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# The North Dakota Limited Liability Company Act: Formation and Tax Consequences

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# THE NORTH DAKOTA LIMITED LIABILITY COMPANY ACT: FORMATION AND TAX CONSEQUENCES

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For many years, lawyers who helped their clients choose forms of business entities in which to operate had really only two choices: the corporation or the partnership. Now a new player, one that combines the qualities of both corporations and partnerships, has entered the game. Under the existing scheme of taxation the new entry, called the limited liability company, will likely replace the partnership and corporation for small to medium size business. The purpose of this article is to explore the formation and tax treatment of limited liability companies (LLCs).

## I. THE TAX ADVANTAGES OF THE LIMITED LIABILITY COMPANY

In order to fully understand the LLC, it is first necessary to explore some of the benefits of its use. This exploration will begin with a brief history of the pre-LLC business choices. A description of the LLC and a discussion of the benefits of the taxation it allows is also included to provide further understanding to the reader.

### A. THE HISTORY OF TAXABLE ENTITIES

The fight for passage of LLC acts is similar to the professional corporation controversy. The professional corporation controversy was a battle waged over corporate tax rates and fringe benefits between professionals, such as tax practitioners and doctors, and the Internal Revenue Service from shortly after World War II until 1970. The fight ultimately resulted in a total victory for taxpayers, thus enabling professionals to incorporate and obtain the long sought after objectives of lower corporate tax rates and fringe benefits, the most important of which were tax deductible pension and profit sharing plans.[1] The tax savings to professionals were substantial, because income tax rates on ordinary income for individuals during that period of time reached 70% and higher, while tax rates at the corporate level were typically, at the lower brackets, 25% or less and around 50% at the top.

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1. *See, e.g.* Kintner v. United States, 216 F.2d 418 (9th Cir. 1954) (requiring a medical association to be treated as a corporation for income tax purposes).

In North Dakota, a similar situation was experienced involving farm corporations, which ultimately led to the passage of laws permitting corporate farming in 1983.[2] Before 1983, farmers managed to obtain the advantage of lower corporate tax rates by utilizing cooperative associations[3] and joint stock companies for federal and state tax purposes.[4]

Until 1986, the corporation was the entity of choice in which to operate, for not only did it enjoy substantial tax advantages, it also provided limited liability. Because most small corporations were not significantly more expensive to maintain than sole proprietorships, corporate tax savings were available. In 1986, however, this favorable attitude began to change. For the first time in this nation's history, individual tax rates were cut to less than the corporate tax rates.[5] This is no longer true in 1993, as the top individual rate is now 39.6% on income in excess of $250,000.[6] The new maximum corporate tax rate is 35% on income in excess of $10 million.[7]

Perhaps more important than the 1986 change to corporate tax rates was the so-called "repeal of *General Utilities*" in 1986. The taxpayer in *General Utilities Operating Co. v. Helvering*[8] was a corporation in the process of distributing all of its assets in liquidation.[9] The assets had appreciated in value. The Internal Revenue Service (IRS) contended that a tax should be levied on the gain to the corporation. That gain was measured by the spread between the fair market value of the assets and their basis at the time of liquidation.[10] The Court held for the taxpayer and exempted that gain from taxation.[11]

The doctrine imbedded in the *General Utilities* decision ultimately found its way into section 336 of the Internal Revenue Code, which initially exempted a corporation from any gain on the distribution of assets in liquidation. Section 336 also exempted other types of distributions, including distributions by way of dividends, partial liquidations, or

2. N.D. CENT. CODE Chap. 10-06. Farmers previously were forbidden to incorporate their farm operations by state law.

3. N.D. CENT. CODE Chap. 10-15 (providing for cooperative associations).

4. I.R.C. § 7701(a)(3) (1988). This section provides that the term "corporation" includes associations, joint stock companies, and insurance companies.

5. I.R.C. § 1 (1988 & Supp. IV 1992), I.R.C. § 11 (1988). Section 1 of the Internal Revenue Code concerns tax rates imposed upon individuals. Section 11 of the Internal Revenue Code concerns taxes imposed upon corporations.

6. I.R.C. § 1 (1988 & Supp. IV 1992).

7. I.R.C. § 11 (1988). A cursory glance at the rates would indicate that the corporate tax rate is lower. However, this is not true when one considers that the corporate tax is applied to the corporation itself. In order for the profits to ultimately reach the owners of a corporation, they will first be taxed at the corporate level and then taxed once again as those profits are distributed as dividends.

8. 296 U.S. 200 (1935).

9. General Utilities Operating Co. v. Helvering, 296 U.S. 200, 203 (1935).

10. *Id.*

11. *Id.*

redemptions. Over the years, there were inroads carved into that doctrine, but still, prior to the Tax Reform Act of 1986, it was relatively cheap, taxwise, to liquidate a corporation because the size of the gain at the corporate level was generally modest and the gain at the shareholder level was a capital gain.[12] When overall tax rates were reduced in 1986, the proponents of the Act suggested that the repeal of *General Utilities* was one means by which an enormous amount of revenue could be raised so as to cause the Tax Reform Act of 1986[13] to be revenue neutral.[14] This was not true. Instead of creating revenue, corporations are now largely unable to liquidate, as the tax cost of liquidation will often exceed 50% of the value of the assets of the corporation.[15]

The first strategy of tax planners following the Tax Reform Act of 1986 was a headlong rush into the election of S taxation.[16] An S corporation can avoid the corporate level gain on appreciated assets ("built-in gain") on liquidation or other sale if it has always been an S corporation or if its election to be an S corporation occurred prior to December 31, 1986. If the election to S corporation status occurred after December 31, 1986,[17] and the corporation was a C corporation,[18] the corporation will be liable for gain on liquidation (the so-called repeal of *General Utilities*) for a period of ten years after the election takes effect.[19] Still, the S corporation has the advantage of a single tax on its income paid by its shareholders which is generally taxed at lower overall rates than C corporations. Few practitioners recommended operating as a general partnership because of the unlimited liability faced by the individual partners.[20] Of course, a limited partnership can provide limited liability to its limited partners, but they forfeit that limited liability if they take an active part in the management of the partnership.[21]

12. I.R.C. § 331(a) (1988). Section 331 of the Internal Revenue Code provides that the amount received by a shareholder of a distribution in complete liquidation of a corporation is treated as full payment in exchange for stock. *Id.* The gain is measured by calculating the difference between the value of the assets received in liquidation and the shareholder's basis in his or her stock in the corporation.

13. Tax Reform Act of 1986, Pub. L. No. 99-514, § 632, 100 Stat. 2086 (1986); codified as amended at I.R.C. § 1374 (1988 & Supp. IV 1992) (hereinafter Tax Reform Act of 1986).

14. STAFF OF JOINT COMMITTEE ON TAXATION, 99th Cong., 1st Sess., GENERAL EXPLANATION OF THE TAX REFORM ACT of 1986 336-39 (Comm. Print 1987).

15. For example, in liquidation, a corporation will be taxed at rates of up to 35% on the appreciation of its assets, while the shareholders will pay a 28% capital gain tax for the appreciation value in their stock.

16. Simplified, the income of an S corporation is taxed directly to its shareholders. *See* I.R.C. § 1366(a) (1988). In other words, the S corporation is a pass-through entity in which shareholders are taxed but the entity itself is not. *Id.*

17. Tax Reform Act of 1986, *supra* note 13 (concerning built-in gains for subchapter S corporations).

18. I.R.C. § 11 (1988) (taxing a C corporation as its own entity).

19. *See* Tax Reform Act of 1986, *supra* note 13.

20. N.D. CENT. CODE § 45-06-07 (Supp. 1993) (detailing partnership joint and several liability).

21. N.D. CENT. CODE § 45-10.1-22(1) (Supp. 1993).

### B. THE LIMITED LIABILITY COMPANY: A NEW BUSINESS ENTITY

The foregoing discussion is intended to set the stage to introduce the limited liability company (LLC). The LLC is an entity which is tailor-made to suit the needs of business, because under current law it usually delivers the lowest practicable overall tax cost, while at the same time offering limited liability.[22] The LLC does this by essentially combining the best aspects of a partnership and a corporation.

