

117. *See, e.g.*, FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 40–62 (1991); Frank H. Easterbrook & Daniel R. Fischel, *Limited Liability and the Corporation*, 52 U. CHI. L. REV. 89, 93–97 (1985). *But see* Richard A. Booth, *Limited Liability and the Efficient Allocation of Resources*, 89 NW. U. L. REV. 140, 144, 147 (1994).

118. *See generally* Susan Saab Fortney, *Professional Responsibility and Liability Issues Related to Limited Liability Law Partnerships*, 39 S. TEX. L. REV. 399 (1998); Susan Saab Fortney, *Seeking Shelter in the Minefield of Unintended Consequences: The Traps of Limited Liability Law Firms*, 54 WASH. & LEE L. REV. 717 (1997); Robert R. Keatinge, *The Floggings Will Continue Until Morale Improves: The Supervising Attorney and His or Her Firm*, 39 S. TEX. L. REV. 279 (1998); N. Scott Murphy, *It's Nothing Personal: The Public Costs of Limited Liability Law Partnerships*, 71 IND. L.J. 201 (1995).

119. *See, e.g.*, R. Bruce Thompson II, *The Creation of North Carolina's Limited Liability Corporation Act*, 32 WAKE FOREST L. REV. 179, 187 (1997) ("The NCBA's choice of liability alternative number one was based on the experience of other states. The only opposition to LLC legislation in other states came from the plaintiffs' bar."). An interesting debate on this issue appears in Larry E. Ribstein & Mark A. Sargent, *Check-the-Box and Beyond: The Future of Limited Liability Entities*, 52 BUS. LAW. 605, 641–645 (1997).

120. STEPHEN B. PRESSER, PIERCING THE CORPORATE VEIL § 2:55 n.7 (2006); Rebecca J. Huss, *Revamping Veil Piercing for All Limited Liability Entities: Forcing the Common Law Doctrine Into the Statutory Age*, 70 U. CIN. L. REV. 95, 119–22 (2001); *see* Northern Tankers

exceptions to the rule of limited liability.[121] There has been no showing that making limited liability more broadly available increases the possibility (likelihood) that the debtor will be a thinly capitalized business entity.[122] We

(Cyprus) Ltd. v. Backstrom, 967 F.Supp. 1391, 1398–1409 (D. Conn. 1997) (applying alter ego theory in the context of, among other points, intermingling of assets, common ownership, inadequate capitalization, and failure to observe corporate formalities, the veils of numerous entities, including LLCs, were pierced); Mills v. Webster, 212 B.R. 1006, 1007, 1009–10 (Bankr. M.D. Fla. 1997) (finding that the veil of the LLC was not pierced); Ditty v. Checkrite, Ltd., Inc., 973 F.Supp. 1320, 1335–36 (D. Utah 1997) (finding that the veil of the LLC was not pierced); Steven C. Bahls, *Application of Corporate Common Law Doctrines to Limited Liability Companies*, 55 MONT. L. REV. 43 (1994); J. William Callison, *Rationalizing Limited Liability and Veil Piercing*, 58 BUS. LAW. 1063, 1067 (2003); Debra Cohen-Whelan, *Individual Responsibility in the Wake of Limited Liability*, 32 U.S.F. L. REV. 335, 348–54 (1998); Eric Fox, *Piercing the Veil of Limited Liability Companies*, 62 GEO. WASH. L. REV. 1143, 1144 (1994); Robert B. Thompson, *The Limits of Liability in the New Limited Liability Entities*, 32 WAKE FOREST L. REV. 1, 1 (1997).

121. *See, e.g.*, KY. REV. STAT. §§ 138.448(1), 139.185, 141.340(3) (LexisNexis 2003 & Supp. 2005) (imposing upon the managers of a manager-managed LLC and upon the members of a member-managed LLC joint and several liability for, respectively, gasoline and special fuels taxes, sales and use taxes and withholding taxes, each with a retroactive effective date of July 15, 1994). *See generally* Thomas E. Rutledge, *Limited Liability (or Not): Reflections on the Holy Grail*, 51 S.D. L. REV. 417 (2006) (reviewing statutory exceptions to the otherwise available rule of limited liability); Allan G. Donn, *Is the Liability of Limited Liability Entities Really Limited?*, American Bar Association Continuing Legal Education Presentation (Feb. 2, 2006) (surveying protection of managers and owners of an entity against liability arising from claims against the organization or its co-owners).

