

State Law & State Taxation Corner

Piercing the LLC Veil—Is Tax Classification a Relevant Characteristic?

By Thomas E. Rutledge

While the equitable remedy of veil piercing “seems to happen freakishly, like lightning, it is rare, severe and unprincipled”¹; it seems that courts are finding that its limitations and principles as developed in the context of the corporation are applicable in the context of LLCs. For example, in *Kubican v. The Tavern, LLC*, the West Virginia Supreme Court wrote: “Accordingly, we hold that W. Va. Code §31B-3-303 permits the equitable remedy of piercing the veil to be asserted against a West Virginia Limited Liability Company.”² This also appears to be the case in Delaware.³ As observed in *Bowen v. 707 On Main*, “The principle of piercing the corporate veil ... also is applicable to limited liability companies and their members.”⁴ Still, courts are struggling with certain aspects of the application of piercing doctrine to LLCs, especially the question of “compliance with [corporate] formalities.”⁵ Another feature that is making an appearance in favor of piercing is the consideration of the tax status of the LLC.

As is discussed below, tax treatment has no place in the piercing analysis, and tax classification should not be a factor in whether or not to set aside the rule of limited liability.

GreenHunter Energy

In *GreenHunter Energy*, the Wyoming Supreme Court affirmed the piercing of a single-member LLC, therein permitting issues of tax classification and treatment be utilized as part of a decision to pierce. This reliance upon tax characteristics is a troubling concept.⁶

GreenHunter Energy, Inc. was the sole member of GreenHunter Wind Energy, LLC (the “LLC”). The LLC contracted with Western Ecosystems Technology, Inc. (“Western”) for certain consulting services. Western was never paid for those services. After receiving a judgment in its favor against the LLC exceeding \$43,000 and finding the LLC without assets to satisfy the judgment, an action was brought against the corporate member seeking to pierce the veil of the LLC.



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Initially, it is worthy of note that the opinion describes piercing as the “extraordinary equitable remedy,” providing further support to the notion that piercing is not of itself a cause of action.⁷ Further, the Court noted that this determination, as are all determinations on piercing, must be made “under the specific circumstances of [the] case.”⁸

The single-member LLC had, for itself, no employees. Rather, employees of the member corporation performed services on behalf of the LLC. The most damning factor in support of piercing was the under-capitalization of the LLC. Essentially, it had no dedicated capital. Rather, from time to time, the parent corporation would contribute certain amounts to the LLC with the direction that certain invoices be satisfied. Needless to say, no contribution was ever made for the purpose of satisfying the plaintiff’s invoices. This control of what invoices would and would not be satisfied also indicated the parent’s inappropriate domination of the LLC’s activities.

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To this point, the opinion appears to be well within the accepted grounds and factors for piercing the veil. That said, there are troubling aspects of this opinion in that the trial court appeared to focus on issues of tax classification of the LLC, an analysis that was permitted by the Wyoming Supreme Court. This single-member LLC had a federal default tax classification as a “disregarded entity,” and no election was filed to treat the LLC as an association taxable as a corporation.⁹ It was noted that the LLC’s tax return was consolidated with that of its corporate parent; consequent thereto, the parent was able to deduct \$884,092 in expenses and claim an additional loss of \$61,047.¹⁰ From these facts the Court concluded:

Appellant has enjoyed significant tax breaks attributable to the LLC’s losses, without bearing any responsibility for the LLC’s debt and obligations that contributed to such losses. Such a disparity of the risk and rewards resulting from this manipulation would lead to injustice.¹¹

When the corporate defendant pointed out that “Federal tax law allows the LLC’s losses to be attributed to [the single-member] and a consolidated tax return filed,” the Supreme Court noted that the tax treatment was only one factor utilized in the determination to pierce the veil:

Instead, [the trial court] considered Appellant’s tax filings as only one of many relevant pieces of evidence demonstrating that Appellant directed benefits from the LLC to itself, while at the same time it concentrated wind farm project debts it decided would not be paid in the LLC.¹²

So there you have it—the Wyoming Supreme Court believes that a liability shield is more subject to being pierced if the primary obligor is taxed on a passthrough basis. This decision is not unique. For example, in *Rednour Properties, LLC v. Spangler Roof Services, LLC*,¹³ the piercing of a single-member LLC was affirmed on the basis that it was a single-member LLC that had been organized “for tax purposes.”¹⁴

