

# Regarding the Disregarded Entity

By Thomas E. Rutledge and Stacy C. Kula

The “disregarded entity” is often described as a “tax nothing,” an entity not only transparent to but actually outside the contemplation of the tax code. Problems arise, however, when the hybrid nature of the tax nothing LLC is not fully considered – while the structure may be ignored for purposes of federal taxation it can and often does impact upon matters governed by state law. While there are other structures that can be disregarded entities, the most common is a single-member LLC (SMLLC).

## Pro se representation

Jessica has held the titles for a number of years to several rental properties. Her attorney, seeking to partition liabilities that may arise from one property, from the other properties and from the landlord owner, capitalizes a series of new SMLLCs, each holding one rental property. The existing leases are amended to substitute the appropriate new SMLLC for Jessica as the landlord and the property transfers are properly recorded with the county land records. Shortly thereafter, Jessica loses patience with a tenant who is (once again) late on the rent. Jessica goes to the court and completes the papers for a forcible detainer/eviction.

When the otherwise pro forma hearing on the petition is heard, Jessica is dismayed as the complaint is dismissed. How could this be? Either of two paths is possible. Being a creature of habit she may have listed herself, rather than the SMLLC,

as the owner and landlord of the property. Of course, with the recently completed reorganization, she is neither. Not being a party to the lease arrangement (it is between the tenant and the SMLLC), Jessica cannot object to the tenant’s default. More on that lack of standing below.

Alternatively, she may have filed the complaint in the name of the SMLLC, but here the matter of the problem shifts. Jessica is not an attorney. Each SMLLC is a legal entity, and its property is not the property of its owner. Numerous courts have held that an LLC, even a single-member LLC, may appear in court only through licensed counsel and not pro se through one who, even if an owner, is not an attorney.

The case most directly on point is *Lattanzio LLC v. Comta*, wherein the Court rejected an effort by the sole member of an LLC, himself not being an attorney, to represent the LLC. Reciting its interpretation of the federal court rule that the two permissible types of representation are “that by an attorney . . . and that by a person representing himself” and that it “does not permit ‘unlicensed laymen’ to represent anyone else other than themselves. . . .”, the Second Circuit explained the basis for the requirement that litigation be conducted through licensed attorneys. Essentially, non-lawyers burden both the court and the opposing side in the case through their lack of familiarity with rules and requirements.

Another decision coming to a similar conclusion is the Louisiana case of *Collier v. Cobalt LLC*, wherein an LLC could not be represented by its

sole member even as it acknowledged “the apparent harshness of this rule in a situation such as that alleged here, *i.e.*, when a legal entity consisting of a sole employee and shareholder is unable to afford counsel.”

While decided in the context of a two-member LLC, the Kentucky Court of Appeals has held that where one of the members, on the LLC’s behalf, filed an action, he was engaged in the unauthorized practice of law.

The SMLLC will be recognized as a legal entity distinct from its member when appearing in court, and the sole member should not expect to be able to represent the legal interests of the LLC unless that sole member is as well an attorney.

