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Corporations and Limited Liability Companies

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CORPORATIONS AND LIMITED LIABILITY COMPANIES

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I. INTRODUCTION

THE Texas Legislature was not in session during the Survey period,[1] so there were no legislative amendments to either the Texas corporation statutes or the Texas Limited Liability Company Act. There were only a few corporation law cases during the period that merit attention, and the most important of these are grouped into the two general categories of (1) shareholder, officer, and director liability and (2) the interpretation and construction of corporate agreements. The most significant developments in the limited liability company area involve Internal Revenue Service rulings regarding entity classification for federal income tax purposes.

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1. October 1, 1993 through September 30, 1994.

II. CORPORATIONS

A. Personal Liability of Officers, Directors, and Shareholders

1. *Alter Ego Theory and Related Doctrines*

The most troubling opinion of the year, *Leitch v. Hornsby*,[2] was issued by the San Antonio Court of Appeals on September 28, 1994. Grady Hornsby was a cable television installer who injured his back while lifting a reel of wire from a truck. Hornsby was apparently employed by two corporations, Pro Com Marketing Services, Inc. (Pro Com) and Cable Television Employment Services, Inc. (CTES), neither of which was a worker's compensation insurance subscriber.[3] As a result, no worker's compensation coverage was available for the injury. Hornsby sued both corporations as well as Russell Leitch and Hal Crews, the corporate presidents and sole shareholders, in their individual capacities. Hornsby alleged, among other things, that the defendants negligently failed to provide him with a safe workplace, adequate tools and safety training, and competent co-workers to assist with his work. Although the jury did not find that either corporation was the alter ego of its sole shareholder, it found that the negligence of Pro Com, Leitch, and Crews was a proximate cause of Hornsby's injury. The trial court entered judgment against the three defendants, jointly and severally, for nearly $700,000 in damages and pre-judgment interest.

In affirming the judgment, the San Antonio Court of Appeals noted that Leitch and Crews took an active part in the operations of the business that employed Hornsby and wrote that "Leitch, Crews, and the corporation each had a duty under tort law not to injure—actively or passively."[4] The court reasoned that "[i]f there is individual negligence, as the jury found in this case, it is not necessary to pierce the corporate veil. Only where the individual's negligence is merely derivative of the corporation's negligence is it necessary to pierce the corporate veil."[5] The court concluded that the officers "were held individually liable because they themselves committed negligence that proximately resulted in an injury to Hornsby. Thus, Leitch and Crews are liable *regardless of whether alter ego was found.*"[6]

A more reasonable approach to the case appeared in the dissent by Justice Peeples. He pointed out that although Leitch and Crews were co-employees with Hornsby and not his employer, the majority's holding in-

2. 885 S.W.2d 243 (Tex. App.—San Antonio 1994, writ requested).
3. Although the opinion states that ". . . Leitch and Crews, each president and sole shareholder of their respective corporations, both took an active role in managing the daily operations *of the business which employed Hornsby*," it is unclear whether Hornsby was an employee of CTES. *Id.* at 250 (emphasis added). The jury found that Hornsby was an employee of Pro Com. *Id.* at 248.
4. *Id.* at 249.
5. *Id.* at 250.
6. *Id.* (emphasis added).

dicated that "individuals who work for a company owe as individuals the same duty the company owes . . . ."[7] While acknowledging that a corporate officer or employee can, in certain circumstances, be liable for his or her own negligence, Peeples wrote that "this rule applies only when the employee committed an independent tort—that is, owed an individual duty to the injured person apart from the employer's duty and breached that duty."[8] Peeples cited *J. Weingarten, Inc. v. Moore*,[9] *Maxey v. Citizens Nat'l Bank*,[10] and *Russell v. Edgewood Independent School Dist.*[11] as well-settled authority for the proposition that "unless alter ego is established, corporate agents and officers are personally liable for their actions taken in the course of employment only when they breached a duty that they owed as an individual to the injured person."[12] Considering the impact that the majority's decision could have on officers, directors, and shareholders of closely-held corporations, practitioners should hope that the Texas Supreme Court will take the opportunity to correct this terrible precedent from the San Antonio Court of Appeals.

