REPORT #748

TAX SECTION

New York State Bar Association

TASK FORCE ON THE NEW YORK
TAX TREATMENT OF LIMITED LIABILITY
COMPANIES
OUTLINE OF ISSUES AND ALTERNATIVES

January 26, 1993

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January 27, 1993

Honorable Mario M. Cuomo
Governor of the State of New York
Executive Chamber
Albany, New York 12224

Re: New York Tax Treatment of Limited Liability Companies

Dear Governor Cuomo:

Limited Liability Companies, known as "LLCs", are increasingly popular forms of business enterprise. As you know, LLC legislation has been introduced in the New York Legislature, and your administration is devoting considerable attention to the New York State and City revenue effects of LLC legislation, and the appropriate tax treatment of LLCs.

Last year the Tax Section formed an LLC task force to consider these issues. The task force has met with State and City officials on several occasions. The work of our task force and the conclusions they have reached thus far are summarized in the enclosed outline.

The Tax Section strongly supports the concept of New York LLC legislation. We recognize, however, that many complex and challenging questions are raised by the potential revenue impact of LLCs, and the various alternatives for LLC-based revenue raising.

It is important to adopt user-friendly LLC legislation that will encourage, rather than confound, potential users of New York LLCs. On balance, the task force believes that any LLC-based

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revenue rising should take the simplest form possible. Accordingly, the task force generally favors the imposition of flat fees or taxes, over the enactment of a new LLC income tax.

We commend you for your recognition of the importance of LLC legislation to New York, and we commend the work that the State and City have done thus far. There remains, however, much to be done. The Tax Section continues to be available to offer our assistance.

Very truly yours,

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TAX SECTION

TASK FORCE ON THE NEW YORK

TAX TREATMENT OF LIMITED LIABILITY

COMPANIES

OUTLINE OF ISSUES AND ALTERNATIVES

January 26, 1993

NYSBA Tax Section Task Force on the New York
Tax Treatment of Limited Liability Companies --
Outline of Issues and Alternatives

Over the past several months a task force of interested attorneys has been considering the New York State and City revenue implications and tax treatment of limited liability companies.[*] As of yet no New York legislation providing for the establishment of limited liability companies has been enacted, but comprehensive bills have been introduced into the New York State Legislature, and are the subject of considerable study and interest.[1] On December 4, 1992, Senator Daly conducted a hearing concerning the New York tax treatment of limited liability companies, at which the task force testified.[2]

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[*] The members of the task force are: Roger J. Baneman, William B. Brannan, Robert Brown, John A. Corry, Thomas Humphreys, Bruce Kayle, Jerome Kurtz, Richard Leder, Carolyn Joy Lee, Robert J. Levinsohn, Brian L. Schorr and Esta Stecher. With the exception of Messrs. Kurtz and Schorr, all of the task force members are members of the Executive Committee of the New York State Bar Association Tax Section. Mr. Kurtz has served as Commissioner of the Internal Revenue Service and currently is a professor of law at the New York University School of Law. Mr. Schorr is a member of the Business Law Section of the New York State Bar Association and Co-Chair of The Association of the Bar of the City of New York and The New York State Bar Association Joint Drafting Committee of the Proposed New York Limited Liability Company Law. This outline was prepared by Carolyn Joy Lee. Helpful comments were received from Michael L. Schler, William L. Burke and Arthur A. Feder.

[1] Assembly bill No. A. 11016 was introduced in the New York State Assembly by Assemblymen G. Oliver Koppell and Jerrold Nadler during the 1992 legislative session. Two similar bills, Nos. S. 8180 and S. 8882, were introduced in the New York State Senate by Senator John B. Daly during the 1992 legislative session. The pending legislation is referred to herein as the "Bill."

[2] A copy of Bruce Kayle's testimony on behalf of the task force is attached as Exhibit A.

We understand that, as a political and budgetary matter, there is concern that the introduction of limited liability company ("LLC") legislation into New York be "revenue-neutral." Efforts of state and City officials, industry groups, this task force and other committees have therefore focused on identifying the revenue implications of making the LLC vehicle available in New York, and on various methods for addressing any revenue loss anticipated as a result of LLC legislation. This outline sets forth the task force's analysis of these issues.[3]

I. Summary of task force conclusions.

Measuring the revenue implications of introducing LLCs into New York requires consideration of two factors: the potential loss of revenue as new and existing businesses choose the LLC over alternative and more highly taxed forms of business organization; and the potential increase in revenues as the availability of the LLC stimulates business growth in the State and City. We are not revenue estimators or experts in economic development, and we do not presume to predict the economic and revenue effects of LLC legislation in New York. We have, however, provided commentary to State and City personnel on various federal, state and local tax issues that we believe should be taken into account in the revenue estimating process and these are discussed in Section II, below.

We also have considered various alternative forms of LLC taxation and LLC-based revenue rising. Section III of the outline sets forth our comments on the structural, technical and

[3] The task force also has given consideration to various technical tax questions presented by the integration of LLCs into the existing New York State and City tax laws, and is evaluating the implications of the proposed LLC legislation for individual estate planning. These topics will be addressed in the future, as needed.

practical strengths and weaknesses of various alternative revenue-raising approaches.

In addition to our technical insights, however, our practical experience as tax advisers compels us to emphasize the importance of enacting LLC legislation that is user-friendly. We are very concerned about the complexity inherent in imposing a new income tax on LLC's -- concerned about the difficulties in crafting a fair, technically sound and readily workable statute; concerned that the imposition of an LLC income tax will metamorphose into additional State and City taxes on partnerships and other business vehicles; and concerned that, like the 10% real property gains tax Commissioner Wetzler cited in his December 4 LLC testimony, the original principles of an LLC income tax will be eroded and lost to future (and perhaps entirely unrelated) budgetary needs.

Our experiences as tax and business advisers also have sensitized us to the problems New York State and City experience in appearing competitive and attracting new business. We are therefore quite concerned that New York's introduction of a complicated and potentially burdensome new taxing scheme applicable to LLCs will reinforce the perception of New York as a high-tax jurisdiction. This, would, we believe, discourage the use of New York LLCs and the conduct of LLC business in New York.

In light of these concerns, and assuming that some LLC-based revenue-raising is necessary to the enactment of LLC legislation in New York, we generally favor the imposition of some form of flat fee or flat annual tax over other forms of revenue raising. As discussed in Section III.B.3., below, there are any number of different kinds of flat fees or taxes that could be imposed on LLCs or their members. And while we recognize

that the flat fee approach is not a perfect solution, we have concluded that it is superior to the introduction of new income taxes on LLCs.

II. Review of revenue considerations.

A. In general.

In order to consider the revenue questions posed by LLCs it is useful to have an overview, albeit simplified, of the existing New York State and City taxing regimes. New York State and New York City both impose franchise taxes on C corporations. The State franchise tax ranges from a minimum tax of $350-$1,500 to a tax on net income at rates up to 9% (plus the 15% HTA surcharge). The City's general corporation tax likewise provides for a $300 minimum tax, and a net income tax at rates up to 8.85%. Both the state and City taxes also provide for a tax on capital. In addition, New York City imposes an alternative tax on corporate income increased by compensation paid to officers and 5% shareholders; and New York State imposes an alternative minimum tax similar to the federal corporate alternative minimum tax. For each of the State and the City, therefore, corporations pay the greatest of these various alternative taxes, and also pay State and City taxes on subsidiary capital.

