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Tax Considerations in Selecting a Business Entity: The New Entity Classification Rules

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TAX CONSIDERATIONS IN SELECTING A BUSINESS ENTITY: THE NEW ENTITY CLASSIFICATION RULES

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I. INTRODUCTION

Determining the appropriate form for a business venture requires careful consideration of a number of tax and nontax factors. This decision is usually made by comparing the relative advantages and disadvantages of conducting the endeavor as a proprietorship, a partnership, a regular corporation, an S corporation, or a limited liability company. Once the form is selected, careful planning and drafting is required to ensure that the entity: (1) is organized properly under state law; and (2) receives the desired classification for federal tax purposes.

The most important tax consideration is whether the venture will be classified as a corporation that is itself subject to taxation, or as a "pass-through" entity whose income or loss is reported on its owners' individual tax returns. A venture seeking pass-through treatment may form a corporation eligible to elect taxation under Subchapter S[1] of the Internal Revenue Code (Code) or it may be organized in a manner that allows classification as a partnership for tax purposes. The Subchapter S rules are relatively uncomplicated and recent legislation has expanded the types of corporations eligible for the election. Until quite recently, however, classification of a venture as a partnership raised many difficult issues and uncertainties.[2]

Final Regulations issued in December, 1996, greatly simplify these classification procedures by allowing most unincorporated

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1. *See* I.R.C. §§ 1361-1379 (1996).

2. It has been suggested that more than 1,000 articles have been published to explain the IRS regulations, case law, and administrative procedures and rulings on this topic. *See* Richard M. Lipton & John T. Thomas, *Proposed Check-the-Box Business Classification Regulations Simplify Rules*, 13 J. PARTNERSHIP TAX'N 195 (1996)..

ventures to obtain partnership treatment by checking a box on the appropriate form. Generally, these "check-the-box" regulations provide pass-through tax treatment for any business organization that is not specifically defined as a corporation.[3] The new regulations reflect the fact that legislation in many states now provides limited liability for owners of certain unincorporated entities—an attribute traditionally available only to shareholders of a corporation. For example, most states permit formation of limited liability companies and many authorize limited liability partnerships. The elimination of this important distinction between corporations and other entities made the existing tax classification rules outdated and merely a trap for the unwary.

II. DISTINCTIONS BETWEEN THE ENTITIES

A. *Regular or "C" Corporation*

A regular or "C" corporation is an entity taxable under Subchapter C[4] of the Code. Most C corporations are formed according to state laws by filing articles of incorporation. Often, the rules governing corporate management, capital structure, and shareholder rights are codified in extensive and well-understood state laws.

A significant nontax aspect of a corporation is that its owners ordinarily are not personally liable for corporate debts. This feature makes the corporate format attractive to parties who wish to limit their potential losses to the capital that they invest in the venture. The most important tax aspect of a C corporation is that its income and gains are subject to two levels of taxation: first, when the income and gains are earned by the corporation, and again, when a distribution is made to corporate shareholders. Corporate losses are deductible only against corporate income and do not pass through to the shareholders.

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3. Treas. Reg. §§ 301.7701-2(b)(1) to 301.7701-2(b)(8) (1996).
4. *See* I.R.C. §§ 301-385 (1996).

B. S Corporation

An S corporation is an incorporated entity whose shareholders elect to have the venture taxed under Subchapter S of the Code instead of under Subchapter C. Many corporations are not eligible for this election because the number and the kind of shareholders S corporations may have is significantly limited. An eligible corporation can elect Subchapter S treatment at its inception, or it may operate as a C corporation and convert to an S corporation later. Similarly, a corporation that operates under Subchapter S may terminate its election and convert to a C corporation. For nontax purposes, S and C corporations are treated in the same manner and are subject to the same state laws. Thus, shareholders of S corporations are not personally liable for corporate obligations. A significant difference between S and C corporations is that an S corporation is limited to one class of stock, whereas a C corporation may issue various stock classes.

The main tax effect of a Subchapter S election is that the corporation's income, deductions, gains, and losses generally are not subject to taxation at the corporate level. Instead, these tax items pass through to the shareholders, who report their shares of each corporate item on their personal tax returns. A corporate level tax may be imposed, however, on certain income of S corporations formerly operated as C corporations.

In most respects, shareholders of S corporations are taxable in the same manner as the partners of a partnership. However, a number of important differences between partnership and S corporation taxation exist.