122. It needs to be recognized, however, that expansions in limited liability forms have occasionally been accompanied by measures that increase protections for involuntary creditors. In 2000, in connection with the adoption of rules sanctioning the use of LLCs, LLPs, and PSCs by Kentucky attorneys, KY. SUP. CT. R. 3.022(f) (2000), the Kentucky Supreme Court adopted rules requiring that firms so organized maintain minimum amounts of malpractice insurance or other assets available to satisfy injured clients. KY. SUP. CT. R. 3.024 (2000); *see also* Thomas E. Rutledge & Douglas C. Ballantine, *Kentuck[y] Supreme Court Considers Rule Permitting LLCs/LLPs/PSCs*, LLC ADVISOR (August 20, 1999); James C. Seiffert et al., *Kentucky Supreme Court Approves the Practice of Law in Limited Liability Entities*, KY. BAR ASSOC. BENCH & BAR, at 53 (2000) (discussing adoption of KY. SUP. CT. R. §§ 3.022, 3.024 and their implications). Similar rules have been adopted in other states. *See generally* COLO. R. CIV. P. 265I.A. (2006); IND. ADMISSION & DISCIPLINE R. 27(h) (2006); MASS. SUP. CT. R. 3:06(3) (2006); OHIO SUP. CT. R. § III (2006); WIS. SUP. CT. R. 20:5.7(b)(2004); Sheldon I. Banoff & Steven F. Pflaum, *Limited Liability Legal Practice: New Opportunities and Responsibilities for Illinois Lawyers*, 17 CHI. B. ASS'N. REC. 37 (2003). *See also* Anthony E. Davis, *Special Issue Institutional Choices in the Regulation of Lawyers: Article and Response: Professional Liability Insurers as Regulators of Law Practice*, 65 FORDHAM L. REV. 209, 211, 216–220 (1996) (arguing that by denying coverage for activities that, with proper planning and caveats, are permitted by the disciplinary rules, such as conflicts of interest, office- and cost-sharing, and activities undertaken as the officer or director of a client, insurers preclude attorneys from engaging in particularly problematic behavior). *But see* Charles Silver, *Professional Liability Insurance as Insurance and as Lawyer Regulation: Response to Davis*, 65 FORDHAM L. REV. 233 (1996) (arguing that while Davis may be correct as to the effect of limitations on coverage, he is

need as well to recognize the minimal likelihood of reporting, either in the press or in published rulings, of the undoubted situations in which a worthy tort claimant has dropped a claim in the face of a judgment-proof tortfeasor, the burdens of waging an action to pierce the veil, and the possibility (likelihood) of a bankruptcy filing further delaying or entirely precluding any actual recovery.

VI. THE REVENUE QUESTIONS THAT ESCAPED DEBATE

In retrospect, it seems almost irresponsible of the various state legislatures to have passed their LLC statutes into law and then continued to update those statutes (conform them to) post Check-the-Box without exploring the revenue implications of the decision.[123] At the same time, the various state revenue commissions' failure to appreciate the consequences of Check-the-Box and the single-member LLC (SMLLC) needs to be highlighted, as it was upon their expertise that the state legislatures relied.[124] One of the three essential failures of the reform process in the United States has been that "social costs have been

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in error in believing that coverage limitations are put in place for reasons of professional regulation as contrasted with generally applicable underwriting principles). Malpractice coverage is at times also required in the medical community. *See* American Medical Association, *Liability Insurance Requirements*, http://www.ama-assn.org/ama/pub/category/4544.html. The AMA identifies Colorado, Connecticut, Florida, Georgia, Kansas, Massachusetts, Pennsylvania, Rhode Island and Wisconsin as mandating malpractice coverage for certain professions, with California, Missouri, Arizona, and Indiana having statutes mandating insurance coverage for admission to certain hospital privileges. *Id.* These statutes are not all limited in scope to medical doctors. *Id*. For example, the Connecticut mandatory insurance statute extends to osteopaths, chiropractors, nature therapists, and podiatrists; the Georgia statute appears to be limited to doctors of optometry; and the Kansas statute encompasses pharmacists, physicians, podiatrists, optometrists, physical therapists, certified nurse anesthetists, and dentists. *Id.*

123. ADMINISTRATION OF GOVERNOR. PAUL E. PATTON, SECURING KENTUCKY'S FUTURE 48 (2003) ("In 1994 the legislature authorized the LLC form of business organization in Kentucky and created the largest loophole in the history of our tax code.") This statement is at best hyperbole. To the extent the revenue "loss" was based on the SMLLC, the "loophole" arose in 1997 out of actions of the IRS and the subsequent decision of Kentucky to allow the formation of single member LLCs. Prior revenue loss was limited to entities formed as LLCs (exempt from license tax) that would have otherwise been organized as corporations (subject to the license tax) and not as partnerships, limited partnerships, or unincorporated divisions. Further revenue "loss" can as well be ascribed to the fact that Kentucky applied a multi-factor analysis to the apportionment of income of corporations (property, payroll, and sales, with sales double weighted) and a single factor gross receipts analysis to multi-state structures taxed as partnerships. This obvious planning opportunity pre-existed the LLC and LLP.