In *Western Horizontal Drilling v. Jonnet Energy Corp.*,[13] the Fifth Circuit addressed whether the Texas Legislature's 1993 amendments to article 2.21A(3) of the Texas Business Corporation Act[14] eliminated the applicability of the alter ego doctrine, in the context of breach of contract claims, when corporate formalities have been disregarded. The case arose in April, 1991, when Western sued Jonnet Energy Corp. (JEC) in Texas state court to collect a debt of approximately $200,000. JEC removed the case to federal district court. Western later joined the shareholders of JEC, Elmer Jonnet and Joe Jonnet, as parties and attempted to pierce JEC's corporate veil. In 1992, Western requested that Elmer and Joe Jonnet admit that JEC was "merely a conduit for your personal finances and business transactions."[15] The Jonnets never responded to the requests for admission, thereby allowing them to be deemed admitted pursuant to Rule 36(a) of the Federal Rules of Civil Procedure. Western moved for summary judgment against both JEC and the Jonnets, based on the alter ego theory. The Jonnets opposed the motion as to themselves, arguing that the admissions alone did not establish personal liability under the alter ego theory. After summary judgment for Western was granted, the Jonnets moved to amend the judgment on the grounds that the legislative amendments to article 2.21A(3) had superseded the alter ego theory. The court denied their motion.

On appeal, the Jonnets argued that because the 1993 amendments prohibit contract claimants from relying on a failure to observe corporate

7. *Id.* at 251.
8. *Id.*
9. 449 S.W.2d 452 (Tex. 1970).
10. 507 S.W.2d 722 (Tex. 1974).
11. 406 S.W.2d 249 (Tex. Civ. App.—San Antonio 1966, writ ref'd n.r.e.).
12. 885 S.W.2d at 252.
13. 11 F.3d 65 (5th Cir. 1994).
14. TEX. BUS. CORP. ACT ANN. art. 2.21 A(3) (Vernon Supp. 1993).
15. 11 F.3d at 66.

formalities in order to pierce the corporate veil, the Texas legislature had abolished the alter ego theory entirely. The Jonnets cited *Pan Eastern Exploration Co. v. Hufo Oils*[16] for the proposition that nothing more is required to establish an alter ego finding than "the failure of the owners to maintain the corporation as a distinct legal entity,"[17] and asserted that this description of the theory was precisely what was abolished by the Texas legislature in 1993.

The Fifth Circuit rejected the Jonnet's argument, writing that " 'a failure to observe any corporate formality' . . . is *not* synonymous with a 'failure of the owners to maintain the corporation as a distinct legal entity.' "[18] The court stated that the legislative amendments are "clear and unambiguous"[19] in precluding the use of information relating to the failure to observe corporate formalities in proving the alter ego theory, and held that the theory "applies when there is such unity between the corporation and individual that the separateness of the corporation has ceased."[20] Because the court considered the Jonnet's deemed admissions to be nearly identical to the description of the alter ego theory in *Castleberry,* the judgment in favor of Western was affirmed.[21]

2. *Officer and Director Liability After Texas Franchise Tax Delinquency*

Jonnet v. State[22] dealt with whether officers and directors can be held personally liable for the obligations of a corporation which forfeited its privileges because of a failure to pay franchise taxes but which never conducted business after the forfeiture. This lengthy opinion from the Austin Court of Appeals includes a concurrence by Justice Powers and a dissent by Justice Jones, each asserting fundamentally different views of the State's strongest incentive for the prompt payment of franchise taxes—Texas Tax Code section 171.255(a).[23]

In December of 1985, Brent Ranch Operating, Inc. (BRO) acquired several abandoned oil wells in Carson County, Texas and, pursuant to

16. 855 F.2d 1106 (5th Cir. 1988).
17. *Id.* at 1132.
18. 11 F.3d at 69 (emphasis added).
19. *Id.* at 69 n.5.
20. *Id.* at 69 (quoting Castleberry v. Branscum, 721 S.W.2d 270, 272 (Tex. 1986)).
21. *Id.* at 70.
22. 877 S.W.2d 520 (Tex. App.—Austin 1994, writ denied).
23. The statute provides that officers and directors are personally liable for each debt that is created or incurred by a corporation after the date on which its franchise tax report is due and before its corporate privileges are revived. The full text is as follows:

> If the corporate privileges of a corporation are forfeited for the failure to file a report or pay a tax or penalty, each director or officer of the corporation is liable for each debt of the corporation that is created or incurred in this state after the date on which the report, tax, or penalty is due and before the corporate privileges are revived. The liability includes liability for tax or penalty imposed by this chapter on the corporation that becomes due and payable after the date of the forfeiture.