C. General Partnership

Unincorporated ventures with multiple owners typically are considered partnerships for state law and tax purposes. Most partnerships are general partnerships, meaning that each partner is an agent for the venture whose actions may bind the other partners. Every general partner is personally liable for all partnership obligations; a general partner's personal assets are potentially at risk if the venture is unsuccessful. Partners may organize and operate their partnership informally pursuant to an unwritten understanding, or they may formalize their arrangement through a written partnership agreement.

D. Limited Liability Partnership

A variation of the general partnership is the Limited Liability Partnership (LLP) in which a general partner's liability has been limited by amendments to the state's Uniform Partnership Act.[5] An existing general partnership must apply and register under state law to obtain LLP status. A partner in an LLP is not personally liable for the negligence or misconduct of his or her partners, or for the negligence or misconduct of partnership agents or employees not under his or her direct supervision and control. However, partners in an LLP remain liable for their own negligence and misconduct and for the negligence and misconduct of other persons under their direct supervision and control. Liability for other types of partnership obligations is unaffected.

E. Limited Partnership

Another kind of partnership is a limited partnership, which is formed by executing and filing a written instrument in accordance with state statutes. A limited partnership must have at least one general partner that bears personal liability for partnership obligations. The limited partner's status is similar to that of a corporate shareholder in that limited partners cannot participate in partnership business affairs, they cannot bind the partnership, and their liability for partnership obligations is limited to the capital they have invested.

General and limited partnerships are taxable under Subchapter K[6] of the Code. The main tax feature of a partnership is that no tax is imposed at the partnership level. Instead, each partner reports his share of each item of the partnership's gain, loss, income, deduction, or credit on his personal tax return. Joint ventures engaged in specific types of activities may elect to be

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5. *See* 805 ILL. COMP. STAT. 205/15 (West 1996).
6. *See* I.R.C. §§ 701-761 (1996).

excluded from the tax rules of Subchapter K; these ventures are treated as co-ownerships. Certain publicly traded partnerships are excluded from Subchapter K and are taxable as C corporations.

F. Limited Liability Company

Most states have enacted statutes that permit the formation of limited liability companies (LLC) that provide limited liability for all members regardless of the location of its operations. An LLC is a noncorporate entity in which all members can participate in management and which, if appropriately structured, is treated as a partnership for federal income tax purposes. By combining statutory limited liability with partnership tax status, the LLC may provide a business structure that is superior to a corporation, S corporation, partnership or limited partnership.

Because members of an LLC are not personally liable for the entity's debts most state LLC statutes protect creditors by requiring the LLC to disclose the amount of contributions the members have agreed to make to the LLC and by prohibiting distributions to members that would render the LLC insolvent or unable to pay its debts. Generally, members of an LLC may participate in management of the entity without sacrificing their limited liability protection. However, an LLC may choose a centralized management structure that provides for one or more managers. Although a member of an LLC cannot transfer the right to participate in management without the consent of some or all of the other members, a member may freely transfer his economic interests in the LLC. An LLC does not have perpetual life and may dissolve at the end of a stated term or upon a member's withdrawal. However, the remaining members may agree to continue the LLC's business.

G. Co-Ownership

In a co-ownership, each co-owner is deemed to own an undivided portion of the mutually held property. One co-owner is not an agent for other co-owners and cannot bind or create obligations for them. An arrangement is considered a co-ownership if it involves the passive holding of property and if the owners do not engage in any significant business activities. If the owners actively participate in operating the property, their arrangement is likely to be considered a partnership for state law and tax purposes.

A co-ownership arrangement can have markedly different tax consequences than a partnership. For example, most tax elections in a partnership are made at the partnership level and bind all of the partners. These elections include the use of installment-method reporting, selection of the partnership's tax accounting method, and the election of nonrecognition on like-kind exchanges. In contrast, each co-owner is free to make his own elections on the tax treatment of various items, which may result in each of the co-owners using a different method. Unlike a partnership, co-owners share most tax items in proportion to their interests in the property; they cannot contractually allocate various income and loss items among themselves.

III. CLASSIFICATION OF ENTITIES FOR TAX PURPOSES

In December, 1996, the Treasury issued Final Regulations under Code section 7701[7] that permit most domestic business organizations except corporations and joint-stock companies to be taxed as pass-through entities. Generally, these rules replace existing regulations that classify an entity as a corporation for tax purposes if it exhibits more than two of four "typical" corporate characteristics. As a practical matter, entities such as limited partnerships and limited liability companies no longer need clauses in their operating agreements specifically designed to exclude at least two of these characteristics.[8]

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7. Treas. Reg. §§ 301.7701-1, 301.7701-2, and 301.7701-3. The Treasury previously announced its intention to issue proposed regulations in Notice 95-14. *See* 1995-1 C.B. 297.