124. "Certain states are out-and-out aggressive. But in most, you can drive a Mack truck through the revenue department and no one will notice. They're often clueless about how to question our tax planning strategies and techniques." Ian Springsteel, *State Tax Audit 1998*, CFO MAGAZINE, June 1, 1998 (quoting an unnamed oil company senior tax planner), *available at* http://www.cfo.com/article.cfm/2990445/c_ 3046554?f= magazine_coverstory (last visited Nov. 12, 2006).

generated without any demonstrable and compensating social benefit[s]."[125] To the extent that it took place, the reallocation of the tax burden was a substantial and non-consensual transfer of value which occurred without meaningful debate.[126]

LLCs and LLPs, each created during the 1990s and generally expected to provide pass-through tax classification and limited liability for owners of small businesses, have become an unintended means of narrowing the tax base in many states.[127] LLCs have reduced state tax revenues in part because states did not modernize their tax legislation to accommodate the new form of business entity. The states presumed that individuals subject to the personal income tax would own LLCs, so that the income would be pass-through and taxed at the individual level. Anecdotal evidence supports the conclusion that these situations are far and away the most common applications of the LLC. In fairness to the debate, it must be recognized that many common applications of the LLC have not had a negative consequence upon the state fisc. For example, for reasons of taxation as well as professional tradition, law and accounting firms have traditionally been organized as general partnerships.[128] Subsequent to the enactment of LLC (and LLP) legislation, these professional practices have reorganized into a new form affording limited liability. The tax consequence of the reorganization was zero—the business was taxed exclusively at the owner level both before and after.[129]

Another common business is the small manufacturing concern owned by two generations of a family. Traditionally, the operating company was organized as a corporation, and typically an S-corporation election was in place. If the family owned the realty on which the company operated, it was typically owned by the family in a separate partnership and leased to the

125. Allan Walker Vestal, *". . . Drawing Near the Fastness?"—The Failed United States Experiment in Unincorporated Business Entity Reform*, 26 J. CORP. L. 1019, 1019–20 (2001). This is not to say that arguments cannot be made that LLCs generate social benefits. *See* Callison, *supra* note 4, at 966–67 (discussing social benefits of the LLC form advanced by Professor Jonathan Macey). It is only to say, as Professor Macey observed, that such arguments were not before the legislatures as they enacted the LLC statutes. *Id.*

126. Vestal, *supra* note 125, at 1028. Under this classically liberal formulation, private wealth accumulation through a business not subject to an entity level tax results in a value transfer to the owners equal to the differential in the overall tax liability between a single and a double tax system. *See id*. Conversely, it may be argued that a double-level system results in an excess extraction of value. This debate will not be either held or resolved here.

127. William F. Fox, *The Ongoing Evolution of State Revenue Systems*, 88 MARQ. L. REV. 19, 31 (2004).

128. *See* Thomas E. Rutledge, *The Place (If Any) of the Professional Structure in Entity Rationalization*, 58 BUS. LAW. 1413, 1413–16 (2003).

129. This statement is true at the federal level and is accurate at the state level conditioned on the firm doing business in a state or states where there is no entity level tax on the LLC or LLP into which the general partnership is reorganized.

corporation on a triple-net basis. Through judicious adjustments to the lease rates, the earnings of the corporation would be held down while providing an income stream to the family. Even if the corporation had not made an S-corporation election, its taxable earnings would be further reduced through deductible bonuses to the shareholder employees. While, conceptually, the earnings of the corporation, absent an S-corporation election, would be subject to two levels of taxation, the reality is that such businesses would have few if any taxable earnings. The tax distinction between this structure and a pair of LLCs is not appreciable.

At the same time, it must be acknowledged that the LLC, in both its multi- and single-member forms, as utilized by large corporations, has become an effective means of state tax planning.[130] Income earned by an LLC owned by a single out-of-state member may be taxable under a state's corporate income tax, but there are legitimate questions regarding whether a company with no presence other than owning another company that has nexus can be subject to a state's corporate income tax. In other instances the "loophole" was created by the state's decision to apply its tax code in an illogical manner. For example, Kentucky did not impose the corporate license tax on LLCs, even those that were for federal and state income tax purposes classified as corporations, and allowed those classified as partnerships to apportion income using a single factor sales formula.[131]

It may be that some of the academic proponents of the reforms of the 1990s believed that the taxation of business entities is "irrational,"[132] but the argument was not made in Frankfort, and we have found no evidence that it was made in the other state capitals. Indeed, one can only imagine that had the

130. Examples of methods employed appear at Figures 2 and 2A of SECURING KENTUCKY'S FUTURE, *supra* note 123. Tax planning with LLCs has not been restricted to large corporations or to Kentucky. *See, e.g.*, Colin McDonald, *Winnebago Windfall*, MISSOULIAN, Oct. 16, 2004, at A1 (describing use of LLCs to own recreational vehicles purchased out of state to avoid sales tax).

131. According to a former Kentucky Revenue Cabinet official who has asked to remain nameless, the tax authorities never made an initial decision to exempt the LLC from the license tax. Interview with Anonymous Kentucky Revenue Cabinet official (May 2006). Rather, as the LLC Act was being considered, they assumed, without investigation, that LLCs would pay the tax. *Id*. Only after passage of the LLC Act did they realize the LLC did not fall within the license tax statute. *Id*.; *see also* Fox, *supra* note 127, at 31–32; Rutledge & Vestal, *supra* note 6 at 27 n.35.