TEX. TAX CODE § 171.255(a) (Vernon 1992).

Statewide Rule 14,[24] had a statutory duty to plug the wells. In 1989, BRO filed a franchise tax report which listed Elmer and Joe Jonnet as its officers and directors.[25] BRO failed to file its next franchise tax report, which was due on March 15, 1990, and ultimately forfeited its charter in December of that year. In December of 1989, BRO was warned by the Railroad Commission that an action to compel compliance and assess penalties would be forthcoming. BRO did not comply, and after a hearing on the matter, the Commission issued an order dated December 3, 1990, assessing a penalty of $28,000 against the corporation.

BRO did not pay the penalty, so the State filed suit against BRO, Elmer Jonnet, and Joe Jonnet. The State relied on section 171.255(a) in asserting that Elmer and Joe Jonnet were personally liable for the obligation. The Jonnets claimed that they were not liable under section 171.255(a), because the penalty was not a debt "created or incurred" after March 15, 1990, the date BRO's franchise tax report was due. Instead, they argued that the penalty related back to BRO's initial violation of Rule 14, which occurred in December of 1985. The district court rendered judgment against BRO and the Jonnets, jointly and severally, for $48,000 in penalties as well as attorney's fees and court costs.

On appeal, the Jonnets again argued that BRO's obligation related back to the date that it first violated Rule 14, and cited several cases in which debts based on the breach of a written instrument related back to the date of the instrument. The court rejected the argument, pointing out that BRO's liability was not based on an agreement between the parties but arose because of the Railroad Commission's statutory authority under the Texas Natural Resources Code. The statute provides that the Railroad Commission *may* assess penalties for rule violations,[26] and that once a violation has been committed, each day the violation continues may be considered a *separate violation* for penalty assessment purposes.[27] The court reasoned that each day that BRO's rule violations continued constituted separate statutory violations, and that BRO's obligation was created when the penalty was actually assessed by the Commission.[28] Because the penalty was assessed on December 3, 1990, several months after BRO's franchise tax delinquency, the court affirmed the Jonnets' personal liability for the obligation under Tax Code section 171.255(a).[29]

Justice Powers concurred in the decision but emphasized the importance of properly applying the relation-back doctrine and the rule of strict construction when officers and directors are to be held personally liable under Tax Code section 171.255(a). Powers analyzed several cases apply-

24. 16 TEX. ADMIN. CODE § 3.14 (Vernon 1993). *See also* TEX. NAT. RES. CODE ANN. § 89.011 (Vernon Supp. 1995); TEX. NAT. RES. CODE ANN. § 89.012 (Vernon 1993).

25. It was a bad year for Elmer and Joe. *See supra* notes 13-20 and accompanying text.

26. TEX. NAT. RES. CODE ANN. § 81.0531(a) (Vernon Supp. 1993).

27. *Id.* § 81.0531(b).

28. 877 S.W.2d at 524.

29. *Id.*

ing the doctrine and the rule[30] and wrote that Texas courts have not "engrafted . . . an appendage holding that officers and directors are never personally liable whenever it may appear that a post-forfeiture debt, in the sense of a legally enforceable, liquidated money obligation, has some connection to a pre-forfeiture event, cause, or circumstance."[31]

