Business Organizations—Limited Liability Companies in Arkansas: The Knowns and the Unknowns

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CASENOTES

LIMITED LIABILITY COMPANIES IN ARKANSAS: THE KNOWNS AND THE UNKNOWNS

I. INTRODUCTION

During its regular session of 1993, the General Assembly of the State of Arkansas passed Act 1003, the "Small Business Entity Tax Pass Through Act," otherwise known as Arkansas's Limited Liability Company Act. As a result, Arkansas joins the ranks of several other states which recognize a new business entity called the Limited Liability Company ("LLC").

Other states have enacted statutes which are very similar to Arkansas's LLC statute. Accordingly, many aspects of creating and using an LLC have become standardized through use of those statutes. This note will discuss these "knowns" in order to give the reader a better understanding of the new entity. However, there are many "unknowns" of LLC operation which have not become standardized. These unknowns will not be resolved until either all the states recognize the new entity or the judicial system provides guidance for its treatment. This note will also discuss these unknowns of LLCs to help the reader identify and perhaps avoid the pitfalls which may be found in LLC operation.

II. HISTORY AND DEVELOPMENT OF THE LLC CONCEPT

Wyoming enacted the first LLC statute in the United States in 1977. In 1982, Florida enacted a similar statute. Additionally, entities similar to LLCs developed on other continents, such as Europe and South America. The purpose behind the enactment of the LLC legislation was to create a business entity which would offer investors the limited liability of a corporation while qualifying for taxation as a partnership. Prior to the enactment of LLC statutes, investors seeking both limited liability and pass-through taxation

were generally limited to operation as either an S corporation or a limited partnership. Legislatures intended the LLC to qualify for pass-through taxation and also to provide the desirable characteristics of limited liability and corporate structure.

The IRS originally took the position that an LLC should not be classified as a partnership for tax purposes because the LLC members would not be personally liable for the LLC’s debts. Thus, widespread use of the Wyoming and Florida statutes, as well as the adoption of similar statutes in other states, was hindered by the uncertain tax status of LLCs. However, when the IRS classified a Wyoming LLC as a partnership for federal tax purposes in 1988, this classification set the stage for rapid development of the new entity across the nation.

This change in position by the IRS led to the rapid adoption of LLC statutes, similar to the Wyoming and Florida statutes, in several additional states. Furthermore, ten other states are currently

5. Id. An S corporation or “small business corporation,” as defined in § 1361(b)(1) of the Internal Revenue Code, is a domestic corporation that does not have more than 35 shareholders or more than one class of stock. I.R.C. § 1361(b)(1) (1986). An S corporation cannot be a member of an affiliated group, have any nonresident alien shareholders, or be an “ineligible corporation.” I.R.C. § 1361(b)(2) (1986). Boris I. Bittker & James S. Eustice, Federal Income Taxation of Corporations and Shareholders § 6.01 (5th abr. ed. 1987).


11. Id. The states which have enacted LLC statutes are listed as follows by year of enactment in chronological order to show the trend of rapid expansion:


considering the possibility of LLC adoption. The enactment of LLC statutes in the remaining states should be expected to continue unless the IRS again changes its position concerning the tax treatment of LLCs.

Although there are some technical differences among the LLC statutes enacted thus far, there is a tendency toward uniformity. This uniformity results from reliance on the American Bar Association’s Prototype LLC Act and from the uncertainty regarding tax treatment of LLCs formed under statutes which differ significantly from those that the IRS has approved.


14. SARGENT, supra note 10. For a comparison of several of the early LLC statutes, see SARGENT, supra note 10, at chapter 4.
15. SARGENT, supra note 10.
16. See SARGENT, supra note 10. The Business Law Section of the American Bar Association has compiled a prototype act which was released on November 19, 1992.
17. See SARGENT, supra note 10.
III. COMPARISON WITH OTHER BUSINESS ENTITIES

The LLC is an attempt to combine the most desirable aspects of each commonly recognized business organization.\textsuperscript{18} Accordingly, the LLC can best be explained by comparing its differences and similarities to the more familiar business entities.

A. Comparison to Limited Partnerships

In a limited partnership, the limited partners enjoy limited liability for the acts of the partnership.\textsuperscript{19} However, in order to be classified as a limited partnership, the organization must also have a general partner who is not protected from personal liability.\textsuperscript{20} Limited partners are restricted from exercising control over the limited partnership, and a limited partner may be held liable as a general partner if he or she exercises too much control.\textsuperscript{21}

LLC members, like limited partners, also have limited liability.\textsuperscript{22} However, a great advantage of LLC status over limited partnership status is that no restrictions exist on the right of the members to control or manage the LLC.\textsuperscript{23}