But There is Contrary Law

There are cases holding to the contrary, namely that tax treatment is not a factor in piercing. For example, in *Madison County Com. District v. CenturyLink, Inc.*,¹⁵ in assessing whether there would be jurisdiction over a corporate parent, the fact of a consolidated tax return was found to not support piercing. In support of that determination, the Madison County court cited *AT&T v. Compagnie Bruxelles Lambert*¹⁶ and *Dalton v. RAW Marine, Inc.*,¹⁷ each for the proposition that filing a consolidated tax return is not a basis for piercing the veil. On the analogous point, the filing by an LLC of a “partnership” return does not change the nature of the relationship between the LLC’s members into a partnership relationship.¹⁸ In response to the argument that consolidated tax returns justify piercing, the decision in *Newman v. Motorola, Inc.*¹⁹ provides:

These allegations are insufficient to warrant piercing the corporate veil when Verizon Wireless exists as a separate corporate entity, maintains its own financial records, has a separate purpose, and when there has been no allegation that it exists solely as a sham corporation.²⁰

Likewise, in *In re American Honda Motor Co., Inc.*,²¹ the court held that a consolidated financial statement, even when combined with interlocking directors, did not

support piercing.²² In *Alkanani v. Aegis Defense Services, Inc.*,²³ responding to an effort to utilize tax treatment in order to pierce, the court wrote:

Fourth, Plaintiff also failed to provide any case law supporting his theory of attributing liability to Aegis LLC because of the existence of a pass-through tax structure of a disregarded entity. Between 2006 and 2008, when 100% of Aegis LLC's shares were owned by Aegis UK, Aegis LLC was treated as a disregarded entity by the IRS and the taxable income earned by Aegis LLC was reflected in federal and District of Columbia tax returns filed by Aegis UK. In the case of a limited liability corporation [sic] with only one owner, the limited liability corporation [sic] must be classified as a disregarded entity. Instead of filing a separate tax return for the limited liability corporation, the owner would report the income of the disregarded entity directly on the owner's tax return.²⁴

Tax Treatment Should Not be a Piercing Factor

It is not appropriate to incorporate into piercing analysis the question of tax classification. Initially, to do so draws a line between entities that are for tax purposes treated on a passthrough basis versus those that are taxed on the entity basis, setting the former on a path towards piercing while the latter are not. In an age in which most employment is provided by passthrough organizations,²⁵ it is bad policy to suggest that those organizations are *ab initio* more prone to being pierced than are traditional corporations taxed under Subchapter C.

Second, tax classification in no manner impacts upon whether the entity in question has been misused to the detriment of the third-party. In *GreenHunter Energy*, for example, had the LLC been taxed as a C corporation, with all other facts remaining the same, the LLC still would have been without assets with which to satisfy the plaintiff's claim. The tax treatment of the organization did not impact the pool of funds available as the proverbial

"trust fund" to which creditors look for satisfaction of their claims.²⁶ While in *GreenHunter Energy* the parent was able to claim losses, those losses were generated by either capital contributed to the LLC and then disbursed in satisfaction of LLC obligations or by creditor financing. There is nothing *ab initio* improper in benefiting from the consequences of limited liability, namely shifting risk to unsecured creditors.²⁷

Third, this sort of analysis introduces an unnecessary level of complexity in that numerous jurisdictions impose entity-level taxes on what are, for federal tax purposes, disregarded entities.²⁸ If piercing analysis is to look at tax classification as a factor, what will be the result when there is a divergence between federal and state treatment? Will

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it weigh in favor of or against piercing that the entity is for federal purposes a passthrough entity, even as in its jurisdiction of organization it is subject to (and pays) entity-level taxes? What will be the result when the federal passthrough entity pays entity-level taxes in some of the jurisdictions in which it does business, but not in the one in which piercing is sought?

Conclusion

Piercing law is complicated enough without the introduction of another ill-defined factor, namely tax treatment. While the *GreenHunter Energy* decision is a mainstream application of under-capitalization and alter-ego analysis, its introduction of tax classification into the analysis is unfortunate and should not be followed by other courts.