Justice Jones disagreed with the majority and, in a compelling dissent, characterized the rationale for disregarding the corporate form and imposing personal liability on the Jonnets as nothing more than a "whim"[32] that was "contrary to the clear intent of the legislature."[33] Reviewing the facts, Jones pointed out that BRO did not have any assets or conduct any business after March 15, 1990, and that nothing in the record indicated that the Jonnets had dealt improperly with BRO's assets before it ceased doing business. Jones reasoned that an analysis of Tax Code section 171.255 as a whole, including the subsection that excuses officers and directors from liability for debts created or incurred without their knowledge, leads to the inescapable conclusion that "when the legislature decided to impose personal liability on directors and officers for corporate debts created or incurred after a failure to report or pay franchise taxes, it did not have in mind post-forfeiture judgments or penalties against defunct corporations that had not transacted any post-forfeiture business whatsoever."[34] Jones further analyzed several of the cases cited by Justice Powers and concluded that "there is only one reasonable interpretation of the scope of personal liability imposed on directors and officers by section 171.255(a): the debt must have been created or incurred by a post-forfeiture transaction of business by the corporation."[35]

Serna v. State[36] involved facts and issues similar to those presented in *Jonnet*. Doer Energy Corporation (DEC) took control of a lease that included four capped oil wells. Prior to the forfeiture of its corporate privileges for the failure to pay franchise taxes, DEC uncapped and abandoned the wells. The State brought suit against DEC and two of its officers to compel compliance with Rule 14 and to assess administrative penalties. The trial court rendered judgment against all three defendants,

30. *See, e.g.*, Schwab v. Schlumberger Well Surveying Corp., 145 Tex. 379, 198 S.W.2d 79 (1946); Missouri, K. & T. Ry. Co. of Tex. v. State, 100 Tex. 420, 100 S.W. 766 (Tex. 1907); McKinney v. Anderson, 734 S.W.2d 173 (Tex. App.—Houston [1st Dist.] 1987, no writ); River Oaks Shopping Ctr. v. Pagan, 712 S.W.2d 190 (Tex. App.—Houston [14th Dist.] 1986, writ ref'd n.r.e.); Curry Auto Leasing, Inc. v. Byrd, 683 S.W.2d 109 (Tex. App.—Dallas 1984, no writ).

31. 877 S.W.2d at 527.

32. *Id.* at 538.

33. *Id.* at 530.

34. *Id.* at 533 (citing First Nat'l Bank v. Silberstein, 398 S.W.2d 914, 915-16 (Tex. 1966) and Longoria v. Atlantic Gulf Enter., Inc., 572 S.W.2d 71, 78 (Tex. Civ. App.—Corpus Christi 1978, writ ref'd n.r.e.), Justice Jones stated that Tax Code § 171.255 "was meant to impose personal liability on officers and directors only for debts arising from a post-forfeiture transaction of business by a corporation." 877 S.W.2d at 532).

35. 877 S.W.2d at 535.

36. 877 S.W.2d 516 (Tex. App.—Austin 1994, writ denied).

jointly and severally, for $21,000 in penalties, attorney's fees, and court costs.

One officer appealed, claiming that after corporate privileges are forfeited, an officer must take a specific action that creates a corporate debt before that officer can be held personally liable for the debt. Following the rationale of *Jonnet*,[37] Justice Smith wrote that the relation-back doctrine applied only to contractual obligations and that the term "created or incurred" in Tax Code section 171.255(a) was "broad enough to include debts that have been 'brought on' by an act of omission."[38] Further, Smith found that the requirement of section 171.255(a) that a debt be created or incurred after the date on which a franchise report or tax is due "refers to the *timing of the liability* rather than the timing of specific actions of the corporate officers."[39] In affirming the trial court's judgment, Smith wrote that "[h]olding officers liable for failing to act on a continuing obligation, after the forfeiture of corporate privileges, inflicts a significant punishment on corporate officers for neglecting an obligation to protect the environment by plugging oil wells and strongly encourages timely payment of franchise taxes."[40]

B. Construction of Corporate Agreements

1. Shareholder Agreement and Life Insurance Proceeds

In *Little v. X-Pert Corporation*[41] the Texas Supreme Court considered whether the corporation or the wife of a deceased former shareholder was entitled to the proceeds of a life insurance policy held by the corporation under the terms of a shareholder agreement. About two years prior to his death, James Little and three of his associates formed X-Pert Corporation. They executed an agreement containing mutual covenants to buy and sell a shareholder's interest either upon his death or if the shareholder wished to make a sale of stock during his lifetime. In order to fund a purchase of stock upon a shareholder's death, the agreement provided that the corporation would purchase life insurance policies on each shareholder, pay the premiums, and be named as legal beneficiary. The agreement further provided that "[i]n the event of the sale of a stockholder's interest during his or her lifetime, or upon the termination of this buy-sell agreement for any reason, each respective insured stockholder shall have the right to retain all contracts of insurance on his or her life . . . ."[42]

