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Did the Federal Check-the-Box Regulations Open up at State Tax Pandora's Box--A Reflection on State Conformity to the New Federal Classification Scheme of Single-Member LLCs

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Note

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On December 17, 1996, the Treasury Department (Treasury) issued final regulations that drastically changed the legal terrain of entity classification and taxation. These regulations, better known as check-the-box regulations,[1] greatly simplified how certain eligible entities,[2] Limited Liability Companies[3] (LLCs) included, can elect the manner in which they are taxed at the federal level.[4] Furthermore, the regulations clarified the tax treatment of single-member LLCs.[5] With check-the-box regulations in place, single-member LLCs are now taxed as a sole proprietorship,[6] a branch, or a division, de-

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1. Treas. Reg. § 301.7701-3 (1997).

2. In general, eligible entities are business entities that are not classified as corporations. *See* Treas. Reg. § 301.7701-2(b) (1), (3)-(8) (1997).

3. A limited liability company is an unincorporated business form that combines limited liability for all its members with a desirable income tax treatment. *See* ROBERT W. HAMILTON, THE LAW OF CORPORATIONS IN A NUTSHELL § 2.2 (4th ed. 1996). An LLC is formed by filing a document called "articles of organization" with a state official. *Id.*

4. *See* Scott D. Smith, *What Are States Doing on the Check-the-Box Regs?*, 76 TAX NOTES 973, 973 (1997). Effective as of January 1, 1997, the final check-the-box regulations enable eligible entities to be taxed in a manner that they choose—corporation or partnership if they have two or more members, and corporation or sole proprietorship if they have only one member. *See id.* at 975-76.

5. *See* Smith, *supra* note 4, at 976.

6. *See* LARRY R. RIBSTEIN & ROBERT R. KEATINGE, RIBSTEIN & KEATINGE ON LIMITED LIABILITY COMPANIES § 2.03 (1996) (defining a sole

pending on whether the member is an individual or a corporation.[7]

From the perspective of taxpayers, LLCs have become the ideal choice of entity. They provide the benefit of limited liability to all their members with only a single level of tax.[8] Before the promulgation of the new regulations, the Internal Revenue Service (IRS) used the "corporate resemblance" test set forth in the Kintner regulations to determine whether an LLC would be classified as a corporation for federal income tax purposes.[9] Possibly because of the problems inherent in applying this test to one-member entities,[10] single-member LLCs became de facto corporations for federal income tax purposes even though multimember LLCs generally qualified for pass-through taxation.[11] Under

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proprietorship as "a one-person business form, under which the income of the business is simply reported on the owner's [tax] return").

7. *See* Treas. Reg. § 301.7701-3(b)(1)(ii) (1997). The regulations also provide default classification rules if eligible entities do not make an election. If an eligible domestic entity has two or more members, it will be classified as a partnership, but the entity will have no tax identity if it has only one member. *See* Treas. Reg. § 301.7701-3(b)(i)-(ii) (1997). For an explanation of disregarded entities, see *infra* notes 63-69 and accompanying text.

8. KAREN C. BURKE, FEDERAL INCOME TAXATION OF CORPORATIONS AND STOCKHOLDERS IN A NUTSHELL 19 (4th ed. 1996). Partnerships are governed by section 701 of the Internal Revenue Code, which "provides that a partnership is not taxable as an entity, but that the partners individually are liable for income taxes in their separate capacities." PAUL R. MCDANIEL ET AL., FEDERAL INCOME TAXATION OF BUSINESS ORGANIZATIONS 99 (2d ed. 1997). On the other hand, "corporations are taxpaying entities, separate and distinct from their shareholders." *Id.* at 383. See *infra* note 19, describing the manner in which C corporations are currently taxed at the federal level.

9. *See* Treas. Reg. § 301.7701-2 (1993) (as amended in 1983). Under the test, partnerships that more closely resembled corporations would be subject to entity-level taxation. *See* ROBERT W. HAMILTON, CORPORATIONS INCLUDING PARTNERSHIPS AND LIMITED PARTNERSHIPS 149 (5th ed. 1994). For a more detailed discussion of the six-factor test, see *infra* notes 22-30 and accompanying text.

10. *See infra* notes 32-38 and accompanying text.

11. *See* Rod Garcia, *Single-Member LLCs: Basic Entities Raise Complex Problems*, 68 TAX NOTES 142, 142-43 (1996). Garcia characterized the Treasury's acting deputy tax legislative counsel, Michael Thomson, as describing the uncertainty surrounding the tax treatment of single-member LLC as follows:

> [B]ecause the Service hasn't had to rule on a request for passthrough treatment for a one-person LLC, IRS officials aren't convinced that one-member LLCs can overcome the [Kintner] test. Nor . . . are they convinced that one-member LLCs can pass the four-factor test with the same ease and frequency as have LLCs with two or more members.

Id. at 142. Noting Garcia's assumption that if the IRS was not persuaded to treat single-member LLCs as partnerships that one-owner LLCs would be the current federal rules, however, unless a single-member LLC elects to be taxed as a corporation, it is entirely disregarded as an entity separate from its owner.[12]

Unfortunately, the new federal elective classification system is a trap for the unwary because the same classification may not be available at the state level. Indeed, it is unlikely that the states will follow the federal classification scheme in every respect any time soon, if ever.[13] Unfortunately, such uncertainties at the state level will take away some of the positive effect created by the simpler and more efficient federal check-the-box rules.[14]

This Note explores the appropriate tax treatment of single-member LLCs, an issue that has bedeviled tax practitioners since the IRS permitted a Wyoming LLC to be classified as a partnership for federal income tax purposes in 1988.[15] Part I examines the historical and current tax treatment of single-member LLCs under both the federal and state tax laws. Part II discusses the policy implications resulting from the increased use of LLCs on the business, economic, and legal environment. Part III discusses the policy considerations that may discourage state conformity and the possible consequences of nonconformity by the states. Part IV highlights the significant benefits of conformity and encourages states to conform to the federal classification scheme. In addition, Part IV explores alternative methods of taxation states can apply, and recommends both short-term and long-term taxing schemes that may reduce potential revenue loss. Finally, Part IV concludes by urging states to conduct a comprehensive study on the effect of LLCs on their jurisdiction's overall revenue, and to implement a taxing scheme that will strike a balance between the needs of taxpayers in meeting their tax burden and the needs of the

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taxable as corporations, Bernard Wolfman stated: "I find anything but inevitable a result that would have a two-member LLC not treated as an 'association,' but a one-member LLC, one that lacks 'associates' and therefore not a partnership, treated *ipso facto* as an 'association' and therefore a corporation." *How to Treat Single-Member LLCs*, 68 TAX NOTES 361, 361 (1995).

12. *See* Treas. Reg. § 301.7701-3 (1997).

13. *See* Payson R. Peabody, *States Generally Endorse Check-the-Box but Key Issues Remain*, 86 J. TAX'N 228, 228 (1997).

14. *See* Hugh M. Dougan et al., *"Check the Box"—Looking Under the Lid*, 75 TAX NOTES 1141, 1149 (1997) ("Even though the proliferation of state LLC and LLP statutes was a major motive for the new classification rules, state-law issues are likely to hinder or at least complicate taxpayers taking advantage of those rules for some time to come.").

15. *See* Rev. Rul. 88-76, 1988-2 C.B. 360.

state in collecting adequate revenue with greater administrative efficiency.

I. THE TAX TREATMENT OF SINGLE-MEMBER LLCS: PAST AND PRESENT

Despite the current disparity in the tax treatment of LLCs, conformity between state and federal income tax traditionally has been "the rule, not the exception."[16] Historically, entity classification under state law determined the kind of tax treatment an entity would receive at the federal level.[17] Proper classification was crucial because classification as a corporation would generally subject an entity to multiple levels of federal and state taxation.[18] Despite some judicial interpretations of state constitutional mandates that may indicate otherwise,[19]

16. Prentiss Willson, Jr., *State Taxation of Limited Liability Companies and Partnerships*, TAX LAW AND PRACTICE 1289, 1305 (PLI Tax Practice Course Handbook Series No. 383 1996).

17. *See* Kenneth H. Heller & Michael K. Carnevale, *Check-the-Box Final Regs. Simplify Entity Classification*, 28 TAX ADVISER 296, 296 (1997).

18. *See* Victor E. Fleischer, Note, *"If It Looks Like a Duck": Corporate Resemblance and Check-the-Box Elective Tax Classification*, 96 COLUM. L. REV. 518, 518 n.3 (1996). The federal corporate income tax is levied first at the marginal rate of 35% under I.R.C. § 11. *See id.* The shareholder is taxed next at a marginal rate as high as 39.6% on dividends received under section 61(a)(7). *See id.* Hence, the combined effect of those two levels of taxation may potentially expose a shareholder to an effective marginal rate of 61% on business income. *See id.*

19. *See* Harriet Hanlon, *Electronic Commerce Taxation Debated at Cost Conference*, Mar. 7, 1997, *available in* LEXIS, FEDTax Library, TNT File (citing Cheney v. St. Louis Southwestern Railway Co., 394 S.W.2d 731 (1965). The *Cheney* court held that state adoption of the Interstate Commerce Commission's standard classification of accounts violated the Constitution of Arkansas by improperly delegating the determination of state taxable income to a federal agency). Hanlon also discussed other cases where reliance on the Internal Revenue Code (IRC) was challenged. *See* Hanlon *supra.*

According to the article, even though "a state may conform to the IRC, it may not conform to federal rules and regulations promulgated." *Id.* Some state statutes specifically provide for the inclusion of administrative and judicial decisions, and regulations issued thereunder. *See id.* Where the state statute does not explicitly provide for conformity, "in practice the construction of the state statutes is influenced by federal rules and regulations." *Id.* By adopting the IRC, the states generally avoid recreating the wheel, but they lose some control. *See id.*

the states usually adopted federal tax provisions[20] and used the federal tax base to compute their own taxes.[21]

A. PRE-1997 FEDERAL ENTITY CLASSIFICATION: THE "CORPORATE RESEMBLANCE" TEST

Combining limited liability and pass-through taxation, the emergence of LLCs as viable business entities has blurred the formalistic legal distinction between corporations and partnerships.[22] Prior to 1997, in an effort to preserve this distinction, the IRS used the "corporate resemblance" test set forth in the Kintner regulations to determine an LLC's eligibility for partnership tax treatment.[23] The result was the elevation of form over substance, focusing on hypertechnical differences that plagued the IRS with enormous administrative burdens[24] and caused taxpayers to expend considerable resources on compliance.[25]

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20. *See generally* Hanlon, *supra* note 19 (stating that as many as 46 states currently have corporate income tax laws that rely on the Internal Revenue Code).