The limited liability company is new only in America. As early as 1892, the German empire created an entity with essentially the same characteristics as the LLC, which was called Gesellschaft mit beschränker Haftung (GmbH).[23] The concept spread throughout Europe and South America, with such organizations being introduced in Brazil in 1919, France in 1925, Cuba in 1929, Argentina in 1932, Mexico in 1934, Belgium in 1935, and Switzerland and Italy in 1936.[24]

In 1977, a Texas oil company approached the Wyoming legislature and convinced it to pass the first United States enabling legislation permitting LLCs.[25] Similar legislation was passed in Florida in 1982.[26] However, there was no real interest in limited liability companies until the corporation lost its charm by reason of the Tax Reform Act of 1986. Then, in 1988, the Internal Revenue Service issued a revenue ruling to the effect that Wyoming LLCs would be taxed as partnerships.[27] The rush was on! By the close of 1992, eighteen states had passed such legislation. North Dakota's act was passed in the 1993 legislative session and became effective on August 1, 1993.[28] A limited liability company reporter has sprung into existence and in its first issue it predicted that by the close of 1993, at least forty states will have adopted LLC legislation.[29] At last report, 35 states have adopted enabling legislation, and LLC legislation has been proposed or studied in all other states.[30]

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22. Currently, there is minimal rate difference on top tax brackets between individuals and corporations. However, that rate difference is offset by the fact that profits from corporations are taxed twice. The fact that an LLC should not bear any tax burden upon liquidation, combined with the flexibility of partnership taxation, should result in the lowest overall tax rate.

23. *See* Rev. Rul. 77-214, 1977-1 C.B. 408; Rev. Rul. 93-4, 1993-3 I.R.B. 5.

24. *See* Philip P. Whynot, *A Historical Update*, LIMITED LIABILITY COMPANY REP. Jan./Feb. 1993, at 93-106.

25. *See id.*

26. FLA. STAT. § 608.401-.471 (1993).

27. Rev. Rul. 88-76, 1988-2 C.B. 360.

28. N.D. CONST. art. IV, § 13 (Supp. 1993). This section provides that every law enacted by the legislative assembly (with exceptions) takes effect on the first day of the following month of August. *Id.* North Dakota's Limited Liability Company Act was passed in the 1993 legislative session. 1993 N.D. Laws, ch. 92, § 8.

29. *See* Whynot, *supra* note 24, at 93-106.

30. *State-by-State Tax Treatment of LLCs chart*, LLC ADVISOR, Nov. 1993, Advance Issue, at 3 (Kathleen A. Larrison ed.).

### 1. *The Determination of Tax Status*

To understand LLCs, it is necessary to examine Internal Revenue Service rulings and the means by which the Internal Revenue Service determines whether an entity should be taxed as a corporation or as a partnership. Since the only taxable entities under federal tax laws are individuals, trusts, estates, and corporations,[31] early on the courts found it necessary to examine the characteristics of an entity to determine how it would be taxed. The ancestor of all the cases on this topic is *Morrissey v. Commissioner*,[32] which involved a trust organized to develop real estate.[33] As distributions of property by a trust are deductible from income,[34] it was the trust's position that the tax would be passed on to the beneficiaries by way of distributions instead of the trust being taxed.[35] Based upon the familiar doctrine that substance prevails over form, the IRS contended that in substance, the trust was really a corporation.[36] This seemingly radical view, that a trust could be considered a corporation, was upheld by the Supreme Court and is good law today. *Morrissey* is also the progenitor of many disputes presented to the courts over the years, including the professional corporation conflict[37] and the classification of joint stock companies[38] as corporations for federal tax purposes discussed above.

In *Morrissey*, the Supreme Court announced that there are essentially four characteristics used to distinguish corporations from other types of entities. Those characteristics are:

1. limited liability;
2. centralization of management;
3. free transferability of interest; and
4. continuity of life.[39]

The Internal Revenue Service's fight against tax shelters included an attempt to use the *Morrissey* tests to disallow the tax losses that flowed through a limited partnership to its investors, claiming that a limited partnership more closely resembled a corporation than a partnership. In *Lar-*

31. I.R.C. § 1 (1988 & Supp. IV 1992); I.R.C. § 11 (1988).
32. 296 U.S. 344 (1935).
33. Morrissey v. Commissioner, 296 U.S. 344, 348 (1935).
34. I.R.C. § 651 (1988).
35. *Morrissey*, 296 U.S. at 348.
36. *Id.* at 349.
37. *See* discussion *supra* part IA.
38. A joint-stock company is an entity with all the characteristics of a corporation but without limited liability. Federal tax law treats joint-stock companies as corporations. *See* I.R.C. § 7701(a)(3) (1988).
39. *Morrissey*, 296 U.S. at 359-60. Each of these characteristics are discussed more in Section II, *infra*.

*son v. Commissioner*,[40] the IRS raised that very argument. While the Tax Court originally decided the *Larson* case in favor of the government, it subsequently withdrew the opinion and reissued it, deciding the issue in favor of the taxpayer on the basis of the then existing regulations.[41] Had the partnership in *Larson* been deemed a corporation, its losses would have been frozen inside the corporation and not passed on to the investors.[42] As most tax shelters were organized as limited partnerships, such a determination would have brought a swift halt to the tax shelter business.

The regulations under which the *Larson* court made its decision were promulgated by the Commissioner in 1960 in an attempt to turn back the tide of the professional associations which were being formed at the time.[43] The regulations are weighted heavily in favor of finding partnership status as opposed to corporate status because in 1960, the IRS was fighting the attempts of professionals (such as doctors, lawyers, etc.) to achieve corporate tax advantages. For example, the 1960 regulations (which are still in effect) state that an organization must possess three of the four characteristics described above to qualify as a corporation.[44] In the event of a dead heat (i.e., the entity has two corporate and two partnership characteristics) the entity will be deemed to be a partnership.[45] In any event, the *Larson* court held that the limited partnership had two corporate and two partnership characteristics and was to be taxed as a partnership.[46]

Limited liability companies potentially have three partnership characteristics and one corporate characteristic; thus, they should be offered partnership tax status. An LLC will always have the corporate characteristic of limited liability.[47] One LLC partnership characteristic is its lack of continuity of life. This is because in North Dakota, LLCs exist for a period of only thirty years and will terminate upon the death or bankruptcy of a partner and many other events.[48] A termination of a partnership is not a serious matter from the tax standpoint, although it can be

40. 66 T.C. 159 (1976).

41. Larson v. Commissioner, 65 T.C. 159, 159 (1976).

42. *See* I.R.C. § 11 (1988). The losses would be frozen in a corporation because a C-corporation is not a flow-through entity. *Id.*

43. *Cf.* Treas. Reg. § 301.7701-2 (1) (1993).

44. *Id.*

45. *Id.*

46. *Larson*, 65 T.C. at 159.

47. N.D. CENT. CODE § 10-32-29 (Supp. 1993).

48. N.D. CENT. CODE § 10-32-109 (Supp. 1993). Terminations include retirement of a member, expulsion of a member, and redemption of a member's interest. *Id.*

detrimental in other respects.[49] Properly planned, the termination and liquidation of a partnership is tax-free.[50]

A limited liability company will not possess the corporate characteristic of free transferability of interest if the complete transfer of a partnership interest requires the consent of a member.[51] This is the second partnership characteristic of an LLC. North Dakota law requires unanimous consent for the complete transfer of an interest, although a transfer of the members financial interest does not require consent.[52]

A limited liability company will not have centralized management, a third corporate characteristic, if each member retains the right to management. However, an LLC that elects a board of governors charged with the management of the entity will have centralized management.[53]

### 2. *The Flexibility of Partnership/LLC Taxation*

Now that the IRS has blessed the North Dakota LLC, it should be the dominant form of business for new entities.[54] Except for publicly-traded companies and those companies that fear a liquidation, partnership and corporation formation will probably be seriously curtailed. The tax advantages of an LLC over both C and S corporations are significant. One cannot predict when a certain tax advantage may be important or even crucial to the continued success of a business enterprise. Therefore, it is necessary to examine those tax differences, with caution to the reader in two regards: First, partnership tax law can be utterly confusing and more difficult than even corporate tax law; and, second, to the extent possible during this discussion, tax consequences will be simplified and examples used whenever possible.

