Converting to a Limited Liability Company: Considerations for Alaska Business Organizations

This Note examines the Alaska Limited Liability Company Act in terms of the advantages and disadvantages of converting to a Limited Liability Company ("LLC") from a partnership or corporation. The Note begins with an examination of the historical development of the LLC. The Note then explains how to ensure that an LLC will be classified as a partnership for federal tax purposes. The next part of the Note explains how to convert an LLC to a partnership, concluding that while conversion may not be difficult, it would be facilitated by a statutory conversion provision and may also not be advantageous enough to justify conversion. The Note then focuses on conversion of corporations to LLCs, concluding that conversion of corporations would be disadvantageous in most cases because of the serious negative tax consequences. Finally, the Note summarizes a few of the problems that may result from using a new organization form that is neither a partnership nor a corporation.

I. INTRODUCTION

Combining the limited liability of corporations and the federal tax advantages of partnerships, Limited Liability Companies ("LLCs") have attracted the attention of a variety of business organizations. LLCs are unincorporated business associations formed by filing articles of organization with the state. Owners of an interest in an LLC are called members, and all members may participate in the control and management of the LLC. LLCs seem best suited for closely held businesses and joint

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2. Id. § 2.10, at 2-2.

ventures, where each member desires some degree of control but does not want his personal assets open to liability.\textsuperscript{4}

Now that Alaska has adopted a Limited Liability Company Act,\textsuperscript{5} many partnerships, limited partnerships and corporations may wish to convert to LLCs. However, because the Internal Revenue Service ("IRS") generally does not find conversion of a partnership to be a termination of the partnership but does find conversion of a corporation to be a liquidation of assets subject to taxation, partnerships will find conversion to be easier and more economical than corporations.\textsuperscript{6} Before any business converts, though, the partners or shareholders should carefully weigh the pros and cons of LLCs. LLCs remain a fairly new form of business organization, and many questions remain as to whether they will be treated more like corporations or partnerships in a variety of contexts.

II. HISTORY

While Alaska was one of the last states to adopt an LLC statute,\textsuperscript{7} it was one of the first to recognize the potential benefits of this type of business organization.\textsuperscript{8} In the 1970s, an LLC statute was proposed in Alaska.\textsuperscript{9} This statute was driven by the desire of an oil company based in Texas to make operations in Alaska easier by using a business organization that was flexible and less expensive than the corporate form.\textsuperscript{10} Alaska hoped to raise revenue for the state through filing fees and taxes.\textsuperscript{11} While the proposed legislation failed because of concerns over the federal tax treatment

\begin{itemize}
  \item [4.] \textit{Id.} § 2.02, at 2-3 to 2-4.
  \item [5.] \textsc{Alaska Stat.} § 10.50 (Michie Supp. 1995).
  \item [6.] \textit{Compare} Rev. Rul. 95-37, 1995-1 C.B. 130 (stating that neither the partnership nor any of the partners will incur tax liability if the business remains substantially the same and the partners' interests do not change) \textit{with} I.R.C. §§ 331, 336 (1996) (requiring the corporation and the shareholders to pay tax on the appreciation of the assets of a corporation upon its dissolution).
  \item [7.] Wayne M. Gazur, \textit{The Limited Liability Company Experiment: Unlimited Flexibility, Uncertain Role}, \textsc{58 Law \\& Contemp. Probs.} 135, 141-42 (Spring 1995). More than 40 states adopted their LLC acts between 1990 and 1994. \textit{Id.} As of October 1995, only two states, Hawaii and Vermont, did not have LLC legislation. 1 \textsc{Ribstein \\& Keatinge, supra} note 3, § 1.06, at 18-4 (Supp. 1995).
  \item [9.] \textit{Id.} The first LLC act was proposed on April 8, 1975, as House Bill 403 in the Alaska House and Senate Bill 354 in the Alaska Senate. \textit{Id.} at 544 n.46.
  \item [10.] \textit{Id.} at 544.
  \item [11.] \textit{Id.}
\end{itemize}
of the LLC, the move toward the enactment of LLC legislation had begun.

The rush to enact LLC legislation did not truly begin until 1988 when the IRS announced in Revenue Ruling 88-76 that a Wyoming LLC would be treated as a partnership for tax purposes. In Revenue Ruling 88-76, the IRS established that LLCs would receive federal tax treatment as a partnership as long as the LLC did not possess more corporate characteristics than non-corporate characteristics. Prior to that ruling, the IRS had been unwilling to permit a business organization that allowed for limited liability for all members to be treated as a partnership for federal tax purposes.

Revenue Procedure 95-10, specifically addressing LLC classification, is now available to guide the taxpayer in avoiding classification as a corporation. This revenue procedure not only sets out the conditions under which the IRS will provide a private letter ruling on whether a business organization constitutes an LLC, but also sets out ruling guidelines indicating how flexible the IRS will be when classifying LLCs.

The Alaska Limited Liability Act became effective on July 1, 1995. This Act was drafted by members of the Tax and Business

12. Id. The Alaska statute was voted down due to tax concerns even before the IRS could issue an information letter in response to the request made by Frank M. Burke, Jr., concerning the Alaska Limited Liability Act. Id. at 544 & n.46.

13. 1 RIBSTEIN & KEATINGE, supra note 3, § 1.06, at 1-8 to 1-10 (noting that states began enacting LLC legislation after the IRS shifted its policy by issuing Revised Rule 88-76 in 1988, which addressed the Wyoming statute, and General Counsel Memorandum 39798 which announced in 1989 that the absence of personal liability would not preclude classification as a partnership). In 1977, Wyoming became the first state to enact LLC legislation, followed by Florida in 1982. All other states waited for the IRS announcement. Gazur, supra note 7, at 139-41.

14. Rev. Rul. 88-76, 1988-2 C.B. 360. Corporate characteristics include the following: (1) associates, (2) purpose to conduct business and divide gains, (3) continuity of life, (4) centralized management, (5) free transferability of interests and (6) limited liability. Treas. Reg. § 301.7701-2 (1993). Because partnerships and corporations have the first two characteristics in common, those characteristics have been disregarded in distinguishing between corporations and partnerships. David C. Culpepper, Tax Aspects of Limited Liability Companies, 73 OR. L. REV. 5, 6 (1994).

15. 1 RIBSTEIN & KEATINGE, supra note 3, § 1.06, at 1-8 to 1-9.


17. Id.

Law Sections of the Alaska Bar Association and was largely based on the prototype LLC act and the Alaska corporate code.

Because Alaska has what is considered a "flexible" statute, a business organization wishing to convert to an LLC must carefully formulate its articles of organization if they wish to receive federal tax treatment as a partnership. The Alaska statute provides default rules that should ensure treatment as a partnership for federal tax purposes, but a converting business organization may want to contract around certain of the default provisions of the Alaska statute that seem to be penalty default rules. For example, Alaska Statute section 10.50.290 provides for per capita distribution of profits and losses. In instances where members have widely different interests in an LLC, this rule may be unpalatable for minority owners who would not want per capita distribution of losses and majority owners who would not want per capita distribution of gains. This type of penalty default rule seems to encourage the use of operating agreements to set out terms governing LLCs in Alaska. While this provides a good deal of flexibility, it takes out much of the certainty of the organizational form and makes uniform treatment of LLCs difficult.

