State Law & State Taxation Corner

When a Single-Member LLC Isn’t and When a Multiple-Member LLC Is

By Thomas E. Rutledge

Single-member LLCs ("SMLLCs") are curious and highly useful creatures. Much of that utility is based upon their ease of organization (seldom will the sole member need to engage in detailed negotiations as to the terms of the operating agreement) and the default federal tax treatment as disregarded entities. That utility can be hampered when there is a question as to whether or not the LLC is in fact an SMLLC. Careful attention, both at the time of formation and the throughout the LLC’s life, as to whether or not it is in fact an SMLLC is necessary. Absent that attention, there may be surprises, and seldom are surprises welcome. These same principles find sometimes curious application in other unincorporated forms. Conversely, we find circumstances in which at least the tax code will conflate two persons into one or in some other way elect not to treat what would otherwise be a partnership other than as a partnership.

The SMLLC is largely a creation of the so-called Check-the-Box classification regulations. Prior to their issuance, even as certain LLC acts contemplated SMLLCs, their taxation was unresolved. The Check-the-Box regulations made clear the default taxation of an SMLLC, and today every LLC Act allows for the formation of SMLLCs. An SMLLC, for purposes of federal income tax classification, will be treated as a sole proprietorship, if the sole member is a natural person, and as a division, if the sole member is a corporation or other business entity, including another LLC, in either case a “disregarded entity.” Of course, certain states do not, for purposes of state income and other taxation, treat the SMLLC as a disregarded entity, but rather treat it as an independent taxpayer. Even though a disregarded entity for purposes of federal and certain other income tax purposes, the SMLLC has, for state law purposes, a very real existence.

When, however, do you have an SMLLC? That threshold question is rather more involved than it may seem at first blush. Actually, it can be a rather involved question, one determined by asking first for what purpose the question is being asked. The question needs to be divided between whether the LLC is an SMLLC for tax purposes and whether the LLC is an SMLLC for purposes of state law. The same LLC may, when viewed through these alternative lenses, be or not be an SMLLC.
The Disregarded Entity Limited Partnership

Consider a limited partnership having the minimum-required one general partner and one limited partner. Beth, a natural person, is the general partner. Beth’s wholly owned LLC, which has not checked the box to be classified as a corporation, is the limited partner. From the perspective of state law we have a valid limited partnership; Beth and her LLC are legally distinct from one another, and the same “person” is not the sole general and the sole limited partner.

Alternatively, when viewed from the tax perspective, we have a disregarded entity. Obviously, Beth is a natural person and has her own tax identity. Beth’s SMLLC, however, does not for income tax purposes have its own identity. Rather, Beth and the LLC are one and the same. In that the purported “partnership” has but one partner, it is not subject to Subchapter K, and rather is a disregarded entity.

Does Community Property Law Apply?

Certain states provide for community property ownership. Under the community property regime, each spouse is deemed to hold an undivided 50-percent ownership in all marital property. As described by the IRS:

The theory underlying community property is analogous to that of a partnership. Each spouse contributes labor (and in some states, capital) for the benefit of the community, and shares equally in the profits any income earned by the community. Thus, each spouse owns an automatic 50% interest in all community property, regardless of which spouse acquired the community property. Spouses may also hold separate property, which they solely own and control, but the law in the community property states does not favor this.

Does that mean that in a community property state it is not possible to organize a disregarded entity SMLLC owned by a married person, as the spouse will be automatically deemed a co-owner?

That exact question was addressed by Rev. Proc. 2002-69, wherein it considered the tax classification of an entity owned by a husband and wife in a community property jurisdiction. Assuming the entity in question is wholly owned by the husband and wife (i.e., no person other than one or both of the spouses are considered an owner for purposes of federal income tax), and as well assuming that the entity has not elected to check the box to be classified as a corporation, then they have the option of treating the entity either as a partnership or, in the alternative, treating the entity as disregarded. Should the former option be chosen, each of the spouses will be treated as a 50-percent owner in the partnership. Alternatively, should the LLC be treated as a disregarded entity, its activities will be reported on Schedule C. Assuming the husband and wife are filing a joint return, this may be something of a distinction without a difference, at least for the purposes of federal income taxes. It may matter, however, if they are filing their returns on a separate basis. Irrespective of income taxes, the ability to treat the entity as wholly owned by one spouse may permit the reduction of SECA and Medicare taxes.