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49. Such detrimental matters would include sorting out relations between the former partners and their claims to partnership assets.

50. The properly planned liquidation of a partnership or LLC should be tax-free because the gain on liquidation will only be recognized if the member receives money in an amount greater than his or her basis or there is a non-pro rata distribution of inventory, receivables, or depreciable property. I.R.C. § 751 (1988 & Supp. IV 1992).

51. Rev. Rul. 88-76, 1988-2 C.B. 360.

52. N.D. CENT. CODE § 10-32-31 (Supp. 1993). Section 10-32-31 provides that financial rights are transferable in whole or in part, subject to restrictions imposed in the Articles of Organization, the operating agreement, a resolution adopted by the members, or any other written action by members of the limited liability company. *Id.*

53. Of course, even if centralized management is found, the LLC will still be taxed as a partnership because the LLC will still have only two corporate characteristics—limited liability and centralized management.

54. The IRS favorably ruled on the North Dakota LLC act on March 23, 1994, in an unreported private ruling to a law firm. Priv. Ltr. Rul. (Mar. 23, 1994). The IRS favorably ruled on the Minnesota LLC act in the same manner in September, 1993. North Dakota's LLC act is largely borrowed from the Minnesota version, with changes when necessary to coincide with existing North Dakota law.

a. Flexibility in Ownership

Any person can be a member of a limited liability company.[55] Of course, any entity can be a stockholder in a C corporation, but the types of stockholders that are allowed for S corporations are restricted.[56] For example, S corporation shareholders may not include nonresident aliens, other corporations, partnerships, and certain trusts.[57] If a prohibited party becomes an owner of stock in an S corporation, the S election is terminated. When such a termination occurs inadvertently, it can be a tax catastrophe.[58] S corporations can only have 35 shareholders, a requirement which seldom causes any difficulty. Corporations with more than 35 stockholders are often publicly-traded, but because a publicly-traded LLC would usually possess all four of the *Morrissey* corporate characteristics, there will likely be no publicly-traded LLCs.

C corporations can have any number of classes and types of stock, but S corporations can only issue common stock.[59] However, there are situations where it is desirable to issue equity interests which closely resemble preferred stock and LLCs can have differing classes of ownership rights and interest. For example, a retiring member of an LLC might exchange his or her regular partnership interest for an interest which is fixed in value, much in the nature of preferred stock. This would constitute a so-called estate tax freeze, where the partnership interest is redeemable by the partnership at a price which is fair at the time of issu-

55. N.D. CENT. CODE § 10-32-02(28) (Supp. 1993). A "person" includes both individuals and organizations. N.D. CENT. CODE § 10-32-02(36) (Supp. 1993). An "organization" means any domestic or foreign limited liability company, corporation, partnership, limited partnership, joint venture, association, business trust, estate, trust, enterprise, and any other legal or commercial entity. N.D. CENT. CODE § 10-32-02(32) (Supp. 1993).

56. I.R.C. § 1361(b)(1) provides that the term "small business corporation" means a domestic corporation which is not an ineligible corporation and does not have:

1) More than 35 shareholders;
2) A shareholder who is not an individual (with exceptions);
3) A nonresident alien as a shareholder; and
4) More than 1 class of stock.

I.R.C. § 1361(b)(1) (1988).

I.R.C. § 1361(b)(2) provides that an ineligible corporation is a corporation which is:

a) A member of an affiliated group;
b) A financial institution; or
c) An insurance company subject to tax under chapter L of the I.R.C.

I.R.C. § 1361(b)(2) (1988 & Supp. IV 1992).

57. *Id.*

58. If an S corporation loses its election, it reverts to C corporation status. I.R.C. § 1362 (1988). S corporations usually pay dividends and there is no second tax to the shareholder on dividends in the normal case. *Id.* That same dividend paid by a C corporation will be taxable to its shareholders. *Id.* Accordingly, the inadvertent termination of S statutes will likely cause two taxes to be paid: one by the C corporation and one by the shareholder. *Id.*

59. *See generally* I.R.C. § 1361 (1988) (stating that S corporations may only have one class of stock). While an S corporation can only have one class of stock, § 1361 of the I.R.C. provides that voting rights among the shares of a stock are disregarded in determining whether a corporation has more than one class of stock so long as the distribution and liquidation rights are identical. I.R.C. § 1361(c)(B)(4) (1988).

ance, but may be substantially below fair market value at the time of death. Such a device is not possible in an S corporation, since it would constitute a second class of stock, which will automatically terminate the S corporation election.[60]

There are no restrictions on a C corporation owning subsidiary corporations. However, an S corporation may not do so, for if an S corporation is either a parent or a subsidiary, it becomes a member of an affiliated group, which terminates the S election.[61] The penalty for running afoul of this not well-known rule is again the automatic loss of the S election.[62] LLCs, on the other hand, can be a first, second, third or one-hundredth-tiered member of a group, all with no loss of tax benefits.

### b. LLCs Are Not Taxed as Separate Entities

C corporations are liable for tax at rates ranging to 35%.[63] In addition, C corporations can be subject to an additional tax on unreasonable accumulated earnings[64] and personal holding company earnings.[65] S corporations normally are not taxed because their income is passed on to the shareholders to be taxed. However, S corporations are taxed under some circumstances on their passive income[66] and in some circumstances on their built-in gains.[67] Those gains are for sales of appreciated property within ten years of the time of making an S election.[68] Limited liability companies, on the other hand, are not taxable under any circumstances and all of their income is passed on to the members to be taxed at that level.[69] LLCs, considered partnerships for tax purposes, are never subject to the tax on personal holding companies or unreasonable accumulations of earnings.[70]

Losses incurred by a C corporation are deductible only against the corporation's income and are not available to the shareholders because a corporation is not a pass-through entity. Business losses can be carried

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60. *See supra* note 56. Note that section 2701 of the Internal Revenue Code can cause gift tax liability at the time that a former interest is exchanged for a redeemable interest. I.R.C. § 2701 (Supp. IV 1992).

61. I.R.C. § 1361(b)(2)(A) provides that an ineligible corporation is a corporation that is a member of an affiliated group. I.R.C. § 1361(b)(2)(A) (1988). An affiliated group is one in which the parent has 80% or more of the stock of a subsidiary. I.R.C. § 1504(2) (1988).

62. *Id.*

63. I.R.C. § 11 (1988).

64. I.R.C. § 531 (1988). The accumulated earnings tax is equal to 28% of the accumulated taxable income. *Id.*

65. I.R.C. § 543 (1988). This section concerns personal holding company income.

66. I.R.C. § 1375 (1988 & Supp. IV 1992). This section places a tax on S corporations that have gross receipts of which 25% or more are passive investment income. *Id.*

67. I.R.C. § 1374 (1988 & Supp. IV 1992).

68. *Id.*

69. I.R.C. § 702 (1988 & Supp. IV 1992).

70. I.R.C. §§ 532, 542 (1988).

back three years and forward fifteen years,[71] while a C corporation can carry back a capital loss for three years and forward five.[72] S corporation losses pass through to the shareholder but are subject to some limitations. These limitations are, in effect, the same limitations as those encountered by LLCs with one difference which will be more fully discussed later.[73] Losses are deductible by S shareholders[74] and LLC members[75] to the extent of their basis in their stock or their partnership interest. However, such losses may not be deducted if the member or stockholder is not "at risk" within the meaning of section 465(a) of the Internal Revenue Code.[76] Moreover, the interest component of losses may not be deducted by the members of an LLC or the shareholder of an S corporation except to the extent that those individuals have investment income.[77] Finally, neither the shareholder in an S corporation or a member in an LLC may deduct losses against their earned or portfolio income if those losses are passive in nature, all pursuant to the so-called passive loss rules of section 469 of the Internal Revenue Code.[78]

S corporation shareholders have far too often been denied their deductions for S corporation losses because of a trap in the law. The trap is that an S corporation losses may only be deducted to the extent of the shareholders' basis in their stock plus the amount of their loans made directly to the corporation.[79] The following is a typical example of this problem.