In March of 1991, Little and his wife sold their stock to one of the other shareholders. Little died approximately one month later. At the time of his death, the corporation had a $250,000 life insurance policy in force on

37. *See supra* notes 22-35 and accompanying text.
38. 877 S.W.2d at 519.
39. *Id. (emphasis added).*
40. *Id.* at 520.
41. 867 S.W.2d 15 (Tex. 1993).
42. *Id.* at 16.

his life. The insurance company paid the insurance proceeds to the corporation, and Little's widow demanded that the proceeds be paid to her. X-Pert sought a declaratory judgment that it was entitled to the insurance proceeds and that its obligations under the shareholder agreement had been performed. The trial court granted the corporation's summary judgment motion, holding that the corporation was entitled to the insurance proceeds, all accrued interest, and attorney's fees from Little's widow.[43] The Amarillo Court of Appeals affirmed, holding that although the intent of the shareholder's agreement was to give James Little a right to the insurance policy upon a sale of his stock, he had not exercised his right.[44]

Before the Texas Supreme Court, Mrs. Little argued that the shareholder agreement established the relationship between her husband's estate and the corporation, and that under the agreement, the corporation had received the insurance proceeds on behalf of the estate. Further, she claimed that the appellate court erred in adding an "unstated requirement . . . that her husband have taken some affirmative step before his death to claim the policy benefits."[45] The court agreed, concluding that the language and the purposes of the shareholder agreement unambiguously supported her claims.[46] Importantly, the court stated that although the language of the agreement might support the corporation's position if viewed in isolation, the clause providing the right to acquire the insurance did not "expressly require a selling shareholder to affirmatively elect to receive the benefits of the life insurance policy."[47] The court found that there was no reason why an election would be necessary because: (1) the premiums had already been paid; (2) Little could obtain the policy for no additional consideration; and (3) no selling shareholder "would ever elect *not* to receive the . . . insurance policy under the circumstances of this case."[48] Chief Justice Phillips and Justices Hecht, Cornyn, and Enoch concurred in the judgment but felt that the agreement was ambiguous and that the issue should have been remanded to the trial court for resolution.[49]

2. Right of First Refusal on Corporate Subsidiary's Assets

In *Capital Parks, Inc. v. Southeastern Advertising and Sales Sys., Inc.*[50] the Fifth Circuit considered whether the holder of a right of first refusal on the stock and assets of a corporate subsidiary was entitled to exercise the right when a third party agreed to purchase the stock of the parent corporation. In 1984, Southeastern and Capital agreed that Capital would have a preemptive right to purchase all the issued and outstanding

43. *Id.*
44. *Id.*
45. *Id.* at 17.
46. *Id.*
47. *Id.*
48. *Id.* at 18 (emphasis added).
49. *Id.* at 18-19.
50. 30 F.3d 627 (5th Cir. 1994).

shares of Waco Memorial Park, Inc. (Waco), a wholly-owned subsidiary of Southeastern, or substantially all of Waco's operating assets. In 1993, the Loewen Group (Loewen) made an offer to purchase all the shares of Southeastern as well as all the assets that were owned by its shareholders and used in the company's business. Capital notified Southeastern of its intent to exercise its rights with respect to Waco and, when Southeastern was unresponsive, filed suit in state court to enjoin the proposed transaction. The defendants removed the suit to federal district court and filed a Rule 12(b)(6) motion to dismiss for failure to state a claim upon which relief can be granted.

In the district court, Capital alleged that Southeastern had breached the option agreement because Loewen's offer was for the purchase of the "business of the Companies,"[51] which included the Southeastern shares as well as Waco's operating assets. Capital also claimed that Waco was the alter ego of Southeastern; thus, an offer to purchase the stock or assets of Southeastern constituted an offer to purchase the assets of Waco. The district court granted the motion to dismiss and denied Capital's motion for leave to amend its complaint.

