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Revenue Ruling 88-76

Partnership classification.

An unincorporated organization operating under the Wyoming Limited Liability Company Act is classified as a partnership for federal tax purposes under section 301.7701-2 of the regulations.

ISSUE

Whether a Wyoming limited liability company, none of whose members or designated managers are personally liable for any debts of the company, is classified for federal tax purposes as an association or as a partnership.

FACTS

M was organized as a limited liability company pursuant to the provisions of the Wyoming Limited Liability Company Act (Act). The purpose of M is to acquire, own, and operate improved real property. M has 25 members, including A, B, and C.

The Act provides that a limited liability company may be managed by a designated manager or managers, or by its members. If the limited liability company is managed by its members, management authority is vested in its members in proportion to their capital contributions to the company. M is managed by its designated managers, A, B, and C.

Under the Act, neither the members nor the designated managers of a limited liability company are liable for any debts, obligations, or liabilities of the limited liability company.

The Act also provides that the interest of a member in a limited liability company is part of the personal estate of the member; however, each member can assign or transfer the member's respective interest in the limited liability company only upon the unanimous written consent of all the remaining members. In the event that the remaining members fail to approve the assignment or transfer, the assignee or transferee has no right to participate in the management or become a member of the limited liability company. However, the assignee or transferee is entitled to receive the share of profits or other compensation and the return of contributions to which the transferring member would otherwise be entitled.

A limited liability company formed under the Act is dissolved upon the occurrence of any of the following events: (1) when the period fixed for the duration of the company expires; (2) by the unanimous written consent of all the members; or (3) by the death, retirement, resignation, expulsion, bankruptcy, dissolution of a member or occurrence of any other event that terminates the continued membership of a member, unless the business of the company is continued by the consent of all the remaining members under a right to do so stated in the articles of organization of the company. Under M's articles of organization, the business of M is continued by the consent of all the remaining members.

LAW AND ANALYSIS

Section 7701(a)(2) of the Internal Revenue Code provides that the term "partnership" includes a syndicate, group, pool, venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not a trust or estate or a corporation.

Section 7701(a)(3) of the Code provides that the term "corporation" includes associations, joint-stock companies, and insurance companies.

Section 301.7701-1(b) of the Procedure and Administration Regulations states that the Code prescribes certain categories, or classes, into which various organizations fall for purposes of taxation. These categories, or classes, include associations (which are taxable as corporations), partnerships, and trusts. The tests, or standards, that are to be applied in determining the classification of an organization are set forth in sections 301.7701-2 through 301.7701-4.

Section 301.7701-2(a)(1) of the regulations sets forth the following basic characteristics of a corporation: (1) associates, (2) an objective to carry on business and divide the gains therefrom, (3) continuity of life, (4) centralization of management, (5) liability for corporate debts limited to corporate property, and (6) free transferability of interests. Whether a particular organization is to be classified as an association must be determined by taking into account the presence or absence of each of these corporate characteristics. In addition to the six major characteristics, other factors may be found in some cases which may be significant in classifying an organization as an association, a partnership, or a trust.

Section 301.7701-2(a)(2) of the regulations further provides that characteristics common to partnerships and corporations are not material in attempting to distinguish between an association and a partnership. Since associates and an objective to carry on business and divide the gains therefrom are generally common to corporations and partnerships, the determination of whether an organization which has such characteristics is to be treated for tax purposes as a partnership or as an association depends on whether there exists centralization of management, continuity of life, free transferability of interests, and limited liability.

Section 301.7701-2(a)(3) of the regulations provides that if an unincorporated organization possesses more corporate characteristics than noncorporate characteristics, it constitutes an association taxable as a corporation.

In interpreting section 301.7701-2 of the regulations, the Tax Court, in *Larson v. Commissioner*, 66 T.C. 159 (1976), acq., 1979-1 C.B. 1, concluded that equal weight must be given to each of the four corporate characteristics of continuity of life, centralization of management, limited liability, and free transferability of interests.

In the present situation, M has associates and an objective to carry on business and divide the gains therefrom. Therefore, M must be classified as either an association or a partnership. M is classified as a partnership for federal tax purposes unless the organization has a preponderance of the remaining corporate characteristics of continuity of life, centralization of management, limited liability, and free transferability of interests.

Section 301.7701-2(b)(1) of the regulations provides that if the death, insanity, bankruptcy, retirement, resignation, or expulsion of any member will cause a dissolution of the organization,

continuity of life does not exist. Section 301.7701-2(b)(2) provides that an agreement by which an organization is established may provide that the business will be continued by the remaining members in the event of the death or withdrawal of any member, but such agreement does not establish continuity of life if under local law the death or withdrawal of any member causes a dissolution of the organization.

Under the Act, unless the business of M is continued by the consent of all the remaining members, M is dissolved upon the death, retirement, resignation, expulsion, bankruptcy, dissolution of a member or occurrence of any other event that terminates the continued membership of a member in the company. If a member of M ceases to be a member of M for any reason, the continuity of M's not assured, because all remaining members must agree to continue the business. Consequently, M lacks the corporate characteristic of continuity of life.

Under section 301.7701-2(c)(1) of the regulations an organization has the corporate characteristic of centralized management if any person (or group of persons that does not include all the members) has continuing exclusive authority to make management decisions necessary to the conduct of the business for which the organization was formed.

Under the Act, a limited liability company has the discretion to be managed either by a designated manager or managers, or to be managed by its members. Because M is managed by its designated managers, A, B, and C, M possesses the corporate characteristic of centralized management.

Section 301.7701-2(d)(1) of the regulations provides that an organization has the corporate characteristic of limited liability if under local law there is no member who is personally liable for the debts of, or claims against, the organization. Personal liability means that a creditor of an organization may seek personal satisfaction from a member of the organization to the extent that the assets of such organization are insufficient to satisfy the creditor's claim.

Under the Act, neither the managers nor the members of M are personally liable for its debts and obligations. Consequently, M possesses the corporate characteristic of limited liability.

Under section 301.7701-2(e)(1) of the regulations, an organization has the corporate characteristic of free transferability of interests if each of the members or those members owning substantially all of the interests in the organization have the power, without the consent of other members, to substitute for themselves in the same organization a person who is not a member of the organization. In order for this power of substitution to exist in the corporate sense, the member must be able, without the consent of other members, to confer upon the member's substitute all the attributes of the member's interest in the organization. The characteristic of free transferability does not exist if each member can, without the consent of the other members, assign only the right to share in the profits but cannot assign the right to participate in the management of the organization.

Under the terms of the Act, a member of M can assign or transfer that member's interest to another who is not a member of the organization. However, the assignee or transferee does not become a substitute member and does not acquire all the attributes of the member's interest in M unless all the remaining members approve the assignment or transfer. Therefore, M lacks the corporate characteristic of free transferability of interests.

M has associates and an objective to carry on business and divide the gains therefrom. In addition, M possesses the corporate characteristic of centralized management and limited liability. M does not, however, possess the corporate characteristics of continuity of life and free transferability of interests.

HOLDING

M has associates and an objective to carry on business and divide the gains therefrom but lacks a preponderance of the four remaining corporate characteristics. Accordingly, M is classified as a partnership for federal tax purposes.