III. ENSURING PARTNERSHIP STATUS

When converting to an LLC, one of the primary concerns will be ensuring that the new entity is classified as a partnership for federal income tax purposes. When ruling on whether an entity

19. See Robert L. Manley, Limited Liability Companies, C966 ALI-ABA 53, 69 (July 22, 1994) (attributing the Alaska statute to the prototype as it is set out in 2 Ribstein & Keatinge, supra note 3, at app. B (1994)).
21. Flexible statutes may be distinguished from "bullet-proof" statutes. Bullet-proof statutes require that an LLC be structured in such a way that federal tax treatment as a partnership is assured by forcing compliance with the most recent regulations. While flexible statutes may require more care in drafting, most companies will prefer the ability to include the corporate characteristics that they desire. See Gazur, supra note 7, at 142-43.
22. Manley, supra note 19, at 69-70.
23. Alaska Stat. § 10.50.290 (Michie Supp. 1995). But see 1 Ribstein & Keatinge, supra note 3, app. 5-1, chart 2 (showing that 26 states allocate gains and losses by pro rata contribution).
24. Most states, including Alaska, follow the federal tax characterization of an entity for state tax purposes or treat LLCs as partnerships. See 1 Ribstein & Keatinge, supra note 3, § 17.20, at 17-70 to 17-71. In states such as Alaska, where corporations are subject to state income tax and partnerships are not, this issue raises the concern that LLCs will take revenue away from the state since they may have formerly been run as corporations. Florida departs from the
qualifies as a partnership or an association, the IRS looks at four corporate characteristics: continuity of life; free transferability of interests; centralization of management; and limited liability.\textsuperscript{25} If the entity has more than two corporate characteristics, it will be classified as an association.\textsuperscript{26} Because most entities that wish to convert to an LLC want limited liability, they are basically left to choose one of the three remaining characteristics.

Under Revenue Procedure 95-10, the IRS has demonstrated that it will be fairly liberal in interpreting these characteristics in the context of LLCs,\textsuperscript{27} and so an LLC may qualify for the tax benefits of a partnership even if it would be considered a corporation under a narrow interpretation of the rules. Revenue Procedure 95-10 describes both the requirements for requesting a ruling on whether the LLC qualifies as a partnership for federal tax benefits and some predictions as to when the IRS will find that an LLC lacks any of the four corporate characteristics.\textsuperscript{28}

The Treasury Department and the IRS recently released proposed regulations that would eliminate the four factor classification test.\textsuperscript{29} These regulations are referred to as “check-the-box” provisions because they allow certain unincorporated business organizations to choose whether they would like to be treated as partnerships or as associations for federal tax purposes.\textsuperscript{30} The
reason given for providing business organizations an option is that the traditional distinctions between partnerships and corporations are blurring as states pass statutes allowing unincorporated organizations to possess "corporate" characteristics. If these proposed regulations are adopted, a business could be defined as an association or partnership for federal tax purposes even if it had all four corporate characteristics, as long as it was not publicly traded. The proposed regulations would also reduce the burdens on both business organizations and the IRS by simplifying the application of the tax code.

For now, all four corporate characteristics need to be considered when formulating the articles of organization and the operating agreement of an LLC. A flexible statute, like the Alaska statute, provides the company with the opportunity to formulate the business organization to best fit its needs. The flexibility does leave open the possibility, however, that the organization will not receive federal or state tax treatment as a partnership if it becomes too similar to a traditional corporation.

A. Continuity of Life

According to section 5.01(1) of Revenue Procedure 95-10, the IRS will generally find that an LLC lacks continuity of life if the LLC is run by member-managers and if the operating agreement provides for the dissolution of the LLC in the event of the death, incompetency, bankruptcy, retirement, resignation or expulsion of any one of the member-managers without further action by the members. The operating agreement may contain the provision that a vote by a majority in interest in the LLC can prevent this automatic dissolution without jeopardizing the characterization that the LLC lacks continuity of life. A continuation by a vote of the majority in interest requires that, of the remaining members, holders of a majority of the profit interest and a majority of the capital interest vote to continue the business. If the members control the LLC without selecting managers, the conditions for

34. Id. § 5.01.
dissolution of the company must apply to each and every mem-
ber.  

Although Revenue Procedure 95-10 specifies many terms that can be included to show an LLC lacks continuity of life, it also states that an LLC will lack continuity of life if there is a meaning-
ful chance of dissolution.  

The IRS has indicated that a “meaningful possibility of dissolution” will include any event that is a legally possible occurrence no matter how improbable.  

Therefore, an Alaska LLC need not list all possible dissolution events in its Articles of Organization, but must clearly establish that there is a “meaningful chance of dissolution” for the organization to be found to lack continuity of life.

A company relying on the default rule of the Alaska statute can be almost certain that the LLC lacks continuity of life. The statute provides that an LLC is dissolved if a person’s membership in the LLC terminates, and demands termination of membership in the case of death, incompetency, bankruptcy, retirement, resignation and expulsion. Most of these events will create a “meaningful chance of dissolution,” and the majority of LLCs will probably want to contract around this default provision to limit the number of occurrences that could potentially cause dissolution or trigger a vote of members. As many businesses do not want to risk dissolution upon the termination of one owner’s interest, a number

37. Id. § 5.01(4).
39. The default rule of Alaska Statute § 10.50.400 provides:

A limited liability company is dissolved and its affairs shall be wound up if . . .

(2) all of the members of the company consent in writing unless an election under AS 10.50.085(a) is in effect;

(3) a person’s membership in the company terminates, unless

(A) the affairs of the company are continued by the consent of all the remaining members on or before the 90th day following the termination of the membership; . . .

(C) an election under AS 10.50.085(a) is in effect and

(i) the election provides that the termination does not cause the company to dissolve; or

(ii) the person whose membership terminates is not a manager of the company . . . .

ALASKA STAT. § 10.50.400 (Michie Supp. 1995).
40. Id.
41. ALASKA STAT. §§ 10.50.210 (Michie Supp. 1995) (termination of membership in the case of death or incompetency), 10.50.225 (termination of membership in the case of bankruptcy), 10.50.185 (voluntary termination of membership), 10.50.205 (removal of members). These are all default provisions that may be contracted around in the LLC's operating agreement.
of companies will want to have continuity of life and limited liability as their two corporate characteristics.