Another LLC preference over the limited partnership is that, regardless of whether the LLC is managed by all of its members or by a manager, all members have limited liability.\textsuperscript{24} Although a limited partnership may have an S corporation as the general partner, thereby providing limited liability to all individuals, such an arrangement is relatively restrictive and cumbersome.\textsuperscript{25}

\begin{footnotes}
\item[19] Ark. Code Ann. § 4-43-303(a) (Michie 1991). In contrast, partners in a general partnership are all jointly and severally liable for the debts and liabilities of the partnership. Id. § 4-42-307.
\item[20] LLCs—Pass-Through Benefits, Limited Liability, 80 Tax Focus, (CCH), No. 12, 1, 3 (March 10, 1993).
\item[25] LLCs—Pass-Through Benefits, Limited Liability, supra note 20. The S corporation, as a general partner, is subject to unlimited liability. However, the owners of the S corporation have limited liability. As a result, no individuals are subject to unlimited liability. See Kalinka, supra note 4, at 1120.
\end{footnotes}
B. Comparison to General Partnerships

An LLC, like a general partnership, can be structured to provide that management be conducted by all of its members, by a designated individual, or by any multi-member variation.\textsuperscript{26} LLCs also enjoy the same pass-through, or member-level, taxation as general partnerships.\textsuperscript{27} However, unlike general partnerships, LLC members have shareholder-type limited liability.\textsuperscript{28} As a result, no member, not even a manager or group of managers, is held liable for the acts or omissions of any other member, manager, agent, or employee of the LLC.\textsuperscript{29}

C. Comparison to Corporations

1. \textit{In General}

An LLC member resembles a shareholder in a corporation in that the LLC member retains no personal liability for the debts and obligations of the LLC beyond the amount invested in the LLC, including unpaid contributions to capital owed by the member.\textsuperscript{30} The LLC is an entity separate from its owners, which can sue or be sued in the name of the LLC.\textsuperscript{31} Like a corporation, an LLC has the powers needed to conduct its business.\textsuperscript{32} For example, the LLC has the power to buy, sell, or improve property and to enter into contracts.\textsuperscript{33}

Although LLCs are similar to corporations in offering limited liability to the members, the LLCs differ from corporations in that LLC statutes do not expressly govern the issuance of ownership interests or contributions to capital.\textsuperscript{34} LLCs avoid the application of the mandatory provisions of older corporate statutes, such as the requirement of a board of directors, certain officers, annual meetings, and detailed rules regarding voting rights.\textsuperscript{35} Thus, the LLC allows

\begin{itemize}
  \item \textsuperscript{26} See Lovely, supra note 24, at 386; Ark. Code Ann. § 4-32-401 (Michie Supp. 1993).
  \item \textsuperscript{27} Sargent, supra note 10, at § 1.03.
  \item \textsuperscript{28} Sargent, supra note 10, at § 1.03.
  \item \textsuperscript{29} Ark. Code Ann. § 4-32-304 (Michie Supp. 1993).
  \item \textsuperscript{31} Kalinka, supra note 4, at 1089. See Ark. Code Ann. §§ 4-32-305, -1101 (Michie Supp. 1993).
  \item \textsuperscript{32} Kalinka, supra note 4, at 1089.
  \item \textsuperscript{33} Kalinka, supra note 4, at 1089; Ark. Code Ann. § 4-32-701 (Michie Supp. 1993).
  \item \textsuperscript{34} Keatinge et al., supra note 22, at 386.
  \item \textsuperscript{35} Sargent, supra note 10, at § 1.03.
\end{itemize}
business owners to eliminate intermediate level management and to operate the business directly through any organizational structure they wish. Consequently, LLC members have great flexibility in defining the LLC’s operation and may draft the operating agreement accordingly.

2. Comparison to S Corporations

LLCs do not closely resemble S corporations because they are not subject to the numerous restrictions imposed on S corporations. For example, an LLC, unlike an S corporation, is not limited to a maximum of thirty-five members. Likewise, LLC members may include corporations, partnerships, nonresident aliens, and charities. The rights of all members of an LLC do not have to be equal. In contrast, an S corporation can have only one class of stock, and the S corporation’s income and losses must always be allocated pro rata among its shareholders.

The LLC provides several important tax advantages which are not available if the entity is structured as an S corporation. For example, if a business is properly formed and operated as an LLC, it will generally be taxed under subchapter K of the Internal Revenue Code. This type of taxation is preferable to the tax treatment of a corporation which elects subchapter S taxation.

IV. Overview of the Arkansas LLC Act

The owners of an LLC interest are not referred to as shareholders or partners; rather, they are referred to as “members.” A member

36. SARGENT, supra note 10, at § 1.03. It should be noted that under the “Arkansas Business Corporations Act,” corporations with 50 or fewer shareholders may also determine their organizational structure through their articles of incorporation. ARK. CODE ANN. § 4-27-801(c) (Michie 1991).