The Code Sec. 761 “Qualified Joint Venture”

The Internal Revenue Code includes a number of provisions pursuant to which either two or more natural or organizational persons, each being an independent legal person for state law purposes, may be counted as being only a single person. There is a similar rule applicable to certain husband and wife partnerships to the effect that they are disregarded for tax purposes. These “qualified joint ventures,” created by the Small Business and Work Opportunity Tax Act of 2007: (i) must be owned only by a husband and wife; (ii) the husband and wife must file a joint return; and (iii) both the husband and wife must mutually participate in the trade or business. Assuming both spouses elect qualified joint venture status, their partnership will not be treated, for tax purposes, as a partnership. The IRS explains the benefits of electing qualified joint venture status as follows:
Because a business jointly owned and operated by a married couple is generally treated as a partnership for Federal tax purposes, the spouses must comply with filing and record keeping requirements imposed on partnerships and their partners. Married co-owners failing to file properly as a partnership may have been reporting on a Schedule C in the name of one spouse, so that only one spouse received credit for social security and Medicare coverage purposes. The election permits certain married co-owners to avoid filing partnership returns, provided that each spouse separately reports a share of all of the businesses’ items of income, gain, loss, deduction, and credit. Under the election, both spouses will receive credit for social security and Medicare coverage purposes.24

It should be noted that, according to the IRS, this treatment is limited to what are state law partnerships; an LLC owned by a married couple, even if classified for tax purposes as a partnership, may not elect to be a qualified joint venture.25

### Assignees Are Not Members, but They Are Partners

An assignee of an interest in a partnership or LLC is neither a partner nor a member unless and until some required threshold of the incumbent partners or members elect the assignee into that status.26 Different states impose different rules as to whether and how the assignor ceases to be a partner or a member.27 Let’s assume that the formula employed in the Revised Uniform Limited Liability Company Act (RULLCA) and Kentucky applies and that after a member assigns all of its interests in the LLC, the assignor remains a member until the other members terminate that status.28 Let us now assume what was a two-member LLC; the one member has assigned her entire interest to a third party and assume as well that the remaining member has determined to dissociate the assignor member. The remaining member has not, however, elected to admit the assignee as a member.

For state law purposes, the LLC has a single member; the assignee has only the rights of an assignee, and the one remaining member has exclusive rights to manage and control the LLC. Any provisions of the LLC Act particular to SMLLCs29 are now applicable.

It is not the case, however, that there is now a disregarded entity SMLLC. Yes, there is only one state law member, but state law “member” is not a set co-extensive with tax law “partner.”30 Rather, the state law assignee is treated for tax purposes as a partner.31

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### Some Multiple-Member LLCs Are Disregarded Entities

Some LLC acts permit “members” who lack an economic participation in the venture.32 To the extent provided for in the operating agreement, these noneconomic members have the rights of a member. Typically, these members are not partners for purposes of the Code in that they lack any risk should the venture fail or any upside if it is successful.33 As such, an LLC with a member with a 100-percent interest in the economics of the transaction and another member with a zero-percent interest in the economics of the transaction but holding, for example, the right to vote the LLC’s application for bankruptcy protection is for tax purposes an SMLLC with a default classification as a disregarded entity.

### Conclusion

As long as there are rules under either state law or the Code conditioned on the entity having only a single owner or having more than a single owner, it will be necessary to categorize between the possible treatments. Problems will arise if the initial reaction is not scrutinized under the rules applicable to the perspective from which the determination needs to be made.

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**ENDNOTES**

1  Reg. §§301.7701-1, et seq.
2  For example, the Delaware LLC Act, adopted in 1992, never prohibited SMLLCs. See Del. Code Ann. tit. 6, § 18-201(a). In contrast, at the time of its 1994 adoption, the Kentucky LLC Act precluded the formation of an LLC with a single member. See Ky. Rev. Stat. Ann. §275.025 (requiring affirmative statement that the LLC has two or more members), repealed by 1998 Ky. Acts., ch. 341, §23.
3  See Reg. §§301.7701-2(a) (“If the entity is disregarded, its activities are treated in the same...
man as a sole proprietorship, branch, or division of the owner.”4)

Still, disregarded entity treatment may at times be seen as less than advantageous. See, e.g., Amy S. Elliott, "Disregarded Entity Reg May Not Further Bankr’ Bankruptcy’s Rehabilitation," Tax Notes Today (Oct. 21, 2014) (discussing the application of the discharge of indebtedness (DOI) rules of Code Sec. 108 to a bankrupt disregarded entity and the absence of an exception from the recognition of DOI income by the sole member).