B. Free Transferability of Interests

The IRS will generally rule that an LLC lacks free transferability of interests if the operating agreement or statute requires that a member, or those members owning more than a twenty percent interest in the LLC's capital, income, gain, loss, deduction and credit, has the approval of the majority of non-transferring members in order to transfer the member's interests in its entirety. In the case of LLCs managed by members, this qualification needs to apply only to members who are managers for the IRS to rule that the LLC lacks free transferability of interest. The IRS's stand on this issue appears quite generous because members with less than a twenty percent interest or members who are not managers of member-managed LLCs seem to be able to transfer their interest freely without triggering a vote of the non-transferring members.

In Alaska, a member may not assign his or her interest without the consent of all of the other members unless otherwise provided in the operating agreement. While this may seem extreme compared with the flexibility of the IRS requirement, an Alaska LLC relying on the default rule could be sure that the IRS would rule that the company lacked free transferability of interest. This default provision seems quite stringent in light of the IRS ruling and could be amended to reflect the flexibility of the IRS.

C. Centralization of Management

LLCs are generally either managed by all of the members or by member-managers. If the LLC is managed by the members, all members have the authority to bind the LLC, much like a general partnership. When the LLC is managed by member-

42. Rev. Proc. 95-10 § 5.02(2), 1995-1 C.B. 501. It is important to bear in mind that a member has free transferability of interests only if the member can assign all of his rights, including the right to manage the company. If members are allowed to transfer only their economic rights, this does not qualify as free transferability of interests. Rands, supra note 32, at 22 n.111.
44. ALASKA STAT. § 10.50.165(a) (Michie Supp. 1995).
45. See Gazur, supra note 7, at 157.
46. 1 RIBSTEIN & KEATINGE, supra note 3, § 8.05, at 8-14; see ALASKA STAT. § 10.50.250(a) (Michie Supp. 1995) (stating that unless the LLC is managed by managers, all members are agents of the LLC and may bind the LLC by acts that conform with the usual and customary way of conducting business).
managers, only those members selected to act as managers have the ability to bind the LLC.\textsuperscript{47} An LLC managed by all of the members will almost always be classified as lacking centralized management.\textsuperscript{48} When an LLC is governed by managers selected from the members, the LLC may lack centralized management if the member-managers own at least twenty percent of the interests in the LLC, depending on the degree of control the members have over the managers.\textsuperscript{49} The IRS will not rule that an LLC lacks centralized management if the members periodically elect member-managers, or if members have virtually unrestricted authority to discharge member-managers.\textsuperscript{50}

The Alaska default rules clearly create an entity that lacks centralized management. In the absence of a provision to the contrary, "the members of a limited liability company manage the affairs and make the decisions of the company."\textsuperscript{51} Indeed, most states have a default rule providing for decentralized management among all the members.\textsuperscript{52} This rule seems to fit with the notion that LLCs are similar to general partnership in that third parties may rely on any member's ability to bind the firm.\textsuperscript{53}

D. Limited Liability

A company will generally want limited liability, and the IRS will rule that an LLC lacks limited liability only if "at least one assuming member validly assumes personal liability for all (but not less than all) obligations of the LLC, pursuant to express authority granted in the controlling statute."\textsuperscript{54} Additionally, the IRS will look to the assets of the assuming members in the aggregate and will rule that the LLC lacks limited liability if the LLC demonstrates that the assuming members have substantial assets that creditors can reach.\textsuperscript{55}

The Alaska statute default rules establish the corporate characteristic of limited liability:

\textsuperscript{47} 1 RIBSTEIN \& KEATINGE, supra note 3, § 8.09, at 8-21; see ALASKA STAT. § 10.50.250(b), (c) (Michie Supp. 1995) (stating that a member is not necessarily an agent of the LLC if the LLC is managed by a manager, but that the manager is an agent of the LLC).
\textsuperscript{48} Rev. Proc. 95-10 § 5.03(1), 1995-1 C.B. 501.
\textsuperscript{49} Id. § 5.03(2).
\textsuperscript{50} Id.
\textsuperscript{51} ALASKA STAT. § 10.50.110(a) (Michie Supp. 1995).
\textsuperscript{52} 1 RIBSTEIN \& KEATINGE, supra note 3, § 8.03, at 8-4.
\textsuperscript{53} Id. § 8.02, at 8-3, and § 8.05, at 8-14.
\textsuperscript{54} Rev. Proc. 95-10 § 5.04, 1995-1 C.B. 501.
\textsuperscript{55} Id.
A person who is a member of a limited liability company is not liable, solely by reason of being a member, under a judgment, decree, or order of a court, or in another manner, for a liability of the company, whether the liability arises in contract, tort, or another form, or for the acts or omissions of another member, manager, agent, or employee of the company. This provision absolves the members from virtually all liability and is one of the cornerstones of the foundation of LLCs.

IV. CONVERSION FROM PARTNERSHIPS TO LLCs

Conversion of a partnership or limited partnership into an LLC can be a fairly simple process. The Alaska statute does not provide for statutory conversion or mergers of partnerships into LLCs, however, and this omission makes conversion a bit more difficult than it needs to be. While conversion from a partnership to an LLC may provide some advantages, at least one commentator has suggested that these are not advantages “by a sufficient margin to justify the creation of a whole new area of business organization law.” This suggestion leaves one wondering whether conversion is as necessary and beneficial as the popularity of the LLC suggests.

A. Advantages and Disadvantages of the LLC

The most obvious advantages of an LLC over a general or limited partnership are that every member may limit his or her personal liability without sacrificing the ability to participate in the management of the firm, may share directly in the profits of the firm and may take advantage of the pass-through tax structure of a partnership. These advantages can be utilized by any kind of closely held business, including law firms or associations of physicians.

Converting a limited partnership to an LLC would be advantageous because the former general partner could avoid incurring future liabilities, even if he chooses not to be absolved of liabilities incurred under the limited partnership. Another advantage of conversion for limited partnerships is that participation in the control of an LLC, unlike control of a limited partnership, does not carry the risk that members may lose their limited liability protection. By removing this possibility, members gain

58. 1 RIBEISTEIN & KEATINGE, supra note 3, § 2.01, at 2-2.
59. Compare ALASKA STAT. § 32.11.120 (Michie 1993) (stating that limited partners will lose their limited liability if they participate in control of the business) with ALASKA STAT. § 10.50.265 (Michie Supp. 1995) (stating that a
the advantage of having as much input and control as they would like without opening themselves up to liability. Furthermore, the fiduciary duties of the managers to the members may not be as great as the fiduciary duty of the general partner to the limited partners.60

LLCs and partnerships are quite similar in their requirements for conducting business in Alaska. For example, unless members or partners unanimously consent to continue the business according to the default rules of Alaska, both the LLC and limited partnership will terminate upon the occurrence of an event that is specified in the articles of organization or partnership agreement as causing dissolution.61 However, an LLC will not come into existence in Alaska until articles of organization are filed with the Department of Commerce and Economic Development,62 while a general partnership does not have any such filing requirements.63 A limited partnership is more like an LLC than a general partnership since a limited partnership does not exist until it files a certificate with the Department of Commerce and Economic Development.64 Both LLCs and limited partnerships must have registered agents and pay filing fees.65 An LLC has the additional burden of filing a biennial report.66