37. SARGENT, supra note 10, at § 1.03; ARK. CODE ANN. § 4-32-102(k) (Michie Supp. 1993) (defining “operating agreement”).


42. Kalinka, supra note 4, at 1106; I.R.C. §§ 1361(b)(1)(D), 1366(c) (1988).

43. Kalinka, supra note 4.

44. Kalinka, supra note 4.

45. Kalinka, supra note 4. If an LLC is classified as a partnership for tax purposes, the LLC would not be subject to corporate level tax, alternative minimum tax, accumulated earnings tax, or personal holding company taxes. Lewis D. Solomon et al., Choice of Entity, Tax Mgmt. (BNA) No. 456, at A-18(5) (Apr. 5, 1993).

of an LLC may be an individual, a partnership, a corporation, or other entity, including another LLC.  

An Arkansas LLC may be formed by filing executed articles of organization with the Secretary of State of Arkansas. The articles must state the LLC’s name, the latest date of dissolution, the address of its registered office, the registered agent in Arkansas and, if management is vested in a manager or managers, a statement so indicating. The articles of organization may be amended or restated at any time.

LLC status is achieved after several requirements are met. The LLC’s name must include the designation, “Limited Liability Company,” “Limited Company,” or the abbreviation, “L.L.C.” or “L.C.,” “LLC” or “LC.” An LLC providing professional services must have a similar designation with the inclusion of the word “Professional.” An LLC may be organized for any lawful business purpose; however, if the purpose for which it was formed makes it subject to other special provisions of law, the LLC must also comply with those provisions. Each LLC must maintain a registered office in Arkansas and provide the address of its registered agent for service of process.

Many of the Act’s provisions are “default rules,” which apply only in the absence of contrary provisions in the articles of organization or the operating agreement. The Act also requires that a written operating agreement be executed by all members of the LLC. The members must maintain a copy of the operating agreement at the registered office throughout the duration of the LLC.

Unless otherwise provided in the articles of organization or the operating agreement, an LLC is “member-managed,” allowing each member the authority to bind the LLC. However, LLC members

47. Id. § 4-32-102(f).
48. Id. § 4-32-201.
49. Id. § 4-32-202.
50. Id. § 4-32-203.
51. Id. § 4-32-103(a). Cf. Id. § 4-27-401(A)(1) (Michie 1991) (providing corporate name requirements).
52. Id. § 4-32-103(d) (Michie Supp. 1993). Cf. Id. § 4-29-207(c) (Michie 1991) (providing name requirements for corporations offering professional services).
53. Id. § 4-32-106 (Michie Supp. 1993). For example, attorneys practicing as LLCs must continue to abide by the rules established by the state bar association and the state supreme court. Keatinge et al., supra note 22, at 458.
55. See, e.g., Id. §§ 4-32-301, -401, -402, -403, -603.
56. Id. § 4-32-102(k).
57. Id. § 4-32-105(a)(3).
58. Id. §§ 4-32-301, -401.
may agree to a "manager-managed" arrangement, providing that management be vested in a manager or managers who may or may not be members of the LLC.59 No member or manager of an LLC is personally liable for the LLC's obligations simply by virtue of being a member or manager.60 A member may contribute property, services, cash, or a promissory note to the LLC in exchange for an LLC interest.61 In the operating agreement, the members may allocate the LLC's profits, losses, and distributions among themselves in any way they choose.62 The Act also provides that a member's interest in an LLC may, unless otherwise provided in the operating agreement, be assigned in whole or in part, and such assignment will not dissolve the LLC.63 However, the assignee is not automatically entitled to all the rights and privileges of the member.64

An LLC can be dissolved upon certain specified events in the Act.65 In commencing the dissolution process, the members or managers may file articles of dissolution with the Secretary of State.66

V. TAX TREATMENT OF LLCs

One of the primary attractions to the LLC as a choice of business organization is the pass-through taxation treatment.67 While some states have enacted so-called "bulletproof" LLC statutes, which assure pass-through tax treatment, the Arkansas LLC statute is not "bulletproof," but rather allows for a great deal of flexibility in

59. Id. § 4-32-401(b)(2).
60. Id. § 4-32-304.
61. Id. § 4-32-501. However, the Arkansas Constitution provides that no private corporation shall issue stock except for money or property actually received or labor done. ARK. CONST. art. XII, § 8. Therefore, if the LLC is classified as a private corporation, it may not be possible to contribute a promissory note or future services in exchange for an LLC interest. Id.
62. ARK. CODE ANN. §§ 4-32-503, -601 (Michie Supp. 1993). Cf. Id. § 4-27-601(C)(3) (Michie 1991) (providing profits are apportioned according to the relative rights of the classes of stock as described in the Articles of Incorporation).
63. Id. § 4-32-704 (Michie Supp. 1993). Cf. Id. § 4-42-603 (Michie 1991) (providing a general partnership formed pursuant to Arkansas law will dissolve at the express will of any partner, expulsion of any partner, death of any partner, or bankruptcy of any partner).
64. Id. §§ 4-32-704(a)(2), -706 (Michie Supp. 1993).
65. Id. §§ 4-32-901, -902. Such events include those set forth in writing in the operating agreement or articles of organization, all the members' written consent, an event of dissociation of a member, or entry of a decree of judicial dissolution. Id.
66. Id. § 4-32-906.
This flexibility allows LLC members to respond to IRS changes.69