132. *See, e.g*., Dale A. Oesterle, *Subcurrents in LLC Statutes: Limiting the Discretion of State Courts to Restructure the Internal Affairs of Small Business*, 66 U. COLO. L. REV. 881, 881 (1995) ("Some reformers . . . are motivated by a perception that a corporate level income tax is irrational."); Anthony P. Polito, *Advancing to Corporate Tax Integration: A Laissez-Faire Approach*, 55 S.C. L. REV. 1, 2 (2003) ("The classical double taxation system applicable to corporations has been flawed for decades. It has introduced serious allocative distortions into the economy. Its effect on the distributive justice of the tax burden is most charitably described as uncertain, but might also be described as arbitrary and capricious.").

argument been framed in those terms, and not simply in terms of the move being good for business, the measures would hardly have enjoyed the lopsided margins by which they were passed.

VII. TOWARD A REVENUE-DRIVEN RE-EXAMINATION

It is a fair assessment that the states adopted the LLC form without extensive debate about the policy choices in these acts, and certainly without careful consideration of the revenue implications of the reform. It would be a myth to assert that the business law reforms of the 1990s were the product of deliberation in the various states.

In general, the LLC legislative process was anything but deliberative,[133] and in many state legislatures the question was reduced to: "is it good for business?" Well, if by "good for business" (a prospective supposition) one means "is an option adopted by business" (a retrospective observation), then *of course* the elimination of entity-level taxation while maintaining limited liability is good for business. Let's see, on one hand I may pay more taxes; on the other hand I may pay fewer taxes.[134]

If one uses the "if we build it, they will come" test, then the LLC has been a smashing success; extraordinarily good for business. The history in Kentucky is illustrative. In 1994, the year the LLC option became available, the Secretary of State received articles of organization for 415 LLCs while 8,406 new corporations were formed.[135] The lines crossed in 2001, with LLC filings exceeding corporations.[136] In 2004 there were 14,839 LLCs formed against only 6,685 corporations.[137]

133. This is not to suggest that there was a lack of diligence and effort in the various drafting committees, often made up of dedicated attorneys who devoted unbillable time to crafting the state acts as submitted to the state legislatures. But their task was to draft a product that answered the question "If our state is to have an LLC act, how should it read?" Their task was not to determine "What are the broad social implications of the LLC to this state?" *See also* Mark I. Weinstein, *Limited Liability in California 1928–31: It's The Lawyers*, 7 AM. L. & ECON. REV. 439 (2005) (discussing the adoption in 1931 of limited liability for corporations organized or doing business in California and the role in that adoption of members of certain elite California law firms).

134. As observed by Arthur Godfrey, "I am proud to be paying taxes in the United States. The only thing is—I could be just as proud for half the money." IRS.gov, Tax Quotes, http://www.irs.gov/newsroom/article/0,,id=110483,00.html (last visited Nov. 12, 2006).

135. Kentucky Secretary of State, Business Services, Annual Business Filings Statistics, http://sos.ky.gov/business/filings/statschart.htm (last visited Nov. 12, 2006); *see also* Jordan, *supra* note 112.

136. In that year, 7,386 LLCs were formed against 7,260 corporations. Kentucky Secretary of State, *supra* note 135.

137. *Id*. In 2005, the year in which "Tax Modernization" went into effect, 6,943 domestic corporations were formed against 14,028 LLCs. *Id.*

But, of course, the fact that the creation of LLCs is good for business in the sense that the new form is popular is beside the point. Indeed, the very popularity of the LLC form may indicate that, in creating the form, the legislature "fail[ed] to strike an appropriate balance between private gain and social benefit."[138] Others have suggested that, at minimum, the case for the economic efficiency of the extension of limited liability requires much more information than was available when the legislative decisions were made.[139]

If, as Bill Callison has suggested, success came too easily to the proponents of the LLC,[140] one might wonder whether there is a weakness in the new structure that might cause it to be re-examined and possibly changed. It is not an easy possibility to advance that the tidal wave of LLC adoptions might be undone. But the failure to meaningfully discuss the policy implications of the limited liability extension, the fiscal implications of flow-through taxation treatment, and the creation of dissonance between popular conceptions and the law[141] may make the façade weaker than it at first appears.

If there is a key to the weakness of the LLC façade, it is the failure to address the fiscal implications of the newly available business forms. The record fails to demonstrate a conscious examination of the consequences of making the LLC available in choice of entity decisions and the impact of altered decisions upon the fisc. Today a retrospective assessment of those impacts is, if anything, even more difficult to undertake. Assumptions must be made as to which LLCs would have been organized at all, rather than remaining sole proprietorships or divisions, as general or limited partnerships, and or as corporations. From the latter group, we need to assess (guess) as to which would have elected S-corporation status, an undertaking made all the more difficult by the continued relaxation of the S-corporation rules over the last decade. One must predict, in the absence of the LLC option, what business activities would have left the jurisdiction to find more favorable treatment. And to be fair, one must compare the extended treatment of economic activity in the LLC form and the corporate form by taking the comparison beyond the firm to the members or shareholders, and accounting for different tax rates.

138. Vestal, *supra* note 125, at 1029.

139. *See* William W. Bratton & Joseph A. McCahery, *An Inquiry into the Efficiency of the Limited Liability Company: Of Theory of the Firm and Regulatory Competition*, 54 WASH. & LEE L. REV. 629 (1997).