Family limited partnerships may not want to convert to an LLC for estate planning reasons.67 A limited partnership interest is valued at its "going concern value" for estate tax purposes rather than its liquidation value.68 The "going concern value" is generally not as high as the liquidation value because it is based on the price that the interest in the partnership could be sold for instead

61. ALASKA STAT. § 10.50.400 (Michie Supp. 1995); id. § 32.11.370. (Michie 1993).
62. Id. § 10.50.080 (Michie Supp. 1995).
63. Id. § 32.05.020 (Michie 1993).
64. Id. § 32.11.010 (Michie Supp. 1995).
65. Id. §§ 32.11.830 (Michie 1993) (requiring a registered agent for limited partnerships), 32.11.870 (establishing filing fees for limited partnerships), 10.50.055 (Michie Supp. 1995) (requiring an LLC to maintain a registered agent at all times), 10.50.850 (establishing filing fees for LLCs).
66. Id. § 10.50.750 (Michie Supp. 1995).
68. Id.
of the value of the interest if the assets of the firm were liquidated. Since an LLC membership interest may contain the power to dissolve and thus liquidate the LLC, the IRS is more likely to value the interest at its liquidation value. If the interest in the LLC passes through an estate, the overall tax will be higher than if the business had remained a limited partnership. For this reason, family limited partnerships should be cautious when considering conversion.

B. Tax Consequences of Conversion

A partnership wishing to convert to an LLC can choose among several methods of conversion. In weighing these options, the primary consideration should be taking advantage of Revenue Ruling 95-37, which does not treat conversion of the partnership to the new entity as a taxable liquidation of the old partnership. Revenue Ruling 84-52, which deals specifically with the conversion of a general partnership into a limited partnership, states that conversion does not trigger gain or loss for a partner for income tax purposes unless his share of the interest in the partnership changes. Revenue Ruling 95-37 applies the same standard to partnerships wishing to convert to LLCs. Revenue Ruling 95-37 explains that conversion does not close the taxable year for any partner, and that the resulting LLC does not need a new taxpayer identification number. It also states that under Internal Revenue Code ("IRC") section 1223(1), the holding period of a partner's total interest in the partnership will not change.

Under Revenue Ruling 95-37, partners will not recognize gain or loss under section 741 or section 1001 according to section 721 of the IRC. Section 721 does not require either a partnership or a partner to recognize gain when a partner contributes property to the partnership in exchange for a partnership interest. In the case of conversion to an LLC, the partner is basically exchanging his property, the interest in the partnership, for an interest in the LLC. If generally the same kind of business is carried on, the partnership

69. Id.
70. Id.
75. Id.
76. Id.
77. Id.
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does not incur tax under section 708 of the IRC because the conversion does not qualify as a termination or as a sale or exchange.\(^\text{78}\)

Conversion will not cause a partner's adjusted basis to change as long as her share of the liabilities of the partnership remain the same.\(^\text{79}\) If a partner's share of the partnership liabilities increases, the amount of the increase will be deemed a contribution to the LLC, and the partner's basis will be increased by the amount of the contribution according to IRC section 752(a).\(^\text{80}\) This scenario may occur if, prior to conversion, a general partnership has a recourse debt that becomes nonrecourse after conversion.\(^\text{81}\) Since this change may affect the partner's share of the liability, he will be deemed to have made a contribution to the firm when his liability increases.\(^\text{82}\) The partner may avoid this scenario by maintaining the recourse nature of the debt by individually assuming the liability before conversion and maintaining the liability after conversion.\(^\text{83}\)

If a partner's share of the liabilities of the partnership is reduced, this change will be considered a distribution under IRC section 752(b).\(^\text{84}\) The partner's basis will be reduced by the amount of the distribution, and the partner must recognize gain on the distribution in the amount that the distribution exceeds her adjusted basis.\(^\text{85}\) This result may occur when a general partner in a general or limited partnership is relieved of liabilities. This scenario will probably not happen often because partnership recourse liabilities and partner recourse liabilities will be borne by the same members who incurred them, and many creditors may be unwilling to release the general partner from liability. Under Alaska Statute section 32.05.310,\(^\text{86}\) a partner continues to be liable after conversion unless the creditor consents to release the partner from liability. In fact, the general partner may not wish to be released from liability since he might then have to recognize gain.\(^\text{87}\) Even after conversion, a member may incur personal obligations on behalf of the LLC for which he will be liable.

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78. *Id.*
79. *Id.*
80. *Id.*
81. SARGENT & SCHWIDETZKY, *supra* note 67, § 3.02(1)(g).
82. *Id.*
83. *Id.*
86. ALASKA STAT. § 32.05.310 (Michie 1993).
All in all, a partnership or limited partnership wishing to convert to an LLC will have few negative federal tax consequences. Conversion will be fairly smooth if the division of interests remains substantially unchanged, and if the partnership and LLC carry on substantially the same type of business.

C. Options for Conversion

A partnership may be converted to an LLC in four different ways.\textsuperscript{88} If properly planned, all four methods of conversion may be accomplished without incurring federal taxes.\textsuperscript{89} As discussed more fully below, the fourth method of conversion is the most likely to result in adverse tax consequences since it requires a dissolution of the partnership, a taxable event, prior to the formation of the LLC.\textsuperscript{90}

The first method of conversion is to have the partnership form an LLC to which it contributes all of its assets.\textsuperscript{91} The LLC accepts the liabilities of the partnership in exchange for these assets.\textsuperscript{92} The partnership may then receive one hundred percent interest in the LLC. Although many states require at least two members for the formation of an LLC,\textsuperscript{93} the Alaska statute requires only that two or more persons organize the LLC and sign and deliver the Articles of Organization.\textsuperscript{94} The statute also states that the persons organizing the LLC need not be members.\textsuperscript{95} This indicates that a single member LLC would be theoretically possible in Alaska.\textsuperscript{96} The LLC may be able to have a single member, the partnership, for conversion purposes, and then divide up the interests among the members once it has been formed. This division would then satisfy the IRS requirement that an LLC have two members to receive

\textsuperscript{88} Id. at 27-28; see also ROBERT W. WOOD, LIMITED LIABILITY COMPANIES: FORMATION, OPERATION, AND CONVERSION § 5.9, at 185-86 (1993).

\textsuperscript{89} See Rev. Rul. 95-37, 1995-1 C.B. 130.

\textsuperscript{90} Golding, supra note 71, at 31.

\textsuperscript{91} Id. at 27.

\textsuperscript{92} Id.

\textsuperscript{93} See 1 RIBSTEIN & KEATINGE, supra note 3, § 4.03, at 4-3 to 4-4. Because partnerships usually require two or more people, many states require two members for LLCs to ensure partnership status for federal income tax purposes. Id. § 4.03, at 4-4. This rule may be short-sighted because the resignation or death of one member of a two-member LLC would then cause dissolution and perhaps, more importantly, the loss of limited liability. Id.

