

# **The FAQs of LLCs**

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## I. THE FAQs OF LIMITED LIABILITY COMPANIES

### A. What is an LLC?

An LLC is a new type of business entity. Under state law, it is neither a partnership nor a corporation, but a new and different type of entity, created pursuant to statute. The owners of an LLC are referred to as "members" and have rights that are in some ways similar to those of corporate shareholders and in some ways similar to partners in a partnership. Generally, the members (owners) of an LLC are not personally liable for the debts and obligations of the LLC, just as corporate stockholders are not personally liable for the debts and obligations of the corporation. At the same time, an LLC with two or more members will usually qualify for taxation as a partnership, *i.e.*, flow-through taxation. (A single-member LLC will generally not be treated as a taxable entity distinct from its member.) Thus, the LLC may offer the best of both worlds: limited liability similar to a corporation, and the flexibility and tax advantages of a partnership.

#### 1. How is it different from a partnership?

The most important difference is that the partners in a partnership are personally liable for the debts and obligations of the partnership. In contrast, the members of an LLC are not personally liable for the debts and obligations of the LLC.<sup>1</sup> Also, the LLC statute creates certain specific rules for the formation, operation, and management of LLCs, which may not apply to partnerships. For example, since an LLC is created pursuant to a specific registration process set forth in the statute, failure to go through that process necessarily means that no LLC exists. In contrast, a partnership can be created informally, without going through the statutory partnership registration process. Finally, a partnership requires two or more partners, while an LLC can be formed with a single member.

#### 2. How is it different from a limited partnership?

In a limited partnership, the limited partners have limited liability. However, every limited partnership must have at least one general partner, and that general partner is personally liable for partnership debts. An LLC is not required to have a "general partner" – no member has to accept personal liability for debts of the entity.

Also, limited partners may not participate in management of the partnership, or they lose

their liability protection. Members of an LLC may participate in management without losing their liability protection.

3. How is it different from a C corporation?

In a C corporation, the income tax applies at both the entity level and the owner level. In an LLC, generally partnership taxation rules will apply, and thus the income tax will apply only at the owner level (although the entity must still file a partnership information return).

Also, corporate statutes generally provide less flexibility in structure and governance than the LLC law does.

4. How is it different from an S corporation?

In an S corporation, the double taxation inherent in a C corporation can be avoided, but various other restrictions apply (*e.g.*, the "one class of stock" rule, and limits on the number and type of stockholders). An LLC generally offers more flexibility than an S corporation.

**B. How good is the liability shield?**

1. What kinds of liability does it protect against?

A member in an LLC is shielded from vicarious liability, *i.e.*, liability arising out of the acts of others. The member is not shielded from liability arising out of his or her own acts or omissions. For example, doctors A and B form an LLC to practice medicine. Doctor A treats patient Jones, and commits malpractice. Doctor B is not involved in treating patient Jones. Doctor B will **not** be jointly liable to Jones simply because Doctor B is a co-member of the LLC with Doctor A. However, Jones can sue Doctor A, and Doctor A will not be protected from liability by the LLC structure. The LLC only protects against vicarious liability, not against liability for one's own acts.

2. Can the shield be pierced?

There is no reported Hawaii decision answering this question. In some states, the liability protection given to members of an LLC may be clearer and more absolute than the protection given to corporate stockholders. Unfortunately, that is not true in Hawaii.

As originally enacted in 1996, the Hawaii LLC law specifically provided that the members of an LLC may be held personally liable in some circumstances. The LLC law referred

to, and incorporated, the corporate law doctrine of "piercing the corporate veil," which allows courts to find that stockholders are jointly liable for corporate debts in situations where corporate formalities have not been observed,<sup>2</sup> capitalization is clearly inadequate, personal and corporate funds have been co-mingled, or where other reasons may exist for treating the stockholders as effectively the *alter ego* of the corporation.

