THE PENNSYLVANIA
BAR ASSOCIATION

QUARTERLY

JUN 3 0 1993

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Use Of A Limited Liability Company For Conducting Business In Pennsylvania

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This article considers the use of a limited liability company as an entity for conducting business in Pennsylvania. In recent years there has been an explosion of interest nationally in the limited liability company. A limited liability company potentially offers its owners (commonly referred to as "members" or "associates") the same favorable federal income tax treatment otherwise available only to partnerships. However, unlike partners of a general partnership, the members of a limited liability company are not personally liable for the debts, obligations, or liabilities of the business. This applies as well to those members who actively participate in the conduct and management of the business. Hence, the limited liability company offers important advantages where associates wish to jointly participate in conducting the business venture.

To date, the Pennsylvania legislature has considered, but has not yet enacted its own limited liability company statute. As a result, there is considerable confusion as to whether it is feasible for Pennsylvania residents to conduct business activity in Pennsylvania through a limited liability company organized under the statute of a sister state. This article considers the benefits and risks of using a foreign limited liability company to conduct business in Pennsylvania.

BACKGROUND

In 1977, Wyoming became the first state to enact a statute providing for limited liability companies.[2] Florida followed suite in 1982, enacting its own limited liability company statute similar to that of Wyoming.[3] As late as 1988, there were only a handful of limited liability companies organized under the laws of both Wyoming and Florida. Then in 1988, the IRS issued a favorable public ruling regarding the treatment for purposes of federal income taxation of a Wyoming limited liability company.[4] Stimulated by the Service's classification of the Wyoming limited liability company as a partnership for federal income tax purposes, this new business entity became "hot" and other states rushed to enact their own versions of the statute.

To date a total of twenty states have enacted statutes providing for the organization of limited liability companies.[5] Virtually all other states are drafting or have already proposed their own statutes. In the fall of 1992, the Pennsylvania legislature

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[2] Wyo. Stat. Ann. §§17-15-101 to 136 (Michie 1977).

[3] Fla. Stat. Ann. §608.401 to 471.

[4] Revenue Ruling 88-76, 1988-2 CB 360.

[5] Those states that have enacted limited liability statutes are: Arizona, Colorado, Delaware, Florida, Georgia, Iowa, Illinois, Indiana, Kansas, Louisiana, Maryland, Minnesota, Nevada, Oklahoma, Rhode Island, Texas, Utah, Virginia, West Virginia, and Wyoming.

considered its own version of a limited liability company statute, but the bill was not enacted. Currently, the bill is before the legislature, but its fate is unclear. Thus, if a limited liability company is to be used to conduct business in Pennsylvania, it must be organized under the laws of a foreign jurisdiction.

Under the provisions of the Wyoming limited liability company statute, as well as those of most other states, it is relatively easy to organize a limited liability company. Articles of Organization are filed with the state, much as with a limited partnership. The words "limited liability company" (or comparable description) must be used in the company's name to identify it as a limited liability company. Under the state statute, members are not liable for the debts, obligations, or liabilities of the limited liability company, but they can be liable to the limited liability company itself for the unpaid balance of their stated capital contributions. This still limits their exposure for loss to their equity contributions, whether paid or unpaid. A member also is liable to restore distributions made to him while the association's liabilities exceed its assets. Under the Florida statute, these liabilities to the limited liability company can be waived with the unanimous consent of all the members; however, such waiver is ineffective against any creditor who lends to the limited liability company prior to an amendment of the articles on record with the state.[6]

Members share in the profits or losses of the limited liability company based upon their proportional interests in the company, or as otherwise provided in the limited liability company's operating agreement.

BENEFITS OF LIMITED LIABILITY COMPANY

Traditionally, partnerships have been the favored entity where all associates wish to participate in the management and conduct of a joint business venture. Partnerships offer maximum flexibility from the perspective of organization and management, as well as for purposes of federal income taxation. Not only does the partnership provide the tax benefits of a "pass-through" entity (a single level of taxation), but it also offers partners maximum flexibility in sharing the economic (and tax) benefits and burdens of the business venture.

So-called "S" corporations (i.e., corporations that elect to be taxed under Subchapter S of the Internal Revenue Code) also enjoy tax treatment as a pass-through entity in a manner comparable to that of a partnership. However, S corporations generally provide less flexibility than partnerships in management and organization, and there generally is less flexibility in allocating tax and economic benefits and burdens. On the other hand, partnerships present one very significant draw-back as a vehicle for conducting a joint business venture. Partnerships do not shield associates from the debts, obligations, or liabilities arising from the business venture—the most important and long-cherished benefit derived from using a business corporation. Whereas bona fide shareholders are never liable for the debts and obligations of their corporation, all partners of a general partnership are jointly and severally liable for the debts and obligations of the partnership under state law.[7] This is the principal short-coming of using a general partnership to conduct a joint business venture.