21. *See* William B. Curlee, *Deductible or Not Deductible? The Michigan SBT Question*, 26 TAX ADVISER 672, 672 (1995) ("The majority of states that impose a corporate income tax begin the computation of state taxable income with the corporation's taxable income as reported on either line 28 . . . or line 30 of Form 1120, U.S. Corporation Income Tax Return [and adjust the figure] for various state-defined additions and subtractions to determine the corporation's state taxable income.").

22. *See Ernst & Young Supports 'Check-the-Box' Proposal for Domestic and Foreign Entities*, 68 TAX NOTES 408, 408 (1995) [hereinafter *Ernst & Young*] (commenting on how the emergence of LLCs increased the pressure on the classification system, which caused both taxpayers and the IRS to devote considerable resources to achieve formalistic legal distinctions).

23. *See* Fleischer, *supra* note 18, at 524.

24. *See* Garcia, *supra* note 11, at 142 (referring to filing requests for partnership tax treatment of LLCs as "a pointless dance"). Garcia paraphrases Michael Thomson, Treasury's acting deputy tax legislative counsel, commenting that too many resources were wasted "by the IRS and the private sector in resolving classification issues . . . even though in the end the taxpayer [got] the desired status." *Id.* Permitting taxpayers choice of classification would cause "little if any substantive change." *Id.*

25. *See* Thomas E. Rutledge, *Lawyer Praises Check-the-Box Regs.*, Aug. 22, 1996, *available in* LEXIS, FEDTax Library, TNT File, at para. 2-4 (explaining how the hyper-technical four-factor test caused taxpayers to needlessly expend time and money in identifying and eliminating corporate characteristics in their organizational documents); *see also Unofficial Transcript of IRS Hearing on 'Check-The-Box' Regs*, Aug. 26 1996, *available in* LEXIS, FEDTax Library, TNT File, at para. 100 (discussing the problem Kintner posed to small business, which did not have the resources to hire professionals who knew how to work around the rules).

The "corporate resemblance" test was a two-tiered, six-factor test.[26] The first two threshold factors—the presence of "associates" and an objective to carry on a business—determined whether the rest of the factors would be applied.[27] Once these two factors were met, the four Kintner factors—continuity of life, centralized management, limited liability, and free transferability of interests—determined the proper classification of unincorporated entities.[28] Since the first set of factors were common to both partnerships and corporations,[29] most entity classification controversies revolved around the Kintner factors. Unincorporated entities were classified as a corporation if they displayed at least three of the four factors.[30]

In general, by preparing organizational documents that ensured partnership classification, multimember LLCs qualified for conduit taxation by meeting less than three of the four factors of the Kintner test.[31] The corporate resemblance test was cumbersome to apply to single-member LLCs, however, because they lacked the threshold characteristic of "associates."[32] A single-member LLC, by definition, cannot be an "association" because it has only one member. Hence, there was a great deal of uncertainty as to whether single-member LLCs should be taxed as partnerships or corporations because they did not fit the definition of either category.[33]

Advocating partnership tax treatment, some scholars and practitioners argued that single-member LLCs lacked both continuity of life and centralized management and thus should not be classified as corporations.[34] On the other hand, under

26. *See* Rory M. Deutsch, *Regs Clarify One-Owner LLC Tax*, NAT'L L.J., Mar. 17, 1997, at B8.

27. *See id.*

28. *See id.*

29. *See id.*

30. *See id.*

31. *See id.* (discussing the "use of awkward transferability, dissolution and management provisions in governing documents to achieve the desired tax treatment" under prior regulations).

32. *Id.* Even though the IRS clarified the tax treatment of multimember LLCs through Rev. Proc. 95-10, 1995-1 C.B. 401, it declined to comment on the appropriate tax treatment of single-member LLCs until 1995. *See id.*

33. *See id.*

34. *See, e.g.*, Michele L. Giovagnoli, *Missouri Limited Liability Companies: An Innovative and Developing Business Choice*, 63 UMKC L. REV. 701, 721 (1995) (stating that since a single-member LLC dissolves upon the death, retirement, withdrawal or bankruptcy of its only member, it lacks continuity of life, and since it is managed by all of its members, it lacks centralized man-

both the Uniform Partnership Act (UPA)[35] and the Internal Revenue Code (IRC),[36] the definition of a partnership contemplates "an association of two or more persons" who engage in a business for profit as co-owners and divide the gains derived therefrom. Thus, some scholars argued that treating an entity with only one owner as a partnership was unjustifiable, even if only for tax purposes.[37] Agreeing with that assertion, the IRS refused to classify single-member LLCs as partnerships but failed to clarify what the appropriate tax treatment should be.[38]

As a way of getting around the partnership rules, tax practitioners have long advised clients to create a nominal second-member interest.[39] Consequently, careful tax planning would enable an entity to comply with the formalistic partnership guidelines with very little adverse economic impact.[40] The formation of a partnership with a de minimis second member interest entailed significant risks, however, in light of the lack of guidance from the Treasury and the IRS on how small the second interest must be before the entity would be considered a single-member LLC.[41] In addition, if the second member interest in-

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agement).

35. REV. UNIF. PARTNERSHIP ACT § 101(4) (1994).

36. *See* 26 U.S.C. § 7701(a) (2) (1994) (defining a partnership to include "a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not . . . a trust or estate or a corporation").

37. *See, e.g.*, Steve Montgomery et al., *Classification of Single-Member LLCs To Be Clarified Under Final "Check-the-Box" Regulations*, 28 TAX ADVISOR 13, 13 (1997) (stating that even though the proposed check-the-box regulations sanction the formation of single-member LLCs, "it is unclear how a taxpayer can justify treating an entity with one owner as a partnership").

38. *See* Richard M. Baskett, *IRS and Senate Push Change in Business, Trusts Tax Treatment*, MONT. LAW., July/Aug. 1996, at 13-14; Rev. Proc. 95-10 § 4.01, 1995-1 C.B. 502 (stating that classification as a partnership was available only to those entities with two or more members). See *infra* note 61 and accompanying text for an explanation of the possible motivations by the IRS not to grant partnership tax treatment to single-member LLCs.

39. *See* Montgomery, *supra* note 37, at 14 (describing the process of how "LLCs have been formed in recent years with a 99% and a 1% interest controlled directly or indirectly by the same owner" to get around classification hurdles).

40. *See* Tax Executives Institute, *Tax Executives Institute, Inc. on Notice 95-14 Relating to Entity Classification Submitted to the Internal Revenue Service*, July 20, 1995, *available in* LEXIS, FEDTax Library, TNT File (noting how the use of partnership ownership structures such as 99.9:0.1 needlessly emphasize form over substance).

41. *See* Sheryl Stratton, *Open Questions Absorb Government in Corporate Tax Context*, May 13, 1997, *available in* LEXIS, FEDTax Library, TNT File (noting the lack of guidance from the Treasury regarding the consequences of

volved a related party,[42] there was a risk that the IRS might invoke the "single economic interest" theory, and classify the LLC as a single-member LLC.[43] Thus, if the IRS decided to ignore the presence of a second member, imposition of a corporate tax on the LLC would result.

Until the uncertainties surrounding the tax classification of single-member LLCs were clarified by check-the-box regulations, tax advisors recommended making an S corporation election to obtain limited liability and pass-through tax treatment.[44] The two entities are by no means perfect substitutes, however, and single-member LLCs provide some significant advantages over S corporations. Primarily, unlike S corporations, which are governed by the debt assumption rules of Subchapter C,[45] LLCs generally enable their members to contribute property without triggering income recognition.[46] Furthermore, unlike S corporations, the liquidation and distribution of the assets of a single-member LLC do not give rise to gain recognition on appreciated property.[47] Finally, unlike S corpora-

having a second member with a de minimis interest on the classification of an entity).

42. Related parties include, among other things, parent/subsidiary or brother/sister corporations. *See* I.R.C. 1504(a) (1) & (2) (1997).

43. Rev. Rul. 77-214, 1977-1 C.B. 408 *modified and superseded* by Rev. Rul. 93-4, 1993-3 I.R.B. 5. For example, if a subsidiary formed a partnership with another subsidiary owned by the same parent, because of the common ownership and economic interest of all the entities involved, the IRS sometimes simply ignored the presence of a second member. *See* Susan Pace Hamill, *The Taxation of Domestic Limited Liability Companies and Limited Partnerships: A Case for Eliminating the Partnership Classification Regulations*, 73 WASH. U. L.Q. 565, 570 n.17 (1995). The IRS used the single economic interest doctrine mostly in the foreign context. *See id.*

44. *See* Matthew A. Melone, *Limited Liability Company vs. S Corporation*, 57 TAX'N FOR ACCT. 289, 289-93 (1996) (conducting a comparative analysis of LLC and S corporations). In general, the requirements to make an S corporation election include, among other things, having no more than one class of stock, a maximum of 75 shareholders and not belonging to the group of persons specifically excluded from owning S corporation stock such as C corporations and nonresident aliens. *See* I.R.C. § 1361(b)-(c). Upon satisfying these requirements, a successful election involves the filing a of valid, timely Form 2553, *Election by a Small Business Corporation*. *See* Stewart S. Karlinsky, *Current Developments—Eligibility, Elections and Terminations; Operations; and Legislation*, 28 TAX ADVISOR 635, 635 (1997).

45. *See* I.R.C. §§ 351, 357 (1997). Sections 351 and 357 of Subchapter C apply to the assumption of debt on an asset contribution to an S corporation. *See id.* In sum, these rules require, among other things, that an owner be 80% in control of the corporation in order to qualify for the nonrecognition of the assumed liability as income. *See id.*

46. *See* Melone, *supra* note 44, at 291-92.

47. *See* Francis J. Wirtz & Kenneth L. Harris, *Tax Classification of the*

tions, single-member LLCs can be used as an alternative to C corporation subsidiaries and thereby reduce the need to use consolidated returns.[48]

B. STATE CLASSIFICATION OF SINGLE-MEMBER LLCS BEFORE CHECK-THE-BOX REGULATIONS

In general, LLCs are "creatures of state law."[49] Since the IRS granted favorable tax treatment to LLCs in 1988,[50] there has been a rapid growth in LLC legislation,[51] partly due to competitive pressures among the states to attract new business.[52] Presently, all fifty states and the District of Columbia have LLC statutes,[53] only thirty-one of which provide for single-member LLCs.[54]

One-Member Limited Liability Company, 59 TAX NOTES 1829, 1830 (1993); *see also* Melone, *supra* note 44, at 290 (explaining the disadvantages associated with the one class of stock requirement, which precludes creative financial planning).