In its de novo review and affirmance of the dismissal, the Fifth Circuit found that Waco was an independent legal entity with its own assets and liabilities; therefore, Southeastern never had the ability to directly transfer Waco's assets to a third party.[52] Further, the court found that because the offer was only for the purchase of the parent corporation's stock, the offer did not affect the ownership of Waco's assets or trigger the right of first refusal.[53] Regarding Capital's alter ego argument, the court affirmed the district court's findings that piercing Waco's corporate veil would have no effect because the option contract was binding only upon Southeastern and no evidence indicated that Southeastern had been formed as a fiction to avoid liability with respect to the option agreement.[54]

C. Authority of Corporate Officers After Receivership

A case of first impression in Texas, *Chitex Communication, Inc. v. Kramer*[55] presented the issue of whether the president of a corporation under the control of a court-appointed receiver can file a voluntary bankruptcy petition on behalf of the entity. The question arose out of divorce proceedings between Daniel Donovan and Cathleen Kramer. In August, 1993, a divorce decree was issued along with a ruling that the stock of Chitex Communication, Inc. was a marital asset. The decree appointed Norman Fischer as receiver of the corporation, transferred ownership of one-hundred percent of its shares to him, and divested Donovan and Kramer of "all legal right, title and ownership of the stock of the Texas

51. *Id.* at 629.
52. *Id.*
53. *Id.*
54. *Id.* at 630.
55. 168 B.R. 587 (S.D. Tex. 1994).

corporation . . . including all voting and other rights related thereto."[56] Further, the decree enjoined Donovan and Kramer from interfering in any manner with Fischer's control over the assets, liabilities, and records of the corporation. Donovan took no steps to appeal the decree.

In October of 1993, Donovan filed a voluntary bankruptcy petition for Chitex in the purported belief that he had authority to do so as president of, and attorney for, the company. He also sought a temporary restraining order and injunction to ensure that Fischer and Kramer would not violate the company's rights under the bankruptcy code's automatic stay provisions. Kramer apparently filed a motion to dismiss the bankruptcy proceedings and, partly because of Donovan's failure to appear at a hearing on the issue, the proceedings were dismissed with prejudice. Donovan appealed the dismissal to the federal district court in Corpus Christi on the grounds that the bankruptcy court had not acted in the best interests of the debtor.

In affirming the dismissal, the district court noted that no Texas court had addressed whether the president of a corporation in receivership can file a petition for bankruptcy relief, on behalf of the entity, in federal court. The district court found that although the divorce decree did not explicitly remove Donovan as an officer or director of Chitex, "it is axiomatic that a decree that vests 100% ownership and all rights of management of a closely held corporation in a receiver constitutes a de facto removal of Donovan from any position of authority."[57] Further, the court found that "the authority of the officers of the corporation had been entirely superseded by that of the court"[58] and that "[a]lthough the receiver had no more authority or power than Donovan did before the divorce decree, he did acquire Donovan's entire interest in Chitex."[59]

III. LIMITED LIABILITY COMPANIES

The nationwide trend toward recognition and acceptance of the limited liability company (LLC) continued during the Survey period. As of November, 1994, only two states—Hawaii and Vermont—lacked an LLC statute of one form or another. Practitioners have become increasingly familiar with the flexibility and tax benefits that this form of entity can offer,[60] but there is some concern that the favorable treatment afforded by the Internal Revenue Service (the Service) may eventually come

56. *Id.* at 588.
57. *Id.* at 589-90.
58. *Id.* at 590.
59. *Id.*
60. *See, e.g.*, Robert R. Pluth, Jr., *The Limited Liability Company: A New Alternative*, TRUSTS & ESTATES, Sept. 1994, at 14-17; Richard C. Reuben, *Added Protection*, ABA JOURNAL, Sept. 1994, at 54-57.

under congressional scrutiny if it results in a significant revenue loss to the United States government.[61]