140. Callison, *supra* note 4, at 953–54.

141. While this dissonance may be an issue with respect to the extension of limited liability to the partnership and the limited partnership through the LLP and LLLP, the authors acknowledge that this is less the case with the LLC, as it lacked an organizational precedent, and its very name placed third parties on notice of its most relevant organizational aspect.

One can imagine policy makers in good economic times forgoing such a horribly complex prediction[142] as to the fiscal impact of the LLC form. Economic times were good when the LLC statute was enacted nationwide in the early 1990s, and one can imagine the policy makers convincing themselves that an ever-expanding economic pie would mask any cost of the LLC form. After all, it was good for business.

The error began to unravel with the economic downturn starting in 2001. The effect of the economic situation on state budgets is significant and continuing. Like many other states, Kentucky faced a severe shortfall in revenue. The budget shortfall ran to over $144 million in FY 2003 on an original revenue projection of just under $7 billion, or about 2%.[143] For FY 2004 the revenue shortfall was projected to be $365 million on an original revenue projection of $7 billion, or about 5%.[144] The fiscal 2005 deficit was predicted to be $710 million.[145]

The Commonwealth was not alone in this situation.[146] One estimate was that the aggregate of state revenue shortfalls would be $29 billion in fiscal 2003 and $82 billion in fiscal 2004.[147]

Many factors contributed to the shortfalls, and the economic situation in Kentucky was only a part of the broader, discouraging economic picture. Some of the factors can be ascribed to the business cycle, to the macro-economics of a post 9/11 world, or to the policies of the Bush administration, depending upon one's political orientation. But one of the factors which

142. "I never make predictions, especially about the future." DAVID BRIN, THE TRANSPARENT SOCIETY 263 (1998) (quoting Yogi Berra). "There are two classes of people who tell what is going to happen in the future: Those who don't know, and those who don't know they don't know." Steve Coll, *The Long Shadow of Black Monday*, WASH. POST, Feb. 28, 1988, at H9 (quoting John Kenneth Galbraith).

143. ADMINISTRATION OF GOVERNOR PAUL E. PATTON, AN ASSESSMENT OF KENTUCKY'S FISCAL CONDITION 5B, Table 1 (2002).

144. *Id.*

145. Governor Ernie Fletcher, 2004 Budget Address to Kentucky Legislature (Jan. 27, 2004), *available at* http://governor.ky.gov/multimedia/speeches/budgetad2004.htm (last visited Nov. 12, 2006).

146. Speaking as of April 14, 2005:

> As lawmakers craft their budgets for next fiscal year [July 1- June 30], just over half the states report facing another round of shortfalls. Twenty-six states report fiscal FY 2006 gaps. In 17, the gaps are above 5 percent of general fund spending. The cumulative gap reached nearly $27 billion, but has declined from that level as lawmakers have taken actions to close the shortfalls.

Press Release, National Conference of State Legislatures, *States Still Struggling to Keep Budgets Balanced* (Apr. 14, 2005), *available at* http://www.ncsl.org/programs/press/2005/pr050412.htm.

147. This is the figure developed by the National Association of State Budget Officers, with information from the National Governors' Association. Website of the National Association of State Budget Officers, The Perfect Storm, http://www.nasbo.org/extras/extrasPerfect.php (last visited Nov. 12, 2006).

contributed to the state revenue shortfall is structural: the exclusion from taxation of business activities undertaken in LLC form that would previously have been taxed at the effectively higher tax system applied to corporations.[148]

What is the extent of the shortfall caused by the LLC form? The same analytical complexity which prodded policy makers to assume away the cost and skip the calculation in good times may be expected to prod policy makers in difficult times to use easy (and inaccurate) proxies.[149]

In Kentucky, corporate tax collections, comprising the corporate income and the corporate license taxes, can be easily tracked over time, and prior to the 2005 Tax Modernization Plan, were trending down. From the 1990 level of $380.6 million,[150] amounting to 9.33% of total tax revenues, corporate tax collections dropped to $332.3 million in 2002[151] for 4.45% of total tax revenues. Such a drop appears interesting but not compelling until one realizes that the decline in revenue occurred even as the tax rate was increasing.[152] Governor Patton observed that if corporate tax receipts had remained at 10% of the state budget, the state would have had additional revenues of $359 million.[153]

Could it be argued that the unexamined cost of the LLC form to Kentucky was $359 million simply on the basis of the diminution of corporate tax receipts as a percentage of the general fund? Of course not; such an argument

148. This is a subset of all activities undertaken through the LLC. *See supra* notes 122–23 and accompanying text.

149. One significant problem is that the state government in Kentucky simply had no reliable estimates for the loss in business tax revenues from the passage of the LLC statutes, and no reliable figures for tax receipts from businesses. *See, e.g.*, Jordan, *supra* note 112, at A1 ("State officials don't know how much business-tax revenue they have lost since the Kentucky Limited Liability Companies Act was passed in 1994. They *think* it's a lot."); *Multiple Taxes: Governor Outlines Tax Modernization Plan*, STATE TAX REV., Feb. 15, 2005, at 5 ("With respect to corporate taxes, the Governor said that 'loopholes' allowing large out-of-state companies to use the limited liability company (LLC) structure to avoid paying tax were neither fair nor responsible."). Furthermore, such estimates fail to address systemic inelastic failures of a sales tax system premised upon a manufacturing economy when applied to a service economy.