\textsuperscript{94} ALASKA STAT. § 10.50.070 (Michie Supp. 1995).

\textsuperscript{95} Id.

\textsuperscript{96} Manley, supra note 19, at 78-79.
federal tax treatment as a partnership. If the proposed check-the-box regulations are adopted, this point will become moot as a one-member LLC could opt to be treated as a "nothing," meaning that the one member LLC would be treated more like "a sole proprietorship, branch or division of the owner."

In states where two members are required at all times, a dummy corporation that owns a one percent interest in the LLC must be formed. This corporation can then be liquidated by the LLC after the ninety-nine percent interest in the LLC is distributed pro rata among the new members (that is, the former partners whose partnership is dissolved). This method is cumbersome, and the Alaska provision appears to be a useful tool for converting partnerships into LLCs.

The second method of conversion is referred to as the interests contribution method. Partners transfer their shares of the partnership to the LLC and receive membership interests in the LLC in exchange. Upon dissolution of the partnership, its assets are distributed to the LLC, which assumes the liabilities of the former partnership. This method of conversion is the best way of ensuring that the IRS will not consider the conversion a termination of the partnership, and will prevent the entity from incurring adverse tax consequences.

The third proposed method of conversion requires the partners to amend their partnership agreement into Articles of Organization for an LLC.

97. Revenue Procedure 95-10 establishes that an LLC must have two members at all times. Rev. Proc. 95-10, 1995-1 C.B. 501, 502. The IRS will not consider a ruling request unless the LLC has at least two members. Id. If the LLC does not have two members after the issuance of the ruling, the letter ruling ceases to apply and the LLC no longer qualifies as a partnership for federal tax purposes. Id.

98. See supra text accompanying notes 29-32.


100. Golding, supra note 71, at 27 & n.9.

101. Id. at 27.

102. Id.

103. Id.; WOOD, supra note 88, § 5.11, at 187.

104. Golding, supra note 71, at 27.

105. Priv. Ltr. Rul. 93-21-047 (Feb. 25, 1993). Although this private letter ruling is not binding, the IRS did rule that a termination of the partnership did not result from the conversion into an LLC and that gain or loss of the members would not be recognized, except according to I.R.C. § 752. See 1 RIBSTEIN & KEATINGE, supra note 3, § 17.13, at 18-187 (Supp. 1995); see also Golding, supra note 71, at 31.

106. Golding, supra note 71, at 28; WOOD, supra note 88, § 5.9, at 185.
filed, the LLC purchases the assets of the partnership using the assumption of the partnership’s liabilities as consideration.\textsuperscript{107} This method appears to be similar to a statutory conversion of a partnership into an LLC, and the IRS will probably not find this to be a taxable event if the percentage interest of each owner does not change and the business conducted by the entity remains substantially the same.\textsuperscript{108}

A fourth way to form an LLC is to dissolve the partnership entirely and distribute all of the assets pro rata among the partners who incur the partnership’s liabilities in return.\textsuperscript{109} The partners then contribute these assets to the LLC in exchange for interests in the LLC and the assumption of the liabilities of the partners, which they incurred on the dissolution of the partnership.\textsuperscript{110} The IRS could view this as a taxable dissolution of the partnership under IRC section 708(b)(1)(A).\textsuperscript{111} Furthermore, partners may incur a tax if they are deemed to have received cash in excess of their basis in the partnership interest or if the partner’s share of the debt of the partnership is deemed to have been reduced during the conversion process.\textsuperscript{112}

Of the four methods of conversion, the interests contribution method and the method of amending the partnership agreement seem the least likely to result in an IRS determination that the partnership has been terminated, which is a taxable event according to IRC section 708.\textsuperscript{113}

D. Superiority of Including a Conversion or Merger Provision in the Statute

Many states have statutory conversion or merger provisions that facilitate the conversion of a partnership or even a corporation into an LLC. States allowing statutory conversion of other entities into LLCs include Colorado, Connecticut, Kentucky, Missouri, North Carolina, New Mexico, New York, Tennessee and Virginia.\textsuperscript{114} States allowing for statutory mergers of LLCs with other

\begin{itemize}
\item \textsuperscript{107} Golding, \textit{supra} note 71, at 28.
\item \textsuperscript{108} WOOD, \textit{supra} note 88, § 5.10, at 186-87 (stating that the IRS held in Private Letter Ruling 90-10-027 (Feb. 25, 1993) that such a conversion was not a taxable event in the case stated, even where the petitioner had not made it clear whether the state statute contained a conversion provision).
\item \textsuperscript{109} Golding, \textit{supra} note 71, at 27.
\item \textsuperscript{110} \textit{Id.}
\item \textsuperscript{111} \textit{Id.} at 31.
\item \textsuperscript{112} WOOD, \textit{supra} note 88, § 5.11, at 188-89.
\item \textsuperscript{113} Golding, \textit{supra} note 71, at 32.
\item \textsuperscript{114} 1 RIBSTEIN & KEATINGE, \textit{supra} note 3, at app. 11-1, chart 12 (Washington,
business organizations include Alabama, Arizona, Delaware, Georgia, Idaho, Iowa, Louisiana, Maryland, Minnesota, Missouri, New Hampshire, New Jersey, North Dakota, Oklahoma, Rhode Island, South Dakota, Texas, Virginia and Wyoming. While these statutes vary greatly, they all simplify conversion in a direct, statutory manner. The Alaska statute, which allows only for the merger of two or more LLCs, could be improved by amending the statute to allow for mergers of LLCs with partnerships and corporations or even conversion of those entities into LLCs.

The Connecticut statute provides a good example of the advantages of having a statute allow for the conversion of partnerships and limited partnerships into LLCs. The statute clarifies that all obligations of the partnership become the obligations of the LLC, and it smooths out the transfer of property ownership. The statute requires that actions or proceedings against the partnership continue as if the conversion did not occur, and requires that actions or proceedings against a general partner continue as if conversion had not occurred. Furthermore, the statute clearly explains that the general partner continues to bear the same liabilities "except as may be provided in the operating agreement with respect to those liabilities of such person to other members of the limited liability company that has been converted pursuant to section 34-199."

This long list of items demonstrates that while conversion is simple in some regards, the implications are enormous. Considering the absence of guidelines in the area of the conversion and merger of LLCs, statutes can play an important role in defining the implications of such actions.