New York State also imposes a corporate-level tax on S Corporations. This tax is designed to equalize the combined individual and S Corporation rate of tax on S Corporation income with the rate of tax on C Corporations. Currently state taxes on S Corporations range from the $350-$1,500 minimum tax to a tax at 2.475% of net income. New York City does not recognize S Corporation status, and thus taxes S Corporations in the same manner as it taxes C Corporations, at rates up to 8.85%.

New York State imposes no entity-level tax on partnerships. New York City imposes a 4% unincorporated business tax ("UBT") on the net income of partnerships, sole proprietorships and other unincorporated businesses. Certain exceptions from the UBT are available for persons engaged in trading activities for their own account, and for certain real estate businesses. In addition, an exemption from the UBT is provided for income allocated to corporations subject to City franchise tax. While the application of this exemption is imperfect, the general concept is to prevent the imposition of UBT on income that is also subject to City UBT or general corporation tax at the partner level.

New York State and City also impose personal income taxes on income earned by individuals. For New York State the maximum rate of tax is 7.875%. For New York City residents the maximum rate of tax is 3.91%, plus a temporary additional tax surcharge of 14%, for a total current effective tax rate of 4.46%; nonresidents of the City pay tax on City-sourced earnings at a maximum rate of .65%. Individuals include in taxable income their distributive shares of income from partnerships and s Corporations.

New York State currently imposes various filing fees, as follows:

1. One-time corporation organization fee of $125.00.

2. One-time limited partnership organization fee of $200.00.

3. One-time foreign corporation authority to conduct business fee of $225.00.

4. One-time foreign limited partnership application for authority to conduct business fee of $200.00.

5. Annual corporate maintenance fee of $50.00.

6. There is no annual partnership maintenance fee.

In addition, State mandated publication costs generally run $1,000 - $2,000 on the formation of a limited partnership.

B. Revenue effects of LLC legislation.

The revenue effects of enacting LLC legislation in New York are two-fold. First, there is the potential for revenue loss if businesses that would otherwise use more highly-taxed vehicles are instead drawn to use LLCs. Second, there is the potential for revenue gain if the availability of LLCs in New York stimulates new business activity and growth. The task force has no particular expertise in "economic development" issues, and therefore we have not engaged in any detailed analysis of this aspect of the question. We believe however, that in an era of unprecedented individual and corporate mobility and sophisticated communications and information technology, businesses are increasingly able to locate in areas with favorable tax structures. As tax lawyers we are well aware of the business community's sensitivity to state and local taxes, and we believe this is an important factor that must be taken into account in considering legislation on the very topical and business-oriented subject of LLCs. It also is our impression, from our meetings with State and City personnel to date and from the testimony

offered at the December 4 hearing, that these business growth issues have not yet been analyzed and debated with the same thoroughness as the State's and City's analysis of the potential for revenue losses.

With respect to the analysis of the potential revenue loss if New York businesses elect to use LLCs rather than more highly-taxed vehicles, we have considered two kinds of questions: the extent to which existing businesses will move into the LLC form; and the extent to which new business will choose the LLC form over other types of vehicles. In evaluating these possibilities we have considered both tax and non-tax factors that influence a decision to convert into, or engage in business through, an LLC, as compared to a C Corporation, an S Corporation or a partnership.

1. Non-tax considerations with respect to the use of a Limited Liability Company.

With respect to the non-tax considerations affecting the choice of an LLC, and the comparison of the LLC to other forms of business vehicles, we offer the observations outlined below. It should be noted that as a business matter there are elements of the LLC that resemble corporations, and other elements that resemble partnerships.

a. Limited liability.

The obvious benefit of LLCs is that all members are protected from personal liability for the entity's debts.

- In this respect LLCs provide the same business format as C and S Corporations.

- Limited partnerships currently provide some member protection.

  -- use of a limited partnership is however considered too cumbersome in many small business situations.

  -- involvement of limited partners in management raises concerns, although the recent New York limited partnership amendments provide greater flexibility.

  -- partnership tax classification requires the formation and capitalization of a general partner entity, which causes complexities.

- In the case of professional LLCs, each LLC member would remain personally liable for his or her own negligence, wrongful act or misconduct, or for that committed by a person tinder his or her direct supervision or control. However, a member would not be personally liable for any negligence, wrongful act or misconduct committed by any other member or employee of an LLC who is not under his or her direct supervision and control.

b. Management and organizational structure.

If so desired, all members of an LLC may actively participate in the management of the business. On the other hand, an LLC can also be structured to provide for centralized management by a small number of members.

- The management of an LLC can therefore be tailored in much the same fashion as corporate management.

- As compared to limited partnerships, members would not risk personal liability by having an active role in management.

- As compared to general partnerships, one can restrict the authority of certain members, or classes of members.

c. Capital structure.

LLCs can issue more than one class of ownership interest, and can provide for any variety of special economic arrangements.

- C Corporations have no federal tax restrictions per se on their capital structure, but in general their capital structures are less flexible than those of partnerships or LLCs.
- REITS and RICs do have some federal tax law restrictions that restrict their ability to provide for different classes of economic interests.
- S Corporations are severely constrained by federal tax law, in that they can have only one class of economic interest. That single class of stock can, however, include both voting and non-voting stock. Furthermore, recent regulations permit fairly liberal use of subordinated debt and warrants in S Corporations, which can be used to provide greater flexibility in capital structure.
- LLCs are essentially the same as partnerships in terms of the broad flexibility available in capital structure, classes of interest, priorities, and income and loss allocation.

d. Ownership restrictions.

There are no legal restrictions on the types of persons who can be members of LLCs.

- The sharpest contrast on this point is with S Corporations. Federal tax law imposes severe restrictions on who can be a shareholder in an S Corporation.
    - -- Only non-foreign individuals, the estates of individuals, and limited types of trusts are qualified shareholders; and overall the S Corporation can have no more than 35 shareholders. S Corporations are therefore unsuitable vehicles for business ventures involving corporations, foreigners, pension funds, partnerships, financial institutions, most

kinds of trust, or even a large group of individuals (e.g., employees).

- Membership in an LLC is open to as broad a range of persons as is membership in a general or limited partnership or ownership of C Corporation stock.

- The lack of ownership restrictions make partnerships and LLCs considerably more attractive than S Corporations in terms of estate planning.

- Even if there is no initial need for flexible ownership and/or economic participation, it is often sensible to provide flexibility in the organizational structure in the event a future need should arise. Thus, the relative restrictiveness of S Corporations presumably prompts considerable shifts away from the formation of S Corporations.

e. Transferability of members' interests.

Federal income tax classification of an LLC as a partnership, rather than a corporation, frequently will require that the LLC impose substantial restrictions on the transferability of members' interests. The proposed LLC Bill, drawing from federal tax law, would permit admission of a new LLC member only upon the consent of at least a majority in interest of the other members.

- This differs from C Corporations. The lack of a readily transferable membership interest, and the federal characterization of "publicly-traded partnerships" as C Corporations, mean that the LLC will not replace or substitute for the publicly-traded corporation.