White owns all the stock of an S corporation which requires a working capital loan from a bank. The banker loans $100,000 directly to the S corporation. Of course, the banker insists that White personally guarantee the loan and he does. The S corporation incurs a $40,000 loss, but White's basis in his stock is only $1,000. White can only claim losses up to that amount. Had he been properly advised, White would have caused his banker to loan the money to him. He, in turn, would reloan it to the

71. I.R.C. § 172 (1988 & Supp. IV 1992). Section 172 concerns the income and credits of partners and their distributive shares. *Id.*

72. I.R.C. § 1212 (1988 & Supp. IV 1992). Section 1212 deals with capital loss carrybacks and carryovers. Corporations may carry a capital loss backwards in time 3 years. *Id.* A capital loss can be carried forward 5 years. *Id.*

73. The difference is that S corporation shareholders may not add their share of the corporation's debt to their basis in their stock.

74. I.R.C. § 1366(d) (1988). The limitation is for the sum of basis plus loans to the corporation. *Id.*

75. I.R.C. § 704(d) (1988).

76. Generally, a taxpayer is "at risk" for:

a) The amount of money and the adjusted basis of other property contributed by the taxpayer; and

b) The amount loaned by the taxpayer to that entity.

77. I.R.C. § 163(d) (1988 & Supp. IV 1992).

78. Passive losses may not be deducted against other forms of income. I.R.C. § 469 (1988 & Supp. 1992).

79. I.R.C. § 1366(d) (1988).

corporation and have the corporation personally guarantee the note to the banker, thereby giving the banker the same amount of security. Had White cast the transaction this way, he could deduct the $40,000 loss, as that amount is less than his stock basis ($1,000) plus loans to the corporation ($100,000).[80]

In an LLC, each shareholder's basis of his or her membership interest is increased by his or her share of partnership debt.[81] Had White formed an LLC, the loan could be made directly to it, as common sense and normal business practice would dictate, because White's basis would include his share of the $100,000 loan.

#### c. Special Allocations

Partnership tax law includes a doctrine known as "special allocations,"[82] which is totally foreign to C or S corporations. Basically, special allocations are what the term implies: namely the partners can decide to whom income or deductions will be allocated. For example, suppose there is an LLC with two members, Black and White, in which Black has invested $100,000 to purchase a pasta-making machine and White devotes his skills as a pasta maker. White insists upon a "sweetener" for his investment by requiring that all the depreciation on the pasta-making machine be specially allocated to him. Because federal partnership tax law permits this to be done, he expects that this will produce tax deductions, lowering his tax for the year. In an S corporation, the depreciation of the pasta machine would be shared between the shareholders ratably, depending upon the ownership of the stock. In the C corporation, the depreciation would be deductible only to the corporation. Special allocations of income and other tax attributes can be made, but the rules concerning special allocations are exceptionally complex and are beyond the author's announced scope of this article. The law and accounting firms who will be advising LLCs will require library aides for this.[83]

#### d. No Double Tax

Current cash distributions to shareholders of a C corporation are taxable as dividends.[84] The income that was generated to pay the dividend has already been taxed to the C corporation at the corporate level. When

80. *See* Harrington v. United States, 605 F. Supp. 53 (D. Del. 1985).
81. I.R.C. § 752 (1988).
82. I.R.C. § 704(b) (1988).
83. A recommended source is WILLIAM S. MCKEE et. al, FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS, (2d ed. 1977).
84. I.R.C. § 301 (1988 & Supp. IV 1992). Cash distributions pursuant to liquidations or redemptions can be very complicated, and they are beyond the scope of this article. Simplified, depending on the situation, cash distributions could be considered either ordinary income or capital gain.

paid as a dividend, it is taxed again at the shareholder level. It would not be uncommon for this double tax to more than exceed half of the corporation's net income when it reached the pocket of a C corporation shareholder by way of a dividend.[85] Cash distributions to an S corporation shareholder are taxed only once, so long as the distributions do not exceed the shareholder's basis in his stock and are not distributions that are "out of" the corporation's earnings at a time when it was a C corporation.[86] The S corporation's single layer of taxation feature is the same for LLCs. A member of an LLC is taxable on his share of its income as of the last day of its year.[87] Further, cash distributions to a member of an LLC are not taxable so long as the amount of cash received does not exceed the member's basis in his partnership interest.[88] When gain is recognized to a partner due to a distribution of cash exceeding the partner's outside basis, the partnership can increase the basis of its assets to reflect that gain so long as an election allowed by partnership tax law is in place.[89] This is one of a number of such basis adjustments that are available to a partnership that are totally foreign to S and C corporations.

e. Tax-Free Liquidation

Corporations have often been likened to a lobster trap. A lobster trap is designed so that the lobster has an easy time getting into the trap but has a very difficult, if not impossible time getting back out. Similarly, it is easy to transfer property to a corporation, for many such transfers qualify as tax-free pursuant to section 351 of the Internal Revenue Code.[90] However, taking property out of a corporation almost invariably involves paying taxes either on dividends or income at both the corporate and shareholder level in the event of a liquidation.[91]

Not so well known is the fact that taxpayers can inadvertently create taxable gain by transferring property to a corporation when they do not comply with the requirements of section 351 of the Internal Revenue

85. For example, if the corporation's assets were worth $1,000,000 and the corporation's basis was $200,000, the gain would be $800,000. With approximate state and federal tax rate assumed to be 40%, the tax would be $320,000. Assume the shareholders' state and federal rate is 35% and they have $100,000 basis in their stock. The shareholders' personal gain is then $580,000, with a resulting tax of $203,000. Thus, the total tax would be $523,000.

86. I.R.C. § 1368 (1988 & Supp. IV 1992).

87. I.R.C. § 701 (1988); I.R.C. § 702 (1988 & Supp. IV 1992).

88. I.R.C. § 731(a)(1) (1988).

89. I.R.C. § 734(b)(1) (1988). This section allows gain recognized to a distinctive partner to increase its basis.

90. I.R.C. § 351 (1988 & Supp. IV 1992) ("No gain or loss shall be recognized if property is transferred to a corporation and immediately after the exchange such person or persons are in control of the corporation"). "Control" is defined as 80% of the voting power of all stock. I.R.C. § 368(c) (1988 & Supp. IV 1992).

91. I.R.C. §§ 331, 336 (1988).

Code.[92] As an example of this type of situation, suppose Black and White agree upon a business venture to build a motel. Black owns the land and White has arranged for the financing and obtained local zoning approval. It is agreed that White will transfer his land to a newly formed corporation and Black will transfer a loan commitment he has negotiated and zoning approval to the newly formed corporation, all in exchange for stock. Although both Black and White together have 100% control of the corporation immediately following the transfer, the transaction is nevertheless taxable both to Black and White since Black did not transfer "property." The loan commitment and efforts expended in obtaining zoning are services, not property. Black is taxed upon the fair market value of the stock that he receives as ordinary income and White, unfortunately, is taxed on any gain realized in the transfer of the land. If the land had a basis of $100 and a fair market value of $10,000, White would have a $9,900 gain. This result would apply to a transfer to either an S or C corporation.[93]

Had the parties made the same transfers to an LLC, White would have no gain, since *any* transfer of property to a partnership in exchange for a partnership interest is tax free. There is no 80% control requirement for transfers to partnerships as there is for corporations.[94]

The liquidation of a C corporation has been adequately described above. It is taxable, and taxable at both the corporate and shareholder level because of the so-called repeal of *General Utilities*.[95] The liquidation of an S corporation is usually only taxable at the shareholder level, and gain is recognized to the extent that the fair market value of the assets received by the shareholders exceeds their basis.[96] Gain may be recognized to the S corporation if it has appreciated assets and less than ten years has elapsed since the date of its S election.[97]