V. CONVERSION OF A CORPORATION

In addition to more favorable tax treatment, LLCs have a few other advantages over corporations, especially closely held and S corporations. Converting a corporation to an LLC is almost

D.C. also allows for statutory conversion of certain business entities into LLCs). 115. WOOD, supra note 88, § 5.16, at 71 (Supp. 1995). 116. ALASKA STAT. § 10.50.500 (Michie Supp. 1995). 117. 1 BAGLEY & WHYNOTT, supra note 1, § 3:10. 118. CONN. GEN. ST. ANN. § 34-200 (West 1995). 119. Id. 120. Id. 121. Id. 122. An S corporation is a small business corporation, as established under subchapter S of the Internal Revenue Code. The purpose of this type of corporation is very much like that of the LLC: to allow closely held businesses to
always problematic, however, because of the adverse tax consequences. The conversion will be considered a termination of business, and the IRS will treat the event as a liquidation of assets, causing the corporation and the shareholder to recognize gain.123

A. Basic Advantages of the LLC over the Traditional Corporate Form

The LLC has several advantages over the corporation. One of the most obvious reasons for a corporation to organize as an LLC is to avoid two-tier taxation.124 Corporations are taxed first on their corporate profits, and then shareholders are taxed on the distribution of those profits.125 This results in a double taxation on the same profits. Partnerships are not treated as taxable entities, and the only tax is on the distribution of profits to the partners.126 Each partner pays taxes on the portion of the profits she receives from the partnership.127 The differing tax treatment of partnerships and corporations have led many businesses to reject the corporate form. Many commentators have called for an integrated tax system that eliminates this perversion by taxing all entities once.128 Part of the appeal of organizing as an LLC rather than a corporation is that profits are taxed just once, but members remain insulated from liability and do not have the many restrictions of an S corporation.

Another advantage of the LLC is that it is not subject to the special accounting requirements that corporations must follow.129 LLCs would not have to establish special surplus accounts for

have limited liability like a corporation but have the pass-through tax treatment of a partnership. S corporations are more limited in use than LLCs because they are subject to a variety of restrictions. JEROME P. FRIEDLANDER II, THE LIMITED LIABILITY COMPANY § 3.1 (1994). For example, each member must be a person, not another corporation; the corporation must be organized in the United States; no member may be a non-resident alien and only one class of stock may be issued. Id. The restrictions on S corporations recently became less rigid when President Clinton signed the Small Business Job Protection Act on August 20, 1996. [1996] Stand. Fed. Tax Rep. 5 (CCH) ¶ 48,814, at 79,488 (Aug. 29, 1996). An S corporation can now have 75 members (increased from 35); trusts, employee plans and I.R.C. § 501(c)(3) tax exempt organizations may be shareholders of an S corporation; and S corporations may now own subsidiaries. Id. at 79,488-89.

123. WOOD, supra note 88, § 5.2, at 170.
124. 1 RIBSTEIN & KEATINGE, supra note 3, § 1.03, at 1-2.
125. Id. § 16.02, at n.4.
126. Id. at n.5.
127. Id.
128. Id. § 16.03, at 16-5 & n.20.
129. Id. § 1.03, at 1-2.
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dividends, as corporations are required to do.\textsuperscript{130} Simplified accounting may be especially appealing to smaller corporations. Furthermore, smaller businesses may prefer LLCs since the statutes governing them generally do not require management by a governing board of directors as do corporate statutes.\textsuperscript{131}

One advantage of a C corporation over an LLC is in the area of medical care. Currently, only C corporations are allowed to deduct employees' medical expenses as part of their expenses while not requiring employees to report the cost as income.\textsuperscript{132} It will be interesting to see if Congress ever allows LLCs to do the same given their special status as a hybrid entity.

B. Tax Consequences and Methods of Conversion

Presently, conversion from a corporation to an LLC results in a corporate level tax and a tax for shareholders. IRC section 336 requires the recognition of gain on the appreciated value of assets when a corporation is dissolved, and IRC section 331 results in a tax to the shareholders on the distributed assets.\textsuperscript{133} Thus, conversions from C corporations and S corporations to LLCs will be rare because of the negative tax consequences incurred.\textsuperscript{134}

Gain must be recognized despite the structure of the transaction. The corporation may contribute its assets for interests in the LLC to be divided among shareholders.\textsuperscript{135} The corporation can liquidate its assets to be distributed among the shareholders who would then contribute those assets to the LLC in exchange for membership interests in the LLC.\textsuperscript{136} A final option would be to treat the conversion as a merger of the C or S corporation into the LLC with shareholders receiving membership interests in the new LLC in exchange for their former shares.\textsuperscript{137} No matter how an
entity structures the transaction, it is highly unlikely that the IRS will not treat it as a taxable event.\textsuperscript{138}

A few situations may exist where the cost of conversion will be minimized by other factors. Corporations with loss-producing assets or net operating loss carryovers may be able to afford conversion by using the loss to offset any gain.\textsuperscript{139} A few S corporations that do not have built-in gain and do not have appreciated assets may also consider conversion. Additionally, conversion may be a viable option for an S corporation where the shareholders' basis in the stock is greater than the value of the assets so that the shareholders will have a capital loss that exceeds gain from the distribution.\textsuperscript{140} These cases will be rare, however, and the tax consequences of conversion will normally make conversion prohibitively expensive.\textsuperscript{141}

C. Comparison to the S Corporation

Although the LLC and the S corporation have many of the same attributes, the LLC has a number of advantages over the S corporation because it does not have as many restrictions.\textsuperscript{142}

Despite recently expanding the number of allowable shareholders from thirty-five to seventy-five, S corporations continue to have other restrictions making LLCs more attractive.\textsuperscript{143} For example, non-resident aliens and corporations may still not be shareholders,

\begin{itemize}
\item \textsuperscript{138} Id.; see also Golding, supra note 71, at 37-42 (admitting that while a few possibilities for conversion without a taxable result may exist, they are risky and unrecognized).
\item \textsuperscript{139} Golding, supra note 71, at 37.
\item \textsuperscript{140} Wood, supra note 88, at 170-71.
\item \textsuperscript{141} Golding, supra note 71, at 37. A C corporation that converts will suffer a double tax, while an S corporation may or may depending on whether it has any I.R.C. § 1374 built-in gains. The C corporation will pay tax on any built-in asset gain or loss, and shareholders will pay tax on the amount to which the value of the distributed assets exceeds the adjusted basis of the shares. I.R.C. §§ 311, 331(a) (1996). The S corporation will pay a corporate entity tax only if it has any untaxed § 1374 built-in gains. These built-in gains can be found in corporations that converted to S corporations within the past 10 years, and represent the value of the appreciation of the corporate assets at the time of conversion. Marc Golding calculated that the tax in Oregon for a C corporation or for an S corporation with I.R.C. § 1374 built-in gains will be about 60% after combining federal and state taxes. For an S corporation without I.R.C. § 1374 built-in gains, the tax will still be around 45%. Golding, supra note 71, at 37 n.45.
\item \textsuperscript{142} Schorr, supra note 135, at 30, reprinted in FORMING AND USING LIMITED LIABILITY COMPANIES 191, 197 (PLI Corp. Law & Practice Course Handbook Series No. B-805, 1993).
\end{itemize}
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although electing small-business trusts, employee plans and section 501(c)(3) tax exempt organizations may now become shareholders.\(^{144}\) S corporations can now own qualified subsidiaries,\(^ {145}\) but may still issue only one class of stock.\(^ {146}\) If any of these requirements ceases to be met, the S corporation will lose its status and automatically become a C corporation. The corporation may regain its status as an S corporation by taking measures to remedy the violation. The LLC does not cap the number of members who can participate as owners in the company, and membership may be distributed among several classes of ownership interests.\(^ {147}\) Members may be other corporations, foreigners and foreign corporations.\(^ {148}\) Like S corporations, an LLC can form subsidiaries in order to insulate itself from the risks associated with new enterprises.\(^ {149}\)