8. *See supra* text accompanying note 2.

A. *The Prior Regulations*

Under the rules in effect before the "check-the-box" regulations, a venture was not considered a partnership if it met the tax definition of a corporation.[9] Since the Code defines the term corporation to include unincorporated "associations,"[10] an organization was classified as a corporation for tax purposes even though considered a partnership under local law. In this situation, the association was taxed under the corporate tax rules of Subchapter C rather than under the partnership rules of Subchapter K.

Because the Code fails to provide criteria for classifying associations as corporations, guidelines evolved through case law, regulations, and administrative rulings. The Supreme Court established the basic test in *Morrissey v. Commissioner*,[11] holding that an unincorporated association is taxable as a corporation if it more closely resembles a corporation than any other kind of entity. This resemblance is determined by comparing the characteristics of the association in question with typical corporate characteristics.

In 1960, the Treasury issued regulations that partially adopted the *Morrissey* corporate-resemblance test for classifying associations.[12] According to these regulations, an entity was classified as a corporation if it exhibited a majority of the corporate characteristics described in *Morrissey*:

1) the presence of associates;
2) a business objective and profit motive;
3) continuity of life;
4) centralized management;
5) limited liability; and
6) free transferability of interests.

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9. I.R.C. § 761(a) (1996). *Cf.* I.R.C. § 7701(a) (1996)

10. I.R.C. § 7701(a)(3) (1996).

11. 296 U.S. 344 (1935).

12. In *Morrissey*, the court noted that the Treasury was permitted to issue different rules defining the term association and may clarify or change these rules. *Morrissey*, 296 U.S. at 354.

Since the first two factors, associates and a profit objective, are common to corporations and partnerships, the regulations did not count them in distinguishing a partnership from an association.[13] Thus, an unincorporated association was classified as a corporation for tax purposes only if it exhibited more than two of the remaining characteristics—continuity of life, centralized management, limited liability, and free transferability of interests.[14] Each of these characteristics was given equal weight in determining an entity's classification.[15]

The test in the regulations differed significantly from the analysis the Court used in *Morrissey*. *Morrissey* involved an overall evaluation of the similarity between the entity in question and a corporation. In contrast, the regulations simply required counting the number of corporate characteristics the entity exhibits, without weighing the degree of corporate similarity each factor contributes.[16] Thus, an organization that lacked two or more corporate characteristics was classified as a partnership even though its overall nature was more like a corporation. The regulations were purposely skewed this way to prevent unincorporated professional practices from adopting corporate pension plans which, at that time, provided far greater tax benefits than were available to professional partnerships.[17]

Although the classification of a venture was governed by the tax regulations, local law applies in determining whether the legal relationships referred to in the regulations do exist.[18] Local law was examined in determining if a particular corporate characteristic is present in an organization. The regulations

13. Treas. Reg. § 301.7701-2(a)(2) (1996).

14. *Id.*

15. Treas. Reg. § 301.7701-2(a)(3) to -3(b)(2) (1996). *See also* Larson v Comm'r, 66 T.C. 159 (1976), *acq.* 1979-1 C.B. 1.

16. In *Larson v Comm'r*, the Tax Court suggested that it would have classified the entity in question as a corporation if the regulations permitted applying different weights to the corporate characteristics. *Larson*, 66 T.C. at 185.

17. The Service's litigation had failed to prevent professional groups from being characterized as associations taxable as corporations. *See* U.S. v. Kintner, 216 F.2d 418 (9th Cir. 1954), *aff'g* 107 F. Supp. 976 (D. Mont. 1952).

18. Treas. Reg. § 301.7701-1(c) (1996). *See* Richlands Med. Ass'n v. Comm'r, T.C.M. 1990-660 (professional association taxable as corporation where state law provided entity with continuity of life, centralized management, and limited liability).

indicated that general partnerships organized under the Uniform Partnership Act (UPA) do not generally exhibit any of the pertinent corporate characteristics.[19] Similarly, limited partnerships subject to the Uniform Limited Partnership Act (ULPA), the Revised Uniform Limited Partnership Act (RULPA),[20] or state statutes corresponding to these uniform acts generally lack the characteristics of continuity of life and centralized management.[21] Therefore, ventures subject to these statutes ordinarily were classified as partnerships.[22]

Although the Internal Revenue Service (Service) eventually abandoned its attempt to bar corporate pension plans for professionals,[23] the anti-corporation slant of the regulations continued to allow ventures to be classified as partnerships even though they grant investors most of the important benefits of corporate status. This result contributed to a proliferation of tax shelters organized as limited partnerships.