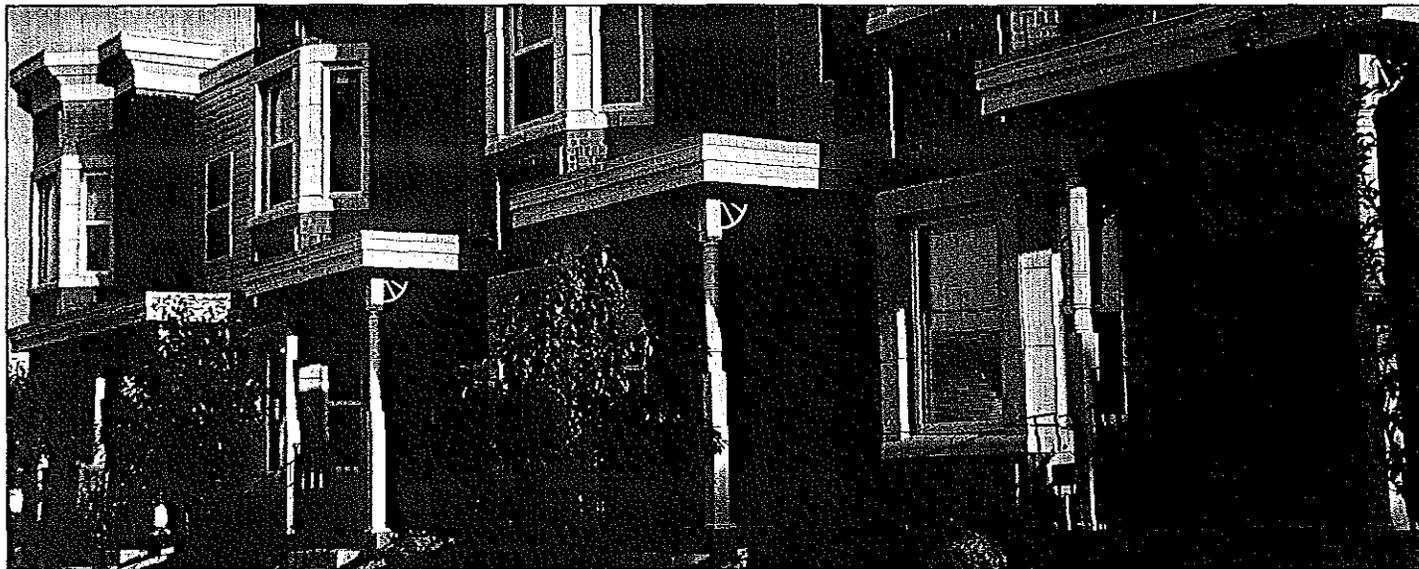
## State income taxes

While for purposes of federal tax classification an SMLLC may be a disregarded entity without its own tax identity or obligations, certain states (including Kentucky) impose entity-level taxes on what are for federal tax purposes pass-through structures. These issues need to be considered for not only the jurisdiction of organization, but also for each state in which the LLC is or will be doing business.

While an SMLLC may have employees, for purposes of federal employment taxation the sole member has been treated as the employer with personal responsibility for the collection and remission of those levies. However, effective January 1, 2009, the SMLLC is treated as the “employer,” and the liability of the sole member for any failure to collect and remit employment taxes is determined

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under Code Sec. 6672. Still, the sole member's compensation is K-1 income subject to quarterly estimated payments.

### Local occupational taxes

The application of local business license taxes may be significantly altered by the use of an SMLLC. The Louisville/Jefferson County (Ky.) Metro Revenue Commission administers a local occupational license tax imposed on business net profits. Individuals are subject to tax only if engaged in a licensable business activity and only on their net profits derived from that business. An individual receiving rental income from real property is rebuttably presumed to be engaged in a licensable business activity unless the individual's gross receipts derived from rental property are less than \$50,000. Individuals with annual gross rental receipts of less than that amount are not considered to be engaged in a

licensable business activity and are not taxed. The Commission considers an SMLLC a *de jure* business entity and, therefore, all of its activities licensable business activities. Thus, all net profits earned in an SMLLC, including the first dollar of rental income, are considered taxable.

### Standing

Under most statutory formulations, an interest in an LLC is personal property, and the property of the LLC is that of the LLC as a legal entity distinct from its members. That being the case, even the context of an SMLLC, the member, qua member, does not have the capacity to either object to the injury to the LLC's property or to enforce an agreement of the LLC. Rather, those rights are vested within the LLC. Any action to protect that property or enforce those rights must be brought by the LLC in its own name or, in appropriate circumstances, by a derivative action.