48. S corporations cannot be used as an alternative to C corporation subsidiaries, because C corporations are statutorily excluded from owning shares in S corporations. *See* I.R.C. § 1361(C)(2) (Supp. 1997). In addition, until 1996, S corporations were generally not permitted to have a subsidiary. *See* Bruce D. Bernard, *Recent Developments Affect Choice-of-Entity Decision*, 25 TAX'N FOR LAW. 260, 261 (1997). Under the new Section 1361(b)(3), however, the requirement has been relaxed to allow S corporations to own both S and C corporation subsidiaries. *See id.* See *infra* notes 70-77 and accompanying text for a more detailed explanation of the use of single-member LLCs as an alternative to filing consolidated returns.

49. *See* Kathryn A. Pischak, *State Tax Issues Complicate the Decision to Do Business as a Limited Liability Company*, 83 J. TAX'N 76, 76 (1995) (chronicling the historical development of LLCs).

50. *See* Rev. Rul. 88-76, 1988-2 C.B. 360.

51. *See* RIBSTEIN & KEATINGE, *supra* note 6, § 1.06, at 5-12. With the exception of Wyoming (1977) and Florida (1982), the rest of the states enacted their LLC statutes between 1990 and 1996. *See id.*

52. *See* Carol R. Goforth, *The Rise of the Limited Liability Company: Evidence of a Race Between the States, but Heading Where?*, 45 SYRACUSE L. REV. 1193, 1288 (1995) (noting that attracting new business and retention of existing sources of revenue gave states the incentive to enact LLC legislation).

53. *See id.*

54. *See* ALASKA STAT. § 10.50.070 (Michie 1997); ARIZ. REV. STAT. § 29-631 (1997); ARK. CODE ANN. § 4-32-201 (Michie 1997); COLO. REV. STAT. § 7-80-203 (1997); CONN. GEN. STAT. § 34-120 (1997); DEL. CODE ANN. tit. 6, § 18-201 (1997); GA. CODE ANN. § 14-11-203 (1997); HAW. REV. STAT. § 428-202 (1997); IDAHO CODE § 53-607 (1997); 805 ILL. COMP. STAT. 180/5-1 (West 1997) (effective Jan. 11, 1998); IND. CODE § 23-18-2-4 (1997); ME. REV. STAT. ANN. tit. 31, § 621 (West 1997); MINN. STAT. § 322B.105 (1997); MO. REV. STAT. § 347.037(1) (1997); MONT. CODE ANN. § 35-8-201 (1997); NEB. REV. STAT. Section 21-2605 (1997); N.H. REV. STAT. ANN. § 304-C:12 (1997); N.M. STAT. ANN. § 53-19-7 (Michie 1997); N.Y. LAW § 203 (McKinney 1997); N.C GEN. STAT. §

Prior to the enactment of the final check-the-box regulations, most states followed the federal classification of LLCs for tax purposes.[55] Thus, LLCs eligible for partnership tax treatment at the federal level were generally classified as partnerships for state tax purposes, whereas single-member LLCs were classified as corporations.[56] Nevertheless, in states that had neither a personal nor a corporate income tax, the issue of LLC classification became more or less irrelevant.[57]

C. THE CURRENT TAX TREATMENT OF LLCS UNDER BOTH THE NEW FEDERAL CHECK-THE-BOX REGULATIONS AND THE MYRIAD STATE TAX LAWS

After the Kintner classification regime proved burdensome to both taxpayers and the Treasury,[58] the IRS proposed an elective classification scheme to simplify the classification of unincorporated entities.[59] Initially, the proposal limited eligible unincorporated entities to entities with two or more members, which could elect to be taxed as a partnership or corporation.[60] After much debate,[61] however, the IRS finally included single-

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57C-2-20 (1997); N.D. CENT. CODE § 10-32-05 (1997); OHIO REV. CODE ANN. § 1705.04(A) (Anderson 1997); OKLA. STAT. tit. 18, § 2004 (1997); OR. REV. STAT. § 63.044 (1997); PA. CONS. STAT. § 8912 (1997); R.I. GEN. LAWS § 7-16-5(a) (1997); S.C. CODE ANN. § 33-44-202 (Law. Co-op. 1997); TEX. CORPS. & ASS'NS. CODE ANN. § 4.01(A) (West 1997); UTAH CODE ANN. § 48-26-103(2) (1997); VA. CODE ANN. § 13.1-1010 (Michie 1997); WASH. REV. CODE § 25.15.070(1) (1997). The remaining two-member jurisdictions permit nonlocal single-member LLCs to register to do business despite the differences in the law under which the LLC was organized. *See* Peabody, *supra* note 4, at 233.

55. *See* Smith, *supra* note 4, at 976; *see also*, Bruce P. Ely & Joseph K. Beach, *The LLC Scoreboard*, 74 TAX NOTES 1329, 1329-33 (1997) (tabulating pre-check-the-box state tax treatment of LLCs).

56. *See* Smith, *supra* note 4, at 976.

57. *See* Pischak, *supra* note 49, at 78. Nevada, South Dakota, and Wyoming have no personal or corporate income tax. *See id.*

58. *See, e.g.*, Fleischer, *supra* note 18, at 529 (discussing the administrative burden that the Kintner rules created by forcing "taxpayers and the Treasury to devote more and more time to drafting and examining the organizational documents of new ventures").

59. *See* I.R.S. Notice 95-14, 1995-14 I.R.B. 7. The proposal was received with much enthusiasm and uniform support from practitioners. *See also* Ernst & Young, *supra* note 22, at 408 (commenting on how an elective classification system would ease the IRS's administrative burden and provide taxpayers a "welcome sense of certainty").

60. *See* I.R.S. Notice 95-14, 1995-14 I.R.B. 8.

61. *See, e.g.*, Garcia, *supra* note 11, at 142 (surmising that the IRS may have refused to extend partnership classification to single-member LLCs because of concerns regarding classifications of foreign entities, subversion of the consolidated return rules, or the difficulty in applying the corporate re-

member LLCs as eligible entities under the elective classification scheme.[62]

The new check-the-box regulations provide that unless a single-member LLC chooses to be taxed as a corporation it will be disregarded for federal income tax purposes.[63] For individual LLC owners, "all the activities of [a disregarded] entity are treated as if they were actually performed by the owner."[64] Because a disregarded entity has no tax identity, no tax form needs to be completed on behalf of the entity.[65] The business income and loss will be reported on the tax return of the owner as if the business were operated as a sole proprietorship.[66]

On the other hand, a corporate LLC owner will treat the income and loss items as derived from a branch or a division.[67] Thus, the income and losses of the wholly owned subsidiary will be reported in combination with the corporate member's income and losses without the application of the consolidated return rules.[68] Furthermore, the dividend payments by the

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semblance test). One commentator has suggested that the IRS may have been "concerned that allowing single-member LLCs to easily obtain passthrough status could allow large corporations to selectively plan their consolidated returns." *See id.* Currently, the consolidated-return rules work on an all-or-nothing basis. *See* William A. Klein, *What's Wrong with Single-Member LLCs?*, Dec. 28, 1994, *available in* LEXIS, FEDTax Library, TNT File, (challenging the notion that a single-member LLC with pass-through taxation is an abuse).

62. *See* Treas. Reg. § 301.7701-3(b)(1)(ii) (1997).

63. *See* Treas. Reg. § 301.7701-2(a) (1997).

64. Christopher Barton, *Much Ado About a Nothing: The Taxation of Disregarded Entities*, 75 TAX NOTES 1883, 1883 (1997).

65. *See* Wolfman, *supra* note 11, at 361. Unlike associations, no separate federal tax filings are required if an entity is disregarded for federal tax purposes. LLCs with two or more members will file Form 1065, while individual single-member LLCs will include the income derived from the entity on Form 1040, the federal individual income tax return. *See id.*

66. *See* Peabody, *supra* note 13, at 228-29.

67. *See id.*

68. *See* Roger F. Pillow et al., *Check-the-Box Proposed Regs. Simplify the Entity Classification Process*, 85 J. TAX'N 72, 84 (1996). Even though "the consequences of 'being disregarded' have not been adequately described in the check-the-box regulations, . . . [t]ransactions between disregarded entities and their owners, and transactions between commonly owned disregarded entities, are 'interdivisional transactions' that should be completely ignored." Barton, *supra* note 64, at 1884. On the other hand, "[t]ransactions between disregarded entities and unrelated third parties cannot be ignored and should be given treatment similar to transactions in which corporations have been disregarded under existing law." *Id.* Hence, the transactions may be disregarded under current income tax regulations such as "conduit financing arrangement" regulations or under the step-transaction doctrine. *Id.*

LLC to the corporation as well as gains and losses associated with intercompany transactions will all be disregarded.[69]

For corporate members, single-member LLCs may provide an alternative to the current parent/subsidiary structure and the filing of consolidated returns.[70] In general, consolidated returns are useful in combining the income and losses incurred by the parent company and subsidiaries—with the exception of intercompany gains and losses—to produce taxable income as one economic unit.[71] In the absence of consolidated reporting, the parent company and each subsidiary would be required to file separate stand-alone tax returns, which may subject each of them to a tax liability greater than if the returns had been combined.[72]

Nonetheless, in light of some of the complex rules governing consolidated returns that "make consolidated filing unappetizing,"[73] corporations may find it worthwhile to convert their subsidiaries into single-member LLCs,[74] even in the face of harsh tax consequences associated with conversion.[75] Even

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69. *See id.*

70. *See, e.g.*, Lawrence M. Axelrod, *Are Consolidated Returns Obsolete?*, 74 TAX NOTES 89, 90 (1997) (asserting that the complexity of consolidated return rules may encourage corporations to convert their subsidiaries into LLCs). Currently, consolidated returns are available for election by corporations with at least an 80% ownership interest in their subsidiaries. *See* I.R.C. §§ 1501-04 (1997). Furthermore, through the use of disregarded entities, parent corporations may engage in selective consolidation, which is prohibited under current consolidation rules. *See supra* note 61; Barton, *supra* note 64, at 1886.

71. *See* BORIS BITTKER & JAMES EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS § 13.40 (6th ed. 1994).

72. *See* David S. Miller, *The Tax Nothing*, 74 TAX NOTES 619, 621-22 (1997).

73. Axelrod, *supra* note 70, at 93. Axelrod gives two examples of consolidated return rules—Separate Return Limitation Year (SRLY) and intercompany transaction rules. *See id.* SRLY limits the use of certain tax attributes such as net operating loss (NOL) carryovers to the income or tax liability generated by a subsidiary alone. *See* Treas. Reg. § 1.1502-21T(c) (1997). The intercompany transaction rules are governed by Treas. Reg. § 1.1502-13 (1997).