150. *See* Commonwealth of Kentucky Comprehensive Annual Financial Report for the Fiscal Year Ended June 30, 1998, at 175 (providing historical figures for 1989 through 1998).

151. *See* Commonwealth of Kentucky Comprehensive Annual Financial Report for the Fiscal Year Ended June 30, 2004, at 174–75 (providing historical figures for 1995 through 2004).

152. In 1990 the maximum corporate tax rate in Kentucky was 7.25% on all income over $250,000. That year the rate was increased to 8.25% on all income over $250,000. KY. REV. STAT. ANN. § 141.040; *see* Jordan, *supra* note 112.

153. *An Assessment of Kentucky's Fiscal Condition*, *supra* note 143, at ii; *Securing Kentucky's Future*, *supra* note 123, at 11. It is worth observing that (former) Governor Patton's statement assumes that the business community should expand at least at the same rate as does the requirement of the state budget. It should be noted that by 2004 corporate tax revenues had rebounded to $452.7 million, comprising 5.71% of total tax revenues. *See* Commonwealth of Kentucky Comprehensive Annual Financial Report for the Fiscal Year Ended June 30, 2004, at 174–75 (providing historical figures for 1995 through 2004).

would be impossible to sustain. But it must be observed that in budgetary matters, when policy makers are pushed to find ways to come to balance, equivalence of numbers all too often substitutes for soundness of analysis. And as a matter of coincidence, the $359 million "LLC shortfall" was almost equal to the $365 million projected FY 2004 budgetary shortfall.

As the attention of legislatures looking for revenue sources falls on the LLC, the divergence between popular conceptions and the law created by the reforms of the 1990s might make a challenge to the continued treatment of the LLC as a pass-through even stronger. In Kentucky, this was made strikingly clear when the Governor addressed the need for tax reform to meet the budgetary shortfall. In suggesting that businesses should be expected to pay an increased part of the tax burden, Governor Patton declared that we need a new business tax model which differentiates between "real partnerships" and LLCs.[154]

Now, the situation in Kentucky was unique because of the manner of application of its bifurcated corporate tax, but its bifurcation illustrates how at least one state made a perhaps illogical decision that unquestionably cost the state tax revenues it would have otherwise received. In addition to a graduated income tax, Kentucky imposed a "license tax" on all corporations.[155] The tax has been interpreted as a tax on the privilege of doing business in the corporate form.[156] On the basis that an LLC's "formation"[157] is distinct from a corporation's "incorporation," the Kentucky revenue authorities determined that the license tax would not apply to LLCs, even those classified for income tax purposes as corporations.[158] The "planning opportunity" identified by the tax attorneys and accountants was obvious—reorganize existing corporations as LLCs. The LLC would continue to be classified as a corporation, so its income tax liability would remain constant.[159] But the business was then exempt from the license tax. If we are to place credence in John Maynard Keynes,[160] we cannot fault those professional counselors who so advised their clients, nor the clients who took advantage of this opportunity.[161] At the same

154. Jordan, *supra* note 112; *see also* Vestal, *supra* note 4, at 888.

155. The license tax has been repealed effective January 1, 2006. Commonwealth of Kentucky, Department of Revenue: Corporation Income Tax, http://revenue.ky.gov/business/corptax.htm (last visited Nov. 12, 2006).

156. Bosworth, Auditor v. Evansville & Bowling Green Packet Co., 199 S.W. 1059, 1062 (Ky. Ct. App. 1918).

157. KY. REV. STAT. ANN. § 275.020 (LexisNexis 2003 & Supp. 2005).

158. Actually, "determined" may go too far in suggesting deliberation.

159. The conversion transactions were structured to satisfy § 368(a)(1)(F).

160. "The avoidance of taxes is the only intellectual pursuit that carries any reward." The Quotations Page; Quotation Details, http://www.quotationspage.com/quote/1346.html (last visited Nov. 12, 2006).

161. "A taxpayer need not arrange its affairs so as to maximize taxes as long as the transaction has a legitimate business purpose." Procter & Gamble Co. v. Comm'r of Internal

time, we must at least question how a state that in 1993 raised 26.1% of its total corporate tax revenue from the license tax could so cavalierly exempt such a range of businesses from its reach.[162]

How might entities which are not "real partnerships" be asked to assume an increased part of the tax burden? Governor Patton suggested that LLCs become subject to the Commonwealth's corporate license tax,[163] or that the entire business tax structure be overhauled to include a "business activities tax."[164] It would have been a relatively simple step, in such a climate, to recover the tax "loss" from the rise of the LLC to apply the license tax to all LLCs that were for purposes of federal income taxation classified as corporations. A similar rule could have applied as well to SMLLCs in which the sole member is a corporation.