ENDNOTES

¹ See Frank H. Easterbrook and Daniel R. Fischel, *Limited Liability and the Corporation*, 52 U. CHI. L. REV. 89 (1985).

² *Kubican v. The Tavern, LLC*, 752 SE2d 299 (W. Va. 2013). See also *Filo Am., Inc. v. Olhoss Trading Co., L.L.C.*, 321 FSupp2d 1266, 1269 (M.D. Ala. 2004) ("commentators who have discussed the issue as a nationwide matter

have concluded that the 'veil-piercing' doctrine applies to LLCs. ... Further, the courts in other States that have considered whether the 'veil-piercing' doctrine applies to LLCs have concluded that it does.")

³ *NetJets Aviation, Inc. v. LHC Communications, LLC*, CA-2, 537 F3d 168, 178 (2008) (indicating that the rules for piercing the veil of an

LLC should be the same as that employed for piercing the veil of a corporation except there should be less weight upon the following of formalities) (applying Delaware law); *Westmeyer v. Flynn*, 889 NE2d 671 (Ill. App. 1st Dist. 2008) (Delaware will apply the same rule for piercing an LLC as it does to piercing a corporation).

⁴ *Bowen v. 707 On Main*, No. CV0202826435, 2004 Conn. Super. LEXIS 375 (Conn. Super. Ct. Feb. 24, 2004). See also *Seater Construction Company, Inc. v. Deka Investments, LLC*, No. 2–12–1140, 2013 IL App (2d) 121140-U (Ill. App. Ct. 2d Dist. 2013).

"A court may disregard the separate LLC entity and the protective veil it provides to an individual member of the LLC when that member, in order to defeat justice or perpetuate fraud, conducts his personal and LLC business as if they were one by comingling the two on an interchangeable or joint basis or confusing otherwise separate properties, records or control." *Bonner v. Bruson*, 585 S.E.2d 917, 918 (Ga. Ct. App. 2003).

The propriety of applying a piercing analysis to LLCs is recognized as well in the comments to the Revised Uniform LLC Act. See Rev. Unif. Limited Liab. Co. Act, §304(b), comment, 6B U.L.A. 476 (2008).

Subsection (b)—This subsection pertains to the equitable doctrine of "piercing the veil"—i.e., conflating an entity and its owners to hold one liable for the obligations of the other. The doctrine of "piercing the corporate veil" is well-established, and courts regularly (and sometimes almost reflexively) apply that doctrine to limited liability companies. In the corporate realm, "disregard of corporate formalities" is a key factor in the piercing analysis. In the realm of LLCs, that factor is inappropriate, because informality of organization and operation is both common and desired.

This subsection does not preclude consideration of another key piercing factor—disregard by an entity's owners of the entity's economic separateness from the owners.

⁵ See, e.g., *Kaycee Land and Livestock v. Flahive*, 46 P3d 323, 328 (Wyo. 2002) ("many of the organizational formalities applicable to corporations do not apply to LLCs."). Certain LLC Acts have sought to minimize or eliminate formalities as an element in piercing analysis. See, e.g., 805 ILCS 180/10-10(c) (1998) ("The failure of a limited liability company to observe the usual company formalities or requirements relating to the exercise of its company powers or management of its busi-

ness is not a ground for imposing personal liability on the members or managers for liabilities of the company."); Ky. Rev. Stat. Ann. §275.185(4) ("Failure of the limited liability company to keep or maintain any of the records or information required pursuant to this section shall not be grounds for imposing liability on any member or manager for the debts and obligations of the limited liability company."); S.D. Codified Laws Ann. §47-34A-303(b) ("The failure of a limited liability company to observe the usual company formalities or requirements relating to the exercise of its company powers or management of its business is not a ground for imposing personal liability on the members or managers for liabilities of the company.").

⁶ *GreenHunter Energy, Inc. v. Western Ecosystems Technology, Inc.*, No., 2014 WY 144, 337 P.3d 454 (Wyo. 2014).

⁷ *Id. Accord Spradlin v. Beads and Steeds Inns, LLC (In re Howland)*, 516 BR 163 (Bankr. E.D. Ky. 2014) (piercing is a remedy and not a cause of action).

⁸ *GreenHunter Energy, supra* note 6. (the test for piercing "is fact-driven and flexible.").