74. There are no federal income tax consequences when forming a disregarded entity. *See* Barton, *supra* note 64, at 1885. Hence, in a state like New York, where single-member LLCs are disregarded, a corporation with multiple subsidiaries operating in those states can virtually avoid the filing of a consolidated tax return by converting all of its subsidiaries into single-member LLCs. *See generally* Miller, *supra* note 72, at 627 n.58 (explaining the possible impact of New York State's tax treatment of single-member LLCs on consolidate return filings).

75. The conversion of a corporation into an LLC is a "termination" event "that serves to trigger the recognition of any deferred gains." Willson, *supra*

more importantly, in states that do not permit consolidated reporting or impose stringent requirements for eligibility,[76] using single-member LLCs instead of subsidiaries may help reduce state tax reporting and liability for the combined group.[77]

In addition to the consolidated return area, the new federal classification scheme is expected to have a significant impact on other aspects of state taxation.[78] The pressing question then is whether and to what degree states will conform to the federal classification scheme. First of all, even if states choose to follow the federal system,[79] some may only selectively incorporate certain federal provisions into their own tax laws.[80] Moreover, a state's classification of single-member LLCs as corporations may signify the most significant deviation from

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note 16, at 1304. A way to get around this problem is to have the subsidiary liquidate tax free into the parent under IRC sections 332 and 337 if the parent owns at least 80%, in value and voting, of the subsidiary's stock. Then, the parent can transfer the property into a newly formed LLC tax free. Unfortunately, the liquidation of a subsidiary into the parent will generally result in the disappearance of the parent company's stock basis in its subsidiary's stocks. *See* Axelrod, *supra* note 70, at 93. Such a result can be particularly undesirable if the parent company had a high basis in the subsidiary's stock. *See id.*

76. *See* Michael S. Schadewald, *Current Issues in Taxation of U.S.-Controlled Foreign Corporations*, 28 TAX ADVISER 580, 581 (1997) (explaining the different types of rules for consolidated reporting at the state level). Some states require separate reporting, which means that each affiliate has to compute its income separately and file its own return. *See id.* Another approach is to have U.S. affiliates filing a federal consolidated return also file a state consolidated return. *See id.* Finally, a third approach is to file a combined return with all affiliates with at least 50% ownership interest. *See id.*

77. *See* Miller, *supra* note 72, at 621-22.

78. *See infra* Parts III & IV (discussing the advantages and disadvantages of following the Federal classification scheme).

79. Currently, Arizona, Illinois, Indiana, Minnesota, Missouri, Nebraska, New Jersey, New York, North Carolina, Pennsylvania, South Carolina, and Utah have indicated that they will conform to the federal system. *See* Smith, *supra* note 4, at 976-77.

80. *See, e.g*, Alabama Department of Revenue, Rev. Proc. 97-001. Alabama currently does not have a single-member LLC enabling statute, and as to a single-member LLC formed in another state that is qualified to do business in Alabama, "the entity will not be disregarded but instead will be treated as a partnership and required to file a separate partnership return." Bruce P. Ely et al., *Single-Member LLCs Are Not Disregarded for Alabama Purposes*, 13 STATE TAX NOTES, July 7, 1997, *available in* LEXIS, STTax Library, STNMAG File. In addition to statutory provisions requiring the filing of a tax return by every entity, the Alabama Department of Revenue was concerned about the potential revenue loss caused by "the use of LLCs as a means to avoid the [Department's] prohibition of both consolidated income tax returns and combined reporting for most corporate groups." *Id.*

the federal system,[81] but in some states, it is not even necessary to classify a single-member LLC as a corporation to impose an entity-level tax.[82]

Some of the state entity-level taxes imposed on LLCs include the Michigan single business tax,[83] the District of Columbia unincorporated business franchise tax,[84] the New Hampshire business profits tax,[85] and the California franchise tax.[86] In California, imposition of an entity-level tax is generally consistent with the state's tax policy in imposing a tax on business entities that benefit from limited liability.[87] Nevertheless, the California Franchise Board recently announced its decision to follow the federal classification scheme and disregard single-member LLCs for California tax purposes.[88]

Of the three states that generally classify LLCs as corporations—Pennsylvania, Texas, and Florida—only the first two recognize single-member LLCs.[89] With the exception of LLCs that perform professional services, Pennsylvania currently imposes a corporate income tax on all LLCs.[90] The state is expected to switch to pass-through tax treatment, however, in 1998.[91] In Texas, a franchise tax is imposed on LLCs in general,[92] which has both an income and capital tax component.[93]

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81. *See infra* notes 89-94 and accompanying text (discussing the states that classify LLCs as corporations).

82. *See* Smith, *supra* note 4, at 979.

83. MICH. COMP. LAWS ANN. § 208.31 (West Supp. 1997).

84. D.C. CODE ANN. §§ 47-1808.1-.7 (1997).

85. N.H. REV. STAT. ANN. § 77-A:2 (Supp. 1997).

86. *See* Terence Floyd Cuff, *California Limited Liability Company Act*, TAX LAW AND PRACTICE 9, 74 (PLI Tax Law and Estate Planning Course Handbook Series No. 374 1995) (explaining the different types of taxes California imposes on LLCs). California generally imposes an annual minimum franchise tax of $800 for the privilege of doing business within the state. CAL. REV. & TAX. CODE §§ 23091, 23153(d) (West Supp. 1997).

87. Miller, *supra* note 72, at n.59.

88. *See FTB Changes Proposed Corporate Classification Amendments*, 13 STATE TAX NOTES 1291, *available in* LEXIS, STTax Library, STNMAG File.

89. *See* Willson, *supra* note 16, at 1325-26.

90. 15 PA. CONS. STAT. § 8925 (1995).

91. *See* Smith, *supra* note 4, at 979.

92. TEX. TAX CODE ANN. §§ 171.001(a)(2), (b)(3) (West Supp. 1998). A franchise tax is a tax based on capital values, and is imposed by 26 states. *See* Pischak, *supra* note 49, at 78-9. Although franchise taxes are generally low, the levy could be significant if the corporation is highly capitalized. *See id.*

93. *See* Willson, *supra* note 16, at 1326.

As of this writing, Texas has no plans to conform to the federal classification system.[94]

II. A VEHICLE FOR TAX EROSION OR THE IDEAL BUSINESS FORM? THE POLICY IMPLICATIONS OF THE CHECK-THE-BOX/LLC SYNERGY

Investors and business owners appear to benefit most from the new classification scheme. As eligible unincorporated entities under check-the-box regulations, LLCs have made it easier for business owners to operate with limited liability and face only one level of tax. Despite all the discussion about LLCs being an ideal business form, however, the concerns of some scholars and commentators about the negative social and economic implications of LLCs should not be ignored. Their arguments ultimately lead one to ask whether the IRS has done the right thing by promulgating regulations that strengthen LLCs and whether the general policy implications disfavor state conformity.

A. IMPACT ON CORPORATE TAX INTEGRATION AND BUSINESS ORGANIZATION LAW

Much of the commentary on corporate tax integration contemplates eliminating the double-taxation of corporation income.[95] Many commentators focus on the lack of a rational basis for imposing the corporate tax and the inequities associated with it.[96] Thus, this section is limited to providing an overview

94. *See* Peabody, *supra* note 13, at 233.

95. *See, e.g.*, Aaron W. Brooks, *Chuck the Box: Proposed Entity Classification Regulations Bring Bad Policy*, 73 TAX NOTES 1669, 1675 n.35 (1996) (stating that "corporate integration is the theory that corporations should be subject to only one level of tax"); Micheal L. Schler, *Taxing Corporate Income Once (or Hopefully Not at All): A Practitioner's Comparison of the Treasury and ALI Integration Models*, 47 TAX L. REV. 509 (1992); George K. Yin, *Corporate Tax Integration and the Search for the Pragmatic Ideal*, 47 TAX L. REV. 431 (1992).

96. *See, e.g.*, Karen C. Burke, *The Uncertain Future of Limited Liability Companies*, 12 AM. J. TAX POL'Y 13, 47 (1995) (stating that "Congress has failed to articulate any clear rationale for the double-tax system"); Susan Pace Hamill, *The Limited Liability Company: A Catalyst Exposing the Corporate Integration Question*, 95 MICH. L. REV 393, 440 (1996) (stating that "as the LLC gains more acceptance . . . it will become increasingly difficult for lawmakers to pretend that the current corporate tax system . . . contains any rationally based tax policy"); Larry E. Ribstein, *The Deregulation of Limited Liability and the Death of Partnership*, 70 WASH. U. L.Q. 417, 451-57 (1992) (noting the lack of "normative" basis for the distinction in taxation between

of the discussions pertaining to what impact if any LLCs may have on the whole issue of corporate tax integration.[97] This section also deals with the possible adverse effect LLCs may have on other business forms.

By making pass-through taxation available to most unincorporated entities, the check-the-box regulations effectively limit the corporate double tax to publicly held corporations, and thereby strengthen the LLC as a viable business form.[98] This result is not without its critics, however. Some commentators view LLCs "as a direct threat to the corporate tax base, arguing that LLCs should either be taxed as corporations or legally limited in some other fashion."[99] Others contend that LLCs were formed by the states in an attempt to achieve corporate tax integration without the approval of Congress.[100]

The ultimate question then is whether LLCs bring the tax system a step closer to achieving corporate tax integration. There are at least two factors that indicate the impact of LLCs on corporate tax integration is minimal. First, there is no such thing as a publicly traded LLC, and public trading appears to be the new proxy for imposing the corporate tax.[101] Second, for most closely held entities, the limited liability/conduit taxation combination has always been available, in some form or another, through S corporations, limited partnerships, or other business forms.[102] Thus, within the context of corporate tax integration, the unique contribution of LLCs is probably limited to making the limited-liability/conduit-taxation combination available with less restrictions than other business forms.

Nonetheless, according to some scholars, the popularity of LLCs will actually impede any legislative progress toward cor-

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corporations and partnerships and the significant costs associated with drawing an arbitrary line).

97. According to some scholars, the emergence of LLCs itself is linked to corporate tax integration. *See* Hamill, *supra* note 96, at 399.

98. *See* Fleischer, *supra* note 18, at 549-50.

99. *See* Hamill, *supra* note 96, at 397 & n.24 (citing several sources that support the contention that LLCs are a direct threat to the corporate tax base).

100. *See id.* at 397 & n.23.

101. *See* Fleischer, *supra* note 18, at 520-21 (stating that under the new federal classification system, the double-taxation scheme remains intact).