Instead, casting a far wider and more finely woven net, in 2005 Kentucky adopted "tax modernization" and, inter alia, subjected almost all limited liability entities to an entity level tax with a limited non-refundable credit to LLC members, partnership partners, and S-corporation shareholders, and eliminated the corporate license tax.[165]

Rev., 961 F.2d 1255, 1259 (6th Cir. 1992). "[T]here is nothing sinister in so arranging one's affairs as to keep taxes as low as possible. Everybody does so, rich and poor; and all do right, for nobody owes any public duty to pay more than the law demands." Comm'r of Internal Rev. v. Newman, 159 F.2d 848, 850–51 (2nd Cir. 1947).

162. In fiscal 1993, corporate tax receipts were $168,061,752, of which $124,255,652 was the corporate income tax and $43,806,100 was the corporate license tax. *See* Kentucky Quarterly Economic and Revenue Report, Annual Edition Fiscal Year 1993:4 at 25.

163. It was estimated that the expansion of the corporate license tax to LLCs would generate only $2.5 million over the two-year budget cycle. It was also predicted by the legislative leaders of both parties that the expansion would probably pass. Tom Loftus & Al Cross, *2000 General Assembly; Patton's Scaled-Back Tax Plan Also in Doubt*, LOUISVILLE COURIER-J., February 26, 2000, at A8. The provision to expand the corporate license tax to LLCs was subsequently included in a tax reform bill. Tom Loftus, *2002 Kentucky General Assembly; House Committee OKs Tax-Relief Bill*, LOUISVILLE COURIER-J., March 21, 2002, at F1. Subsequently, the Legislative Research Commission predicted that the expansion of the corporate license tax to LLCs would generate $4 million to $5 million a year; other estimates place the figure closer to $15 million annually. Marcus Green, *Choosing a Path to Great Form; More Entrepreneurs Favor Limited Liability Companies*, LOUISVILLE COURIER-J., October 28, 2002, at F1. In fact, the tax reform proposal of Governor Patton, presented in the last year of a term tainted by personal scandal of the horizontal nature, was not enacted.

164. The proposal would eliminate the corporate income tax and replace it with a business activity tax based on sales and payroll and would expand the corporate license tax to LLCs. The estimated increase in revenues was $339.6 million. Al Cross, *Patton's Budget Proposal; Legislators: Plan's Complexity is Part of the Problem*, LOUISVILLE COURIER-J., February 6, 2003, at A7.

165. *See generally* Rutledge & Vestal, *supra* note 6, at 26–29. The license tax is repealed for companies whose fiscal years end on or after December 31, 2005. Commonwealth of Kentucky, Department of Revenue: Corporation Income Tax, http://revenue.ky.gov/business/corptax.htm (last visited Nov. 12, 2006).

With economic travail a recurring experience among the states, and many states searching for new revenue sources, what is the worst that could happen in the business entity law arena from the standpoint of the 1990s reformers? Kentucky has changed the pass-through tax status of its domestic LLCs as well as those doing business within its borders.[166] The same fate has befallen domestic and foreign LLPs.[167] Such a move would invite retaliation in the form of actions by other state legislatures to deny pass-through taxation to the business operations of foreign LLCs that are the creations of non-reciprocal states.[168] The entire form could unravel. The same could be done with LLPs.

Could any rational legislature embark upon such a sweeping change without carefully considering the consequences, and having engaged in such a careful analysis, could any rational legislature conclude that the reforms of the 1990s should be unilaterally undone? The irony here is palpable.[169] The herd having been stampeded once based on the "good for business" rationale,[170] it

166. *See* KY. REV. STAT. ANN. § 141.010(24) (2003), as amended by H.B. 272, § 3, including within the definition of "corporation" a foreign LLC as defined in KY. REV. STAT. ANN. § 275.015(6) (LexisNexis 2003 & Supp. 2005).

167. *See* § 141.010(24) (LexisNexis 2003 & Supp. 2005), as amended by H.B. 272, § 3, including within the definition of "corporation" a domestic or foreign limited liability partnership. Domestic and foreign limited partnerships are also classified as corporations. § 141-010(24)(f)–(g).

168. Of course, efforts by any state to differentiate the taxation of domestic and foreign businesses will be subject to challenge under the Commerce Clause. *See, e.g.*, Bacchus Imps., Ltd. v. Dias, 468 U.S. 263 (1984); Boston Stock Exch. v. State Tax Comm'n, 429 U.S. 318 (1977).