In many cases, a limited partnership can be a viable alternative to the general partnership as it provides limited liability to its limited partners. In addition, an S corporation can be used as the general partner of a limited partnership (i.e., a "dummy" or thinly-capitalized S corporation acting as the corporate general partner). This will further limit exposure for the liabilities of the business to the assets (or net worth) of the corporate general partner and the equity contributions of the limited partners.

However, there are other short-comings associated with using a limited partnership that may reduce its appeal for many joint business ventures. For instance, for tax purposes, the corporate general partner may be required to have "substantial net worth" in order to satisfy the entity classification regulations (discussed below). In addition, limited partners will not be liable for the debts and obligations of the partnership

[6] F.S.A. §§608.435(3) and (4), 608.461, 608.462.

[7] 15 Pa.C.S.A. §8327.

only as long as they do not participate in the control of the business. If a limited partner does participate in the control of the business, he can be held to be liable under state law to third-parties who transact business with the limited partnership.[8] Hence, this entity is appropriate only so long as the associates wish to be passive investors. Where all associates wish to actively participate in the conduct of the business, the limited partnership may not be a viable option. In such cases, the limited liability company may be an attractive alternative.

The limited liability company is a hybrid entity providing associates with the limited liability characteristic of a corporation (or limited partnership interest), the opportunity for active participation in the joint business venture (as with a general partnership), as well as the beneficial tax treatment that is otherwise afforded only to partnerships and S corporations.

In addition, the limited liability company is not subject to many of the limitations imposed upon S corporations under the Internal Revenue Code. For instance, there is no limit to the number of associates who can be members of a limited liability company.[9] Limited liability companies are not restricted to one class of stock, as are S corporations.[10] Furthermore, unlike an S corporation, a limited liability company can own more than 80% of the stock of another corporation.[11] If the limited liability company is taxable as a partnership, it will not be subject to these and other cumbersome and restrictive S corporation rules pertaining to qualifications, elections, built-in gain, basis adjustments, and limitations on the deduction of losses.

Thus, the associates of a limited liability company may enjoy the best of both worlds—tax treatment comparable to that of partnerships, without the exposure to liabilities that comes with a general partnership and without the inflexibility and restrictions of an S corporation.

FEDERAL INCOME TAX TREATMENT

For federal income tax purposes, whether an entity is classified as "an entity taxable as a corporation" or as a partnership has been an issue of controversy for decades. The classification of an entity for purposes of federal income taxation is made under Treasury Department Regulations.[12] The Regulations were first issued in 1960 codifying the U.S. Supreme Court's approach to classifying entities enunciated in *Morrissey v. CIR*.[13] The Regulations implement the judicial standards as a mechanical test for classifying entities for purposes of federal income taxation.[14]

Under the Regulations whether an entity is taxable as a corporation is determined by whether the entity possesses certain characteristics of a corporation. The relevant corporate characteristics are:

(1) Limited liability;
(2) Continuity of life;
(3) Centralization of management; and
(4) Free transferability of interests.

In short, under the Regulations the rule is that an unincorporated entity must lack at least two of the four corporate characteristics in order to be taxable as a partnership.[15] Because limited liability company statutes provide for limited liability, at least two of the other three corporate characteristics must be absent for a limited liability company to be classified under the Regulations as a partnership for federal income tax

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[8] 15 Pa.C.S.A. §8523(a). However, the 1988 BCL follows the Revised Uniform Limited Partnership Act (RULPA) in providing a safe-harbor for limited partners who serve as employees, directors, and/or officers of the limited partnership or a corporate general partner. 15 Pa.C.S.A. §8523(b)(1).

[9] Under IRC Section 1361(b)(1), and S corporation can have only 35 shareholders, who must be individuals (other than certain qualified trusts) and cannot be nonresident aliens.

[10] An S corporation is permitted only one class of stock. IRC Section 1361(b)(1)(D).

[11] IRC Section 1361(b)(2)(A) (member of an affiliated group is an ineligible corporation).

[12] Treas. Regs. §§301.7701-2.

[13] *Morrissey v. CIR*, 296 U.S. 344 (1935).

[14] *See, e.g., Phillip G. Larson*, 66 T.C. 159 (1976) (acq.).