- As compared to S Corporations, in many cases LLCs will have to provide for stricter limitations on transfer. Thus, while S Corporations (and their shareholders) may be comfortable simply restricting transfers to avoid acquisitions by non-qualified persons, LLCs may be compelled to restrict altogether the transferability of a substantial (20%) class of membership interests.

- In an LLC all members of an LLC are protected from liability. One of the four tests of corporate classification will, therefore, always be present in LLCs. Furthermore, in terms of avoiding the corporate characteristic of centralized management, an LLC is not as flexible a vehicle, in certain circumstances, as a

limited partnership. Because one corporate characteristic will always be present in LLCs and another may be hard to avoid, it may be critical as a matter of federal tax classification to impose tighter restrictions on transfers of LLC interests than those applied to partnerships.

- As with partnerships, members of LLCs may be able to transfer the economic benefits and burdens of the LLC interest (as opposed to the interest itself) without restriction. Transfer of the right to be admitted as a member of the LLC -- which carries the right to vote and to participate in management -- would however likely be severely restricted.

f. Continuity of the entity.

Again, as a result of federal tax classification concerns, LLCs will generally provide for the dissolution of the entity upon the occurrence of certain events. The proposed LLC bill provides that an LLC is dissolved upon "the bankruptcy, death, dissolution, expulsion, incapacity or withdrawal of any member or only the member or members specified in the operating agreement. ..." Bill §701(d).

- LLCs differ in this respect from C Corporations and S Corporations, which survive as legal entities without regard to the status of their members.

- The kind of dissolution provision prescribed for LLCs is similar to that generally found in limited partnership statutes. The limited partnership dissolution provisions are triggered only with respect to the general partner(s). The LLC provisions could apply to a broader group of members, unless the governing documents specify a particular class of LLC members with respect to which the dissolution provisions apply; the still-developing federal income tax law will be highly important to this aspect of LLC partnership classification.

- The necessity of some kind of dissolution provision will, as a practical matter, often mean that LLC members will have to have a general familiarity and level of comfort with the identity of their partners.

g. Recognition of the entity in other jurisdictions.

To a large extent this is a business concern that will diminish over time, as the law regarding LLCs evolves to provide reliable protection to the LLC and its members in each jurisdiction. Until the transition is completed, however, there will be concerns.

- Foreign investors may be attracted to LLCs because they are accustomed to investing in similar entities, such as the SARL in France, the GMBH in Germany and the Limited formed in Central and South America and used there and in offshore transactions. In addition, because many foreign countries already recognize the LLC as a form of doing business, a U.S.-organized LLC may be able to be used as an investment vehicle in those other countries.
- The utility of LLCs for multistate businesses is still unclear. At least eighteen states have enacted LLC statutes and bills are pending or are being drafted in approximately 28 other states. In addition, two states recognize LLCs formed in other states. A committee of the National Conference of Commissioners on Uniform State Laws is drafting a uniform LLC statute. However, because LLCs are not recognized in all 50 states, there are some risks and disadvantages that will have to be considered if the LLC proposes to engage in business in a state which does not recognize foreign-state LLCs:
    - Whether the limited liability provisions contained in the New York limited liability company statute will be recognized by such state.
    - How inconsistent limited liability provisions will be resolved.
    - Whether the LLC will be permitted to maintain an action, suit or proceeding in the foreign state's courts.
    - How the limited liability company will be treated for state tax purposes in such state.
    - Whether the LLC will be subject to being enjoined from conducting business in the foreign state.

h. Ownership of subsidiaries.

There are no restrictions on an LLC's ownership of more than 80% of a corporation.

- This is in marked contrast to S Corporations, which, under current federal tax law[4], are precluded from owning 80% of another corporation.
- LLCs are in this respect like partnerships; they have the ability to insulate partnership assets from the risk of another business by incorporating that business.
- As a matter of tax planning, however, ownership of groups of corporations by an LLC will often be less efficient than ownership by a parent C Corporation, particularly because of the LLC's inability to file consolidated federal income tax returns. The LLC's ability to own subsidiaries thus becomes less meaningful as the subsidiaries become a more important element of the business.

i. Other business considerations.

Within each industry, and under the particular plans of any given business, there will be factors that influence the type of business entity chosen. Local customs, labor considerations, franchise and distributorship arrangements, governmental licensing requirements, securities laws, lending arrangements, bankruptcy issues and numerous other factors all will influence business decisions, including the type of vehicle chosen.

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[4] The discussion herein is based on the current provisions of Subchapter S, but we do note that federal legislation has been proposed to eliminate this particular restriction on S Corporations and to relax other S Corporation limitations.

2. Tax considerations with respect to the use of an LLC.

For federal income tax purposes, assuming that the classification tests are met, LLCs are treated as partnerships. This classification makes them considerably more tax efficient than C corporations or S Corporations. However, because these efficiencies (and other business advantages) are already largely available through limited partnerships, one cannot simply assume that the introduction of LLCs will suddenly give rise to widespread movement away from corporate vehicles. The task force members believe that for a very large number of substantial new business enterprises, as veil as expansions of existing lines of business, the use of S Corporations currently is not feasible or desirable. Furthermore, in the task force's experience C Corporations are not widely utilized where there are significant tax efficiencies to be achieved through the use of partnerships.

For smaller enterprises, for whom the structural complexities and management constraints of limited partnerships present relatively significant business hurdles, the task force members believe that LLCs will, over time, tend to replace S Corporations. For more substantial enterprises, however, our experience indicates that the existing tax inefficiencies of C and S Corporations, as compared to partnerships, already have exerted significant influences on choice of entity decisions, and will continue to influence this decision whether or not the LLC is available in New York.

In the context of the present inquiry, we have noted the following significant differences in tax treatment between an LLC, or any other partnership, and a C or S Corporation.

a. Pass-through of income and deductions.

Perhaps the most significant aspect of partnership status is the pass-through of partnership income and deductions to the partner/members. This distinguishes partnerships and LLCs from C Corporations and (in certain respects, notably the ability to pass through losses attributable to entity-level debt) from S Corporations.

- Pass-through status avoids a second level of tax on entity income.
- Subject to limitations (such as the passive loss rules) pass-through status permits members to offset income of the partnership with losses from other sources.
- Similarly, the pass-through status of partnerships also permits members to apply partnership losses against member-level income. This can be quite important in start-up situations.
- Because the partnership is not a separately taxable entity, numerous questions presented in the corporate/ shareholder realm, such as the limitation on deductions for compensation to "reasonable" amounts, are of reduced or no importance in the partnership/member realm.
- Corporate members of partnerships are able to include their shares of partnership income and loss in computing their corporate income without the need for complying with consolidated or combined reporting rules.
- Corporations are however also entitled to federal dividends received deductions, and to State and City exclusions for income from subsidiary capital. These factors, coupled with the ability to consolidate/combine with corporate subsidiaries, make the pass-through nature of partnerships of somewhat less concern to corporate investors than to individual investors.

b. Inclusion of entity debt in basis.

Partnership liabilities, both recourse and nonrecourse, are treated as liabilities of the partner/members and, as allocated under federal income tax rules, are included in the members' bases for their partnership interests. Neither C nor S Corporations permit this.

- Basis inclusion permits members to claim losses up to the amount of their respective shares of partnership debts, not just the amounts of equity invested. (Individual members are, however, subject to various restrictions on the use of losses, for example under Code §465.)
- Basis inclusion also permits members to withdraw borrowed funds from the partnership without current income or gain.

c. Tax-free distribution of partnership assets.