In 1999, the Hawaii Legislature passed Act 164 (Senate Bill 1139), which *inter alia* removed the "piercing the veil" language from the LLC statute. The committee report, however, described this as a "housekeeping" measure which made no substantive change in the law. At this point, therefore, it is unclear whether "piercing the veil" is any more difficult in an LLC than a corporation.

Some courts in other states have stated that "piercing the veil" should apply to LLCs in the same way as corporations. *See, e.g., Kaycee Land and Livestock v. Flahive*, 46 P.3d 323 (Wyo. 2002). *Cf. In re Securities Investor Protection Corp. v. R.D. Kushnir & Co.*, 274 B. R. 768 (Bankr. N.D. Ill. 2002), applying Illinois law, and holding that mere failure to observe formalities was not a basis for piercing the veil, but other reasons might suffice.

### **C. How does an LLC work for tax purposes?**

#### **1. How is a single-member LLC taxed?**

Normally, a single-member LLC is a "disregarded entity" for tax purposes – i.e., the existence of the LLC is ignored, and for tax purposes the business is treated as conducted by the member. For an individual, the LLC's operations would simply be included on the individual's tax return, usually on Schedule C. If the member is a corporation or other entity, the LLC's operations would be included in the tax return of the corporation or other entity.

The disregarded entity treatment will apply unless the LLC affirmatively elects to be taxed as a corporation instead. That election can be made by filing IRS Form 8832.

#### **2. Does the IRS ever treat a "disregarded entity" as a separate entity?**

Although a single-member LLC is generally disregarded for the purpose of taxing the income it generates, the IRS does recognize that the LLC is a separate and distinct entity under state law, with liabilities that are distinct from the liabilities of the sole member. Thus, for purposes of liens, levies, and collections, assets held by the LLC are not treated as if they were

owned directly by the sole member, nor are assets held by the member treated as if they were owned by the LLC.<sup>3</sup>

3. How is a multiple-member LLC taxed?

An LLC with two or more members is a partnership for tax purposes, unless the LLC elects (by filing IRS Form 8832) to be treated as a corporation.

4. If an LLC is owned by a husband and wife, do they count as two members?

In IRS Publication 541 and in Rev. Proc. 2002-69, the IRS takes the position that a husband and wife who own an LLC as community property will count as a single owner for purposes of the disregarded entity rule. If they choose to file a partnership return for the LLC, the IRS will accept the position that the LLC is a partnership for tax purposes. If the LLC interest is not community property, the husband and wife constitute two owners. In Publication 541, however, the IRS says that a husband and wife can choose to classify the LLC as a sole proprietorship by filing a Schedule C (Form 1040) listing one spouse as the sole proprietor.

**D. What are the basic types of LLCs?**

1. Who are the managers?

An LLC can be managed by designated managers, who do not necessarily have to be members. In a manager-managed LLC, the managers are specifically identified in documents which are public records, and only the managers have the power to bind the LLC contractually. Thus, a contract signed by a member who is not a manager would not be binding on the LLC. This is similar to a corporation, where only the officers (managers) normally have the power to bind the corporation, and a contract signed by a stockholder who is not an officer would not be enforceable against the corporation.

Alternatively, an LLC can be member-managed, with all members having the power to act for the entity. This is similar to a partnership, where any partner can bind the partnership contractually.

An LLC's registration (which is a public document) must indicate whether it is manager-managed or member-managed.

## 2. How long does it last?

An LLC can be established for a fixed period of time (after which it is dissolved), or it can have an at-will existence, where any member has the power to dissolve it at any time, with or without the consent of the other members. In most cases, an at-will LLC is probably not desirable, since it puts the existence of the entity at the mercy of any member who may be temporarily upset. However, if the members want to make sure that they each have an absolute right to get out at any time, an at-will LLC might be useful.<sup>4</sup>

Nothing in the statute limits the term of an LLC, so a "permanent" LLC can effectively be formed by specifying a duration of, say, 100,000 years.

### E. **How is an LLC formed?**

Since an LLC is defined and created by statute, it can only be created by following the statutory process. In Hawaii, this means filing Articles of Organization (Form LLC-1) with the Department of Commerce and Consumer Affairs.