102. *See id.* (stating that Congress was not terribly concerned about imposing the corporate tax on closely held entities because it provided the ability to evade the corporate-level tax through the use of S corporations and other business forms).

porate tax integration.[103] They assert that because LLCs have little effect on corporate tax revenue, these entities will not compel tax policymakers to deal with the corporate tax integration question any time soon.[104] Therefore, the emergence of LLCs, which has the effect of providing piecemeal integration, actually hinders the congressional development of a comprehensive system for taxing business entities.[105]

Whether LLCs impede corporate tax integration and, if so, whether that is necessarily undesirable depends on how one views the entire business organization/taxation dichotomy.[106] Some business organization scholars have recommended a solution less drastic than eliminating the corporate tax by calling for a reform of current business organization law.[107] By advocating a unification principle, these scholars propose that the current business organization statutes be organized into two forms: (1) the traditional corporate code subject to the double-tax scheme and (2) a standard business code subject to one level of tax that will replace all other business organization statutes.[108]

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103. *See, e.g.*, Burke, *supra* note 96, at 59.

104. *See* Hamill, *supra* note 96, at 433.

105. *See* Burke, *supra* note 96, at 59.

106. *See, e.g.*, Jane G. Gravelle, *The Corporate Income Tax: Economic Issue and Policy Option*, 48 NAT'L TAX J. 267, 267 (1995) (noting that "separate corporate tax has been justified at various times by the special privileges the corporation receives . . . the independent economic power obtained by large corporations, and the need to tax corporations in order to prevent the sheltering of income by high-income individuals"); *see also*, Robert J. Shapiro, *Building a Conceptual Baseline for Corporate Tax Reform*, 50 NAT'L TAX J. 507, 508 (1997) (arguing that a "tax on business profits at the firm level is necessary because, otherwise, some shareholders and business owners would be exempt from much of the tax liability borne by most other citizens"). Therefore, "a business-level tax appears to be the only way of ensuring that one class of citizens does not enjoy special status to delay indefinitely paying tax on much of their income." *Id.*

107. *See, e.g.*, John H. Matheson & Brent A. Olson, *A Call for a Unified Business Organization Law*, 65 GEO. WASH. L. REV. 1, 34 (1996) ("Although full integration of the corporate and individual taxes may be much desired as a matter of policy, the revenue implications of such a change are politically prohibitive.").

108. *See id.* at 30-41. Organized under a standard business code, the standard organization (the resulting simplified entity) will have limited liability, free transferability of interests, continuity of life, pass-through taxation and inherent flexibility. *See id.* at 37; *see also* 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 (1997) (calling for the construction of one "business organization statute that is internally coherent, flexible, understandable, and consistent").

If anything, LLCs promote the unification principle put forth by these scholars. LLCs will reduce, if not eliminate, the need to use S corporations, limited partnerships, and other business forms.[109] Moreover, LLCs will to some extent undermine state corporation law by minimizing the need for businesses to incorporate until they get large enough to engage in public trading.[110] Consequently, by condensing the favorable attributes of several business forms into one, LLCs promote the same efficiency, flexibility, and contractual freedom that a unified business organization law would provide.[111] For those who like the variety, however, this may actually be a disadvantage.[112]

B. THE INCREASED USE OF LIMITED LIABILITY

For individual taxpayers, single-member LLCs are equivalent to sole proprietorships with limited liability. With over fifteen million sole proprietors operating in the nation, the favorable tax treatment of single-member LLCs under the new federal classification scheme may make these entities the most common business organizations in the United States.[113] Even

109. *See* Jerome Kurtz, *The Limited Liability Company and the Future of Business Taxation: A Comment on Professor Berger's Plan*, 47 TAX L. REV. 815, 818-823 (1992) (predicting that LLCs will eventually replace partnerships and S corporations).

110. *See* Hamill, *supra* note 96, at 423-24 (discussing the incentive businesses have to remain an LLC instead of converting to a corporation until the need arises to "issue equity in substantial amounts in order to raise capital").

111. *See generally* Matheson & Olson, *supra* note 107, at 48 (stating that a standard business code under a unification principle would provide a simple and efficient system, and promote contractual freedom). By eliminating centralized management and keeping ownership and control together, the authors argue that a standard business code will increase economic efficiency and reduce agency costs. *See id.* at 42-45. Furthermore, by adopting fewer mandatory rules and more default provisions which a firm can "adopt by inaction or reject by explicitly customizing an alternative term," the authors argue that a standard business code will enhance contractual freedom and flexibility. *Id.* at 47. *But 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) (stating that some of the arguments for the economic efficiency of limited liability companies remain unsubstantiated).

112. *See, e.g.*, Bruce H. Kobayashi & Larry E. Ribstein, *Evolution and Spontaneous Uniformity: Evidence from the Evolution of the Limited Liability Company*, 34 ECON. INQUIRY 464, 469-70 (1996) (arguing that the lack of variety in state business organization statutes will put the states at a competitive disadvantage).

113. *See* RIBSTEIN & KEATINGE, *supra* note 6, § 16.10.

in nonbusiness contexts, single-member LLCs may be useful in shielding assets from certain liabilities by serving as holding companies.[114]

Some argue that by making limited liability so readily available LLCs impose costs on society that are difficult to quantify.[115] A combination of several factors peculiar to closely held businesses may lead to the exploitation of limited liability status to the detriment of society. First, some scholars argue that due to the pressure to maximize cash flow, closely held businesses "have an unusually strong incentive to engage in excessively risky behavior."[116] Second, limited liability reduces the incentive to invest on precautions to avoid accidents.[117] Finally, courts have applied the doctrine of piercing the corporate veil almost exclusively to closely held corporations,[118] indicating, at least in part, the relatively inadequate endowment of capital in closely held businesses to cover for liability.

According to some critics, the primary purpose of limited liability is to facilitate capital accumulation when ownership and management are separate.[119] However, since separation of ownership and management is rare in closely held businesses and the owners will most likely invest even without the benefit of limited liability, however, granting limited liability to owners in closely held businesses has little justification.[120] As a result, one may conclude that making limited liability available to fifteen million sole proprietorships has all the costs to society associated with the use of limited liability but lacks the policy justification for doing so.

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114. *Id.*

115. *See, e.g.*, Henry Hansmann & Reinier Kraakman, *Toward Unlimited Liability for Corporate Torts*, 100 YALE L.J. 1879, 1881 (1991) (asserting that the arguments for limited liability are unpersuasive). Limited liability has the effect of cost externalization. *See id.* at 1883. Hence, by overinvesting in hazardous activities, a business with limited liability may produce "positive value to its shareholder, and thus can be an attractive investment, even when its net present value to society as a whole is negative." *Id.*

116. *Id.* at 1881.

117. *See id.* at 1882.

118. *See* Matheson & Olson, *supra* note 107, at 8 (citing F. HODGE O'NEAL & ROBERT B. THOMPSON, CLOSE CORPORATIONS § 1.10, at 46 (3d ed. 1994)).

119. *See id.* at 8 (citing Paul Halpern et al., *An Economic Analysis of Limited Liability in Corporation Law*, 30 U. TORONTO L.J. 117, 148 (1980)).

120. *See id.*

C. IMPACT ON ADMINISTRATIVE AGENCIES AND TAXPAYERS

There are challenges ahead for federal and state administrative agencies as well as for taxpayers confronted with filing in multiple states. By eliminating the significant administrative costs associated with the pre-1997 Kintner classification regime, it appears that the IRS stands to benefit from check-the-box regulations.[121] There are arguments on both sides, however, as to whether the IRS stands to lose revenue from the new classification scheme, which increases the availability of conduit taxation.[122] Unfortunately, revenue loss appears to be an even more serious problem for the states.[123]

On the taxpayers' side, because of the various approaches employed by the states in classifying and taxing LLCs, the greatest challenge is compliance with state taxation rules for multistate taxpayers. State conformity with the federal system will certainly ease taxpayers' compliance woes, but whether it is better for the states to conform is not so clearly determinable.

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121. *See supra* Part I.A.

122. *See generally* Lee A. Sheppard, *News Analysis: The Dark Side of Limited Liability Companies*, 55 TAX NOTES 1441, 1444 (1992) (noting one commentator's warning to IRS Officials during the initial phases of LLC legislation "that widespread use of LLCs as a result of their adoption by commercially important states could put a big dent in the federal purse"). *But see* Hamill, *supra* note 96, at 419-29 (noting several factors in the current system which illustrate that the threat of LLCs to the corporate tax is "merely theoretical").

123. *See, e.g., Unofficial Transcript of IRS Hearing on "Check-the-Box" Regulations*, *supra* note 25, at para. 147 (discussing the testimony of R. Douglas Bramhall of the California Franchise Tax Board at an IRS public hearing on check-the-box regulations). Mr. Bramhall stated that the revenue-negative effect resulting from disregarding single-member LLCs at the state level is not likely to be ignored, and whatever solution the states turn to in addressing the revenue loss, it will create a disparate federal-state compliance system. *Id; see also* NEW YORK STATE BAR ASS'N TAX TASK FORCE ON THE N.Y. TREATMENT OF LIMITED LIABILITY COMPANIES, OUTLINE OF ISSUES AND ALTERNATIVES (Jan. 27, 1993) [hereinafter NEW YORK BAR ASS'N], *reprinted in* TAX NOTES TODAY, Mar. 11, 1993, *available in* LEXIS, FEDTax Library, TNT File (highlighting the concerns of New York State and City tax and budget officials that the introduction of LLC legislation into the state would result in a net reduction of tax revenues). When confronted with the issue of conformity to the federal pass-through tax treatment of multimember LLCs in 1993, officials of New York state realized that "the enactment of LLC legislation on a basis of pure federal law conformity would be revenue-negative." *Id.*

III. TO CONFORM OR NOT TO CONFORM? THE DILEMMA FACING THE STATES

The elective classification system has significantly highlighted some of the differences between federal and state taxing systems that make conformity difficult. Before deciding whether states should conform to the new federal classification scheme, however, it helps to examine what conformity entails. First, states that do not permit the formation of single-member LLCs within their jurisdiction will have to amend their statutes to do so. Second, the conforming states will have to disregard single-member LLCs for tax purposes, and forgo the imposition of an entity-level tax.

A. CONSTITUTIONAL CONSIDERATIONS AS JUSTIFICATION FOR NONCONFORMITY

Due to constitutional limitations[124] or the unique political, social, and economic structure of some states, certain states may decline conformity.[125] In at least one case, the incorporation of a federal classification scheme into a state's tax statutes was held to be a violation of the state's constitution.[126] Constitutional challenges to a state's conformity with check-the-box regulations seem highly unlikely, however, since some states provide specifically for the inclusion of federal regulations and federal administrative and judicial decisions in their statutes.[127] Furthermore, even in the absence of specific provisions that provide for incorporation, state statutes have in practice been influenced by federal regulations.[128] As a result, a state's choice not to conform will likely be an outcome of policy preferences that drive its legislation. The degree of conformity with the federal system, therefore, remains unpredictable in light of the innumerable issues affecting state legislators' preferences.