The liquidation of an LLC, like any partnership, should be tax-free if properly done. Gain will be recognized on the liquidation of an LLC only if a partner receives money (which includes debt relief) in an amount greater than his or her basis[98] or if the liquidation involves a nonpro-rata distribution of so-called "hot assets."[99] These "hot assets" are substantially unrealized receivables (cash basis receivables),[100] which includes the

92. *See* Bradshaw v. United States, 683 F.2d 365 (Ct. Cl. 1982).
93. *Id.*
94. I.R.C. § 721(a) (1988).
95. *See* I.R.C. §§ 331, 336 (1988).
96. I.R.C. § 331 (1988); I.R.C. § 1371 (1988 & Supp. IV 1992).
97. *See* Tax Reform Act of 1986, *supra* note 13.
98. I.R.C. § 731(a)(1) (1988).
99. I.R.C. § 751(a) (1988 & Supp. IV 1992).
100. I.R.C. § 751(c) (1988 & Supp. IV 1992).

amount of potential depreciation recapture[101] and substantially appreciated inventory.[102] This is a very complex subject and its comprehension is certainly not intuitive. However, there is a simple, bright-line rule: a *pro-rata* distribution of "hot assets" will never trigger gain.[103] For example, assume an LLC is owned by Black and White, each of whom have a $250 outside basis[104] in their partnership interest. The partnership is involved in farming on the cash basis, and has cash of $500, a receivable from the elevator from the sale of last year's crop of $200, and grain in storage bins worth $300. The partnership is liquidated and White takes the cash of $500, and Black takes the grain of $300 and receivable of $200. The grain and receivable are "hot assets." The distribution of these "hot assets" is nonpro-rata. White is treated as having "sold" his 50% share of the grain and receivables, or $150 grain and $100 receivables, to Black in exchange for $250 of the cash received. This distribution is immediately taxable to White. On the other hand, had White and Black each taken $250 in cash, $150 in grain, and $100 of the receivables, there would be no gain to either party upon liquidation because each took their pro-rata share.

The rules for nonliquidating payments (any payment not in liquidation of a partnership's interest) to shareholders and partners is also worth noting. If appreciated property is distributed by a C corporation in full or partial liquidation, the gain is taxable to the corporation and the shareholder if its value exceeds the basis of any stock surrendered as part of the transaction.[105] Had the corporation elected S taxation, there would be no gain at the corporate level unless this was built-in-gain[106] property, coupled with the corporation's S corporation election occurring after December 31, 1986 and the S corporation election being less than 10 years old.[107]

When a C corporation distributes appreciated property, the transaction will typically be taxable. The first line of inquiry then becomes the nature of the transaction. If the transaction is a dividend, there will be a gain to the C corporation for the spread between its basis and the fair market value of the property. There will also be a second tax to the shareholder as a dividend.[108]

101. *See id.*

102. Treas. Reg. § 751-1(d)(2)(ii) (as amended in 1971).

103. *See* I.R.C. § 751(b) (1988 & Supp. IV 1992).

104. In partnership tax law, a partner's basis in his or her partnership interest is called "outside basis;" while the partnership's basis in its assets is called "inside basis." MCKEE, *supra* note 82, at § 6.01.

105. I.R.C. § 336 (1988).

106. *See* I.R.C. § 1374(d) (1988 & Supp. IV 1992). Built-in-gain property is property that has appreciated at the time the S election is made. *Id.*

107. *See* I.R.C. § 1374 (1988 & Supp. IV 1992).

108. I.R.C. § 301 (1988 & Supp. IV 1992); I.R.C. § 336 (1988).

Appreciated property distributed to a shareholder by an S corporation creates gain to the corporation.[109] The spread or gain is taxable income which is once again passed through to the shareholders, assuming that the built-in gain rules do not apply.[110] However, a distribution of appreciated property by an LLC is not taxed (except for non-pro-rata distribution of hot assets) and typically, the members simply take over the partnership's inside basis in the property.[111] For example, assume an LLC owns Greenacre, a valuable tract of farm property[112] with a basis of $100,000 and a fair market value of $500,000. The LLC has no "hot assets." Black decides to retire and agrees to take Greenacre in full satisfaction of his partnership interest. Black's outside basis is $50,000. When Greenacre is deeded to Black, he realizes no gain or loss and takes over Greenacre with a basis of $50,000. Had this been a C corporation, there would have been $400,000 of gain taxed to the corporation and a capital gain to Black of $450,000. Had this been an S corporation, a single gain of $400,000 would pass through to the shareholders to be taxed. However, if Black's basis in his S corporation stock had been $50,000 before the distribution, Black would recognize a $250,000 capital gain.[113]

It cannot be overstated that the flexibility of partnership/LLC rules concerning distributions in partial or complete liquidation can be exceptionally important. Too often, appreciated property is stuck inside the lobster trap created by either an S or a C corporation.[114] Many of the farm corporations that were formed in the 1970s and 1980s spent their savings on federal income taxes to invest in land. Today, many of these corporations would like to convert ownership to individuals, often after a death or retirement, but the tax on the distribution is too high. No such problem presents itself with an LLC, as the liquidation can be free of tax.

For federal tax purposes, a partnership is sometimes treated as an entity and other times is treated as an aggregation of parties.[115] This is a concept which is quite difficult to capture in the mind for more than a fleeting moment due to its dual identity. One example of the "aggregation" theory is the matter of basis adjustments. There are essentially six

109. I.R.C. § 1371(a) (1988 & Supp. IV 1992).

110. I.R.C. § 1374 (1988 & Supp. IV 1992). *See also supra* notes 105-06 and accompanying text.

111. I.R.C. § 732(a) (1988).

112. In North Dakota, LLC farms must comply with the restriction imposed on farm corporations by Chapter 10-06 of the North Dakota Century Code. These restrictions generally require that the shareholders be related and that the corporation is actually farming. N.D. CENT. CODE Ch. 10-06 (1985).

113. Black's basis would be increased by his share of the gain recognized (50% of $400,000 = $200,000) to $250,000; he receives an asset worth $500,000 and hence his gain is the difference of $250,000.

114. *See infra* notes 90-91 and accompanying text. The liquidation cost of an existing corporation would be prohibitive.

115. *See, e.g.*, United States v. Basye, 410 U.S. 441 (1973) (*reh'g denied*, 411 U.S. 940 (1973)).

such basis adjustments, four of which are described below. The first two are found under section 734 of the Internal Revenue Code and the second two are found under section 743 of the Internal Revenue Code. Under section 734, a basis adjustment will occur:

1. When gain is recognized in a partnership's distribution of cash which is in excess of basis.
2. When an asset is distributed to a member that has a basis to the partnership which exceeds the member's outside basis.[116]

The example immediately above illustrates this basis adjustment. Greenacre had an inside basis of $100,000 and was distributed to Black who had an outside basis of $50,000. It is stated above that Black took over Greenacre with a basis of $50,000. The $50,000 of basis which formerly had been a part of basis of the asset when held by the partnership would disappear were it not for this basis adjustment. That basis can then be allocated to other partnership assets, by simply adding that amount to a similar asset's basis as long as it is not beyond their value.[117]

The second two basis adjustments are provided by section 743, one of which is very important to clients served by North Dakota practitioners. Those adjustments are:

1. An adjustment to the partnership's inside basis upon the sale of a partnership interest by one partner to a third party. For example, assume a farm partnership between Black and White which owns Greenacre with a basis of $100,000 and a fair market value of $500,000. White sells his interest to Brown for $250,000. The partnership may "step up" its basis in Greenacre to reflect the purchase price paid by Brown, and that increase in basis is allocated only to Brown. Accordingly, the partnership's basis in Greenacre increases to $300,000, representing Black's one-half share in Greenacre which carries over at $50,000 and the $250,000 paid by Brown. So, if Greenacre is sold for its fair market value, $500,000, Black will recognize a gain of $200,000 and Brown will have no gain or loss.