[15] Treas. Regs. §§301.7701-2(a)(3).

purposes. Of course, this assumes that the Regulations, which essentially were designed to distinguish between partnerships and corporations, are applicable to limited liability companies.[16]

As soon as Wyoming enacted its limited liability company statute, the question arose as to whether the IRS would classify a Wyoming limited liability company as a partnership or as an unincorporated entity taxable as a corporation for purposes of federal income tax. Beginning in the mid to late 1980's, the IRS had began to ease its long-time restrictive position in classifying entities as partnerships, and increasingly the process became less controversial and more certain. In 1988, the Internal Revenue Service issued Revenue Ruling 88-76 holding that the Wyoming limited liability company at issue was taxable as a partnership for federal income tax purposes notwithstanding that the entity possessed the corporate characteristic of limited liability. This favorable tax treatment of limited liability companies as partnerships made them considerably more attractive as vehicles for conducting business.

The Wyoming statute provides that a limited liability company will dissolve upon the death, insanity, retirement, bankruptcy, resignation, or expulsion of any member, unless the remaining members unanimously agree to continue the venture. Based upon this statutory provision, the Service held in Rev. Rul. 88-76 that the Wyoming limited liability company at issue was held to lack the corporate characteristic of continuity of life. In addition, the Wyoming limited liability company was held to lack the corporate characteristic of free transferability of interests. This was because under the state statute a member can only freely assign his economic interest in the limited liability company, but cannot transfer or assign his right to participate as a member without the unanimous consent of all other members.[17]

Thus, lacking at least two corporate characteristics, the Wyoming limited liability company was classified as a partnership. Taxable as a partnership, there is a single level of taxation as profits and losses pass through to the members in proportion to their ownership interests in the limited liability company, or as otherwise provided in an agreement among the members set forth in the organizational documents.

Because the members of a limited liability company will almost certainly wish to avoid exposure to the business entity's liabilities beyond their equity contributions, a limited liability company will virtually always possess the corporate characteristic of limited liability. (Otherwise, the members might just as well use a general partnership to conduct their business.) Thus, to attain favorable partnership tax treatment, it is vital that the entity be structured so that at least two other corporate characteristics are lacking.

The absence of "continuity of life" is a non-corporate characteristic that virtually all limited liability companies have relied upon to be classified as a partnership for federal income tax purposes. As with the Wyoming statute, other states have provided that a limited liability will terminate upon either a termination date provided in the Articles of Organization (limited to a maximum of thirty years under most state statutes), or upon the death, insanity, retirement, bankruptcy, resignation, or expulsion of any member. Such provisions are drafted with the express intention of satisfying the Treasury Regulations. Under the present Regulations, if such events cause a termination of the entity, continuity of life will be absent so long as the consent of all the remaining members or partners is a requirement for continuing the partnership. This means that to avoid continuity of life under

[16] For a discussion of the many technical problems that arise in attempting to apply mechanically the partnership/corporation classification rules to limited liability companies, see Barbara Bryniarski, "Congress and IRS Express Greater Interest in Limited Liability Companies," 12 Tax Management Weekly Report 512 (April 12, 1993).

[17] The Florida and Colorado statutes follow the Wyoming statute with respect to requiring unanimous consent for a transfer of an interest. Other states require only majority approval, which should still constitute a restriction upon transferability sufficient to negate the corporate characteristic of free transferability.

the Regulations, a unanimous vote of the remaining members must be required under the Articles of Organization of the limited liability company.

Such a provision requiring a unanimous vote to continue the enterprise can prove to be a cumbersome device in operating a business entity. However, because avoiding continuity of life is often important in obtaining a classification as a partnership, it is usually necessary to include such provision in the Articles of Organization of a limited liability company. Fortunately, the IRS has proposed changes in July 1992 to the Regulations allowing that where "at least a majority in interest" of the remaining members is required to continue, continuity of life will not be found. Also, in Rev. Proc. 92-35, the IRS adopted the majority-approval standard in lieu of requiring unanimity to continue upon the bankruptcy or removal of a sole general partner.[18] Once this new relaxed standard is adopted in the Regulations in final form, as is expected, it will provide for greater flexibility in using a limited liability company for conducting business and in obtaining favorable tax treatment as a partnership.

Along with the restrictions imposed on the free transferability of interests in limited liability companies, the absence of continuity of life should be readily obtainable by most limited liability companies.

The fourth relevant corporate characteristic, centralization of management, must be negated in the Articles of Organization of a limited liability company if the absence of this corporate characteristic is needed for partnership classification purposes. Most state statutes permit the members of a limited liability company to either reserve management to all members or to designate "managers" for the entity. If management is so designated, the corporate characteristic of centralized management will be present, and thus, could pose a problem for classification purposes. However, the relative ease in negating centralized management means that it is well within the control of the entity itself (with good legal counsel) to be sure of negating at least two of the corporate characteristics. As such, favorable tax treatment should be available to most limited liability companies.