Partnerships generally can distribute partnership property in kind without triggering entity or member-level gain. By contrast, distributions of appreciated property give rise to taxable gain to C and S Corporations, and can also trigger gain at the shareholder level.

- The ability to distribute assets out of the partnership without incurring current tax liabilities provides a great deal of flexibility in managing and planning for the partnership business and with respect to relations between members.
- For example, a family can split up partnership business with relatively few income tax issues, whereas the split-up of an S Corporation presents serious tax questions, and can result in significant taxes.

d. Transfers to partnerships.

Federal tax law permits transfers of appreciated assets to both corporations and partnerships free of tax. However, the corporate provisions are somewhat more restrictive than the provisions applied to partnerships.

- The kinds of transactions eligible for tax-free treatment are more limited under Code §351 than under Code §721.
- Because partners can include partnership debt in basis while shareholders cannot, transfers of encumbered assets to partnerships are generally less likely to trigger tax than similar transfers to corporations.
- As a consequence of the more lenient contribution rules, partnerships provide greater flexibility, both at formation and in the case of subsequent capital infusions, than do corporations.

e. Step-up in partnership asset basis following transfers or death.

Partnerships can elect to adjust the basis of partnership assets following the sale or exchange of a partnership interest, or the death of a member. No such adjustment is available for C or S Corporations.

- The ability to adjust asset bases -- and specifically to step up a purchasing partner's share of partnership basis to reflect the amount paid for his interest -- permits members full tax recognition for the higher price paid for an interest in the partnership business. This largely eliminates potential mismatches in timing and character of income and loss.
- By contrast, while an S Corporation does provide for the pass-through of income and loss, there is no mechanism for making direct, contemporaneous adjustments to S Corporation asset basis to reflect a purchaser's higher price paid. Thus, the sale of an appreciated asset by the S Corporation will require the purchasing shareholder to include his full share of corporate gain in income; at liquidation of the S Corporation the purchaser will have less shareholder-

level gain (or a loss) to offset this current gain, but the timing of the shareholder-level income and loss may not match and any loss would be a capital loss, which can be of limited utility.

- In the case of C Corporations, the lack of a basis adjustment gives rise to two levels of gain, with no future offsetting loss.

- In the context of the closely-held, family businesses, the absence of an entity-level basis step up for S Corporations can be a serious problem. Partnerships can make asset basis adjustments following the death of a member. As a result, the sale of business assets following the member's death will produce little or no income tax liability with respect to the deceased member's share of partnership assets. In S Corporations, however, while the basis of the stock would step up, there is no step-up for the entity's assets. As a result, on such a sale the decedent's heirs will have to include in income the decedent's share of the asset appreciation, with offsetting adjustments made subsequently, when the S Corporation is liquidated or the inherited stock is sold. In the alternative, the stock of the s Corporation could be sold at no gain, but in that event the price received by the heirs would likely be reduced significantly to reflect the absence of a basis step-up to the buyer with respect to the assets.

f. Allocations.

As noted above, partnerships provide great flexibility in economic arrangements among members; and allow the allocation of business income and losses in a manner that corresponds to the members' economic arrangements.

- The flexibility in partnership economic arrangements permits more sophisticated inter-generational planning, and can be quite helpful both as a business matter (where one generation might be providing relatively more capital) and as an estate planning matter (where one generation may have a greater share in growth).

- In an S corporation, the single-class- of-stock requirement is a considerable damper on this kind of planning. Since violation of that requirement disqualifies the corporation as an S, as a practical matter one proceeds with great caution in any potentially unequal element of corporate financing or participation.

- The considerable flexibility partnerships provide also can be quite important in business ventures between capital providers and service providers.

- Partnership form also can be useful in structuring different kinds of compensation arrangements, although the S Corporation rules have developed to permit a fairly wide range of compensation alternatives.

g. Attribution of partnership activities to members.

In various different ways members of partnerships may be treated for tax purposes as if they are themselves engaged in the partnership business. In some situations this could have adverse tax ramifications.

- As a practical matter, because of U.S. and foreign tax laws, foreign investors are unlikely to invest in a partnership or an LLC directly, but are likely instead to make that investment through a foreign corporation.

- Tax-exempt organizations also may find it unattractive to become members of partnerships or LLCs, in part because of the federal unrelated business income tax issues that are often encountered in such forms of investment. They may, therefore, stay out of LLCs and invest instead in C Corporations.

- in terms of New York taxation, deriving nexus to tax corporate members of partnerships by reason of the partnership's New York activity may present compliance responsibilities or increased tax exposure to the corporate member. Corporations in these situations may prefer to conduct business through corporations directly, or through joint ventures with limited-purpose subsidiaries as members.

h. Compensation of members.

As noted above, the pass-through nature of partnerships makes this a non-issue for partnerships and LLCs. In the context of corporations, however, the payment of compensation

to shareholders can be an important element in reducing or eliminating corporate income.

- Professional service corporations probably eliminate corporate income through salary payments.
- In closely-held S and C Corporations where the bulk of the corporate income is derived from the shareholders' services, the payment of compensation also probably is widely used to reduce or eliminate corporate income.
- New York City's “salary add-back” reverses some of this planning by imposing corporate tax on the alternative income-plus-compensation base.

i. Single-member entities.

Because of partnership classification concerns,

- Single member LLCs should not be organized. Indeed, the Bill does not permit single-member LLCs. Persons interested in forming a partnership or an LLC will generally want to include another (preferably independent) person as a member, and have that person hold at least a 1% partnership interest.
- There are also concerns about the tax classification of LLCs and limited partnerships wholly-owned by entities (e.g., subsidiaries) under common control.

3. Tax and non-tax considerations affecting the advisability of converting existing entities into LLCs.

The conversion of an existing business into an LLC presents a number of significant additional tax and non-tax considerations that must be evaluated before making the conversion. Most significant, in our view, are the corporate- and shareholder-level taxes that would be triggered on the conversion of an existing C or S Corporation into an LLC. Unlike the conversion from C Corporations into S Corporations, which can be accomplished without triggering corporate or shareholder income

taxes, the requirement that taxes be paid currently, both at the corporate level (under General Utilities repeal) on the gain in corporate assets and at the shareholder level on gain in the stock makes it exceedingly unlikely, in our view, that the enactment of New York LLC legislation will give rise to widespread conversion of existing C or S corporations with significant appreciated[5] assets. Our observations in this regard are summarized below.

a. Corporate—level taxes on liquidation.

The conversion of an existing C or S Corporation into an LLC is a taxable liquidation of the corporation.

- Net appreciation in the corporate assets is subject to federal, state and local income[6] tax.
- Heretofore unaccrued corporate income may be accelerated and taxed at the time of liquidation.
- Where corporations have unused net operating loss carry forwards, suspended passive losses and the like, the economic benefit of applying those losses against future income would be lost.

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[5] As stated above, however, new business, and expansions of existing businesses, already can achieve considerable tax efficiencies by shifting out of corporate form, and the availability of an LLC may accelerate that process, particularly as to small businesses.

[6] Query, however, whether the liquidation of an S Corporation into an LLC should be subject to New York state and local income or franchise tax if the LLC is also subject to S Corporation-type taxation. See III.B.1.b., below.