One potential disadvantage of the LLC is that it may require membership of at least two people.\(^ {150}\) The terms of the Alaska statute may allow LLCs to have one member, but Revenue Procedure 95-10 bars this alternative if the LLC desires the federal tax benefits of a partnership.\(^ {151}\) This rule in practice precludes any attempt by the state of Alaska to allow for one-member LLCs. The proposed “check-the-box” regulations may, of course, remove this advantage by granting one-member LLCs the option of being treated as a “nothing” for federal tax purposes.\(^ {152}\) An S corporation may also be preferable in that S corporations are not prohibit-

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146. FRIEDLANDER, supra note 122, §§ 3.1-G, 3.2-B.


148. Id.

149. Id.

150. Manley, supra note 19, at 77-78. Manley notes that the IRS’s refusal to rule on single-member LLCs may stem from a concern that corporations will replace wholly owned subsidiaries with single-member LLCs as a way to avoid the rule on consolidated returns. Id.

151. Rev. Proc. 95-10 § 4.01, 1995-1 C.B. 501 (stating that “the Service will consider a ruling request that relates to classification of an LLC as a partnership for federal tax purposes only if the LLC has at least two members”).

ed from using the cash method of accounting under IRC section 448, whereas LLCs may be.\(^{153}\)

D. Similarities with the Professional Corporation

LLCs have been greatly supported by a variety of professionals, including doctors, accountants and lawyers, who hope to avoid vicarious liability for the acts of their partners.\(^{154}\) Although a doctor or a lawyer cannot limit his personal liability for a breach of the standard of care he owes his own patients or clients, his personal assets are protected if another member of the LLC breaches that standard of care.\(^{155}\)

Alaska does have the Alaska Professional Corporation Act.\(^{156}\) Because professional corporations already allow for limited liability of their members, many professional corporations may not want to convert to LLCs because of the adverse tax consequences the shareholders may face. One commentator has noted that aside from the pass-through tax benefits, a professional LLC has few advantages over a professional corporation.\(^{157}\)

VI. PROBLEMS OF A HYBRID ORGANIZATION

An LLC combines different aspects of a partnership and a corporation. It is therefore often difficult to predict how an LLC will be treated in different contexts. Additionally, a firm that converts to an LLC may need to ensure that all creditors and those with whom the prior partnership or corporation has contracted are aware of the change.

A. Treatment of Profit-Sharing Plans and Pension Plans

Profit-sharing plans and pension plans may be used by both corporations and partnerships.\(^{158}\) While both kinds of organizations may use these plans, the question remains as to whether a converting organization may continue its pension plan or profit-sharing plan without interruption. In a private letter ruling, the IRS determined that the transfer of assets from an employee plan of a corporation to an employee plan of an LLC, formed by the same corporation in conjunction with another corporation, was not

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153. See discussion infra Part VLC-D.
155. FRIEDLANDER, supra note 122, § 1.4-I(1).
156. ALASKA STAT. §§ 10.45.010-.510 (Michie 1989).
157. See Gazur, supra note 7, at 181.
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a taxable event.\textsuperscript{159} The IRS treated this transfer as it would a transfer of an employee plan run by a parent corporation to an employee plan run by a subsidiary.\textsuperscript{160} This treatment indicates that the IRS will allow existing profit-sharing and pension plans to continue uninterrupted and therefore, no tax on the gain of such plans will be incurred.

B. Passive Activity Loss Limitations

One issue that has not been resolved in a satisfactory manner is how members of LLCs will be treated in the application of passive activity loss limitations.\textsuperscript{161} It is not just a question of whether members of LLCs will be treated more like shareholders of an S corporation or like partners in a partnership, but whether they will be treated more like general or limited partners. Unfortunately for them, members of LLCs are treated more like limited partners by the IRS, which requires limited partners to meet stricter tests than general partners to show they "materially" participated in the business.\textsuperscript{162} Members are treated more like limited partners because the IRS uses the corporate characteristic of limited liability to determine which test of materiality it should apply.\textsuperscript{163} Because members of LLCs may exercise a great deal of control over the business,\textsuperscript{164} this threshold test appears inapposite to the intentions of Congress. Unless this rule changes, potential members of LLCs who expect losses may want to organize as an S corporation or as a general partnership.

C. Is an Interest in an LLC a Security?

Another point of confusion in many states is whether an interest in an LLC is a security. At the federal level, the characterization of LLCs is made on a case-by-case basis, with the decision

\textsuperscript{159} Priv. Ltr. Rul. 93-43-036 (Oct. 29, 1993) (while private letter rulings cannot be used as precedent in court or before the IRS, they may indicate how the IRS will treat a situation).

\textsuperscript{160} See Rev. Rul. 80-138, 1980-1 C.B. 87 (holding that when employer securities are shifted from an exempt employees' trust held by the parent corporation to a trust managed by the subsidiary, the securities retain their basis for the purpose of computing net unrealized appreciation).

\textsuperscript{161} Individuals, trusts, estates, personal service corporations and closely held C corporations cannot take passive activity losses for activities in which they did not materially participate. I.R.C. § 469(a)(1)(A) (1996). The purpose of this provision was primarily to prevent the use of certain tax shelters. WOOD, \textit{supra} note 88, § 2.34, at 36-37 (Supp. 1995).

\textsuperscript{162} Rands, \textit{supra} note 32, at 27.

\textsuperscript{163} Id.

\textsuperscript{164} WOOD, \textit{supra} note 88, § 2.34, at 36-37 (Supp. 1995).
turning on the extent to which members participate in the operation and control of the organization. Thus, the question of whether an interest is a security has not been clearly answered even for partnerships. Generally, an interest in a limited partnership will be considered a security since the limited partners depend on the general partner for operation of the business. An interest in a general partnership is generally not considered a security since all partners help make the partnership decisions.

LLC statutes allow for a wide range of control of members. The statutes may allow for members to manage the firm themselves, or to appoint certain members to manage the firm. These possibilities mean that for now, whether an interest in an LLC is a security will have to be determined on an individual basis in many states. Commentators have argued that the presumption should be that an interest in an LLC is not a security. This conclusion is based on the premise that an LLC is more like a general partnership since members have the ability to participate in the management and control of the LLC.