Because Arkansas's LLC statute is not "bulletproof," practitioners who form and use LLCs in Arkansas must understand the basis for the IRS's pass-through taxation treatment.70 The practitioner must exercise caution in establishing an LLC on behalf of a client because, if the IRS determines the entity is an association which is taxable as a corporation, the LLC may be burdened with unforeseen tax consequences.71

The IRS classifies an unincorporated organization as either a partnership or as an association, which is taxable as a corporation if it possesses certain characteristics.72 The unincorporated organization will be taxed as a corporation if it has more corporate characteristics than noncorporate characteristics.73 The characteristics considered by the IRS as indicative of corporate status are: "(i) associates, (ii) an objective to carry on business and divide the gains therefrom, (iii) continuity of life, (iv) centralization of management, (v) liability for corporate debts limited to corporate property, and (vi) free transferability of interests."74

The first two characteristics, associates and an objective to carry on business and divide the gains, are common to both partnerships and corporations; therefore, these characteristics do not enter into the analysis.75 The IRS considers the presence of the four remaining characteristics of continuity of life, centralization of management, limited liability, and free transferability of interests in determining whether an LLC is classified as a corporation or a partnership.76 Consequently, practitioners must be certain that a newly created LLC has more noncorporate than corporate characteristics.77

Each of the pertinent corporate characteristics are discussed below as they relate to the determination of the taxation status of an LLC; however, the existence of these corporate characteristics is

69. Id.
70. Schwarcz & Sherbin, supra note 18, at 652.
71. Schwarcz & Sherbin, supra note 18, at 652.
74. Schwarcz & Sherbin, supra note 18, at 652.
based on the provisions of the entity's articles of organization or operating agreement.\textsuperscript{78}

A. Limited Liability

An organization will have the corporate characteristic of limited liability if no member is held personally liable for the organization's debts or any claims against the organization.\textsuperscript{79} The IRS has summarily dismissed this corporate characteristic because members of an LLC will undoubtedly be held to have limited liability, since limited liability is one of the primary reasons for forming an LLC.\textsuperscript{80}

B. Centralized Management

An organization has the corporate characteristic of centralized management if fewer than all the members of the entity have the exclusive authority to manage the entity.\textsuperscript{81} Whether an organization has centralized management will depend on how the members structure the LLC through the operating agreement.\textsuperscript{82} If the LLC is structured to allow member management, the corporate characteristic of centralized management will generally not be found.\textsuperscript{83} However, if the operating agreement provides for a manager or a group of managers which includes fewer than all the members, the characteristic of centralized management may be found to exist.\textsuperscript{84}

C. Free Transferability of Interests

An organization will have the corporate characteristic of free transferability of interests if all or substantially all members have the power to substitute a nonmember for themselves in the organization.\textsuperscript{85} The power of substitution only exists if the member

\textsuperscript{78} LLCs—Pass-Through Benefits, Limited Liability, supra note 20, at 1.


\textsuperscript{81} Treas. Reg. § 301.7701-2(c)(1) (1983).

\textsuperscript{82} SARGENT, supra note 10, at § 2.01.

\textsuperscript{83} Treas. Reg. § 301.7701-2(c)(4) (1983). But see Rev. Rul. 93-6, 1993-3 I.R.B. 8 (holding a five member LLC where all five members were managers to have centralized management).

\textsuperscript{84} SARGENT, supra note 10, at § 2.01. An LLC managed by three of its 25 members was determined to have centralized management. Rev. Rul. 88-76, 1988-2 C.B. 360.

can transfer all rights accompanying his interest in the organization without the approval of the other members.  

All rights of a member’s interest include the right to profits, the right to participate in management, or the right to vote; however, a member can alienate his or her interest in receiving profits without other members’ consent and can retain the other rights accompanying his or her interest. In such circumstances, a transferee merely receives the right to profits and does not become a member of the LLC. This interest entitles the transferee to the right to the transferor’s share of profits.

LLCs formed under the Wyoming and Colorado statutes have been held to lack the characteristic of free transferability of interests. The LLC statutes in those states require all the members to agree to the transfer of a full membership interest. Likewise, the default provision of the Arkansas statute requires an unanimous vote of the membership in order to transfer a complete interest in an LLC. However, the Arkansas statute permits LLCs to provide for the transfer of an interest upon approval of fewer than all the members through the operating agreement. As a result, if the operating agreement provides that less than unanimous consent is required to transfer an LLC interest, an Arkansas LLC may be found to have the corporate characteristic of free transferability of interest.