This discussion is not intended to fully explore the often metaphysical issues incident in defining each of “partner” and “partnership.” See, e.g., Ethan Yale, *Defining “Partnership” for Federal Tax Purposes, Tax Analysts* (May 12, 2011).

8 Presumably the limited partnership has elected to be a limited liability limited partnership in order to limit Beth’s liability for the limited partnership’s obligations. See Unif. Ltd. Part. Act §201(a)(4), 6A U.L.A. 392 (2008); id. §404(c), 6B U.L.A. 432; Ky. Rev. Stat. Ann. §362.2-210(2); id. §362.2-403(4).

See, e.g., *Turner v. Andrew, 413 SW3d 272, 276 (Ky. 2013) (“The LLC and its solitary member, Andrew, are not legally interchangeable. Moreover, an LLC is not a legal co-fog that one slips on to protect the owner from liability but then discards or ignores altogether when it is time to pursue a damage claim. The law pertaining to limited liability companies simply does not work that way.”).*


It must be acknowledged that for purposes of employment taxes the LLC and Beth are distinct from one another. See TD 9356, RIN 1545-BE43 (Aug. 15, 2007) finalizing Reg. §§1361-4(a)(7), (a)(8) and 301.7701-2(c)(2)(iv), Reg. §301.7701-2(c)(2)(v), (e)(5) and (e)(6) finalizing regulations proposed in 2005, REG-114371-05 RIN 1545-BE43 RS. 70 FR 60475 (Oct. 18, 2005), amending Reg. §§1.1361-4, 1361-6 and 301.7701-2.


13 Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington and Wisconsin. In addition, Alaska allows couples to elect into community property treatment.

14 IRM 25.18.11.2(3), *Basic Principles of Community Property Law.*


Apparent, in the absence of an election to treat the LLC owned by spouses in a community property state, the default classification thereof will be as a partnership. See Chief Counsel Advice 200851102 (Oct. 23, 2008).


See, e.g., Code Sec. 1361(c)(1)(A) (all members of a “family” treated as a single shareholder for purposes of the Code Sec. 1361(b)(1)(A)’s limit on the number of shareholders in an S corporation). See also Nelson A. Toner, *Counting Shareholders When They Are Spouses or Family Members, J. Passthrough Entities,* May–June 2015, at 27.


After Windsor, this must extend as well to husband-husband and wife-wife relationships: See E.S. Windsor Est., 2013-2 ustc §50,400, 133 S.Ct. 2675. See also Obergfell v. Hodges, No. 14-556, 2015-1 ustc §50,357, 576 U.S. ___.

See Code Sec. 761(f)(1).

See Code Sec. 761(f)(2).

See Code Sec. 761(f)(2)(c).


See also Thomas E. Rutledge, *State Law & State Taxation Corner, Interest Assignments Among Members, J. Passthrough Entities,* Nov.–Dec. 2015 (as currently scheduled).


See, e.g., Del. Code Ann. tit. 6, §18-801(a)(4) (providing for the admission as a member the successor to the last member); Ky. Rev. Stat. Ann. §275.015(20) (special rules as to what constitutes the operating agreement of an SMLLC); id. §275.285(4)(b) (providing for admission as a member the successor to the last remaining member).

See also Patel v. Bhakta, No. 13-CV-14099, 2014 U.S. Dist. LEXIS 143122 (E.D. Mich. Oct. 8, 2014) (“Defendants also argue that treating someone as a partner for tax purposes ‘is independent of the rights, if any, of the individual under state corporate/company law.’”).


See *Historic Boardwalk Hall, LLC, CA-3, 2012-2 ustc §50,538, 694 F3d 425, Field Attorney Adviceservice 20124002F (March 1, 2013); see also LTR 199910333 (Dec. 18, 1998), Larry E. Ribstein and Robert R. Keatinge, Ribstein and Keatinge on Limited Liability Companies §19.2 (2d ed. December 2014) (“Thus, even if a person is a member under state law, that person will be disregarded if the person has no interest in the economics of the LLC.”).