- Parent corporations that own all or substantially all (at least 80%) of the stock of subsidiary corporations generally would have little inducement to liquidate their subsidiaries and form LLCs. While the corporate liquidation would be tax free, the income and losses from the liquidated corporation’s business would still be in corporate solution. Furthermore, New York State and City would still be collecting franchise and corporate taxes from the corporate members of the LLC. The likelihood of any tax-driven shift from corporate subsidiary status into an LLC thus would appear to be limited to cases where the LLC approach provided some State and City franchise and corporate tax savings, over that to be obtained through combination.

- New York City transfer taxes would be imposed on any City real property distributed on the liquidation, at rates up to 2.625% of the greater of (i) gross fair market value or (ii) the amount of liens, etc. on the realty.

b. Shareholder-level taxes on liquidation.

In addition to corporate-level taxes, shareholders of liquidating corporations also must pay tax on any excess of the liquidating proceeds received over their respective bases for their stock.

- Older shareholders often will perceive this tax as a waste. If the stock continued to be owned by them until death it would pass to their heirs with a stepped-up basis. By accelerating the disposition of stock through a liquidation, shareholder gain would no longer go untaxed.

- Corporate shareholders, who are eligible for a dividends received deduction under federal tax law, have no similar tax exemption for gain realized on the liquidation of a non-subsidiary corporation. They also may well view a liquidation-triggered tax as a waste, given their ability to take in dividends with only slightly more than one level of tax.

- Shareholders of S Corporations will step up their stock basis to reflect corporate gain on liquidation. As a consequence, the shareholder-level income taxes imposed on shareholders of liquidating S Corporations generally will be reduced considerably, mitigating the consequences of the double taxation regime. Shareholders of C Corporations are not entitled to make any stock basis adjustments for corporate-level gain,

and they therefore do experience complete double taxation on the liquidation.

- Shareholders do acquire the corporate assets with a stepped-up basis. Thus, at least one of the taxes paid on liquidation is eventually accounted for through larger depreciation deductions or less gain (or a greater loss) on a future sale. However, where a corporation's assets include intangibles such as good-will, the current inability to amortize the cost basis of such assets can make the timing mismatches considerable; and even with depreciable and amortizable assets, time value of money considerations demonstrate that the value of future tax benefits is considerably less than the current out- of-pocket tax costs.

c. Business considerations.

Again, apart from a comparison of current tax costs to projected tax benefits, one must also consider the business ramifications of converting an existing business into a new form of business vehicle.

- Various kinds of business assets and arrangements could be affected by a corporate liquidation, including:
  - Franchise, licensing and distributorship arrangements
  - Labor agreements; service contracts; pension arrangements
  - Governmental licenses and permits
  - Mortgage and credit line arrangements.
  - Leases
  - Zoning
- In some cases the potential disturbances of an important asset or business arrangement will preclude any change in structure even where, on a purely tax-based analysis, a corporate liquidation may be desirable.
- Funding the current corporate- and shareholder-level taxes imposed on a liquidation can present serious cash flow problems. Even where the amount of tax may not seem large relative to the expected future tax benefits, incurring a current cash liability to pay i

those taxes will be unadvisable or unmanageable for many businesses.

III. Review of alternative revenue raising approaches relating to LLCs.

A. In general.

We have been advised that, in the judgment of New York State and City tax and budget officials, the introduction of LLC legislation into New York would, without some related change in tax law, result in a net reduction in State and City revenues. We further understand that the bulk of this revenue loss is attributable to the projection that there will be new New York businesses that, in the absence of LLC legislation, would utilize the corporate form, and specifically S Corporations, whereas the enactment of LLC legislation would cause these businesses to use the LLC vehicle instead. As a result, if the State and City simply adopted federal conformity and treated LLCs as partnerships for State and City tax purposes, without any increased fee or tax charges, New York State and City budget officials estimate that there would be loss of revenues.

Our task force has no independent ability to evaluate the projected revenue effects of LLCs. We have endeavored to provide insights on factors influencing the choice of an LLC as compared to other vehicles, but the translation of those and other influences into revenue dollars is an exercise that is not within our ken. Furthermore, as noted above, the business-generating effects of LLC legislation in New York must also be taken into account in evaluating the overall revenue picture, but the task force has no expertise in measuring those effects.

For purposes of considering and evaluating various revenue-raising options, the task force accepted as true the State's and City's assumptions that (i) revenue neutrality is a prerequisite to the enactment of LLC legislation in New York, and (ii) the enactment of LLC legislation on a basis of pure federal tax law conformity would be revenue- negative. We also accepted the working premise articulated by State and City officials that revenue-raising options should in some manner relate to LLCs, and we have therefore limited our analysis to different kinds of tax law changes, fee options and the like that would be specifically targeted to LLCs.

Even given these assumptions, however, we believe that the reasonableness of different forms of revenue-raising -- and indeed the viability of the LLC itself -- depends very much upon the amount of offsetting revenue New York must raise. Thus, some forms of revenue raising, in particular the flat fee approach, appear to us to work fairly well at low rate levels. However, a flat fee approach would become an unmanageable burden if the size of New York's estimated revenue needs required the imposition of exceedingly high fees.

More importantly, we believe that the use of an LLC in New York will depend in large part upon the method that New York State and City choose for “taxation” of the LLC and its members. For example, if LLCs were treated as S Corporations by New York State and City, we would anticipate that use of the LLC would be significantly limited. Businesses currently operating in partnership form would generally be quite reluctant to move into an LLC if LLC income were subject to tax at the combined State and city S Corporation income tax rates, which aggregate 11.325%. By contrast, if LLC “taxation” is at a relatively low rate, and

is easily applied, we would expect that the revenue exaction will not significantly undermine the utility of LLCs in New York.

There are many possible schemes of taxation or revenue-raising for LLCs. Because we expect that use of the LLC would be very sensitive to the scheme adopted, and indeed to the nuances of the particular scheme, the evaluation of the various options requires not only a comparison of the theoretical "pros" and "cons" of each, but also an evaluation of the practical effects of each proposal and the likely cost, including compliance costs, imposed on each business under the various options. At this juncture we do not know the overall estimated revenue "loss" from LLC legislation; we do not know how much revenue would be raised under any of the proposals discussed herein; nor do we know how any of the specific proposals would actually develop and apply -- for example, how much a per-member fee would be under the member-based fee approach described in Section B.3. We have, therefore, confined the following discussion to the description and theoretical analysis of various options, with some general observations on their relative attractiveness.

B. Specific alternatives.

1. Taxing LLCs at the entity level.

a. Taxation as C Corporations.

Given New York's high tax rates, the treatment of LLCs as C Corporations seems prohibitive as a business matter and excessive in terms of the likely causes of projected revenue loss. We have therefore not given serious consideration to this approach.

b. Taxation as s Corporations.

LLCs could be treated as S Corporations for New York purposes, in which case all LLCs would be subject to an S Corporation-like State tax, i.e., a tax at a 2.475% rate on net income. If treated in the same manner as S Corporations for City tax purposes, LLC also would be subject to City income tax at rates up to 8.85%; query however whether a lower rate might be considered for LLCs.