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124. *See supra* note 9 and accompanying text

125. *See supra* notes 82-94 and accompanying text (discussing states that impose an entity-level tax on LLCs).

126. *See supra* note 19 and accompanying text.

127. *See supra* notes 19-20 and accompanying text.

128. *See* Hanlon *supra* note 19.

B. STATE NONCONFORMITY: POLICY JUSTIFICATIONS AND ULTIMATE OUTCOME OF DISSENT

The ultimate goal of tax policy is "to provide a fair, efficient, and predictable means of financing government expenditure."[129] To that end, state officials may try to justify their choice not to conform to the federal system by calling attention to the recent negative developments resulting from the increased use of LLCs,[130] such as the rise in administrative costs.[131] Others may support imposing a corporate tax on LLCs as a way of balancing the inequities perpetrated upon C corporation shareholders.[132]

The argument that the emergence of LLCs has negative implications may have some merit, especially within the context of increased availability of limited liability[133] and state revenue loss.[134] It is therefore difficult, if not impossible, to argue with certainty that LLCs are a good development. Nonetheless, by combining the favorable attributes of the myriad of business forms currently available to closely held businesses, LLCs at the very least bring simplicity and efficiency to the existing business organization structure.[135]

In response to the increased use of limited liability, a state can mandate LLCs to carry insurance in proportion to their gross sales.[136] Furthermore, if necessary, courts may liberalize

129. William M. Gentry & Helen F. Ladd, *State Tax Structure and Multiple Policy Objectives*, 47 NAT'L TAX J. 747, 747 (1994). To achieve these goals, state policy makers choose a combination of taxes, "and the interactions between [these] taxes determine the characteristics of the [state] tax system." *Id.*

130. *See supra* Part II.

131. *See supra* Part II.C and accompanying text.

132. *See supra* Part II.A; *see also* Brooks, *supra* note 95, at 1674-76 (arguing that the elective classification system unfairly excludes corporations from electing their tax status). Brooks argues that the high tax cost of conversion from a corporation to an LLC will force most corporations to remain in corporate form. *See id.* Accordingly, he argues that corporations should be given a one time window-of-opportunity to convert to an eligible entity. *See id.*

133. *See supra* Part II.B.

134. *See supra* note 123; and *infra* notes 142-147 and accompanying text.

135. *See supra* notes 109-111 and accompanying text; *see also* HANDBOOK OF THE NATIONAL CONFERENCE OF COMMISSIONERS ON UNIFORM STATE LAWS AND PROCEEDINGS 160 (1989) (calling for clarification and uniformity of "the legal morass governing unincorporated associations"); Brattorn & McCahery, *supra* note 111, at 686 (concluding that LLCs "provide a cost-effective limited liability shell for small firms").

136. *See* Walkovszky v. Carlton, 223 N.E.2d 6 (N.Y. 1966) (demonstrating

the standard for piercing the corporate veil[137] and hold members personally liable for the LLC's obligations.[138] Such measures will encourage LLCs to maintain adequate capital within the entity or carry adequate insurance coverage against liability.

As to the argument that LLCs impede the progress toward corporate integration, it may very well be that they do.[139] It makes no sense, however, to impose the controversial corporate tax on LLCs when most of the argument involving the double-tax scheme calls for its very abolishment.[140] If the business community desires to eliminate the corporate tax, then efforts should be directed toward increasing lobbying efforts or eliminating the numerous obstacles toward corporate tax integration.[141]

The impact of single-member LLCs on consolidated returns should be a more immediate concern to state officials because it has a direct correlation to tax revenue.[142] In states that permit formation of single-member LLCs, consolidated reporting may become a thing of the past.[143] The concern is even more serious in states like Alabama where separate filings are

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the dangers of setting a flat minimum liability insurance). The case demonstrates the need to have liability insurance reflect the size of the business.

137. *See* HAMILTON, *supra* note 9, at 273-322 (discussing case law dealing with piercing the corporate veil).

138. *See generally* Hansmann & Kraakman, *supra* note 115, at 1931-32 (arguing that shareholders should be held liable for corporate torts and that liberalizing the standard for piercing the corporate veil is another form of unlimited liability).

139. *See supra* Part II.A.

140. *See supra* Part II.A.

141. Wayne M. Gazur, *The Limited Liability Company Experiment: Unlimited Flexibility, Uncertain Role*, 58 LAW & CONTEMP. PROBS. 135, 169 n.199 (1995) (discussing the different proposals put forth by the Treasury and the American Law Institute regarding corporate tax integration). Despite the numerous proposals made by the Treasury, however, the corporate double tax system persists because "the public supports it [or] . . . because it serves congressional objectives." Matheson & Olson, *supra* note 107, at 13; *see also* James R. Repetti, *The Misuse of Tax Incentives to Align Management-Shareholder Interests*, 19 CARDOZO L. REV. 697, 716 (1997) ("[M]anagement often opposes corporate tax integration . . . [because it] remove[s] the tax incentive for stockholders to tolerate the inefficient retention of earnings.").

142. *See supra* notes 70-77 and accompanying text.

143. *See supra* notes 70-77 and accompanying text. By liquidating a wholly owned subsidiary up into the parent corporation and subsequently transferring the assets to a newly formed LLC, the parent corporation could attain branch or division treatment for the income derived from the LLC while evading the harsh consequences associated with conversion. *See supra* notes 70-77 and accompanying text.

mandatory.[144] By converting its subsidiaries into single-member LLCs and qualifying for branch or division treatment, a corporate member will be able to combine the income of the affiliated group and avoid incurring separate tax liability for each entity.[145] Hence, in states that impose a separate corporate tax on the income of each corporation in an affiliated group, single-member LLCs become the ultimate vehicle for corporate tax avoidance.[146]

With regard to natural persons owning single-member LLCs, because check-the-box regulations enable taxpayers to choose the type of classification for tax purposes, it is reasonable to assume that most single-member LLCs will not elect to be taxed as corporations. It is, therefore, inevitable that there will be some amount of revenue loss attributable to the absence of entity-level taxation. Because revenue consideration plays a significant role in the state legislative arena, revenue loss is probably the single most significant barrier to state conformity with the federal elective classification scheme. If revenue loss or other policy considerations warrant nonconformity in the minds of state officials, then there are at least two possible ways a state may decline conformity.[147]

1. The Lack of a Single-Member LLC Enabling Statute as a Basis for Nonconformity

A state may refuse to provide an enabling statute for the formation of a single-member LLC within its jurisdiction and/or simply impose an entity-level tax on the LLC. Unfortunately, states that fail to provide single-member LLC enabling statutes are not immune from the problems associated with these entities.[148]

Jurisdictions requiring at least two members currently permit nonlocal single-member LLCs to register to do business

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144. *See supra* notes 70-77 and 80 and accompanying text. Ironically, subversion of the consolidated return rules was one of the reasons why the IRS refused to extend flow-through tax treatment to single-member LLCs prior to check-the-box regulations. *See supra* note 61 accompanying text.

145. *See supra* note 61 accompanying text.

146. *See supra* note 61 accompanying text.

147. *See* Goforth, *supra* note 52, at 1271-72 (noting that in virtually every state, legislators considered "attracting business and revenue to the state, or avoiding the loss of such business and revenues to other states" as being an important factor in passing LLC legislation); *supra* note 52 (discussing the concerns of some state officials regarding revenue loss at the state level).

148. *See* Peabody, *supra* note 13, at 233.

within their jurisdiction.[149] Due to their nondiscriminatory certification practices, two-member jurisdictions, just like the other states, "will be forced to consider how to tax and award credits to single-member LLCs electing to be disregarded for federal tax purposes."[150] Consequently, the refusal or indifference of two-member jurisdictions to provide appropriate legislation for the formation of single-member LLCs appears to have little, if any, rational justification.

2. Nonconformity Arising from Imposition of an Entity-Level Tax

The more common type of state nonconformity will probably involve the imposition of an entity-level tax. If a state chooses to impose some form of an entity-level tax on single-member LLCs, it is important to examine what type of a tax the state will impose and whether multimember LLCs will also be subject to such type of tax. The most likely type of entity-level tax a nonconforming state will impose will be a corporate tax.[151] Unfortunately, since the franchise tax component of a corporate tax is a tax on capital and does not take the business's profitability into account, it could become expensive to a business that is highly capitalized.[152]

If a state chooses to impose a corporate tax solely on single-member LLCs, the discrepancy in tax treatment may cause taxpayers to use some of the ingenious tax planning strategies utilized at the federal level prior to check-the-box regulations, like creating a nominal second member interest[153] or entering into partnerships with related parties.[154] If this is the response, states would then have only succeeded in transferring the litigation from the federal to the state level over issues like when to invoke the single economic interest theory or how small a nominal second interest can be before the entity will be classified as a single-member.[155] Furthermore, the disparity in tax treatment between single-member and multimember LLCs due to an arbitrary classification may implicate serious equity

149. *See id.*

150. *See id.*

151. Forty-six states currently have a corporate income tax. *See* 1 State Tax Guide (CCH) 2531 (July 1997).

152. *See supra* note 92.

153. *See supra* notes 39-41 and accompanying text.

154. *See supra* notes 43 and accompanying text.

155. *See id.*

issues similar to those present at the federal level prior to check-the-box regulations.[156]

In order to avoid disparate treatment based on the number of members, some states may choose to impose a corporate tax on all LLCs. Unfortunately, even though across-the-board corporate taxation may be more equitable, state taxation of LLCs as C corporations may diminish their use as a viable business form,[157] especially in states where the corporate tax rate is high.[158] Consequently, the high tax rate will essentially leave two options to the potential LLC owner: to form an LLC in another jurisdiction or to choose another type of business form.

In addition to the inconvenience caused to a taxpayer, losing potential tax revenue by driving away LLCs from its jurisdiction is not a particularly good outcome for the state. The competition for potential tax revenue from LLCs was what fueled state LLC legislation in the early 1990s,[159] and it does not appear to have subsided. Thus, it is not in the best interest of a state to make itself purposely unattractive to LLCs by designing a tax system that espouses high tax rates, causes compliance difficulties, or both.

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156. *See supra* notes 11, 24, 26-38 and accompanying text. Similarly, in states where single-member LLCs are treated as corporations and multimember LLCs are treated as partnerships for tax purposes, if a two-member LLC loses one of its members because of death or withdrawal, disparate tax treatment has the effect of turning an LLC from a partnership to a corporation overnight. This outcome will penalize the taxpayer for reasons that are outside the control of the taxpayer. It therefore raises serious equity issues.