At the same time, with respect to a claim by a third party to enforce an obligation of the LLC, the members of the LLC, unless there is a basis separate than their members status pursuant to which liability may be attached, are not proper parties to the action. It is for this reason that Jessica's forcible detainer/eviction action could have been dismissed – she was not injured when the tenant did not pay the rent. Rather it was the LLC that was injured.

### Homestead – property tax exemption

Certain states provide a "homestead" tax exemption for owner's occupied principal address. While Kentucky permits the homestead exemption when the property, otherwise qualifying, is owned through an LLC (KRS § 132.810(2)(f)), certain states including Alabama have concluded that properties held through an

SMLLC are not eligible for the homestead exemption. For example, an Alabama Attorney General opinion, after recognizing the statutory rule that "a member has no interest in specific [LLC] property," concluded that the Alabama homestead exemption is not available if the home is owned by an LLC.

### Homestead – bankruptcy

The Bankruptcy Code recognizes and incorporates the various state homestead exemptions. Certain states are famous for high or even unlimited homestead exemptions. Generally speaking, to the extent of the homestead exemption, a bankrupt individual may retain the value of her residence. That protection may be lost, however, if the residence is held in an SMLLC. For example, *In re Hecker* considered a residence owned by a second-tier LLC. The Minnesota homestead exemption applies to a "house owned and occupied by a debtor as the debtor's dwelling place." While there is Minnesota law permitting a "reverse pierce" in order to treat entity-owned property as within the homestead exemption, based upon the absence of the various factors used to justify piercing (*e.g.*, no showing of undercapitalization) and the negative impact upon others including secured creditors, the Court denied Hecker that relief and the claimed homestead exemption was disallowed. Setting aside for now the apparently unique to Minnesota possibility of reverse piercing to claim the homestead exception, it is clear that holding the primary residence in an LLC is at best questionable personal bankruptcy planning.

### Simple partnerships, TEFRA and the tax matters partner

While each partnership is obligated to file a return for each taxable year beginning in that in which it receives income or incurs expenditures allowable as deductions, certain "small partnerships" are exempt from this requirement provided each partner reports her share of partnership income and deductions. In addition, "small partnerships" are exempt from the partnership rules of TEFRA and as well the requirement that the partnership maintain a "tax matters partner." In order to satisfy these requirements, the partnership, in addition to the requirement that at no point in the year does it have more than 10 partners, may only have natural persons, estates or C corporations as partners, and each partner's share of each partnership item must be the same as the share of every other item. Where the partnership has a disregarded entity as a partner, it is no longer a "small partnership" and in consequence is subject to the rules of TEFRA and is outside the scope of Revenue Procedure 84-35. In what would otherwise be a "small partnership," the desire of a partner to hold their interest through an SMLLC significantly alters the partnership's operations.

### Right of occupancy

The New Jersey decision *3519-3513 Realty, LLC v. Law* is a wonderful illustration of the legal effect of a SMLLC. Under New Jersey law, notwithstanding tenant protections otherwise available, an

owner of a multi-unit residence of three or fewer units may compel a tenant to vacate if the owner "seeks to personally occupy a unit." Rosenberg, the sole member of the LLC that was the owner of the building, stated that he desired to occupy the unit and terminated Law's tenancy. The tenant successfully resisted on the basis that it would not be the owner, that being the LLC, that would occupy the unit, but rather Rosenberg.

The dictate is clear: the sole member and the SMLLC are distinct and that distinction has legal effect and consequences.

### Conclusion

"Disregarded entity" is a tax, and not a state law, concept. The determination to operate in any form of business organization involves consequences, some positive and some, on a situational basis, negative. There are entirely legitimate reasons, including but not restricted to limited liability, for holding property and engaging in business through an SMLLC. It must always be recognized that doing so changes the legal relationship between the single owner and both the LLC's property and those third-parties with whom it (rather than the sole member) do business.



*About the authors:*  
Stacy C. Kula is of counsel at Stoll Keenon Ogden PLLC, and Thomas Rutledge is a member at SKO who focuses his practice on business organization law and disputes between business owners.