The computation of the taxable income of an LLC under this approach raises a number of difficult questions. Many of these issues stem from the fact that an entity-based income tax on LLCs is a significant departure from federal income tax conformity. This departure gives rise to the need to make numerous and often complex adjustments to federal partnership computations in order to arrive at the S Corporation equivalent of taxable income for an LLC.

(1) Deductions for members' draws.

In order to measure income fairly LLCs should be entitled to deduct amounts paid or distributed to members to the extent these amounts represent compensation for services or for the use of capital.

- Particularly in light of the federal income tax classification of LLCs as partnerships, it may well be unlikely that the LLC would formally designate partners' draws as compensation for services rendered. Accordingly, New York State and City deductions for compensation should be permitted whether or not the members' draws were designated as such.

- Questions of the reasonableness of the compensation treated as paid for services must be addressed. There are various lines of federal authority that may be relevant (corporate reasonable compensation deduction cases; old federal law "maxitax" on earned income; self employment earnings taxes; "earned income" definitions under Code §§469, 911).

- In the case of businesses traditionally operating in partnership form, the introduction of deductions for members' compensation, and the resulting questions of "reasonable compensation" limitations on LLC deductions, may significantly detract from the acceptability of adopting the LLC form.

- Questions of compensation for the use of property or of capital also will arise; rates of return on invested capital must be considered; debt/equity issues will arise.

- The effect of New York City's alternative tax on income plus officers'/5% shareholders' salaries must be considered; classification of LLC members as officers or 5% shareholders may not be clear; the appropriateness of imposing the alternative tax should be reviewed.

(2) Adjustments for corporate members.

The premise of an S Corporation type of tax on LLCs presumably is that LLCs will be used by individuals who otherwise would have formed S Corporations. This premise is not correct in cases in which LLCs include non-individual members. To avoid overtaxing direct and indirect corporate members of LLCs, one must adjust in some fashion either the LLC-level tax or the corporate member- level tax. Similar adjustments are needed in the New York City context for LLC members whose LLC income is subject to member-level UBT.

- As witnessed by the existing City UBT additional exemption, it is exceedingly difficult to craft an adjustment that works properly at all levels to ensure that income is not subject to duplicative taxes.

- One approach is to abandon the concept of an entity level tax and work instead towards a member-level add-on tax. Tax computation issues will, however, remain.

(3) Separate New York tax accounting.

Because of the differences between the computation of federal partnership income and the income of a deemed S Corporation, most LLCs would have to maintain separate New York tax accounting records. For example:

- Presumably the imposition of an entity-level income tax would include the allowance of entity-level loss carryforwards and carrybacks. LLC NOL provisions must therefore be developed and applied.
- The treatment of LLC passive losses and other losses limited at the federal level must be considered.
- New York must consider whether to recognize basis adjustments made to LLC assets under Code §§734, 743 and 708 or whether to reverse those adjustments.
- New York must consider whether to adopt the partnership model or the corporate model in its treatment of distributions of appreciated property by the LLC.
- New York must consider whether to apply to LLCs the rules of Code §707 or the provisions of Code §267.
- New York must consider whether the income tax treatment of LLCs is affected by corporate liquidation and reorganization provisions.

(4) Expanded scope of tax.

The extension of a broad-based entity-level income tax would include in the scope of LLC taxation various enterprises that currently conduct business as sole

proprietorships or general or limited partnerships. These enterprises are not currently subject to State taxation, and pay City UBT but no City corporate taxes. Any expansion of the scope of businesses subject to entity-level tax has two implications:

- The imposition of an LLC tax on entities not currently subject to S Corporation taxes should enlarge overall revenue collections. In order to maintain revenue neutrality, one would expect that this introduction of new taxpayers will permit a lowering of the overall tax rate, redounding to the benefit of those businesses that "would have been" S Corporations.

- If the rate of LLC taxation is too high relative to the perceived benefits of New York LLC status, businesses that "would have been" partnerships will either remain as partnerships, with their lesser protection and lesser tax burdens, or will seek to conduct business outside New York, through less highly taxed LLCs formed in other jurisdictions.

(5) State-wide UBT.

The introduction of a state-wide income tax on LLCs raises the ominous prospect of a return of the State unincorporated business tax, which was finally, and after much effort, abolished several years ago. If one imposes income taxes on LLCs the premise seems to be that LLCs are used in lieu of S Corporations, and the failure to tax LLCs thus opens a hole in New York's taxation system.

- Query, under this logic, whether limited partnerships may come to be viewed as substitutes for LLCs, with the imposition of income taxes on partnerships not far behind.

- Consider also the difficulty of controlling the upward creep of tax rates, and the erosion of exemptions.

(6) Theoretical weaknesses.

In attempting to adjust for rate differentials through entity-level taxes, both the existing State S Corporation tax and the city UBT set up an artificial taxing regime by segregating the income of one pass-through business from the losses of another, based on the form of entity structure employed to conduct those businesses. Query whether this approach merits extension through the adoption of yet another narrowly drawn entity- based surcharge.

(7) Overall cap.

Consideration should be given to whether the overall tax imposed on any LLC should be capped at the amount of tax the LLC would pay as an S Corporation.

- The extension of an entity-level tax to LLCs would bring in revenues from LLCs that would otherwise have been formed as partnerships, and this might offset, or more than offset, any revenue loss from LLCs that would have been formed as C Corporations. This, in turn, could support a determination to limit LLC-based tax revenues by capping the tax liability of each LLC at the tax that would be imposed under the existing S Corporation regime of taxation.

- Applying such a cap in any regime would involve computational complexities, as discussed in Section B.1.b., above.

(8) Other matters.

Various other technical questions arise from the application of New York's internal tax laws to an entity that is part partnership and part corporation. As noted above, the task force intends to focus on specific issues of internal tax law coordination, but it is more efficient to do this after

the basic question of the manner of taxing LLCs has been addressed.

2. Imposing member-specific add-on taxes.

The basic concept here is to adjust for the perceived S Corporation revenue slippage by imposing taxes at State and City S Corporation rates on the income of an LLC allocated to individual members, with no additional tax on LLC income allocated to persons already subject to New York's corporate tax regime.

a. Measuring entity income.

- A “pure” approach would be to impose the add-on tax on income computed as if the LLC were an S Corporation. This requires adjustments for salary deductions, NOLCs and the like. See above.
- An alternative is to base the add-on tax on the income of the partnership, as computed for federal tax purposes, and without adjustments to approximate corporate income. This could, however, result in significant taxes on service businesses.

b. Tiers.

- In order to identify the “individual” members of an LLC one would have to look not only to the nominal membership but also to interests held by individuals indirectly through partnerships, trusts, and possibly also other LLCs (although that raises questions of how to net one LLC's income and another's losses).

c. Theoretical weaknesses.

- The theory underlying any add-on tax on individual members of an LLC appears to be based on the assumptions that some business income of New York taxpayers should be taxed at rates higher than existing personal income tax rates, and that the imposition of a higher rate of tax is in some way properly associated

with the absence of personal liability for business debts. Query whether these assumptions are justified or appropriate.

d. Collection of tax.

- As an administrative matter the State and City presumably would prefer to collect any member-based add-on tax from the entity, rather than from its individual members.

- The imposition of an entity-level tax with member-specific application does, however, create business problems. For example, corporate members should object to the application of entity funds to pay the add-on tax of individual members. This can generally be handled by proper planning and drafting, but it would bring an added complexity to New York LLCs, and could be particularly burdensome for LLCs formed in other states that expand into New York.

e. Coordination with UBT.