2. When a partner dies, his or her interest passes to his or her estate. Property owned by a decedent acquires a new basis equal to its fair market value at the time of

116. I.R.C. § 734 (1988).
117. *See* I.R.C. § 734(b) (1988).

> death which, in an inflationary economy, means basis is usually stepped-up.[118] Because there is no income tax associated with that step up in basis, it is often referred to as a "free step up in basis."[119] Of course, there may be estate tax, but the step-up in basis occurs even if no estate tax is due. This is a most important provision. It is not common for a North Dakota partnership interest to be sold, but sooner or later all individuals die.

Using the same example above, assume that Black dies when the partnership owns Greenacre with a basis of $100,000 and a fair market value of $500,000. Also, assume the partnership owns grain with a zero basis and a fair market value of $200,000. Black's interest in the partnership is one-half of $700,000 or $350,000, which is its value in his estate. The partnership will increase its basis in Greenacre to $300,000, its fair market value, and will also increase its basis in the grain from zero to $100,000, representing Black's one-half share of the grain. When the grain is sold for its fair market value of $200,000, the $100,000 allocable to Black's estate will result in no gain or loss. If the market had gone down and the grain had sold for $190,000, the estate would have a loss of $10,000.

All these basis adjustments are optional.[120] The option is exercised by filing the election on the partnership return in the year the event occurs.[121] There are no equivalent basis adjustments available to S or C corporations. When a shareholder in a farm corporation dies, his or her estate will increase the basis of the stock in the farm corporation with no advantage unless the estate plans to sell the stock. There is no means by which that increase in fair market value can be imported inside the corporation, be it a C or an S corporation. In contrast, LLC or partnership basis increases that occur by death or upon the purchase of a share can be allocated to increase the fair market value of depreciable assets, with the result that greater depreciation deductions are available to be taken in the future.[122] Again, this device is not available to either S or C corporations.

The rules that concern the tax cost of liquidation for either a C or an S corporation hold yet another lesson: namely, that there will be few conversions of existing S or C corporations into new LLCs. The LLC form of

118. I.R.C. § 1014 (1988 & Supp. IV 1992) (providing that the basis of property acquired from a decedent shall be the fair market value at the date of the decedent's death).

119. *See id.* The basis of property in the hands of a person acquiring that property from a decedent is usually fair market value except as otherwise provided for in section 1014 of the I.R.C.

120. I.R.C. § 734 (1988). The basis of partnership property shall not be adjusted as a result of a distribution of property to a partner unless an election is in place. *Id.*

121. I.R.C. § 754 (1988). Treas. Reg. § 1.754-1(b).

122. I.R.C. § 1014 (1988 & Supp. IV 1992). This is because of the free step-up in basis provided for a person acquiring property from a decedent.

business will largely be used by existing partnerships, limited partnerships or new ventures. There is no tax cost to convert an existing partnership, be it a general or a limited partnership, into an LLC. The tax cost to convert from a C corporation involves the tax at the corporate level caused by the gain created by the repeal of *General Utilities* and a second tax at the shareholder level upon liquidation of the corporation. The tax cost to an S corporation will normally only be the tax cost to the shareholders on liquidation, assuming there are no built-in gains. However, the tax to either an S or C corporation's shareholders is large enough to discourage most clients from choosing that course of action. There will be situations where the shareholder's basis in their stock and the corporation's basis in its assets are both high enough so that the cost of liquidation is minor or nonexistent, in which case conversion into an LLC would be recommended.

f. Miscellaneous Aspects

C corporations enjoy tax deductible fringe benefits for shareholder employees, such as health insurance and group term life insurance.[123] However, the owners of S corporations and partners owning more that 2% of the enterprise do not fully enjoy these tax deductible fringe benefits.[124]

Shareholders of C corporations who receive dividends do not have self-employment (social security or FICA) income.[125] Shareholders of S corporations who receive dividends typically do not have self-employment income, unless the dividends are a substitute for compensation.[126] More and more frequently, the Internal Revenue Service contends that dividends from an S corporation are, in reality, compensation for personal services, thereby imposing FICA taxes and wage withholding upon the dividends.[127]

The income of partners who are active in a business is subject to self-employment tax, which is currently 15.3%.[128] The income of limited partners is specifically exempt by statute from the self-employment tax.[129] The impact of the self-employment tax is thought by many to be similar for members of an LLC. However, section 1402(a)(13) of the Internal Revenue Code does not specifically exclude LLC distributions from the

123. *See* I.R.C. § 7862 (1988).
124. I.R.C. § 162(l)(5) (1988 & Supp. IV 1992); I.R.C. § 1372 (1988).
125. I.R.C. §§ 1401, 1402(a) (1988 & Supp. IV 1992).
126. I.R.C. § 1402(a) (1988 & Supp. IV 1992) (providing the definition of net earnings from self-employment which includes dividends if they are a substitute for compensation).
127. *See, e.g.*, Joseph Radtke, S.C. v. United States, 895 F.2d 1196 (7th Cir. 1990); Spicer Accounting, Inc. v. United States, 918 F.2d 90 (9th Cir. 1990).
128. *See* I.R.C. § 1401 (1988 & Supp. IV 1992).
129. I.R.C. § 1402(a)(13) (1988 & Supp. IV 1992).

self-employment tax base.[130] Payments made to a retiring partner are excluded from self-employment tax so long as the individual performed no services that year and his or her capital account had been paid out before the end of the year in which the payments were made.[131]

When shareholders in a corporation sell their stock, they will almost invariably receive capital gain treatment.[132] The only exceptions to this rule are the so-called collapsible corporation rules imposed by section 341 of the Internal Revenue Code, which are now simple to avoid.[133] While the sale of a partnership interest in a partnership or LLC is the sale of a capital asset, any gain attributable to a so-called "hot asset" will be taxed to the seller as ordinary income.[134] For example, consider the LLC situation above where Greenacre is worth $500,000. Consider further that the LLC also has zero basis grain of $300,000 and a zero basis receivable of $200,000. Black then sells his 50% interest to Brown for $500,000 where he had a basis of $50,000. Black realizes a gain of $450,000, of which $250,000 would be gain from the sale of "hot assets" and taxed to him as ordinary income. Since the top individual rate is 39.6% on income over $250,000 and the capital gain rate is 28%, not much is lost in this disadvantage to partnership taxation.

C corporations may select a fiscal year of their choice, except for professional corporations.[135] S corporations, on the other hand, are, as a practical matter relegated to the use of the calendar year, although they may choose a fiscal year at the cost of prepayment of their tax liability.[136] Partnerships must adopt the same year as the holders of the majority interest in profits and capital, with a business purpose exception which, as a practical matter, means that most LLCs will also be operating on a calendar year basis.

In North Dakota, LLC treatment has been secured for farmers, a feature which is not a part of the Minnesota bill from which the North Dakota statute was taken. One can readily see that the basis adjustments described in the examples above lend themselves particularly to farmers, especially with the basis adjustments that occur on death.[137]

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130. *Id.*

131. I.R.C. § 1402(a)(10) (1988 & Supp. IV 1992).

132. *See* I.R.C. § 1221 (1988).

133. *See* I.R.C. § 341(f) (1988). An election to treat the gain on the corporation's assets in liquidation costs nothing as the repeal of *General Utilities* requires the same result. *Id.*

134. I.R.C. § 756 (1988).

135. I.R.C. § 441(i) (1988). The taxable year for personal service corporations is usually the calendar year.

136. I.R.C. § 444 (1988) (explaining that "[a] partnership, S corporation, or personal service corporation may elect to have a taxable year other than the required taxable year").