#### 1. What are the Articles of Organization?

An LLC's Articles of Organization are similar to a corporation's Articles of Incorporation. The Articles must identify the initial members, the initial managers (if any), the address of the LLC's principal office or place of business, and other basic information. The Articles do not have to state the formula or method of sharing income among the members, nor do they have to state the terms (or even the existence) of buy-sell agreements. Thus, the real economic terms of the deal among the members do not have to be publicly disclosed.

#### 2. What is the Operating Agreement?

The Operating Agreement is a written agreement among the LLC's members setting forth the deal regarding governance and money. By statute, an operating agreement (if one exists) must be in writing.<sup>5</sup> Thus, by definition, there is no such thing as an oral operating agreement.

An Operating Agreement is not required to be filed with the DCCA, and is not public unless the parties choose to make it public.

An LLC is not required to have an Operating Agreement. In the absence of an Operating Agreement, various statutory default provisions will apply.

3. What if we don't have an Operating Agreement?

The LLC law allows a great deal of flexibility, but it includes a number of default provisions that will apply unless there is an agreement to the contrary. Note that since an Operating Agreement must be in writing (if it exists at all), an oral agreement to do something different from the default provisions is presumably void and unenforceable.

The default provisions include some rules that your client may not want. For example, unless there is an agreement to the contrary, distributions to the members must be equal. Thus, if A puts in 80% of the capital and B puts in 20%, they each get 50% of the money distributed unless the Operating Agreement says otherwise. Most clients will neither expect nor want this result. It is therefore important to have a written agreement to deal with these issues.

**F. What are the rights and duties of members?**

1. What does a member have to put in?

There is no minimum amount of capital required to become a member, and the voting power of a member does not have to be related to his or her capital contribution. A member's contribution to the capital of an LLC can be in cash, property (real or personal, including intangibles), or in the form of services. A member's obligation to contribute capital is not excused by the member's death; it becomes an obligation of his estate. Generally, creditors of the entity can enforce the obligations of the members to make capital contributions, but only to the extent that the entity itself could enforce such obligations. For example, assume that A agrees to pay \$10,000 as his capital contribution, payable at the rate of \$2,000 per year for five years. A has only paid \$6,000 at the time that X obtains a judgment against the LLC. X can compel A to put in the remaining \$4,000 according to the original schedule, but cannot compel him to accelerate the payments or to put in any more than \$10,000, even if the judgment remains unsatisfied.

**G. What are the tax effects of contribution of property?**

In general, a transfer of property to a partnership (including an LLC treated as a partnership) in exchange for a partnership interest will not result in the recognition of gain or

loss. The contributor's tax basis in the property becomes the partnership's basis. The partner's basis in the partnership interest acquired is also equal to the partner's pre-contribution basis in the property.

1. How are distributions made?

Although the default provisions provide for equal distributions, virtually any system or formula can be agreed upon. For tax purposes, the distribution system may need to have some economic basis, but as a matter of state law the members can agree on anything they want.

The allocation of profit or loss and the actual distribution of money or property are separate matters, and do not have to be either simultaneous or equal. For example, if the LLC has \$10,000 of profit in the year 2003, it might be allocated 60% to member A and 40% to member B, with each reporting his or her respective share to the IRS and the Department of Taxation. However, they could decide that only, say, \$3,000 of cash will be distributed, and that the distribution will be \$1,500 each to A and B. Moreover, the distribution does not have to take place in 2003, or within any particular time after the end of the year.

To the extent that distributions are made while the entity is insolvent, or to the extent that distributions render the entity insolvent, creditors will generally have the power to force members to disgorge those distributions.

2. How does voting work?

The default provisions give each member one vote (regardless of the size of their respective capital interests), but again this can be changed in the Operating Agreement. Voting power can be made proportional to ownership or completely unconnected to ownership. With certain exceptions, most decisions require a simple majority vote (but this can also be changed).