⁹ See also Reg. §301.7701-3(b)(1)(ii) (default classification of SMLLC).

¹⁰ *GreenHunter Energy, supra* note 6. See also Reg. §301.7701-3(b)(1)(ii).

¹¹ *Id.*

¹² *GreenHunter Energy, supra* note 6. See also Reg. §301.7701-3(b)(1)(ii).

¹³ *Rednour Properties, LLC v. Spengler Roof Services, LLC*, No. 2009-CA-001159-MR, 2011 Ky. App. Unpub. LEXIS 974 (Ky. App. June 10, 2011, modified July 8, 2011; on April 18, 2012, the Kentucky Supreme Court ordered that this decision not be published).

¹⁴ What were those tax purposes were never detailed. Subsequently, the Kentucky LLC Act was amended to make express that being an SMLLC is not a basis for piercing. See Ky. Rev. Stat. Ann. §275.150(1) ("That a limited liability company has a single member or a single manager is not a basis for setting aside the rule otherwise recited in this subsection.").

¹⁵ *Madison County Com. District v. CenturyLink, Inc.*, No. CV 12-J-1768-NE, 2012 U.S. Dist. LEXIS 180066 (N.D. Ala. Dec. 20, 2012).

¹⁶ *AT&Tv. Compagnie Bruxelles Lambert, CA-9, 94 F3d 586, 591 (1996)* ("LBC's decision to include Keystone in its consolidated tax return hardly demonstrates domination.").

¹⁷ *Dalton v. RAW Marine, Inc.*, CA-5, 897 F2d 1359, 1363 (1990).

¹⁸ See *Dickinson v. Martin Collins Surfaces & Footings, LLC*, Civil Case No. 5:11-CV-281-JMH (E.D. Ky. Nov. 20, 2012).

¹⁹ *Newman v. Motorola, Inc.*, DC-Md, 125 F Supp. 2d 717 (2000).

²⁰ In *Drumm Corp. v. Wright*, 755 SE2d 850 (Gn. App. 2014), the court found that the filing of a consolidated state franchise tax return did not support an argument for piercing, citing in support thereof *Madison County and Newman*.

²¹ *In re American Honda Motor Co., Inc.*, DC-Md., 941 F Supp. 528 (1996).

²² *Id.* at 551-52.

²³ *Alkanani v. Aegis Defense Services, Inc.*, DC-D.C., 976 F Supp2d 1 (2013).

²⁴ *Id.* at 9 (citations omitted).

²⁵ *Most of the Private Sector Workforce is Employed by Pass-through Businesses*, THE TAX FOUNDATION (Oct. 29, 2014), available at: <http://taxfoundation.org/blog/most-private-sector-workforce-employed-pass-through-businesses>.

²⁶ See, e.g., *Bing v. Cincinnati*, 56 F Supp at 846, citing *Metropolitan Fire Ins. Co. v. Middendorf*, 188 SW 790, 794 (Ky. 1916) ("Corporate property is essentially a trust fund to be used for the benefit of creditors and shareholders.") (quoting GLUCK & BECKER, RECEIVERS FOR CORPORATIONS).

²⁷ See, e.g., I. MAURICE WORMSER, DISREGARD OF THE CORPORATE FICTION AND ALLIED CORPORATION PROBLEMS, 18 (Baker Voorhis & Co., 1927) ("The policy of our law to-day sanctions incorporation with the consequent immunity from individual liability. It follows that no fraud is committed in incorporating for the precise purpose of avoiding and escaping personal responsibility. Indeed, that is exactly why most people incorporate, and those dealing with corporations know, or at least are presumed to know, the law in this regard."); Bainbridge, *Abolishing LLC Veil Piercing*, 2005 U. ILL. L. REV. 77, 95 ("It is generally accepted that limited liability creates negative externalities. Limited liability allows equity holders to cause the firm to externalize part of the risk and costs of doing business onto other constituencies of the firm and, perhaps, even onto society at large.").

²⁸ See, e.g., Ky. Rev. Stat. Ann. §141.0401. Entity-level taxes imposed upon LLCs are reviewed in Bruce P. Ely et al., *An Update on the State Tax Treatment of LLCs and LLPs*, TAX ANALYSTS, March 2, 2015.

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