137. North Dakota's act also allows professionals to practice in LLCs.

## II. THE GOVERNANCE OF A LIMITED LIABILITY COMPANY

North Dakota's enabling legislation for LLCs was effective on the first day of August, 1993.[138] The North Dakota act is very similar to the Minnesota Limited Liability Company Act,[139] which in turn took as its foundation the finance and entity structures of both Minnesota's business corporation act and partnership statutes.[140] To ensure that an LLC would lack continuity of life and free transferability of interest (aspects which allow an LLC to qualify for partnership tax status), the fundamental rules governing partnerships are followed. However, in other respects, the Minnesota act, and thus the North Dakota act, parallel provisions of their business corporation acts. It is for this reason that those familiar with the organization and governance of corporations will be familiar with most of the provisions governing LLCs. However, there are many differences between LLCs and corporations which simply involve nomenclature. It is thus necessary to first define some terms used by the North Dakota Limited Liability Act:

> "*Member*" - Owners of the limited liability company, analogous to stockholders of a corporation.[141]
>
> "*Membership Interest*" - A member's interest in an LLC consisting of both financial and governance rights.[142]
>
> "*Board of Governors*" - The governing body of an LLC, analogous to a Board of Directors for a corporation.[143]
>
> "*Manager*" - A person elected by the Board of Governors to manage the LLC, analogous to officers for a corporation.[144]
>
> "*Operating Agreement*" - The rules which relate to the management and affairs of the LLC, analogous to the bylaws of a corporation.[145]
>
> "*Articles of Organization*" - Those documents required to be filed with the Secretary of State, analogous to the articles of incorporation of a corporation.[146]

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138. N.D. CONST. art. IV, § 13. *See supra* note 28.

139. MINN. STAT. ANN. § B.01-322 B.960 (West Supp. 1994).

140. Carter G. Bishop & Daniel S. Kleinberger, *Beyond Subchapter S: The New Limited Liability Company*, BENCH & BAR OF MINN., July 1992, at 20.

141. N.D. CENT. CODE § 10-32-02(28) (Supp. 1993).

142. N.D. CENT. CODE § 10-32-02(29) (Supp. 1993).

143. N.D. CENT. CODE § 10-32-02(5) (Supp. 1993).

144. N.D. CENT. CODE § 10-32-02(27) (Supp. 1993).

145. N.D. CENT. CODE § 10-32-02(31) (Supp. 1993).

146. N.D. CENT. CODE § 10-32-02(4) (Supp. 1993).

## A. THE ARTICLES OF ORGANIZATION

The two main instruments which govern an LLC are the Articles of Organization and the Operating Agreement. The Articles of Organization must be filed with the Secretary of State to obtain the benefit of limited liability.[147] If the Secretary of State finds that the Articles conform to state law, and the fees have been paid, a Certificate of Organization will be issued.[148] The issuance of this Certificate begins the LLC's official existence.[149] The Act specifies that certain provisions must be contained within the Articles of Organization.[150] These provisions include:

1. The name of the company (which must include the words Limited Liability Company or the abbreviation LLC);[151]
2. The address of the main executive office;
3. The address of the registered office and the name of its registered agent;
4. The name and address of all organizers;
5. The period of existence for the limited liability company;
6. A statement as to what events terminate the continued membership of a member of the company; and
7. A statement as to whether the members have the power to enter into a business continuation agreement.[152]

If the first board of governors is not named in the Articles of Organization, the organizers may elect the first board of governors,[153] which can consist of one or more governors.[154] If they choose not to elect a board of governors, the members may act with all of the powers, rights, duties, and liabilities of governors until the governors are elected or a contribution is accepted.[155] During that time, the LLC is without a Board of Governors and hence lacks centralized management. The governors' term, unless

147. N.D. CENT. CODE § 10-32-08 (Supp. 1993). In addition, certain fees must be paid pursuant to N.D. CENT. CODE § 10-32-150 (Supp. 1993). These fees currently amount to $135 ($10 for filing of the registered agent and $125 for filing of the Articles of Organization). *Id.*

148. N.D. CENT. CODE § 10-32-08 (Supp. 1993).

149. N.D. CENT. CODE § 10-32-09 (Supp. 1993). A Certificate of Organization is a conclusive presumption that all conditions precedent and required to be performed pursuant to Chapter 10-32 have been performed. *Id.*

150. N.D. CENT. CODE § 10-32-07 (Supp. 1993).

151. N.D. CENT. CODE § 10-32-10(1)(b) (Supp. 1993). Professional Limited Liability Company, or PLC may be used for professional companies.

152. N.D. CENT. CODE § 10-32-07(1) (Supp. 1993).

153. N.D. CENT. CODE § 10-32-67(1) (Supp. 1993).

154. N.D. CENT. CODE § 10-32-70 (Supp. 1993).

155. N.D. CENT. CODE § 10-32-67(1) (Supp. 1993).

otherwise provided in the Articles or Operating Agreement, lasts until the next regular meeting of the members, but must not exceed five years.[156]

The Act provides that certain provisions govern an LLC unless modified by the Articles of Organization. Thus, in addition to the above required provision, the Articles may also contain sections which modify default rules of the LLC Act.[157] These optional provisions apply to such things as cumulative voting for governors, voting power in proportion to the contribution of the members, profits and losses in proportion to the value of contribution, and members protection from expulsion.[158] The North Dakota Century Code provides that these default provisions govern unless they are modified in the Articles of Organization.[159] Thus, if any of the default provisions are not in accordance with the objectives of the founders of an LLC, they may avoid the default provisions by specifying different rules within the Articles of Organization to govern the LLC.

In addition, the Century Code provides for rules which govern unless modified *either* in the Articles of Organization *or* in the Operating Agreement, allowing certain bylaws to be placed within the Operating Agreement, with the advantage of privacy since the rules will not be a matter of public record, as with the Articles of Organization.[160] These provisions deal with things such as quorum requirements, the prohibition of interim distributions, notice requirements for member meetings, and the compensation of the governors.[161] This section allows the drafter to choose where to include provisions which avoid the statutory default provisions.

Finally, the Century Code allows for some matters to be included either in the Articles of Organization or in the Operating Agreement.[162] The more important of these include provisions for a larger than majority vote for certain actions of the members or governors, voting rights granted to nonmembers, classification of governors, and qualifications for governors.[163] These provisions need not be included in either the Operating Agreement or the Articles of Organization because the law does not create default rules, but only authorizes certain regulation by the members of the affairs of the company. Accordingly, these sections would only apply if they are provided for in the Articles or Operating Agreement.

156. N.D. CENT. CODE § 10-32-72 (Supp. 1993).
157. N.D. CENT. CODE § 10-32-07(2) (Supp. 1993).
158. *Id.*
159. *Id.*
160. N.D. CENT. CODE § 10-32-07(3) (Supp. 1993).
161. *Id.*
162. N.D. CENT. CODE § 10-32-07(4) (Supp. 1993).
163. *Id.*

B. THE OPERATING AGREEMENT

The North Dakota Century Code defines the Operating Agreement as:

> Rules, resolutions, or other provisions that:
> A. Relate to the management of the business or the regulation of the affairs of the limited liability company; and
> B. Have been made expressly part of the Operating Agreement by the action, taken from time to time under Section 10-32-69, by the board of governors or the members.[164]

The Operating Agreement is analogous to a business corporation's bylaws in that it controls the inner workings of the company. The Century Code sets forth rules which can either be in the Articles of Organization or in the Operating Agreement.[165] The Code also allows certain optional provisions which, with certain exceptions, may be included in the operating agreement.[166] The exceptions include the naming of persons to serve as the first board of governors, the fixing of a greater than majority governor or member vote, establishing the rights and priorities for distributions and the rights to share in profits and losses, giving or prescribing the manner of granting voting rights to persons other than members otherwise than pursuant to the articles of organization, and eliminating or limiting a governor's personal liability.[167] For provisions dealing with these areas to be effective, they must be included in the Articles of Organization.