3. Do members get paid for services to the entity?

Members who perform services for the entity are not automatically entitled to wages, salaries, or other compensation, although compensation can be agreed upon. Members who advance funds for legitimate expenses of the entity are entitled to reimbursement from the entity.

## H. **What are the rights of third parties dealing with the LLC?**

Generally, a third party dealing with an LLC will want to ascertain whether the LLC is member-managed or manager-managed, as this will determine who is empowered to act on behalf of the entity.

### 1. Who has the power to sign?

In a manager-managed LLC, only the named managers have the power to bind the LLC. Thus, for example, a deed conveying property from the LLC, a mortgage, or a written contract will not be valid unless signed by a manager. Generally, any one manager can bind the LLC, even if there are multiple managers. Managers are normally presumed to have authority to act on behalf of the LLC. However, if the third party dealing with a manager knew or had notice<sup>6</sup> that the manager lacked authority to do a particular act, then the manager does not bind the LLC by doing that act.

In a member-managed LLC, any member has the power to bind the LLC in carrying on business in the ordinary course of business of the type carried on by the LLC. For example, if the LLC operated a car dealership, any member (assuming a member-managed LLC) could normally bind the LLC to a contract to sell a car. This would be true even if the agreement among the members provided otherwise, unless the third party dealing with the member knew or had notice that the member's authority was limited.

If the LLC wishes to place specific limitations on the authority of managers or members, the LLC may want to consider stating those limitations in its Articles of Organization (which is a public-record document).

### 2. What are the rights of creditors and transferees of members?

Transferees of members, and creditors who effectively become transferees through judicial remedies, do not automatically become members, but succeed to the member's right to receive distributions, and to whatever right the member had to obtain a dissolution.<sup>7</sup> This means that the transferee or creditor shares in any distributions made (to whatever extent the member would have), but has no voting power or management rights.

In general, a transferee can become a member only with the consent of all other members, or upon satisfaction of the requirements of the Operating Agreement.

### **I. How does a member get out?**

Any member of an LLC can dissociate himself or herself voluntarily at any time. However, dissociation which is contrary to the Operating Agreement is wrongful dissociation, for which the LLC and/or the other members may be entitled to remedies.

The Operating Agreement may also specify situations in which a member may be involuntarily dissociated, *i.e.*, expelled.

Finally, dissociation can be judicially ordered for certain wrongful acts, such as a willful breach of a member's duties.

#### **1. What are the remedies for wrongful dissociation?**

A member who wrongfully dissociates is liable to the LLC and to the other members for any damages caused by the dissociation. These damages may be offset against any distributions otherwise due to the member.

#### **2. When is a member entitled to be bought out?**

When a member dissociates, rightfully or wrongfully, the member's right to participate in management ceases. In an at-will LLC, the member is entitled to have his interest redeemed by the LLC at the time of dissociation. In an LLC for a fixed term, the member effectively has the status of a transferee (*i.e.*, he shares in distributions but has no vote or management rights) until the end of the fixed term, at which point his interest is redeemed in the final dissolution. In either case, the price paid to the member for his interest can either be fixed by a formula or method set forth in the Operating Agreement, or be set at "fair value" by a court. Any damages for wrongful dissociation would be deducted from amounts otherwise due to the member.

#### **3. What if the dissociated member tries to act for the LLC?**

If the dissociation of a member does not result in the dissolution of the LLC, then the dissociated member may have continuing power to bind the LLC. For a period of two years after the dissociation, the dissociated member can still bind the LLC if the third party dealing with the

dissociated member does not have notice of the dissociation and reasonably believes that the dissociated member is still a member. This two-year period can effectively be shortened to 90 days (but not entirely eliminated) by filing a statement of dissociation with DCCA, and thus making the dissociation a matter of public record.

#### J. **Can I convert some other entity to an LLC?**

Yes. However, in converting an existing entity into an LLC careful attention must be paid to differences between the state law process to be followed and the tax effect. Often, these can be quite different – a process which is simple and straightforward under state law can have complex and drastic tax consequences.