157. Hanna L. Thompson, *New Business Options in Pennsylvania: A Critical Analysis of the Pennsylvania Limited Liability Company and Limited Liability Partnership Act of 1994*, 57 U. PITT. L. REV. 129, 179 (1995); *see also* NEW YORK STATE BAR ASS'N, *supra* note 123 (brushing aside the proposal to treat LLCs as C corporations, stating that the treatment would be "prohibitive as a business matter and excessive in terms of the likely causes of projected revenue loss"). An excessively high tax burden may discourage the formation of LLCs within certain jurisdictions, especially if the states also have a personal income taxes. *See id.*; *infra* note 203 and accompanying text. In states like Texas where there is no personal income tax, however, treating LLCs as C corporations is somewhat justified because the income derived from LLCs would otherwise escape state taxation altogether. *See supra* notes 92-94 and accompanying text.

158. Alaska, Arizona, California, Connecticut, Delaware, District of Columbia, Idaho, Iowa, Kentucky, Louisiana, Maine, Minnesota, New Jersey, New York, North Dakota, Ohio, Pennsylvania, Rhode Island, Vermont and West Virginia have corporate tax rates eight percent or higher. *See* 1 State Tax Guide (CCH) 2531-32 (July 1997). Some of the rates may be graduated. *See id.*

159. *See supra* notes 52 & 147 and accompanying text.

Moreover, if a state imposes a high entity-level tax on LLCs, a potential LLC owner may have to turn to other business forms that provide limited liability and flow-through taxation. The next best alternative seems to be an S corporation, which has a significant qualification hurdle.[160] Even if a one-owner business whose owner is a citizen or a resident of the United States has little difficulty in meeting the requirements to make an S corporation election,[161] the state would still deprive the owner of the choice to form a more desirable entity that provides more flexibility in terms of financing, the potential for growth, and favorable tax consequences upon liquidation.[162]

Even if a state chooses to impose an entity-level tax other than a corporate tax on an LLC,[163] as long as the tax requires the computation of net income to which the tax will be applied,[164] there will be compliance issues that the state must consider.[165] Because the imposition of an entity-level tax will create a significant departure from the federal method of taxation,[166] it may require numerous adjustments to federal computations,[167] which could prove burdensome for the states. The states can shift some of this burden to taxpayers, however, by requiring them to prepare a pro forma federal corporate tax return that will provide the necessary numbers for computing the state tax base.[168] Either way, nonconformity will give rise

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160. *See* I.R.C. § 1361 (1997).

161. *See supra* note 44.

162. *See supra* notes 44-48 and accompanying text.

163. *See supra* notes 82-86 and accompanying text (discussing other types of entity-level taxes).

164. For example, a flat-fee tax will not require any tax base computations, but a corporate tax would. *See supra* note 20.

165. The federal elective classification scheme will shift the burden of determining the appropriate tax base to the states' collection agencies if a single-member LLC chooses to be disregarded at the federal level. *See Unofficial Transcript of the IRS Hearing on "Check-the-Box" Regulations*, *supra* note 25, at para. 147.

166. The imposition of an entity-level tax will treat a single-member LLC as being separate from its owner. *See supra* note 21 and accompanying text. Since a single-member LLC is not treated as a corporation for federal tax purposes unless it affirmatively chooses to, the state will not have the federal corporate taxable income figure from which it can compute its own tax base. *See id.*

167. *See* NEW YORK STATE BAR ASS'N, *supra* note 123.

168. *See* George F. Reilly, *California's Reluctance to Follow "Check-The-Box" Guidelines Raises Constitutional Issues*, 12 STATE TAX NOTES 1677, *available in* LEXIS, STTax Library, STNMAG File. This requirement was effective when California taxed single-member LLCs as corporations, which is

to additional compliance costs that either the states, the taxpayers, or both will have to bear.

IV. CHOOSING CONFORMITY: WHAT ARE THE ALTERNATIVES AVAILABLE TO THE STATES IN MINIMIZING THE REVENUE LOSS?

As outlined in previous sections, the new federal classification scheme has created significant policy and revenue-collection problems for the states. Unfortunately, it does not appear that the states can avoid these newfound problems by not conforming to the federal system. Indeed, from the perspective of taxpayers, nonconformity may exacerbate the existing problem by creating more compliance problems.[169] The fact is, states are in a better position to mitigate the possibly negative implications of the federal elective system than taxpayers because they can always impose some kind of a tax to combat revenue-negative results. Accordingly, this Note makes two sets of proposals. First, because of the need to tax LLC-generated income at least once, this Note recommends conformity in the states with a personal income tax in place.[170] Second, to minimize the revenue loss that conformity might cause, this Note recommends that conforming states implement a flat-fee system in the short term and an add-on tax system in the long term.

A. WHY SHOULD STATES CONFORM?

Even though conformity may have some negative implications, its significant benefits outweigh its costs. Historically, the greatest advantage conformity gave to the states was the ease of tax-base computation.[171] This remains true today, even with the new federal classification scheme. If the states rely on their personal income tax systems to collect revenue from single-member LLCs, the figures they need to compute their own taxes are readily available on Form 1040, the federal personal income tax return.[172] Even though the states will lose some in-

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no longer the case since single-member LLCs are now disregarded under California law if they are also disregarded at the federal level. *See supra* note 88 and accompanying text.

169. *See supra* notes 163-168 and accompanying text.

170. *See infra* notes 185, 203-204 and accompanying text and *supra* note 157 (explaining that in states without personal income taxes conformity will cause the income generated from an LLC to escape state taxation).

171. *See supra* notes 16-21 and accompanying text.

172. *See supra* note 65.

dependence by relying on the figures from the federal return, they will minimize any costs associated with having to compute their own tax base.[173]

Another advantage of conformity is that it facilitates uniformity among the states. A preliminary study conducted by the National Conference of Commissioners on Uniform States Laws (NCCUSL) determined that "'a uniform LLC act was desirable because state diversity would ultimately impede the 'predictability and therefore the interstate utility' of LLCs.'"[174] In addition, uniformity among the states reduces the competitive pressures to attract and maintain businesses, and reduces distortions in investment decisions by business people searching for better tax deals.[175]

Conformity is also a better choice from the taxpayer perspective. It makes compliance easier for taxpayers by promoting predictability and certainty as to the type of taxation imposed by the states.[176] Furthermore, it reduces the need for tax considerations when drafting organizational documents and cuts down on the number of tax forms filed, thereby reducing the cost of taxpayer compliance.[177] Finally, if states conform, taxpayers will not have to settle for a less desirable business form to avoid the uncertainty at the state level.[178]

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173. *See supra* note 163-168 and accompanying text.

174. *See* Burke, *supra* note 96, at 42 (quoting ULLCA, Prefatory Note (August 1994) (approval draft)). The absence of a single-member LLC enabling statute in 19 states is one indication of the lack of uniformity among the states. Although the NCCUSL was referring to LLC enabling statutes and not tax legislation, its assertion still has some applicability to the tax aspects of LLCs. The lack of uniform LLC tax treatment may spell a significant tax burden for LLCs in certain transactions and "increase the risk of multiple state taxation if a single-member LLC transacts business in several states." *See* Reilly, *supra* note 168, at 1681.

175. *See* Ribstein & Keatinge, *supra* note 6, § 17.20.

176. *See supra* note 129 (stating that fairness, efficiency, and predictability are essential in a coherent tax policy); *supra* note 174 (asserting that the lack of uniformity increases the chances of multiple taxation, which, by definition, is unfair); *see also* Dan Shaviro, *An Economic and Political Look at Federalism in Taxation*, 90 MICH. L. REV. 895, 919-21 (1992) (arguing that disparate state taxation increases litigation, tax compliance and administration costs and calling for greater congressional intervention). Although the "aggregate social costs of all the tax planning, compliance, administration, litigation, and politicking attributable to state and local taxation cannot readily be estimated, [they] plainly are enormous." *Id.* at 920. "These burdens, while not entirely avoidable given the existence of multiple governmental units, need not be nearly so great as they are in practice." *Id.* at 921.

177. *See supra* notes 39-43 and 163-168 and accompanying text.

178. *See supra* notes 44-48 & 160-162 and accompanying text; *see also*

Most importantly, conformity benefits the business form itself. In general, LLCs are tax driven—because the uncertainty at the federal level regarding single-member LLCs is finally resolved, conformity will strengthen the single-member LLC as an ideal business form, at least from the perspective of taxpayers.[179] Hence, taxpayers can benefit from the simplicity and efficiency that LLCs will bring to the business organization and its taxation structure.[180]

B. HOW TO CONFORM

As practical as conformity may be, complete conformity is unrealistic because of the significant differences between the tax collection methods of the federal government and the states.[181] There is no single formula to make conformity work, but steps could be taken to coordinate the federal and state tax system so as to minimize inefficiency.

Conformity should start with the nineteen states that, as of this writing, do not have single-member LLC enabling statutes.[182] Because of their nondiscriminatory certification practices, it is unlikely that two-member jurisdictions will be able avoid the classification and taxation problems associated with single-member LLCs.[183] Moreover, the absence of single-member LLC statutes may actually hurt more than help two-member states by making them less competitive in attracting business to their respective jurisdictions.[184]

With regard to taxation, structural conformity with the federal system is possible for most states for two significant reasons: at least forty-one states have a personal income tax system and their systems closely resemble the federal personal income tax.[185] Complete conformity would entail the states relying

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Heller & Carnevale, *supra* note 17, at 299.

179. *See supra* note 174 and accompanying text.

180. *See supra* notes 108-111 and accompanying text.

181. *See supra* note 13 and accompanying text.

182. *See supra* note 54 and accompanying text.

183. *See supra* notes 148-150 and accompanying text.

184. *See supra* notes 52 & 147 and accompanying text. Nonetheless, since a favorable change in the federal tax treatment of LLCs was the impetus behind the initial enactment of almost all LLC statutes by the states, it is reasonable to expect that the new federal system will eventually facilitate the adoption of single-member LLC enabling statutes by all the states. *See supra* notes 50-54 and accompanying text.

185. JEROME R. HELLERSTEIN & WALTER HELLERSTEIN, STATE AND LOCAL TAXATION, § 11.1, at 868 (6th ed. 1997).

solely on their personal income tax systems to tax the revenue generated from LLCs.