The Century Code provides that an LLC "may, but need not, have an Operating Agreement."[168] The Operating Agreement may contain any provision relating to the management of the business or the regulation of the affairs of the limited liability company not inconsistent with law or the Articles of Organization.[169] An act of the board and of the members will be considered part of the operating agreement only if the act expressly states that it is intended to constitute or revise the operating agreement.[170]

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164. N.D. CENT. CODE § 10-32-02(a)(31) (Supp. 1993).
165. N.D. CENT. CODE § 10-32-07(3) (Supp. 1993).
166. N.D. CENT. CODE § 10-32-07(4) (Supp. 1993).
167. *Id.*
168. N.D. CENT. CODE § 10-32-68(1) (Supp. 1993).
169. *Id.*
170. N.D. CENT. CODE § 10-32-68(2-3) (Supp. 1993) (dealing with adoption of the operating agreement).

### C. THE MEMBER CONTROL AGREEMENT

The North Dakota Century Code provides for member-control agreements.[171] A member-control agreement is similar to a shareholder agreement in a business corporation. It is meant to control the rights of the members in order to maintain the entity's viability when the members' concerns take different paths. The section relating to these agreements states that a written agreement among members who have signed contribution agreements, relating to any affairs of an LLC including liquidation, dissolution, and termination, or for the relations among members is valid if it:

> [r]elates to the control of or the liquidation, dissolution, and termination of the limited liability company, the relations among them, or any phase of the business and affairs of the limited liability company, including, without limitation, the management of its business, the declaration and payment of distributions, the sharing of profits and losses, the election of governors or managers, the employment of members by the limited liability company, or the arbitration of disputes, is valid, if the agreement is signed by all persons who are then the members of the limited liability company, whether or not the members all have voting power, and all those who have signed contribution agreements, regardless of whether those signatories will, when members, have voting power. An agreement authorized under this section may allocate to the members authority ordinarily exercised by the board of governors, allocate to the board of governors authority ordinarily exercised by the members, or structure the governance of the limited liability company in any agreed fashion.[172]

The Act further provides that valid member-control agreements are specifically enforceable.[173] However, a member-control agreement may not include an agreement to give transfer consent because of the fear that if a member-control agreement were to allow prior transfer consent, the Internal Revenue Service would find that "free transferability of interest" exists under the *Morrissey* criteria discussed previously.[174] This could have the disastrous effect of the LLC having more than two characteristics of a corporation, and taxed accordingly as a corporation.

171. N.D. CENT. CODE § 10-32-50 (Supp. 1993).

172. N.D. CENT. CODE § 10-32-50(2) (Supp. 1993).

173. *Id.*

174. *See supra* note 39 and accompanying text.

The Century Code provides that the member-control agreement may include a business continuation agreement if the Articles of Organization stated that the members have the power to do so.[175] A statement must be contained in the Articles of Organization whether or not the members have this power.[176] A business continuation agreement has two close cousins whose use should be avoided. The first of these is the agreement to give transfer consent, discussed above. Transfer consent is automatically voided by the LLC act, which specifically disallows the use of it.[177] The second type of agreement is "dissolution avoidance consent."[178] In Minnesota, the drafters of the statute encountered difficulty in attempting to obtain a revenue ruling based upon their LLC statute because their statute sanctioned the use of an advance dissolution avoidance consent. In North Dakota, dissolution avoidance consent is defined as the "consent of all remaining members: a) Given, . . . *after* the occurrence of any event that terminates the continued membership of a member in the limited liability company; and b) that the limited liability company must be continued as a legal entity without dissolution."[179] The effect of this definition is to create the technical dissolution caused when a member dies, goes bankrupt, is expelled, retires, or other events causing dissolution, but to still continue the business as before.[180] It is this dissolution of the entity which is part of the lack of "continuity of life" needed to avoid corporate taxation under *Morrissey*.[181] In contrast, a business continuation agreement is an agreement that, despite the fact that the legal entity has technically dissolved, the business will be continued in a successor organization through a merger, transfer of assets, transfer of member interest, or other manner.[182] The Act provides that a business continuation agreement is specifically enforceable, provided that the Articles of Organization grant the members the power to enter into business contination agreements.[183] Thus, in the case of business continuation agreements, the entity lacks continuity of life because technically there is a legal dissolution. The Internal Revenue Service has ruled that these agreements do not result in "continuity of life."[184]

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175. N.D. CENT. CODE § 10-32-50(1)(d) (Supp. 1993).
176. N.D. CENT. CODE § 10-32-07 (Supp. 1993).
177. N.D. CENT. CODE § 10-32-50(1)(c) (Supp. 1993).
178. N.D. CENT. CODE § 10-32-02(14) (Supp. 1993).
179. *Id.* (emphasis added). The avoidance consent is given after a dissolution has occurred.
180. N.D. CENT. CODE § 10-32-109 (Supp. 1993).
181. *See supra* note 39 and accompanying text.
182. N.D. CENT. CODE § 10-32-02(7) (Supp. 1993). This allows the members to agree predissolution to continue the business even though there has been a technical dissolution of the business. The difference between an advance dissolution avoidance contract and a business continuation agreement is that the latter provides for a technical dissolution. This helps avoid the problem of having the corporate characteristic of continuity of life.
183. N.D. CENT. CODE § 10-32-50(1)(d), (4) (Supp. 1993).
184. Rev. Rul. 93-5, 1993-3 I.R.B. 8; Rev. Rul. 93-6 1993-3 I.R.B. 10.

### D. MISCELLANEOUS PROVISIONS OF THE LLC ACT

To ensure that the characteristic of "free transferability of interest" under *Morrissey*[185] is lacking in an LLC, the Act splits a members' membership interest into "financial rights" and "governance rights."[186] Financial rights are the rights to share in profits, losses, and distributions.[187] Governance rights are all of a members' rights as a member other than financial rights and the right to assign those financial rights.[188] This would include such things as voting for governors, attending meetings, and similar rights.[189] The reason this split is made is to allow a member to be divested of any financial stake in the company but still avoid free transferability of interest. Free transferability is avoided in governance rights by the requirement that, in order to transfer such rights, it is necessary to have the unanimous consent of all the other members.[190] However, this consent cannot be included in a member-control agreement in order to get predissolution consent.[191] In contrast, the financial rights can be freely transferable in whole or in part. Financial rights are those rights to a share of profits, losses, and distributions, but they do not entitle or empower the assignee to become a member, exercise any governance rights, receive notices from the LLC, or cause dissolution.[192] Furthermore, a restriction on the assignment of financial rights may be imposed in the Articles of Organization or the Operating Agreement.[193] Thus, the members may decide to restrict the transferability of the entire membership interest if they so choose.

The Act also provides that North Dakota case law which may pierce the corporate veil applies to LLCs as well.[194] It is not certain how the courts will interpret this provision, given that an LLC has a less organized structure and formalities than a corporation. Presumably, the law will parallel the existing corporate rules.

## III. CONCLUSION

The immense and immediate popularity of the North Dakota LLC Act and similar acts throughout the United States is proof that LLC law is

185. *See supra* note 39 and accompanying text.
186. N.D. CENT. CODE § 10-32-02(17), (20) (Supp. 1993).
187. N.D. CENT. CODE § 10-32-02(17) (Supp. 1993).
188. N.D. CENT. CODE § 10-32-02(20) (Supp. 1993).
189. N.D. CENT. CODE § 10-32-02(17), (20) (Supp. 1993).
190. N.D. CENT. CODE § 10-32-32(2) (Supp. 1993). It is thought that the majority vote of remaining members would be a significant enough restraint upon an alienation to cause a lack of free transferability, but as of yet, the IRS has not conceded to this point in the arena of LLCs. Consent is not needed if the transferee is already a member.
191. N.D. CENT. CODE § 10-32-50(1)(c) (Supp. 1993).
192. N.D. CENT. CODE § 10-32-31(2) (Supp. 1993).
193. N.D. CENT. CODE § 10-32-31(3) (Supp. 1993).
194. N.D. CENT. CODE § 10-32-29(3) (Supp. 1993).

a constantly evolving force. As with all things new, it presents a degree of uncertainty but practitioners should welcome the flexibility interest in the area of partnership tax law. This flexibility should allow much in the way of tax savings. It is this tax savings and flexibility that should be of significant benefit to North Dakota practitioners and their clients.