- It would seem imperative to coordinate any add-on tax approach with the existing UBT, and in particular the application of the UBT's "additional exemption."

- Proper coordination may require changes to the UBT law.

3. Imposing fees or flat annual taxes on LLCs.

LLCs could be subjected to a minimum annual tax not based on net income. There are any number of different kinds of flat fees or taxes that might be imposed, and each has its own merits and peculiarities.

a. Types of fees and taxes.

- LLCs could pay the same minimum tax as that imposed on S Corporations by New York State. This tax, which is based on payroll[7], ranges from $325 to $1,500 per year.

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[7] The tax is $1,500 for gross payrolls of $6,250,000 or more, $425 for gross payrolls between $1,000,000 and $6,250,000 and $325 for gross payrolls of less than $1,000,000.

A New York City minimum tax could also be imposed on LLCs engaged in business in the City.

- LLCs could pay an annual tax based on the number of LLC members. This might be limited to resident members, or might be applied to all members. This tax would be at a level, e.g., $100 per member, which would not be unduly onerous for small businesses with a few members. Alternatively, the member- based fee might be an entity-based sliding scale fee, e.g., $200 for fewer than five members, $1,000 for five to thirty-five members, and even larger amounts for more than thirty-five members. A member-based fee would, however, charge a significantly higher amount for LLCs with a large number of members that could not have qualified as S Corporations. This is in some respects inconsistent with the premise that LLCs are to be taxed because they substitute for S Corporations, and one could address this inconsistency, if appropriate, by providing an overall cap on the amount of the fee.

- LLCs could pay annual minimum tax based on assets. If the base were gross assets the computation would be easier, but this would disadvantage highly leveraged businesses.

- LLCs could pay an annual minimum tax based on liabilities. The use of liabilities might be appropriate to roughly reflect the value of limited liability status to the members. However, contingent liabilities frequently are the main reason for seeking limited liability status. These are very difficult to quantify or audit, and are of questionable use as a basis for taxation.

- LLCs could pay an annual tax based on receipts, or on income.

- LLCs could pay an annual tax based on some combination of income and net worth. For example, the Pennsylvania capital stock tax on corporations is based on half the sum of the average net income capitalized at 9.5 percent plus 75 percent of the corporation's net worth (based on accounting principles).

- Fee could be imposed on initial and subsequent filings by the LLC.

b. Other considerations.

- Any kind of fee or minimum tax-based structure raises concerns of equity and fairness, particularly where entities in the same line of business pay the same amount of “tax” on dramatically different incomes. If, however, the overall burden of the tax or fee is perceived as small, these concerns may not be significant.

- As discussed above, many large and sophisticated ventures shy away from S Corporations because of their restrictive rules and tax inefficiencies. As a result, one tends to find S Corporations primarily used by small business. In these circumstances, the imposition of a fee on LLCs that is similar to the S Corporation minimum tax may well produce a tax result that closely corresponds to an S Corporation- type tax on those new LLCs that "would have been" S Corporations.

- In tiered structures one must be sensitive to the proliferation of fees on the same basic enterprise. Again, this is more of a concern where fee structures are high, and if LLC-prompted fees lap over into other forms of business vehicle.

- A flat entity- or member-based fee probably would not grow at the same rate as LLC business grows. If this is a serious problem, it may suggest either the use of an income, revenues or assets-based fee, or an entity- or member-based fee that is indexed and increases over time. However, any form of indexation would erode one of the chief benefits of the flat fee approach, which is its simplicity.

4. Adopting a bifurcated statutory approach to LLCs.

A bifurcated approach, similar, for example, to that used in Texas[8], would provide two different statutory types of limited liability entity. One type (an "LLCo") would provide its members absolute protection from all kinds of entity liabilities, whereas the other type (an "LLP") would offer less-than-absolute liability protection. In recognition of the different levels of liability protection, LLCos would be subject to a relatively higher tax burden than LLPs. For example, LLCos might be taxed as S Corporations while LLPs would be treated as partnerships for New York purposes.

[8] We also note that Louisiana has an LLP statute. The following discussion of the business and entity characteristics of LLPs and LLCos is in general terms, however, and is not intended to suggest or substitute for specific statutory language.

a. LLPs.

- Generally speaking, under the Texas statute each member of an LLP is protected from liability caused by the errors, omissions, negligence, etc. of another member or an employee of the LLP not acting under his supervision or control, but the members otherwise remain jointly and severally liable for LLP debts and liabilities.

- As a business matter, the Texas LLP statute provides so little liability protection that it may only be attractive to entities currently doing business as general partnerships.

- An expanded kind of LLP liability protection, extending to all types of liabilities other than for a members' own negligence, would be more in keeping with the existing New York treatment of PC's and the concept of the LLC generally.

- If New York had an LLP statute that provided significant, but not total, liability protection, and imposed a relatively nominal annual registration fee (such as the $100 per member fee imposed in Texas), the LLP vehicle might attract significant participation from the professional firms, and similar kinds of businesses. This could produce considerable fee-based revenues.

- Consider also whether New York law should specifically provide for an LLP that had “general” partners and “limited” partners. This would make the LLP a more attractive vehicle for, e.g., real estate, and might bring in more fees if general partners otherwise worry about liability for their negligence, etc.

b. LLCos.

- The LLCo is a more traditional corporate type of protection of all members from all debts, obligations and liabilities of the entity. Further consideration would have to be given to whether an LLCo would be available to the professions in New York.

c. other considerations.

- The benefit of a statutory LLCo/LLP bifurcation may be in having the choice- of-treatment decision made by the enterprise, based on its evaluation of acceptable levels of member exposure to personal liability, rather

than endeavoring to make fact-based statutory distinctions between and within industries.

- The ability of New York businesses to elect LLCo status, at a cost of a corporate tax no greater than the S Corporation tax, would appear to benefit small business by providing a more flexible business vehicle, without a drain in S Corporation tax revenues. Benefits of federal partnership classification over federal S Corporation status would still be retained for New York LLCos.

- The utility of fully taxable LLCos to C Corporation members would depend on the ability to recoup taxes paid on LLCo- level earnings. Absent an effective credit mechanism a taxable LLCo is less efficient than a partnership.

- In terms of federal characterization, it would be better to avoid New York State laws that called LLCos "corporations."

- One still must resolve the various adjustment issues discussed in section B.1.b., above, in computing a corporate- type tax on an entity that is a partnership for federal tax purposes.

- Query whether registration of an existing New York partnership or "unregistration" of an LLP would give rise to a new entity under New York law. For federal income tax purposes there should be a continuation. New entity status could, however, be relevant under contracts (franchises; loan commitments); could have other tax consequences (transfer taxes); and could raise creditors' rights issues.

- Central to this bifurcated approach are the notions (i) that businesses can elect whether to function as LLPs or LLCos; (ii) that there are real differences between LLPs and LLCos, both in terms of tax burden and in terms of liability protections; and (iii) that it is appropriate as a matter of tax policy to link State and City tax burdens to liability protection.

- Adoption of this bifurcated kind of approach would mean that the introduction of limited liability companies into New York gives rise to two new kinds of entities, not just one. The greater flexibility attending an LLP/LLCo choice therefore also entails a somewhat more complex State statutory regime, and businesses will be faced with somewhat more complicated choice- of-entity decisions.