Finally, the tax treatment of a limited liability company under state and local law is much less certain. For instance, the state of Florida treats domestic (and apparently foreign) limited liability companies as corporations subject to the Florida corporate income tax, even while the same entity is treated as a partnership for federal income tax purposes.[19] Since Florida has no personal income tax, this could create additional state tax for a profitable business. Wyoming has no corporate income tax, and thus, this issue has not been addressed under that state's limited liability statute.

It is uncertain how Pennsylvania (or for that matter, local taxing authorities such as the City of Philadelphia) will treat a foreign limited liability company for state taxation purposes. Conversations with legal counsel in the Department of Revenue suggest that no clear policy has yet been formulated as to how Pennsylvania would tax such entities. It is the Department of Revenue's position that legislative authority would be required before the Commonwealth could tax such an unincorporated entity as a corporation under Pennsylvania law. To date, no entity has filed a corporate or partnership tax return in Pennsylvania identifying itself as a limited liability company. The Commonwealth only requires the filing of partnership information return for purposes of state taxation. If there are any foreign limited liability companies presently conducting business in Pennsylvania, it is unclear whether such an entity would be required to file a partnership return, presumably identifying itself as a limited liability company.

Possibly, if Pennsylvania enacts its own limited liability company statute, the issue of how to tax these entities for state tax purposes also will be addressed by the

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[18] Rev. Proc. 92-35, 1992-1 C.B. 790.

[19] See Alan S. Lederman, "Miami Device: The Florida Limited Liability Company," 67 Taxes 339, 344, 348 (June 1989).

Legislature. The most logical position is to tax these entities for state and local purposes in the same manner as they are taxed for federal income tax purposes. This would mean that a limited liability company taxable as a partnership for federal income tax purposes would not be subject to the Pennsylvania corporate net income tax. However, in general, principles of consistency and rationality do not necessarily move state and local taxing authorities. Thus, the tax treatment of limited liability companies for state and local purposes is presently, and will likely remain, uncertain absent statutory clarification.

LIMITED LIABILITY UNDER PENNSYLVANIA LAW

Despite the beneficial tax treatment afforded limited liability companies, there is considerable uncertainty as to whether this entity is an appropriate choice for conducting business in Pennsylvania. The absence of a Pennsylvania limited liability statute creates doubt as to the treatment of such entities under state law with respect to unincorporated entities. At issue is whether a Pennsylvania court will accord limited liability to the members of a foreign limited liability company doing business in Pennsylvania based upon the relevant provisions of a sister state's limited liability statute. Assuming that the members of the foreign limited liability company comply with all applicable statutory requirements under the law of the foreign jurisdiction, thus assuring limited liability in the foreign jurisdiction, it is still uncertain as to whether a Pennsylvania court would recognize such a treatment of the association under Pennsylvania law. Viewed as a choice of law issue, a Pennsylvania court would need to decide whether its own statutes and public policy ought to provide limited liability to the members of a foreign unincorporated association doing business in Pennsylvania.[20]

There is no case law directly on point concerning the limited liability statutes of Wyoming and Florida, nor have any decisions been reached under any of the more recent limited liability company statutes. However, several jurisdictions have considered an analogous issue with respect to whether limited liability will be recognized as to the associates of a foreign business trust.

For instance, in a series of decisions Texas courts refused to recognize limited liability as to the members of an Oklahoma business trust doing business in Texas. These cases involved tort liability asserted by Texas residents against the foreign business trusts based upon the conduct of business activity in Texas. In the leading case, *Means* v. *Limpia Royalties*,[21] the Texas court held that the members of the Oklahoma business trust were liable to third parties under Texas law in the absence of a Texas statute providing otherwise. As a question of choice of law, the Texas court found that the members of an entity which is not organized as a corporation under its own governing state law (or presumably, a comparable corporate statute of another jurisdiction) can be held personally liable for claims against the association.

There is comparable law in Pennsylvania concerning limited liability as it arises as to the members of a Massachusetts business trust doing business in Pennsylvania. A Massachusetts business trust is not a statutory creation under Pennsylvania law, but rather is a common law association. Nevertheless, Pennsylvania courts have held that the Massachusetts business trust is not contrary to Pennsylvania public policy. In *Wallace* v. *Pennsylvania Co.*,[22] the Pennsyl-

[20] This issue has been addressed in several other states that have their own limited liability company statutes. Colorado, Kansas, Utah, and Virginia provide for the registration of foreign limited liability companies doing business in their jurisdictions, thus recognizing the status of such entities and preserving limited liability for their members.