Unfortunately, by fully conforming with the federal system, there are at least three ways that the states will lose revenue. First, states will lose revenue from start-up businesses that would have used the corporate form in the absence of a choice to form an LLC.[186] Second, corporations may convert their wholly owned subsidiaries into single-member LLCs to receive branch or division treatment.[187] Third, the favorable attributes of LLCs may lead to conversions of nonpublicly traded C corporations into LLCs, thereby forgoing the entity-level tax revenue such entities used to generate.[188]

Choosing conformity would inevitably force states to find another way to raise revenue in light of the revenue loss that is bound to result. The following are a few suggestions on the types of taxes that can be used if sole reliance on the revenue generated from a personal income tax fails to produce the necessary level of revenue for the states.

1. Increasing Tax on Other Business Forms

In an effort to avoid imposing an entity-level tax on all LLCs, states might choose to increase the tax burden on all other business forms.[189] There are two compelling reasons, however, for states not to utilize this method. First, increasing the tax burden on other business forms to subsidize the revenue loss created by LLCs is inequitable. Second, this method of taxation will influence the choice of business form because the tax break LLCs receive would make them more attractive to business owners over other business forms, and may ultimately lead to the disappearance of all other business forms. Ultimately, the tax base may erode without any non-LLC business entities left to tax.

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186. *See, e.g.*, RIBSTEIN & KEATINGE, *supra* note 6, § 17.20 n.9 (stating that in Minnesota up to 20% of "the 2,400 new filings that would have been made by C corporations will instead be made by LLCs").

187. *See supra* notes 70-77 and accompanying text.

188. *See supra* note 75. The conversion of a C corporation into an LLC generally gives rise to gain recognition on appreciated property, and thus, is not a particularly good outcome for the taxpayer. *See supra* note 75. Hence, the risk of a revenue loss arising from the conversion of C corporations into LLCs is minimal. *See supra* note 75.

189. *See generally* Carson, *supra* note 123.

2. A Tax on Gross Receipts

By applying a low tax rate to the gross receipts of an LLC, a state may be able to reduce the revenue loss caused by solely relying on a personal income tax.[190] The most significant advantage of imposing a tax on gross receipts is the system's simplicity and efficiency. Unfortunately, a tax on gross receipts is quite possibly the most inequitable type of tax because it fails to take into account the profitability of a business. Because there are no deductions or losses considered, a business with high sales that is nonetheless losing money could end up paying a great deal of money in taxes when it cannot really afford to pay anything.

3. Flat Fee

In light of the immediate revenue loss states may encounter when they conform, a flat fee imposed on all LLCs may be the best solution. Flat fees provide a simple and efficient way to collect much needed revenue without classification problems.[191] The fees would be member-based or imposed on the entity itself. Yet while this Note recommends the imposition of flat fees to combat revenue loss, it cautions against their use for extended periods of time.

First, flat fees do not take the profitability or size of a business into account unless the fee is indexed to reflect the profitability of a business.[192] Even so indexed, such adjustments may reduce the utility of a flat-fee system by making it unnecessarily complicated to administer.[193]

Another problem with the flat-fee approach is that there is no set formula for determining the optimum flat fee. A low flat

190. *See* HELLERSTEIN & HELLERSTEIN, *supra* note 185, at 233-34 (stating that Washington is the only state that currently "imposes a gross receipts tax . . . as its general tax on business activity in the state"). Unlike states, however, many municipalities impose a gross receipts tax that resemble Washington State's. *See id.*

191. *See* NEW YORK STATE BAR ASS'N, *supra* note 123 (recommending imposition of a low flat-fee on all LLCs after examining several alternatives for minimizing revenue loss).

192. *See id.*

193. *See id.* To adjust for the increased income of the business, the NYSBA Task Force explored the possibility of indexing and increasing the fee charged overtime. *See id.* The Task Force ultimately ruled against indexation, however, since it would frustrate the chief advantage of a flat-fee revenue collection system: simplicity. *See id.*

fee would be ideal, but "low" does not mean much without being appropriately contextualized. A good example of a low flat fee is the California annual minimum franchise tax of $800.[194] Of course, California uses the tax in conjunction with other taxes, but assume that this was the only tax imposed on a single-member LLC. For an LLC with an annual net income of $10,000, an $800 flat fee may seem fair. If the same fee were to be imposed on a corporate LLC with an annual net income of $2,000,000, however, the tax break would turn into a windfall. In addition, a flat-fee system may have regressive tax implications. In the above example, the effective tax rate on the small LLC is 0.8%[195] while the rate on the corporate LLC is 0.0004%.[196] Hence, the business with low or no income would end up paying a higher percentage on its income than a more profitable one would.

As this example demonstrates, part of the difficulty in adopting one taxing scheme that would be applied to all LLCs is that there is no limitation on the kind of persons or entities that can own an LLC interest.[197] As a result, since single-member corporation-owned LLCs would conceivably be bigger and more profitable than individually owned LLCs, it may be necessary to extend different types of tax treatment based on whether a natural person or another business entity owns the LLC interest.

Despite their numerous disadvantages, flat fees might still help states minimize the adverse effects of classification problems and revenue loss in the short run until states better understand the actual revenue effects of LLCs and can devise a more comprehensive plan to overcome such problems. Because of the numerous policy considerations that drive state tax legislation, a

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194. *See supra* note 86.

195. $800/10,000.

196. $800/2,000,000.

197. The problem starts with state law, which collapses distinct entities like corporations and individuals into a single group eligible to own LLC interest. Then, check-the-box regulations exacerbate the problem by extending "nonentity" status to all one-member LLCs, which may cause doctrinal problems at the state level. *See, e.g., Unofficial Transcript of IRS Hearing on "Check-the-Box Regulations, supra* note 25, para. 143 (discussing how the federal tax treatment of corporation-owned one-member LLCs has no basis in state law because state law does not provide for a limited liability proprietorship for a corporate branch or division). Consequently, the federal branch or division treatment of single-member LLCs wholly owned by a corporation raises complicated issues for the states, particularly in the consolidated return area. *See supra* notes 70-77 and accompanying text.

comprehensive plan that will enable the states to adjust to the changes in the federal taxing environment will take time to develop. States therefore need to devise a short-term plan on how to deal with the recent changes at the federal level, and a flat-fee system will serve that purpose quite well.

4. Add-on Tax

Another option available to the states is to implement member-specific taxes that will be added on to the individual taxpayer's personal income tax.[198] An add-on tax, which would provide the necessary level of revenue while avoiding the imposition of an entity-level tax, would be the best taxing scheme for states that have a personal income tax system in place.[199] This Note recommends the use of add-on taxes to minimize revenue loss, but because add-on taxes need to be coordinated with other types of taxes and will take time to develop, an add-on tax system will most likely be a long-term solution.[200]

One of the biggest disadvantages of an add-on tax is that it would require the identification of all individuals who directly and indirectly own the LLC.[201] Fortunately, with single-member LLCs this problem is minimal. As the number of members increases, however, so does the difficulty in identifying the ownership interests through partnerships, trust, or other LLCs.[202] Provided that identification of the individual owners does not frustrate collection efforts, an add-on tax can actually be useful in mitigating revenue loss in states where the personal income tax is low.[203]

A way to avoid the problem of identifying individual owners is to impose an add-on tax on natural persons who directly own the LLC, and an equivalent withholding tax on business entity owners. The individual owners of the business entity members would then report their share of income and add-on tax on their individual returns along, with a credit for their

198. *See* NEW YORK STATE BAR ASS'N, *supra* note 123.
199. *See infra* notes 203-204 and accompanying text.
200. *See* NEW YORK STATE BAR ASS'N, *supra* note 123.
201. *See id.*
202. *See id.*
203. The states that have personal income tax rates less than six percent (graduated) include Alabama, Arizona, Colorado, Connecticut, Maryland, Massachusetts, Mississippi, New Hampshire, Pennsylvania, and Virginia. *See* 1 State Tax Guide (CCH) 3511-12 (Feb. 1997).

share of taxes paid by the business entity. The effect of this taxing method then would be to limit pass-through taxation to one level.

This proposal can be demonstrated as follows. A, B, C, and D each own 25% of X-LLC. A and B are natural persons (individuals), C is a partnership and D is an LLC. X-LLC has an income of $1000 for the year and the add-on tax rate is 5%. A and B will claim $250 each on their state personal income tax returns and pay a tax of $12.50 each. C and D will use some kind of a state form to show $250 in income derived from the LLC and pay a tax of $12.50 each. Then C and D can allocate the $250 income and the $12.50 in taxes paid to their respective individual owners. The individual owners of C and D can then recompute the add-on tax on their own state personal income tax forms on the income indirectly derived from X-LLC and take a credit for the tax already paid by C and D, which should exactly offset each other.

Unfortunately, in states with already high personal income tax rates,[204] an add-on tax may create an excessive tax burden.[205] One way to determine if a tax paid by members of an LLC is excessive is if owners of similar other entities, such as S corporations, are subject to comparatively lower effective tax rates and there is little or no justification for the discrepancy.

Finally, there is the issue of the proper add-on tax rate. The taxing scheme the states will implement most likely will reflect the privilege of operating as a limited liability company. Of course, the privilege's value will not be easy to measure. A state should conduct a comprehensive study on the use of LLCs before deciding what the tax rate should be.[206] The ideal tax rate would raise enough revenue to compensate for the difference between the loss of revenue resulting from foregoing C corporation entity-level tax and the additional revenue raised by the business-generating effect of LLCs.[207] Furthermore, the rate should be adjusted to reflect the state's personal income tax rate so it will not be so excessive as to drive away LLCs.

Because it is difficult, if not impossible, for a state to determine the optimum tax rate from the outset, the state would

204. Eleven states have graduated personal tax rates greater than eight percent. *See id.*

205. *See* NEW YORK STATE BAR ASS'N, *supra* note 123.

206. *See id.*

207. *See id.*

be best advised to start out with the same rate as one imposed on S corporations, or some other entity similar to the LLC, and adjust the rate later based on certain factors. The tax rate adjustments would reflect the changing revenue needs of the state based on cost of administration, the rate at which LLCs are formed within its jurisdiction, the rate at which other business forms are switching to LLCs, the percentage increase in business liability litigation, and other miscellaneous factors.

CONCLUSION

On the eve of the finalization of check-the-box regulations, single-member LLCs have emerged as an ideal business form for one-owner businesses by combining limited liability with conduit taxation. These advantages are somewhat diminished, however, because of certain key issues that remain unresolved at the state level. The viability of single-member LLCs as a business form itself is dependent upon favorable tax laws. It is therefore imperative that states implement scheme that will strike a balance between revenue-raising and procedural clarity and simplicity. Accordingly, this Note recommends state conformity and the implementation of a fair, simple, and efficient taxing method to minimize revenue loss.