5. Fact-based differentiation of "Partnership" LLCs and "Corporate" LLCs.

A test could be devised to identify LLCs that "would have been" partnerships ("Partnership LLCs") if New York had no LLC law. All other LLCs would be "Corporate LLCs". Partnership LLCs would be treated as partnerships and entitled to flow-through tax treatment in New York State, and would be subject to the New York City UBT. Corporate LLCs would be subject to entity-level tax, probably along the lines described in Section B.1.b, above.

a. Types of fact-based tests.

- one or a number of fact-based tests would be used.
- one type of test would require proof (e.g., through actual operation as a partnership) that the LLC members could operate the business in partnership form.
- Another type of test would deem certain industries that are likely to operate in partnership form as automatically qualifying as Partnership LLCs.
- One might impose a special tax, along lines similar to those of Code §1374, on businesses that formerly were conducted as S Corporations but converted into LLCs.
- One might also base a distinction on the "size" of the entity, measured by assets, revenues, income, membership, or anything else. It is, however, difficult to conclude that the size of any of these factors has much relationship to the likelihood of use of the corporate form. Indeed, under current law businesses with more than thirty-five members would be precluded from using S Corporations, but it does not necessarily follow that entities with large memberships should be exempt from an LLC tax.
- One also might base distinctions among businesses or business types on a policy determination to encourage the development of certain industries as beneficial to the overall economic health of the State. However, while this may be a legitimate governmental goal, injecting this factor into the LLC analysis does not serve to clarify the comparisons of the different revenue- raising approaches.

- Examples of existing business-based tax classification may be found, among other places, in the existing New York City UBT exemptions; definitions of "personal service corporations; and federal law classifications of REITs, RICs and publicly-traded partnerships.

b. Other considerations.

- Distinguishing between LLCs in the same industry based on their previous organizational history raises fairness questions.
- Imposing tax on some kinds of businesses (e.g., grocery stores) and not others (e.g., law firms) based on historical practice raises equitable and political issues.
- The exclusion of traditional partnerships from LLC status through the imposition of a heretofore absent tax burden impairs the utility of LLCs in New York, and may cause those partnerships to seek to do business elsewhere.
- For those "Corporate LLCs" subject to entity-level tax, all of the problems of tax computation, outlined above, will remain.
- Any fact-based distinctions between Corporate LLCs and Partnership LLC must take into account the need for clear, understandable and administrable standards, and must be crafted to avoid manipulation and abuse.

6. "Safety net" provisions.

The State and/or City legislatures or administration could be empowered to adjust the amount of LLC-based revenue raised each year to increase or decrease the rates of taxes or fees in order to match LLC-based revenues as closely as possible to LLC-caused losses in other revenues.

- The identification of LLC-caused fall- off s in other revenues, as compared to fall-off resulting from other causes, could prove exceedingly difficult.
- As a matter of tax and business planning, any significant year-to-year shifts in LLC-based taxes would be viewed negatively by the business community.

This is particularly true where the change in LLC tax burdens would stem from other taxpayers' behavior in other time periods, and thus be beyond the businessman's ability to predict or control.

- The delegation of any kind of adjustment authority to the administration obviously would have to be confirmed as legal, and its exercise should probably be subject to appropriate reviews.

7. <u>Overhaul of Hew York taxes applicable to all forms of limited liability entities</u>.

The thesis of such an approach is that, with the advent of LLC legislation, New York businesses can enjoy protection from unlimited liability by utilizing any one of three forms of business vehicles: S Corporations, LLCs and limited partnerships. Since these different kinds of vehicles all serve similar business function, one might eliminate the State and City tax distinctions and tax all three vehicles on the same basis.

- This approach would eliminate distinctions between existing S Corporations (which currently pay state and City corporate taxes at a combined rate of 11.275%), limited partnerships (which currently pay City UBT at 4%) and LLCs (which might otherwise be taxed at one of these rates or on some other basis).

- By broadening the base to include all three types of entities, one could lower the overall tax burden on each. One might be able to substitute a fairly small flat fee on all limited liability entities for the higher S Corporation taxes and proposed LLC taxes or fees.

- Consideration must, however, be given to the difficulty and fairness of effecting any change in the taxation of existing limited liability entities. In particular, increasing the tax burden on existing limited partnerships in order to offset the revenue effects of new LLCs raises considerable problems of tax equity.

- Consider also the potential inequities that arise if one distinguishes between existing and new S Corporations, or between existing and new limited partnerships.

- Consider the business climate effects of an overhaul of New York's taxation of these three vehicles.

- Query whether State and City taxes are appropriately based on an implicit assumption that taxation is a "payment" for limited liability.

- Note also the less than complete protection afforded (i) general partners in limited partnerships, and (ii) members of professional LLCs.

- The problem of New York revenue loss from LLC legislation stems largely from New York's nonconformity to federal law in the taxation of S Corporations. Query whether it is advisable as a matter of tax and economic policy to extend this New York nonconformity further, not only to the new LLC vehicle, but to traditional partnerships as well.

January 26, 1993

NEW YORK STATE BAR ASSOCIATION TAX SECTION
TASK FORCE ON LIMITED LIABILTY COMPANIES

SUMMARY OF TESTIMONY BY BRUCE KAYLE BEFORE THE NEW YORK STATE SENATE STANDING COMMITTEE ON CORPORATIONS, AUTHORITIES AND COMMISSIONS

The New York State Bar Association Tax Section Task Force on Limited Liability Companies is a group of interested practioners that has been studying for over a year various technical and policy issues relating to the possible enactment of LLC legislation in New York State. We are submitting with this testimony an outline in draft form that summarizes much of the Task Force's collected thinking about these issues.

The Task Force has one principal message to deliver today: do not impose entity level income taxes on LLCs.

- LLCs have captured the imagination of a large portion of the business community; tax practioners will need to highlight any tax burdens that New York State or New York City may place on LLCs in advising clients on choosing a location for organization and operation of business or investment activities.

- If an LLC is subject to an entity level income tax in New York, (e.g., comparable to the entity level tax on S corporations), New York LLCs are unlikely to be used by potential investors who would be subjected to a heavier tax burden than under currently available alternatives.

- An entity level income tax on an LLC would result in higher taxes for corporate investors in most cases, unless, as appears unlikely, a suitable credit mechanism can be put in place.

- Only individual investors who otherwise would, if eligible, operate as S corporations would not tend to avoid the LLC because of the entity level income tax.

- Imposition of an entity level income tax, creating a hybrid partnership/corporate type tax regime, would be extremely complicated to administer.

- Initial and annual fees of relatively modest amounts, whether per entity or per member, (or some combination of the two), can be used to raise revenue and leave the LLC attractive for the widest group of potential users.

- A variety of mechanisms for charging different fees for LLCs of different sizes could be employed to address “regressivity” concerns.

Assuming that any potential New York LLC legislation must contain provisions that address revenue concerns raised by the State Department of Taxation and Finance and the State Budget Department, we believe that New York State and New York City would be best served by enacting LLC legislation and addressing those revenue concerns by providing for the collection of relatively modest fixed or graduated initial and annual fees on LLCs and not by providing for an entity level income tax.

December 4, 1992