D. Continuity of Life

An organization has the corporate characteristic of continuity of life when it does not dissolve upon the death, retirement, insanity, bankruptcy, or expulsion of a member. To avoid possessing the corporate characteristic of continuity of life, the IRS requires an LLC to obtain unanimous consent of its remaining members to continue to operate after the occurrence of one of the events listed

86. Id.
93. Id.
above.\textsuperscript{95} Although the IRS has determined that an LLC possesses the corporate characteristic of continuity of life when it requires only a majority vote to avoid dissolution after a termination event,\textsuperscript{96} the IRS has more recently ruled that an LLC lacked continuity of life where the LLC only required a majority of the remaining members and unanimous agreement of the remaining managers to avoid dissolution.\textsuperscript{97}

The default provision in the Arkansas statute requires a unanimous vote of the remaining members to continue an LLC after a terminating event.\textsuperscript{98} However, the statute also provides members with the power to continue the LLC without an unanimous vote through provisions in the operating agreement.\textsuperscript{99} This statutory provision, although added for flexibility, could cause an LLC to have the characteristic of continuity of life.\textsuperscript{100}

E. Other Tax Aspects

If an LLC is classified for tax purposes as a partnership, it may step up the basis of its assets when membership interests are sold.\textsuperscript{101} Additionally, if classified as a partnership, an LLC is not required to recognize income when making distributions of appreciated property.\textsuperscript{102} Furthermore, an LLC member may contribute appreciated property without recognizing gain so long as the individual is not a controlling member after the contribution.\textsuperscript{103}

An LLC which is taxed as a partnership has a significant advantage over an S corporation concerning deductible losses.\textsuperscript{104} An S corporation shareholder's deduction for losses cannot exceed the sum of any loans the shareholder has made to the corporation and the shareholder's basis in his stock.\textsuperscript{105} In contrast, if the LLC is classified as a partnership, the amount of loss a partner may deduct

\textsuperscript{98} Ark. Code Ann. § 4-32-901(c) (Michie Supp. 1993).
\textsuperscript{99} Id. § 4-32-901(c)(2).
\textsuperscript{100} Priv. Ltr. Rul. 90-10-027 (Dec. 7, 1989).
\textsuperscript{101} I.R.C. § 754 (1988). The member's basis in his interest of the LLC generally will be equal to the amount of cash and basis of property contributed. Additionally, no gain or loss is required to be recognized if the member contributes cash, property, or a promise to contribute such in the future. Keatinge et al., supra note 22, at 431.
\textsuperscript{102} Kalinka, supra note 4, at 1107. I.R.C. § 732 (1988).
\textsuperscript{103} LLCs—Pass-Through Benefits, Limited Liability, supra note 20.
\textsuperscript{104} Kalinka, supra note 4, at 1108.
\textsuperscript{105} LLCs—Pass-Through Benefits, Limited Liability, supra note 20.
includes his basis in the partnership, his distributive share of loss, and his allocable share of partnership debt.106

VI. "Unknowns"

LLCs have been in existence long enough that many aspects of use mentioned above have become generally known and fairly predictable. However, a few aspects of LLC use remain unknown.

A. Unsettled Tax Issues

1. Characterization of Debt

The characterization of debt is one of the unknowns. In a partnership, the allocation of liabilities to a partner generally affects the basis of that partner's interest in the partnership.107 The allocation of a liability under the partnership rules is determined by the classification of the liability.108 The liability is classified as recourse or nonrecourse, depending on whether the partner is personally responsible for bearing the economic risk of loss for any debts which are not repaid by the partnership.109 Although still somewhat unsettled, all LLC debt should be classified as nonrecourse debt because an LLC member's liability for debt of the LLC is limited to the amount of the member's capital contribution.110

2. Passive Losses

LLC members must participate in management in order to avoid the limitations on passive activity losses.111 However, the extent of

106. LLCs—Pass-Through Benefits, Limited Liability, supra note 20. One example is as follows:

Each of ten individuals contributes $100,000 to a newly formed entity to acquire an office building. The entity borrows an additional $500,000 as the balance of the building's $1,500,000 purchase price. If the entity is taxed as an S corporation, each shareholder's loss deductions are limited to his $100,000 basis. However, if the entity is an LLC taxed as a partnership, each member can deduct losses up to $150,000 ($100,000 basis plus $50,000 allocable share of the entity's debt).


109. LLCs—Pass-Through Benefits, Limited Liability, supra note 20, at 4; see also LUBAROFF & SCHORR, supra note 38, at 123-25. Generally, an LLC's liabilities will be nonrecourse debt for tax purposes because no member bears personal liability for the debt of the LLC. Keatinge et al., supra note 22, at 435.