The Service's attempts to curb limited partnership tax shelters through litigation[24] and administrative rulings[25] related to the classification issue were unsuccessful. As a result, Congress has attacked those tax shelters by enacting legislation that eliminates most of the tax benefits limited partnerships formerly provided to

19. Treas. Reg. § 301.7701-1(c) (1996). *See, e.g.*, Foster v Comm'r, 80 T.C. 34, 184-90 (1983). The Uniform Partnership Act has been adopted by all states and territories of the United States except Louisiana.

20. Although the regulations refer to partnerships formed under statutes corresponding to Uniform Limited Partnership Act, an amendment in 1983 provides that these references are deemed to refer to RULPA as well.

21. Treas. Reg. § 301.7701-2(a), (b), (c) (1996). A limited partnership with a corporate general partner may possess centralized management regardless of state law if limited partners own substantially all the interest in the general partner. Treas. Reg. § 301.7701-2(c)(4) (1996).

22. *See, e.g.*, Priv. Ltr. Rul. 9124008 (Mar. 7, 1991) (general partnership converted to a limited partnership under state Revised Uniform Limited Partnership Act classified as partnership).

23. Rev. Rul. 70-101, 1970-1 C.B. 278.

24. *See* Zuckman v. U.S., 524 F.2d 729 (Ct. Cl. 1975); *Larson*, 66 T.C. at 159.

25. *See, e.g.*, Rev. Proc. 72-13, 1972-1 C.B. 735, and Rev. Proc. 74-17, 1974-1 C.B. 438 (establishing rigorous criteria for obtaining an advance ruling classifying an entity as a limited partnership). In 1977, the Treasury issued new classification regulations, Prop. Treas. Reg. § 301.7701, 42 Fed. Reg. 1038 (Jan. 5, 1977), but these were immediately withdrawn. 42 Fed. Reg. 1489 (Jan. 7, 1977).

investors. This legislation includes the passive-loss rules of Code section 469 and the publicly traded partnership rules of Code section 7704, as well as a number of stringent reporting and penalty provisions.[26] However, perhaps a more important factor is the diminished attractiveness of most tax-sheltered investments due to lower tax rates, elimination of the investment tax credit, and the reduction in allowable deductions for items such as depreciation and interest.

As previously mentioned, the former regulations classified an unincorporated organization as a corporation for tax purposes only if it exhibited more than two of these four characteristics: (1) continuity of life; (2) centralized management; (3) limited liability; and (4) free transferability of interests.[27] Generally, a limited partnership or limited liability company could reasonably expect partnership classification under these regulations by inserting clauses in their operating agreements specifically designed to exclude at least two of these characteristics. Nevertheless, sophisticated tax advice was required and business decisions had to conform with these often unwanted provisions in their operating agreements. Indeed, some smaller businesses may have lacked the resources and expertise needed to obtain the desired tax treatment.

IV. THE "CHECK-THE-BOX" CLASSIFICATION RULES

A. General

The new "check-the-box" classification system in the Final Regulations eliminates the complicated four-factor corporate resemblance test. The new regulations replace this test with a simple election. Thus, an entity no longer must restructure its operating agreement to obtain pass-through tax treatment. The Final Regulations also address the taxation of unincorporated business entities having only one owner.

Step one in the classification process is to determine whether

26. *See, e.g.*, I.R.C. §§ 6662, 6698, and 6700.
27. Treas. Reg. § 301.7701-2 (1996).

an "entity" exists for federal tax purposes.[28] This process is a matter of federal tax law that does not depend on recognition of the entity under state law.[29] Thus, a joint undertaking may constitute a separate entity for federal tax purposes if the owners actively carry on a trade, business, financial operation, or venture and divide the profits even though no separate entity exists under state law. For example, co-owners of an apartment building who lease space and also provide services to the occupants are deemed to create a separate entity for tax purposes.[30] Conversely, merely owning, maintaining, and leasing a building does not necessarily create a separate tax entity.