##### 1. What is the state law process?

Generally, any existing Hawaii corporation (S corp or C corp) or existing Hawaii partnership (limited or general) can convert to an LLC by simply filing form X-10 at the Department of Commerce and Consumer Affairs.<sup>8</sup> As a matter of state law, it simply requires the filing of the form and the payment of the filing fee. Similarly, virtually any type of entity can be merged into any other type by a simple one-step filing at DCCA.

##### 2. What are the tax issues in a conversion or merger?

When a partnership converts to an LLC (by either conversion or merger), it remains a partnership for tax purposes.<sup>9</sup> Thus, there will generally be no major tax problems. However, that in partnerships (especially limited partnerships) where non-recourse debt and at-risk rules are important, changing to an LLC may impact the extent to which individual partners are liable (or deemed to be liable) for partnership debt, and thus may have important tax implications.

When a corporation converts to an LLC, for tax purposes it is treated as if it were a dissolution and liquidation of the corporation, a distribution of the assets to the stockholders, and then the formation of a new partnership by a contribution of the assets. The distribution of assets to the stockholders is a taxable event. Thus, there will generally be substantial tax disadvantages. In most cases, if a business already exists in a corporate format, converting the existing entity to an LLC will not be feasible. However, if additional liability protection and/or flexibility in ownership structure are desired, an LLC can be formed to hold the stock of the corporation.

If you decide to proceed with a corporation-to-LLC conversion, probably the best way to do it is to have the shareholders put their stock into a new LLC as its initial capital, then liquidate the corporation into the LLC. This requires only one transfer of assets (compared with two if the corporation is liquidated, its assets distributed to the shareholders, and then the shareholders contribute the assets to an LLC). Also, the shareholders can avoid whatever liability risk is associated with direct ownership of the assets.

It should also be noted that if a cash-basis corporation (*e.g.*, a professional corporation) distributes its receivables, Internal Revenue Code (“Code”) § 336 requires immediate recognition of gain. This is a particular problem for CPA firms, law firms, medical practices, etc. wishing to convert to LLC form. The best practical solution is generally the "parallel entity" technique – form a new LLC to conduct business from the start date forward, with all services performed through the new entity. Let the old corporation remain in existence, operating parallel to the LLC, but move clients or customers to the new LLC as quickly as possible. Eventually, the old corporation is doing nothing but collecting receivables, and when that process is completed, it can be dissolved. This should avoid most of the tax problems. However, if any assets are transferred from the old entity to the new one – including intangibles like a name or trademark – then there should be fair payment made.

#### **K. What are the Hawaii state tax issues for LLCs?**

##### **1. How is an LLC treated for Hawaii income tax purposes?**

The Department of Taxation of the State of Hawaii will follow federal law in treating an LLC as a corporation, a partnership, or a disregarded entity for income tax purposes. If the LLC is a partnership for federal income tax purposes, then it must be a partnership for state income tax purposes. Similarly, if it is a corporation for federal income tax purposes, it must be a corporation for state income tax purposes. If it is disregarded for federal income tax purposes, it must be disregarded for state income tax purposes.

##### **2. How do the general excise and use taxes apply to an LLC?**

Although an LLC may be a "flow-through" entity for income tax purposes (*i.e.*, profits and losses flow through to the members, and no income tax is imposed at the entity level), this is

not true for general excise and use tax purposes. The LLC is a taxable entity, required to pay its own tax, for purposes of the Hawaii general excise and use taxes.

Distributions paid out to the members as their respective shares of the LLC's profits are not subject to general excise tax when received by the members. Other transactions between the members and the entity (such as a sale of goods) may be subject to the general excise tax. HRS § 237-23.5 provides an exemption for certain types of transactions, but not all transactions, between or among related entities. Generally, LLCs may be included among a group of related entities for purposes of HRS § 237-23.5 if they are connected through at least 80% common ownership, measured by both value and voting power.