111. Keatinge et al., supra note 22, at 439.
this "material participation" is an unknown." Generally, members of LLCs will be required to establish that they "materially participate" in the business of the LLC to avoid the deductibility limitations related to losses which are classified for tax purposes as passive activity losses. Until the issue has been clarified, it will remain uncertain whether LLC members, like limited partners, will be required to devote at least 500 hours to the LLC's operation in order to be a "material participant." As to limited partnerships, the IRS has ruled in the past that partners with significant management authority as compared to other partners would be treated as general partners. If LLCs receive similar treatment, some LLC members may be treated as general partners who enjoy less onerous material participation rules. However, until the regulations are clarified, LLC members should devote at least 500 hours to the LLC to ensure the passive activity loss rules do not apply to limit the deductibility of any losses incurred by the members.

3. Accounting Methods

An additional unknown is the accounting method the LLC must use. If the IRS considers an LLC to be a tax shelter, the LLC could be required to use the accrual method of accounting rather than the cash method. If the IRS determines that the LLC members are considered to be limited partners, the LLC would be forced to use the accrual method of accounting.

4. Tax-Matters Partners

Another uncertainty involves the designation of a tax-matters partner. If an LLC is classified as a partnership and has more than

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117. LLCs—Pass-Through Benefits, Limited Liability, supra note 20, at 4. I.R.C. § 448(a) (1988). The IRS's definition of a tax shelter includes a "syndicate," which is a partnership or other entity in which more than 35% of losses are allocable to limited partners or "limited entrepreneurs." I.R.C. § 1256(e)(3)(B) (1988).
118. LLCs—Pass-Through Benefits, Limited Liability, supra note 20, at 4. The IRS has recently taken a favorable position indicating that many professionals will be able to retain the cash method of accounting if they convert to an LLC. Sheldon I. Banoff, New IRS Ruling Encourages Professionals to Form Limited Liability Companies, 79 J. Tax'n 68, 68 (1993) (pertaining to Priv. Ltr. Rul. 93-21-047 (Feb. 25, 1993)).
ten members, the LLC will generally be required to follow the unified audit procedures. 119 As a result, the LLC would be required to designate a "tax-matters partner" (TMP). 120 However, if a TMP is not designated, the general partner who has the largest profits interest will be considered the TMP. 121 Since an LLC does not have a general partner, it is unknown whether a member could be designated as the LLC's TMP. 122

B. Extraterritorial Liability

The limited liability status of LLC members while doing business in states which have not enacted LLC statutes remains unclear. Practitioners and business people should be aware of the possibility that LLC members' limited liability may not be recognized in all states. The members of an LLC who operate the LLC in a state with no LLC legislation run the risk of being held personally liable for the LLC's obligations. 123 Although the Commerce Clause of the United States Constitution requires states without LLC legislation to allow out-of-state LLCs to transact business within their borders, 124 the Constitution does not require those states to tax the LLCs as pass-through entities or to recognize the limited liability of the LLC members. 125 Furthermore, states are not required to apply the law of the LLC's home state. 126

Common law principles of comity will generally influence a host state to recognize the LLC as a legal entity, even though the LLC was created by the articles of incorporation and laws of a different state. 127 However, the principles of comity are not absolute. 128 Unless the foreign state has an LLC statute, LLC members could be held personally liable for the LLC's debts incurred in the foreign state. 129 Since all states have not recognized the LLC as a business entity, an LLC member's limited liability protection is "qualified" at best. 130

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119. Keatinge et al., supra note 22, at 441.
120. Keatinge et al., supra note 22, at 441.
123. Platner, supra note 67, at 231.
124. Sheppard, supra note 68, at 1442 (citing U.S. Const. art. 1, § 8, cl. 3); see also Keatinge et al., supra note 22, at 447.
125. Sheppard, supra note 68, at 1442.
126. Sheppard, supra note 68, at 1442.
127. Schwarcz & Sherbin, supra note 18, at 654 (citing American & Foreign Christian Union v. Yount, 101 U.S. 352 (1879)).
128. Keatinge et al., supra note 22, at 454.
129. LLCs—Pass-Through Benefits, Limited Liability, supra note 20, at 1.
130. LLCs—Pass-Through Benefits, Limited Liability, supra note 20, at 1.
As noted above, LLCs must have the LLC designation present in their name. In many states, the omission of the designation as an "LLC," "LC," "Ltd.," or "Limited Liability Company" may expose the responsible person to liability for the LLC's obligations.