Although there were no significant judicial decisions or legislative changes directly affecting Texas limited liability companies during the Survey period, the Service published several rulings regarding the tax treatment of LLCs organized under other state LLC statutes.[62] In addition, the Service issued its first private letter ruling on whether LLC members are subject to self-employment tax on their distributive shares of the entity's income and loss.[63]

As of the end of the Survey period,[64] there was still no definitive guidance on whether a one-member LLC will be treated as a partnership or as an association taxable as a corporation for federal income tax purposes.[65] One private letter ruling was issued by the Service that highlights a potentially troublesome area for attorneys preparing LLC organizational documents. In Private Letter Ruling 9433008,[66] an LLC with only two members—one individual and his wholly-owned subchapter S corporation—was found to be an association taxable as a corporation rather than as a partnership.[67] The LLC's governing documents provided that before a transferee could become a substituted member, all

61. *See* DAILY TAX REPORT (BNA), Apr. 15, 1994, at G-7 (summarizing comments by a legislative aide to Senator David Pryor at an address to the D.C. Bar Section of Taxation concerning the S Corporation Reform Act of 1993 (S. 1960)).

62. *See* Rev. Rul. 93-92, 1993-42 I.R.B. 11 (addressing LLCs organized under the Oklahoma statute); Rev. Rul. 94-5, 1994-2 I.R.B. 21 (Louisiana); Rev. Rul. 94-6, 1994-3 I.R.B. 11 (Alabama); Rev. Rul. 94-30, 1994-19 I.R.B. 6 (Kansas); Rev. Rul. 94-51, 1994-32 I.R.B. 11 (New Jersey).

63. Priv. Ltr. Rul. 9432018 (May 16, 1994) (ruling that LLC members who actively participate in professional service business are subject to self-employment tax); *see* Meade Emory et al., *Service Says LLC Members Are Subject to SE Tax*, 82 J. TAX'N 50, 50-51 (1995). The Service's position was greatly strengthened by the Treasury's issuance of Proposed Regulation § 1.1402(a)-18. Although this regulation section was issued long after the end of the current Survey period and is not covered in detail here, it essentially provides that a member's distributive share of LLC income is subject to self-employment tax unless (i) the LLC could have been formed as a limited partnership in the same jurisdiction, and (ii) the member could have qualified as a limited partner of that hypothetical partnership. *See* Prop. Treas. Reg. § 1.1402(a)-18(a)-(c).

64. September 30, 1994.

65. On January 17, 1995, however, the Service issued Revenue Procedure 95-10, 1995-3 I.R.B. 20, addressing when it will rule that a particular LLC is taxable as a partnership rather than a corporation. Although the guidance was issued too late to be covered in detail here, the message is clear that one-member LLCs will not be classified as partnerships for federal income tax purposes.

66. Priv. Ltr. Rul.. 9433008 (May 6, 1994).

67. U.S. Treasury Regulation § 301.7701-2 sets forth six corporate characteristics to be used in the determination of whether an association should be classified as an association taxable as a corporation or as a partnership. These characteristics are (1) the existence of associates, (2) the objective to carry on a business and to divide the gains therefrom, (3) continuity of life, (4) centralization of management, (5) limited liability of the interest owners, and (6) free transferability of interests. Treas. Reg. § 301.7701-2(a)(1). The first two characteristics, associates and an objective to carry on a business and divide the gains therefrom, are common to all business associations and are disregarded in the determination. *Id.* § 301.7701-2(a)(2). An association will be taxable as a corporation if it exhibits more than two of the remaining four corporate characteristics. *See id.* § 301.7701-2(a)(1); Morrissey v. Commissioner, 296 U.S. 344 (1935).

the company's other members had to approve the transfer of the membership interest. Because the sole shareholder of the corporation was the only other member of the LLC, the Service ruled that the restrictions on transfer were not meaningful and that the entity possessed the corporate characteristic of freely transferable interests. When that characteristic was combined with the other corporate characteristics of limited liability and centralized management, the Service concluded that the LLC was taxable as a corporation rather than as a partnership.[68] This ruling emphasizes the need for caution and careful review which should be exercised by practitioners structuring tax-advantaged entities for use by business clients.

68. Priv. Ltr. Rul. 9433008 (May 6, 1994).