Any entity except a trust or other organization subject to special tax treatment (such as a REIT or REMIC) is a "business entity" including a single owner entity.[31] A business entity having two or more owners may be classified as either a partnership or a corporation. A one-owner business entity may be classified as a sole proprietorship, as a branch or division of the owner, or as a separate corporation. Although few states currently allow one-member LLCs, it is likely that many states will change their LLC statutes to permit such entities.

B. Automatic Corporate Classification

Under the Final Regulations, certain business entities automatically are classified as corporations for tax purposes.[32] Domestic business entities subject to this automatic classification rule include:

1) An entity formed under a federal, state or Indian Tribe statute that refers to the entity as "incorporated," a

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28. Treas. Reg. § 301.7701-1(a) (1996).

29. The Final Regulations provide three exceptions to the separate business entity rule: (1) an organization that is wholly owned by and is an integral part of a state, (2) native American tribes incorporated under section 17 of the Indian Reorganization Act of 1934 or section 3 of the Oklahoma Indian Welfare Act, or (3) a qualified cost-sharing arrangement described in Treas. Reg. § 1.482-7 (1996).

30. Treas. Reg. 301.7701-1(a)(2) (1996).

31. Treas. Reg. 301.7701-2 (1996).

32. *Id.*

"corporation," "body corporate," or "body politic."
2) An entity organized under a state statute that refers to the entity as a joint-stock company or joint-stock association.
3) A state chartered entity conducting banking activities, if any of its deposits are FDIC insured.
4) A business entity wholly owned by a state or any political subdivision thereof.
5) An insurance company.
6) Any business entity wholly owned by a state or any political subdivision thereof.
7) Any entity that the Code specifically classifies as a corporation for tax purposes outside of section 7701(a)(3), such as publicly traded partnerships under section 7704.

The Final Regulations also describe 82 kinds of foreign entities that are classified as corporations for tax purposes. A grandfather rule permits some foreign entities on the list continued partnership classification if:

1) The entity was in existence on May 8, 1996.
2) That classification was relevant on May 8, 1996.
3) No person treats the entity as a corporation.
4) Any change to the entity's claimed classification within the sixty months prior to May 8, 1996, occurred solely as a result of a change in the organization's documents, and all members recognize the federal tax consequences of any change.
5) The entity had a reasonable basis for treating the entity as other than a corporation.
6) Neither the entity nor any member has been notified in writing that the entity is under examination on or before May 8, 1996.

V. Default Classification as a Pass-Through Entity

A. Domestic Entities

A business entity that is not automatically classified as a corporation under the above rules is referred to as an "eligible entity."[33] An eligible entity is "domestic" if formed or organized under the laws of the United States or of any state. Other entities are "foreign" entities.[34] A domestic entity with at least two members is taxable as a partnership unless it affirmatively elects to be treated as a corporation.[35] Thus, partnership tax treatment is ensured for an unincorporated venture without regard to the presence of some or all of the four corporate characteristics described in the former regulations.

A single member entity (including a single-member LLC) may elect to be taxed as a corporation or to be disregarded for tax purposes.[36] In default of an election, the entity is disregarded, meaning that it is classified as a sole proprietorship if owned by an individual, or as a branch or division (not a subsidiary) if owned by a corporation.[37] A single member entity may not be treated as a partnership.

The rules governing classification of single member entities resolve some of the issues regarding single member LLCs. Some states now permit single-member LLCs, and others are likely to do so. It has been unclear whether the IRS would classify these entities as partnerships for tax purposes. A similar question was raised as to the classification of an LLC formed with multiple members if only one member remains. Another issue concerns treatment of an LLC owned by two or more members under common control--such as an LLC owned by subsidiaries of a common parent.

The treatment of one member entities under the Final

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33. Treas. Reg. § 301.7701-3(a) (1996).

34. Treas. Reg. §301.7701-1(d) (1996).

35. Note that an election to change from an association to a pass-through entity may be treated as a corporate liquidation resulting in taxation under I.R.C. § 311 (1996). *See* Summary of the Regulations. 26 C.F.R. § 301 (1996).

36. Treas. Reg. § 301.7701- 2(c)(2) (1996).

37. Treas. Reg. §301.7701-3(b) (1996).

Regulations is likely to induce many individuals to operate as a limited liability company instead of an S corporation. Generally, an LLC provides the same state law protection from creditors as an S corporation, but is a more flexible and less restrictive business form. Since a one member LLC is disregarded for tax purposes, an individual who forms an LLC will report all business income as from a sole proprietorship on Schedule C.