### 3. What about other state and local taxes?

An LLC that owns real property is subject to the real property tax. If it transfers the property, it is subject to the conveyance tax. Depending on the business it conducts, the LLC (as an entity) can be subject to the liquor tax, the tobacco tax, the rental motor vehicle tax, the tour vehicle surcharge tax, the county vehicular tax, the insurance premium tax, the public service company tax, and/or other State taxes. These taxes apply to the LLC as an entity; they are not "flow-through" taxes imposed at the member level.

#### L. **Are there any labor-law issues?**

An LLC with employees is subject to the Workers Compensation Law, and required to have Workers Compensation insurance like other employers. A single-member LLC may be disregarded as an entity for income tax purposes, but for Workers Compensation purposes the LLC, as an entity, is the employer. This may be important in relation to the "exclusive remedy" rule for work-related injuries.

In a corporation, an owner-employee who owns 50% or more of the stock may elect not to cover himself or herself for Workers Compensation purposes. This rule, as currently written, applies to corporations, but not to LLCs. Thus, it is currently the position of the Department of Labor of the State of Hawaii that owner-employees of LLCs may **not** opt out of Workers Compensation coverage on themselves. Legislation to correct this anomaly was proposed in 2003 and again in 2004 but did not pass.

For other labor-law issues (TDI, pre-paid health care, unemployment, etc.), the LLC as an entity will generally be considered the employer, even if the entity is disregarded and the business is treated as a Schedule C business for income tax purposes.

### M. **Can I do estate planning with LLCs?**

In theory, the same kind of discounts available with a Family Limited Partnership (FLP) should be available with an LLC. In fact, the LLC may be preferable, since no one has to be a "general partner" for liability purposes.

There is a potential problem, however, caused by Code § 2704(b). Under the Revised Uniform Limited Partnership Act (and under HRS § 425D-603) a limited partner may not withdraw from the partnership (and thus obtain payment for his interest) prior to the time or event specified in the partnership agreement.<sup>10</sup> In contrast, under the Uniform Limited Liability Company Act (and HRS § 428-601) a member may dissociate from an LLC at any time, even if the operating agreement provides otherwise. (The member may be liable for damages for wrongful dissociation, but he **can** dissociate.) Any restriction on a member's right to dissociate and thereby obtain a buy-out of his interest may be an "applicable restriction" that is disregarded under § 2704(b).

Basically, § 2704(b) says that a restriction on a partner's right to withdraw and get cashed out is disregarded if the partner and members of his family collectively have the right to remove the restriction. Since the provisions of an operating agreement can be amended by the members of an LLC, a restriction in the LLC's operating agreement can be removed by the members collectively. Thus, if the members of the LLC are all family of the potential withdrawing "partner," then the restriction in the operating agreement may be disregarded under § 2704(b).<sup>11</sup> Obviously, if a restriction on the ability to withdraw and get cashed out is disregarded, then discounts for minority interest and lack of marketability are much harder to justify<sup>12</sup>.

An FLP avoids this issue because the restriction on a partner's ability to withdraw is statutory, not based on the partners' agreement. (Note, however, that the partners in a FLP could amend the partnership agreement to move up the date of termination – thus the difference between the "statutory" rule for FLPs and the "by agreement" rule for LLCs is more theoretical than substantive.)

**N. Can I organize my law firm as an LLC?**

Yes. On June 17, 1999, the Hawaii Supreme Court issued an ORDER AMENDING RULE 6 OF THE RULES OF THE HAWAII SUPREME COURT. The current version of Rule 6 took effect July 1, 1999. The new Rule allows law firms to be organized in any "lawful organizational form," which currently includes LLCs, LLPs, and professional corporations, as well as general partnerships and sole proprietorships.

Section 6(g) now provides that if the firm maintains errors and omissions insurance of at least \$100,000 per attorney or \$5,000,000 total for the firm (whichever is less), then the professional liability of each attorney is limited to responsibility for that attorney's own performance of professional services. A deductible of up to 10% of the required amount is permitted.

Note that the limitation of liability applies only to vicarious liability – an attorney (or other professional) is always liable, without limit, for his or her own malpractice.