[21] *Means* v. *Limpia Royalties*, 115 S.W.2d 468 (Tex. Civ. App. 1938). *See also Cherokee Village* v. *Henderson*, 538 S.W.2d 169 (Tex. Civ. App. 1976).

[22] *Wallace* v. *Pennsylvania Co.*, 346 Pa. 532 (1943).

vania Supreme Court concluded that a person who knowingly deals with a Massachusetts business trust (and thus knows that neither the beneficiaries nor trustees of such association intend to be personally liable for the association's debts) has legally consented not to hold the beneficiaries of the association personally liable for the obligations of the trust. The *Wallace* case arose in the context of an action brought by the assignee of a bank which provided financing to the Massachusetts business trust. The court held that the assignee had (or should have had) knowledge that members of the trust were intended to be accorded limited liability on the loan. Therefore, under the principles of contract law, the assignee was held to be barred from bringing the action against the members of the Massachusetts business trust. However, in *Wallace*,[23] the Pennsylvania Supreme Court also noted in dictum that the agreement to limit liability as between the members of the Massachusetts business trust and those doing business with it *would not affect third parties* who neither expressly nor by clear implication agreed not to hold the members of the association personally liable on the association's contracts.

How these principles would be applied to a foreign limited liability company doing business in Pennsylvania and comprised of Pennsylvania resident members is not entirely clear. Where the business is conducted in Pennsylvania by Pennsylvania residents, a Pennsylvania court would likely apply Pennsylvania law with respect to determining whether limited liability should be afforded the members. As such, the principles of the *Wallace* holding should be applicable. Based upon the holding and the limited dictum of the Pennsylvania Supreme Court in *Wallace*, it is very possible that a Pennsylvania court would find the members of a Wyoming limited liability company liable for actions brought by third parties who had no knowledge of, and thus could not be viewed as having consented to, the limited liability of such members.

"BUSINESS TRUST" UNDER PENNSYLVANIA LAW

There is now statutory authority that might persuade a Pennsylvania court to extend limited liability to a foreign limited liability company even as to third-party tort liability. The 1988 revisions to the Pennsylvania Business Corporation Law ("BCL") included a new provision (effective October 1, 1989) concerning "business trusts" (including those established under the law of a foreign jurisdiction). The new provision of the BCL provides as follows:

> Liability to third parties for any act, omission or obligation of a trustee of a business trust when acting in such capacity shall extend to the whole of the trust estate or so much thereof as may be necessary to discharge such liability, but personal liability shall not attach to the trustee or the beneficiaries of the trust for any such act, omission or liability.[24]

Based upon this new statutory provision according limited liability to the beneficiaries of a domestic or foreign business trust, it is conceivable that a Pennsylvania court would extend comparable treatment to the members of a foreign limited liability company.

On the other hand, it also is possible that this new statute demonstrates that the Pennsylvania legislature knows how to extend limited liability to an unincorporated association, and in its comprehensive review of its statutes chose *not* to extend such to the members of a foreign limited liability company, but *only* to the beneficiaries of a foreign business trust. Thus, even with this new statute providing analogous authority, there is considerable uncertainty as to the status of a foreign limited liability company.

CONCLUSION

Use of a foreign limited liability company to conduct business in Pennsylvania is problematic. The lack of certainty as to

[23] *Id.* at 549.

[24] 15 Pa.C.S.A. §9506(a).

whether a Pennsylvania court will respect the limited liability authorized under another state's statute is the most significant obstacle to using such an entity. This uncertainty will likely outweigh the certainty provided by the IRS in recent years as to the favorable treatment of limited liability companies for purposes of federal income taxation. In many cases, it will be preferable to use a Pennsylvania limited partnership to achieve the same benefits available from using a limited liability company.

If a limited liability company is the entity of choice, perhaps because the members which to participate in conducting the business, it is possible to minimize the members' exposure to the debts and liabilities of the association. For instance, the association should take care in its dealings with the third-parties with whom it conducts business to be sure that they have knowledge (or will be deemed to have knowledge) of its status as a limited liability company. In addition, all contracts between the limited liability company and third-parties select as the applicable law under such contract the law of the foreign jurisdiction in which the limited liability company was organized. Furthermore, some measure of protection against tort liabilities asserted by third-parties (or instance, personal injury actions arising from a rental real property venture) can be attained through property and casualty insurance.