C. Use of LLCs to Practice Professions

Professionals, including accountants and attorneys, have shown great interest in forming and using LLCs. The pass-through taxation given to LLCs is more favorable than that afforded personal service corporations. Additionally, LLCs are attractive to professionals because they allow the professionals to protect themselves from liability for the negligence of others in the same firm. However, while a professional practicing as an LLC has protection from liability for the acts of others, the professional remains liable for his or her own negligence or malpractice. Although these aspects of the use of LLCs by professionals are known, the unsettled nature of extraterritorial liability discussed previously will most likely result in the limited use of LLCs by professionals whose practice requires transactions in states without LLC legislation.

D. Securities Treatment of LLCs

Although LLCs have some corporate characteristics, LLCs are not corporations. Accordingly, LLCs do not issue stock or any other items on the SEC's statutory "laundry list" of securities.

132. Kalinka, supra note 4, at 1091.
134. Keatinge, supra note 133 (manuscript at 6).
135. Keatinge, supra note 133 (manuscript at 6).
138. Keatinge, supra note 133 (manuscript at 7).
139. Sargent, supra note 10, at § 3.02.
any note; stock; treasury stock; bond; debenture; evidence of indebtedness; certificate of interest or participation in any profit-sharing agreement; collateral-trust certificate; preorganization certificate or subscription; transferable share; investment contract; variable annuity contract; voting-trust certificate; certificate of deposit for a security; certificate of interest or
As a result, in order for an LLC interest to be considered a security, it must meet the requirements of an investment contract. An LLC is classified as an investment contract under either the test set out in *SEC v. Howey Co.*, used by many federal and state courts, or the “risk capital” test used in some states.

The *Howey* test defines an investment contract as a “transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or third party.” The courts have been left the responsibility of interpreting what is meant by “money,” “common enterprise,” and “profits,” but the interpretation most important in determining whether an LLC is a security is what is meant by the expectation of profits “solely” from the efforts of others. In considering whether LLC interests are securities under the *Howey* test, the key question is whether the LLC members rely on the efforts of others for profits.

LLCs should not be classified as investment contracts under the *Howey* test unless one of two situations arises. The LLC may fall under the securities regulations if the members are so inexperienced and uninformed that practically all of the control is exercised by the manager. The same may be true if the operating agreement grants so much authority to the manager that the other members


*141. Sargent, supra note 10, at § 3.02.*

*142. 328 U.S. 293 (1946).*

*143. Sargent, supra note 10, at § 3.02. Under the risk capital approach, analysis is as follows:

- an investment contract is created whenever: (1) An offeree furnishes initial value to an offeror, and (2) a portion of this initial value is subjected to the risks of the enterprise, and (3) the furnishing of the initial value is induced by the offeror’s promises or representations which give rise to a reasonable understanding that a valuable benefit of some kind, over and above the initial value, will accrue to the offeree as a result of the operation of the enterprise, and (4) the offeree does not receive the right to exercise practical and actual control over the managerial decisions of the enterprise.


*144. Howey, 328 U.S. at 298-99.*

*145. Sargent, supra note 10, at § 3.01[1].*  
*146. Sargent, supra note 10, at § 3.02[1].*  
*147. Sargent, supra note 10, at § 3.02[1].*  
*148. Sargent, supra note 10, at § 3.02[1]. See Casali v. Schultz, 292 Ark. 602, 732 S.W.2d 836 (1987) (holding that a unit in a general partnership which was sole stockholder of an investment banking firm was a “security”).
have no control rights, such as the inability to remove the manager or amend the articles of organization.\textsuperscript{149}

If the LLC interests are not considered to be a security, the offer and sale of those interests will not entail the requisite securities registration, options to rescind, or other securities law issues.\textsuperscript{150} In addition, claims of fraud relating to the potential security would be heard under common law in the state courts rather than at the federal level.\textsuperscript{151}

E. Other Unknowns

Another area of LLC use which is unsettled is whether an LLC member can bring a shareholder derivative suit against the LLC.\textsuperscript{152} Although the Arkansas statute makes no express provision for a derivative suit by a member, it does provide for a member’s right to review the LLC’s records.\textsuperscript{153} In addition, the operating agreement could provide for derivative action.\textsuperscript{154} As a result, unless provided for in each LLC’s operating agreement, it is unclear whether members of an Arkansas LLC have the right to bring a derivative suit action against the LLC.