**O. What other tax issues arise for LLCs?**

1. How do the passive activity loss rules apply?

In general, passive activity loss rules apply to partners, including LLC members who are partners for tax law purposes. Normally, partners (including LLC members) must satisfy "material participation" standards in order to use losses from the entity to offset active or portfolio income. These rules are generally the same for LLCs treated as partnerships as for ordinary partnerships.

Note that the test is applied at the partner level – it is quite possible for one member of an LLC to "materially participate" in the business of the entity while another does not.

In general, a limited partner is treated as holding an interest in a passive activity. There is some debate as whether a member of an LLC should be considered a limited partner. In particular, in a manager-managed LLC, a member who is not a manager is likely to be considered a limited partner. If regarded as a limited partner, the LLC member would be considered passive unless he satisfies at least one of the tests:

- (1) 500 hours of participation in the activity;

- (2) Material participation in any five of the last ten taxable years; or
- (3) Material participation in a personal service activity for any three prior taxable years

2. What taxable year can the LLC choose?

A partnership, including an LLC taxed as a partnership, can adopt a taxable year other than the calendar year. Generally, partnership income flows through to the partners as of the end of the partnership's taxable year.

To prevent partners from obtaining an easy 11-month deferral, Code § 706(b) limits the ability of a partnership to choose a tax year different from that of its partners. In general, three rules apply:

- (1) If partners owning more than 50% of the partnership have the same taxable year, then the partnership must use that taxable year.
- (2) If no combination of partners owning more than 50% has the same taxable year, but all of its "principal partners" have the same taxable year, then the partnership must use the same taxable year used by all of its principal partners (defined as partners owning 5% or more of capital or profits).
- (3) If neither (1) nor (2) applies, the partnership must adopt the calendar year or a taxable year chosen under the "least aggregate deferral" regulations, Treas. Reg. § 1.706-1 *et seq.*

There is an exception when the partnership taxable year has a "valid business purpose" other than tax deferral.

A partnership may also choose a year that creates up to three months of deferral by agreeing to make non-interest-bearing deposits to be held by the government during the period of deferral. *See* Code §§ 444, 7519.

### 3. How do the at-risk rules apply?

In general, a taxpayer is allowed to claim losses only if, and to the extent, that the taxpayer is "at risk" in the economic activity generating the loss.

Although the at-risk rules have some relationship, at least in theoretical and policy terms, to the passive activity loss rules, they are a separate and essentially independent set of rules – "material participation" for passive loss purposes does not necessarily imply that the taxpayer is at risk, nor is the converse necessarily true.

Like passive activity/material participation rules, the at-risk rules apply to partners (including LLC members) at the individual partner level.

Complex Regulations govern the use of nonrecourse debt for real estate financing. The bottom line is that, if properly structured, an LLC can use "qualified nonrecourse financing." *See* Treas. Reg. § 1.465-27 and Code § 465(b)(6). This can be a way to increase the extent to which LLC members are deemed to be at risk, and thus to increase the extent to which they can use deductions.

Note also that the deductions a partner (including an LLC member treated as a partner) is allowed to take may be limited by the partner's basis in his partnership interest. Thus, in determining whether a loss is deductible, there are three independent (and very technical) sets of rules that may apply:

- (1) basis rules;
- (2) at-risk rules; and
- (3) passive loss rules.

In general – and oversimplifying to some extent – the three sets of rules are applied in that order.

### 4. Do we have to choose a tax matters partner?

In general, a partnership (including an LLC taxed as a partnership) may designate a Tax Matters Partner ("TMP") to direct and coordinate any partnership audit. If the partnership fails to designate a TMP, the IRS or the Tax Court can do so.

The TMP must be a general partner. By regulation, the IRS has declared that a member-manager of an LLC is considered a "general partner" of the LLC for TMP purposes. If there are no member-managers, then all members are deemed to be member-managers for this purpose.

Normally, unless the partners agree otherwise, the "general partner" (as defined above) with the largest share of profits will be the TMP. If two or more partners have equal profit shares, the IRS will choose in alphabetical order.