It also is likely that corporations will increasingly utilize one member LLCs instead of traditional subsidiaries. This may permit the group to isolate separate business lines while avoiding the complexities and expense involved in filing consolidated tax returns. Under the Final Regulations, a single member entity owned by a corporation is treated as a branch or division rather than as a subsidiary.

B. Foreign Entities

The Final Regulations extend the "check-the-box" classification system to foreign organizations, with some modifications. As noted in Notice 95-14, the classification of foreign entities has been particularly troublesome for the Service because of the complexity of the issues and the resources required to resolve them. Classification of a foreign entity requires analysis of complex foreign documents and a sophisticated understanding of foreign business law.

An eligible foreign entity with at least two members automatically is classified as a partnership if any member has unlimited liability. Whether any member has "unlimited liability" is determined solely from the applicable foreign statute or law under which the entity is organized.[38] Unlimited liability exists if the law subjects a member to personal liability for claims against the entity or if the statute merely fails to specifically limit the member's liability. Where optional treatment is allowed, the entity's organizational documents control. A single member foreign entity is disregarded as an entity if the single owner has unlimited liability. Thus, it is treated as a sole proprietorship if

38. Treas. Reg. § 301.7701-3(b)(2)(ii) (1996).

owned by an individual, or as a branch, or division if owned by a corporation. Note that pass-through treatment is the default option for a foreign entity having a member with unlimited liability. The entity may, however, affirmatively elect to be treated as a corporation.

If no member of a foreign entity has unlimited liability, the default classification is taxation as a corporation. However, partnership or pass-through treatment may be affirmatively elected by an appropriate filing. In effect, the default classification for foreign entities corresponds to the likely expectations of the members: corporate treatment for entities having limited liability and partnership treatment where members have unlimited liability.

VI. Election Procedures

No election is required for an existing eligible entity unless a change in classification is requested. The classification of an existing entity is deemed to be the same as on the date prior to the effective date of the Final Regulations.[39] However, a single member entity will be disregarded even if partnership classification was previously granted. A foreign entity is an existing entity only if its classification immediately before the effective date was relevant to any person for federal tax purposes. Although the proposed regulations set forth the information required to be provided in the election, it is likely that the Service will publish a form for this purpose.

Once an election to change classification is made, the entity may not file another election for sixty months.[40] This rule is subject to the following exceptions:

1) No classification change is deemed to occur when an existing entity files an election to be effective as of the effective date of the final "check-the-box" Regulations.
2) An election out of default classification to be effective on the date an entity is formed is not a change of classification.

39. Treas. Reg. § 301.7701-3(b)(3) (1996).
40. Treas. Reg. § 301.7701-3(c)(1)(ii) (1996).

3) The limitation on changing classification does not apply when a business is transferred to a new entity.

A. Effective Date

The "check-the-box" rules are effective as of January 1, 1997. An eligible entity existing before the effective date retains its current classification unless an election to change its classification is made.[41] The current classification will not be challenged if the entity had a reasonable basis for the classification, the entity and all members of the entity recognize the tax consequences in the entity classification within sixty months prior to January 1, 1997, and had not received written notification on or before May 8, 1996, that the current classification is being examined. This effective date applies to domestic and foreign entities.

VII. CONCLUSION

The Final Regulations will greatly simplify the formation and operation of many business enterprises without significant loss of tax revenues. An entity can be classified as a partnership if it has a reasonable basis for that treatment, including ventures whose classification would be uncertain under the prior corporate resemblance test. Obviously, many states will now amend their limited partnership and limited liability statutes to reflect the new tax rules. Since most statutes were enacted to ensure partnership classification for federal tax purposes, the amendments should be readily forthcoming.

The elimination of the two-out-of-four test allows greater flexibility in the structure and operation of many ventures, particularly LLCs. A significant improvement for LLCs is the elimination of the continuity of life test. In the past, many LLCs limited the number of members to avoid the practical problems involved in obtaining a majority vote after every dissolution event. An LLC is now free to operate under any dissolution

41. Treas. Reg. § 301.7701-3(e) (1996).

provisions it deems appropriate—which may call for a vote of all, some, or none of its members. Elimination of the free transferability test means that members can sell their LLC interests without obtaining consent from other members. Thus, large-scale LLCs with many members holding readily salable interests are now possible so long as they are not publicly traded. In a family LLC, parents can now sell their interests without obtaining permission from their partner children. The Regulations are a significant accomplishment for the Service and the Treasury. They are simple to read, interpret, and apply. Hopefully, this represents the future direction of tax administration.