169. Adding insult to irony, such an assault on the traditionally accepted pass-through treatment of LLCs may be made, as it has been in Kentucky, as the economy and the various state revenues are seeing a resurgence of strength. *See, e.g.*, National Governors Association/National Association of State Budget Officers, The Fiscal Survey of the States (June 2006), at vii ("Fiscal 2006—much like fiscal 2005—has been a year of stable financial conditions for the states."); National Governors Association/National Association of State Budget Officers, The Fiscal Survey of the States (June 2005), at ix ("The state revenue picture for most states improved dramatically in fiscal 2005, a situation that is expected to continue in fiscal 2006."); National Governors Association/National Association of State Budget Officers, The Fiscal Survey of the States (December 2004), at 1 ("Amid a slowly recovering economy, many states realized slight revenue gains in fiscal 2004. As a result, many states have been able to increase spending and fewer have been forced to cut their already enacted budgets, and the cuts that did occur were smaller than in previous years."); Jack Brammer, *$136.5 Million Surplus Boosts 'Rainy Day' Fund—State Workers' Retirement, Teachers' Insurance Funds Also Will Benefit*, LEXINGTON HERALD-LEADER, July 11, 2006, at A1 ("General Fund tax receipts for fiscal year 2006, which ended June 30, rose by nearly 10 percent for the second year in a row."); *States of Plenty*, WALL ST. J., June 26, 2006, at A14 ("Thanks to the snappy growth of the U.S. economy over the last three years, state treasuries are now overflowing with tax collections.").

170. Here, we are referring to Kentucky's response to the realization that "Tax Modernization" was not good for business and had numerous inequitable consequences. *See, e.g.*, Rutledge & Vestal, *supra* note 6, at 28–29. In 2006, a special legislative session modified the new tax laws to reduce some of the negative consequences to small business. Effective for

could certainly be stampeded again based on the need to balance already decimated budgets.[171]

CONCLUSION: WHERE DO WE GO FROM HERE?

Rather than again adopt a business-organization statute without regard to its policy and revenue implications, we ought to take the time to carefully discuss the form in all its aspects, a task clearly not undertaken with the LLC. We ought to clearly define the policy implications of an expansion of limited liability, and we ought to have a realistic estimate of the revenue effect, if any, of creating a new form that is taxed on a flow-through basis.

Thus presented, legislatures may make informed decisions on creating new business forms and the continued maintenance of the forms already in existence and use. One of us believes the states should adopt a system under which limited liability and entity taxation are linked. What is the rationale for such a system? Limited liability is a private good. It is not a characteristic of a business firm that can be reproduced by bilateral contracts (unless one engages in the mischievous assumption that the firm could contract with all potential tort claimants); it is an attribute which comes from the grace of the citizens organized as the state.[172] As a private good, it should be exchanged for a public benefit;[173] not an ephemeral benefit like the promise that the concession is "good for business," but rather a direct public benefit in the form of taxation of the firm's profits.

The other of us disagrees that the grant of limited liability should be linked to entity level taxation of enterprise profits, noting that the benefits of limited liability are enjoyed not only by the enterprise and its owners, but also by society as a whole in the forms of reduced transactional costs, opportunities for diversification of investment without supervisory costs, and increased tax

tax years beginning on or after January 1, 2007, the new law returns to conformity with federal reporting rules for partnerships, LLCs, and S-corporations, replaces the AMC with a Limited Liability Entity Tax (LLET) with a credit to the owners for LLET against Kentucky personal income tax liability, and an exemption from the LLET for businesses with less than $3 million of annual receipts or gross profits with a phase-in of the LLET if annual receipts or gross revenue are between $3 and $6 million. *See* KY. REV. STAT. §§ 141.010, 141.0205, 141.0401, 141.042, 141.120, 141.200, 141.206, 141.208, *amended by* 2006 Ky. Rev. Stat. & R. Serv. 1107–27 (West).

171. In another context, looking at the extension of limited liability through the LLC form, J. William Callison suggested that "[c]ontinued critical analysis of limited liability can lead to further change . . . state legislatures might require risk mitigation by . . . charging franchise or other taxes." Callison, *supra* note 4, at 980.

172. *See, e.g.*, Ribstein, *supra* note 10.

173. "Taxes, after all, are the dues that we pay for the privileges of membership in an organized society." KEVIN GOLDSTEIN-JACKSON, THE DICTIONARY OF ESSENTIAL QUOTATIONS, 152 (1983) (quoting Franklin Delano Roosevelt).

revenues collected at the level of the enterprise owners in individual taxes.[174] Still, he would not and does not support illogical tax treatments such as the exception from the Kentucky license tax of LLCs classified as corporations for purposes of income taxation.

Efforts have been made to characterize the restructuring efforts of business in responding to the changing business and tax environment as abusive exploitation of "loopholes."[175] Conversely, the planning opportunities existed only because of conscious (although perhaps not entirely well analyzed) decisions of revenue authorities and state legislatures; whether their utilization is/was abusive is debatable. By analogy, if the state imposed a 6% sales tax on all new cars except those that are silver, the state could not credibly object if the roads were full of silver cars and little if any revenue was received from the sales tax on new cars. For many years the LLC has been the silver car. Its owners may awaken to an excise tax on all cars. This is essentially the fate that has befallen the LLC in numerous states.[176] What will happen elsewhere remains to be seen.

174. *See, e.g.*, EASTERBROOK & FISCHEL, *supra* note 117; Easterbrook & Fischel, *supra* note 117; *see also* Rutledge & Vestal, *supra* note 6, at 33–34.

175. *See, e.g.*, Jordan, *supra* note 112; STATE TAX REV., *supra* note 149.

176. *See* Rutledge & Vestal, *supra* note 6, at 26–29.