The fiduciary duty owed to other members of an LLC also remains an uncertainty. Since the LLC organization is patterned after a partnership, one might assume the members would owe the same fiduciary duty as that owed to other partners;\textsuperscript{155} this fiduciary duty requires that each partner conduct himself or herself toward other partners in utmost good faith.\textsuperscript{156} However in Arkansas, unless provided otherwise in the operating agreement, a member or manager will not be liable to the LLC unless the act or omission of the member or manager amounts to gross negligence or willful misconduct.\textsuperscript{157} Whether the partnership level of fiduciary duty will apply to LLCs in spite of the statutory language will remain unsettled until the courts have the opportunity to clarify the issue.\textsuperscript{158}

VII. Conversion to an LLC

Because the LLC is such an attractive form of business organization, many existing limited and general partnerships as well as

\begin{itemize}
  \item \textsuperscript{149} Sargent, supra note 10, at \S 3.02[1].
  \item \textsuperscript{150} Sargent, supra note 10, at \S 3.03.
  \item \textsuperscript{151} Sargent, supra note 10, at \S 3.03.
  \item \textsuperscript{152} Sheppard, supra note 68, at 1442.
  \item \textsuperscript{153} Ark. Code Ann. \S 4-32-405(b) (Michie Supp. 1993).
  \item \textsuperscript{154} Id. \S\S 4-32-401, -402.
  \item \textsuperscript{155} Lovely, supra note 24, at 413.
  \item \textsuperscript{156} Lovely, supra note 24, at 413.
  \item \textsuperscript{157} Ark. Code Ann. \S 4-32-402(a) (Michie Supp. 1993).
  \item \textsuperscript{158} Lovely, supra note 24, at 414.
\end{itemize}
corporations may wish to convert to an LLC. The following is a brief discussion of the tax issues which arise upon conversion from another existing entity to an LLC.

A. Conversion from a Partnership

Although the Arkansas statute does not specifically provide for conversion from a partnership form,\(^\text{159}\) a limited or general partnership could likely convert into an LLC without incurring any tax liability.\(^\text{160}\) The IRS will permit a limited partnership to merge into an LLC where no change results in the partners' shares or the partnership's assets or liabilities and where all of the existing partners become members of the LLC.\(^\text{161}\) The IRS treats the conversion as a continuation of the partnership and does not require any gain or loss to be recognized.\(^\text{162}\)

The tax-free conversion of a general partnership is also allowed.\(^\text{163}\) However, if the conversion causes a former partner's share of liabilities to be reduced to the point that a deemed distribution is created,\(^\text{164}\) the gain may be taxable as income to the partner if the amount of the deemed distribution is greater than the partner's adjusted basis in the partnership.\(^\text{165}\)

B. Conversion from a Corporation

The Arkansas LLC Act clearly contemplates conversion from a corporation to an LLC.\(^\text{166}\) If a corporation is converted into an LLC by a merger of the two entities, the conversion will, in all probability, be treated as a sale of the corporation's assets and liabilities in exchange for a membership interest in the LLC.\(^\text{167}\) If the fair market value of the corporation's assets is greater than the assets' adjusted bases, the conversion process will result in taxable income to the corporation,\(^\text{168}\) and if the value of the LLC interests

\(^{159}\) ARK. CODE ANN. §§ 4-32-1201(a), (c) (Michie Supp. 1993).
\(^{160}\) LLCs—Pass-Through Benefits, Limited Liability, supra note 20.
\(^{162}\) Id.
\(^{164}\) I.R.C. § 752(b) (1988). Under § 721(b), a reduction in a partner's share of liability is treated as a cash distribution. Therefore, if the cash distribution is greater than the partner's basis in his partnership interest, the partner has taxable income, a "deemed distribution," even though no cash is actually distributed to the partner. Id.
\(^{166}\) ARK. CODE ANN. § 4-32-1201 (Michie Supp. 1993).
\(^{167}\) Platner, supra note 67, at 230.
exceed the individual shareholder's stock adjusted bases, then taxable gain will be recognized at the shareholder level as well.\textsuperscript{169}

The IRS also requires that taxable gain be recognized at the corporate and shareholder levels even if the corporation's assets are liquidated and the proceeds received are then contributed to a new LLC.\textsuperscript{170} If the corporate shareholders exchange their stock for an interest in the LLC, the exchange may be tax-free.\textsuperscript{171} However, if the LLC later liquidates the corporation, the IRS may require that taxable income be recognized at both the corporate and the LLC levels.\textsuperscript{172} The resulting amount of taxable income will depend on the value and the adjusted basis of the corporate assets and the LLC's basis in the liquidated corporation's stock.\textsuperscript{173}

\textbf{VIII. Conclusion}

The Small Business Entity Tax Pass Through Act gives the business planner in Arkansas another option in business organization. The pass-through tax treatment of a partnership combined with limited liability previously available only to limited partners and shareholders is an inviting combination.

The treatment of LLCs by the IRS and the limited liability of LLC members in states with LLC statutes of their own are becoming known. However, the relative newness of LLC status leaves some aspects of liability, taxation, and securities regulation unknown. Until the remainder of the states enact LLC legislation, and until the courts apply the law to this new entity, practitioners and business people alike should venture carefully into the territory of the "unknowns."

\textit{C. Timothy Spainhour}

\textsuperscript{170} Platner, \textit{supra} note 67, at 230.
\textsuperscript{172} Platner, \textit{supra} note 67, at 230.
\textsuperscript{173} Platner, \textit{supra} note 67, at 230.