Generally, the TMP is the conduit for all communication with the IRS. The TMP is obligated to furnish specified information to other partners, or to groups of partners. Note, however, that failure by the TMP to furnish information will generally not be grounds for relief for adversely affected partners.

Selection of the TMP can be extremely important. The TMP may have the power to execute settlement agreements with the IRS, and to bind other partners by doing so. The TMP can sign extensions of time for IRS assessments, and can file a Tax Court petition.

"Notice partners" do not have all of the rights and powers of a TMP, but are entitled to receive direct notice from the IRS of certain actions. Any group of partners holding, collectively, a 5% or greater profit interest can designate one member of their group as a notice partner.

#### 5. What are guaranteed payments?

Certain types of payments from a partnership to one or more of its partners may be treated as if they were payments to a third party. Such payments are not considered distributions of partnership profit to the recipient – they are treated as if the recipient were not a partner, and was simply being paid for some service or property provided to the partnership. Generally, this applies to payments which do not depend on partnership profits.

Example: X, Y, and Z are partners in the XYZ Partnership. X is the Managing Partner. By agreement, X gets \$20,000 per year for serving as Managing Partner, and the remaining profit is split one-third each among X, Y, and Z. The \$20,000 is a fixed number that does not depend on the amount of partnership profits. The \$20,000 is a guaranteed payment.

If X received 5% of total profits first, and then the remaining profits were split one-third to each, the 5% would not be a guaranteed payment.

6. Can a partner take a position on his own tax return that is inconsistent with the partnership return?

The general rule is that each partner must report in a manner consistent with the partnership return (Form 1065). Normally, a negligence penalty will apply to any understatement of tax liability due to inconsistent reporting. In addition, the IRS can automatically adjust an individual partner's return to conform to the partnership return.

If a partner wants to report in an inconsistent manner, he can file Form 8082. As to the specific items listed on the Form 8082 (and only those items), the IRS cannot make an adjustment unless (1) there is actually a partnership audit, or (2) the IRS converts the items to nonpartnership items. (Converting to non-partnership items basically means that the items are handled and resolved at the partner's level, and the partner is not bound by any IRS adjustments made at the partnership level.)

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<sup>1</sup> The members can choose to be personally liable for the debts and obligations of the entity. *See* HRS § 428-303. Normally, the members will not make this choice.

<sup>2</sup> *See*, however, HRS § 428-303(b), which states that the mere failure to observe formalities shall not be a ground for imposing personal liability.

<sup>3</sup> *See* Proposed Treas. Reg. §§ 1.856-9, 1.1361-4, and 301.7701-2.; *see also* Rev. Rul. 2004-41, 2004-18 IRB.

<sup>4</sup> A buy-sell agreement might be preferable, in that it would create an "exit" that did not necessarily involve dissolving the entity.

<sup>5</sup> *See* HRS § 428-103(a).

<sup>6</sup> "Notice" is a defined term in the LLC law. HRS § 428-102. Basically, a person has notice of a fact if the person has reason to know of the fact's existence.

<sup>7</sup> This means that in an at-will LLC, the creditor of a member may be able to force a dissolution against the wishes of all of the members – a good reason not to form an at-will LLC.

<sup>8</sup> An entity doing business in Hawaii but formed in another state can be merged or converted into a Hawaii LLC, subject to any restrictions imposed by the laws of its home state.

<sup>9</sup> *See, e.g.*, Priv. Ltr. Rul. 9525065 (Jun. 23, 1995).

<sup>10</sup> If no time or event is specified, a limited partner can withdraw any time on six months' notice.

<sup>11</sup> If the restrictions on a member's right to withdraw and get cashed out are no more restrictive than the default rule under the applicable statute, the § 2704(b) problem can be avoided. However, the client may often want tighter restrictions. Moreover, tighter restrictions are often used to justify larger discounts.

<sup>12</sup> For further discussion, *see* Tech. Adv. Mem. 9736004 (Jun. 6, 1997).