In Alaska, the legislature resolved this problem by amending the definition of a security to include "a limited liability company interest under AS 10.50" except in cases where "the context otherwise requires." As discussed in the next section, this classification poses problems primarily for accounting reasons. As securities, interests in Alaska LLCs will have to be registered.
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with the state securities agency or find exemptions. The most useful of these exemptions, such as the exemption for small offerings or conversion of business form through reorganization, requires the business to file notice with the Commissioner of Commerce and Economic Development.

D. Methods of Accounting for LLCs

One of the most serious questions facing a partnership wishing to convert to an LLC is whether it can continue to use the cash receipts and disbursements method of accounting, which usually benefits small businesses and partnerships, or whether it will have to switch to the accrual method. IRC section 448(a) prohibits C corporations, partnerships with a corporation as a partner, and tax shelters from using the cash method of accounting. Any LLC that meets the definition of a tax shelter will have to use the accrual method of accounting.

A tax shelter is defined in three ways in the IRC: (1) any enterprise where the sale of an interest requires registration with a federal securities agency; (2) a syndicate; and (3) a business established for the purpose of tax evasion.

Alaska LLCs may find it difficult to avoid falling into the first definition of a tax shelter since legislative history indicates that any enterprise that requires registration or notice to a state or federal regulatory agency of the sale of an interest will qualify as a tax shelter.

175. Id.
176. ALASKA STAT. §§ 45.55.900(a)(v) (Michie 1994) (requiring two-day notice for exemption from registration of a small offering), 45.55.900(b)(13)(B) (Michie 1994) (requiring 30-day notice to have an exemption from registration for conversion of business form).
177. Id.
178. See 1 RIBSTEIN & KEATINGE, supra note 3, § 2-11, at 2-24; see also MANLEY, supra note 174, at 1 (stating that a business using cash basis accounting does not have to recognize income and deductions until it receives income or pays expenses, whereas a business using accrual basis accounting must recognize income and deductions at the time the business incurs the obligation to pay or receive money).
179. I.R.C. § 448(a) (1996) (note that I.R.C. § 448(d)(3) states that an S corporation will not be defined as a tax shelter); see 1 RIBSTEIN & KEATINGE, supra note 3, § 2-11, at 2-24.
180. 1 RIBSTEIN & KEATINGE, supra note 3, § 17.11, at 17-48.
182. Id. § 461(i)(3)(B).
183. Id. § 6662(d)(2)(C).
shelter. As discussed above, even Alaska businesses using a reorganization exemption under Alaska Blue Sky Law may have to give notice to the Commissioner of Commerce and Economic Development. Therefore, a business in Alaska that wishes to continue using the cash method of accounting after its conversion to an LLC may want to procure a no action letter from the Alaska Division of Banking and Securities Regulation stating that the interest in the LLC is not a security because "the context otherwise requires."

An LLC may avoid being classified as a syndicate in two ways. The LLC must either generate income in excess of its losses or have at least sixty-five percent of the members who are active in the management and control of the LLC allocate the losses among themselves. These requirements should not pose an enormous burden to professional groups who generally operate at a profit and whose members are actively involved in management.

An Alaska LLC that has a valid business purpose will probably not fall into the third definition of a tax shelter since the purpose of formation was not tax evasion.

At least one law firm in Alaska has managed to convert from a general partnership to an LLC and to continue to use the cash method of accounting. The firm first received a no action letter from the state securities department, and then received a private letter ruling from the IRS stating that use of the accrual method of accounting was not necessary. The IRS reviewed whether the firm should be treated as a tax shelter under IRC section 448(d)(3), and determined that it should not since the interests in the LLC did

185. See, Manley, supra note 174, at 3. Mr. Manley goes on to note three arguments that could be made in defense of the position that the interest in the LLC is not a security when a professional services firm converts to an LLC: (1) there is no sale or offering because it is merely a conversion of form; (2) it is not really a securities transaction because only licensed professionals devoting their own efforts (rather than relying on the efforts of others) may enter the LLC arrangement; and (3) (assuming no centralized management) all participants are mutual agents and in full control and hence it is like a general partnership. Id.
186. See 1 RIBSTEIN & KEATINGE, supra note 3, § 17.11, at 17-49, -50, -53; Manley, supra note 174, at 4-5.
187. 1 RIBSTEIN & KEATINGE, supra note 3, § 17.11, at 17-53.
not have to be registered with a state or federal securities agency, the firm had not reported a loss during its existence and the firm had a genuine business purpose. A partnership wishing to continue using a cash receipts and disbursement method of accounting should probably seek a no action letter and a private letter ruling to ensure that it can maintain its current accounting system.

E. Duties of Care and Fiduciary Duties

As LLCs are a frequent vehicle of closely held businesses, there continues to be the threat of opportunistic behavior on the part of members. As a hybrid organization, standards of care and fiduciary obligations based on both corporate and partnership law may come into play, as well as theories of agency and contract. Therefore, members of an LLC should be aware of the risks inherent in being a part of an organization where the duties of the people in charge are not clearly defined and where their own behavior may be scrutinized in an unforeseeable manner. One question will be to whom the duties of care apply when the members are corporations. Considering the infrequency of cases where courts have pierced the corporate veil of general partners in limited partnerships, it is unlikely that courts will do so in the case of LLCs.

The Alaska statutes do include a provision requiring a duty of care for managers and managing members of LLCs. Unless otherwise stated in the operating agreement, the statutes also specifically state that members who are not managers do not have the fiduciary duty of managers. The statutes do not answer the question of the duty of care of ordinary members, or deal with concerns over to whom the fiduciary duty will apply when a member of an LLC is not a natural person.

191. Id.
194. DeMott, supra note 192, at 1045 n.6.
197. Id. § 10.50.130.
VII. CONCLUSION

Despite the LLC's benefit of combining the federal tax advantages of a partnership and the limited liability of a corporation, a business should think carefully about the full range of potential consequences before converting. Conversion to an LLC is probably most beneficial and economical for general and limited partnerships seeking to limit the liability of their members. The two simplest methods for a partnership to convert is to have all partners contribute their shares of the partnership to the LLC in exchange for membership interests in the LLC or to amend the partnership agreement into the Articles of Organization of a new LLC. The partnership may want to obtain a no action letter from the Alaska Division of Banking and Securities Regulation and a private letter ruling from the IRS to ensure it will not be classified as a tax shelter under IRC section 448.

Because of the serious federal tax consequences of conversion for corporations, corporations should probably not choose to reorganize as LLCs, but may find LLCs more useful for joint ventures and as a way to hold risk-prone assets. Additionally, while an LLC may avoid some of the restrictive measures placed on the limited partnership and the S corporation, the vehicle is not really all that different from earlier forms of business associations. The uncertainties of the resolution of new problems should be considered before a business chooses to convert.

The Alaska LLC statute is well drafted. Its flexible nature will allow a number of different businesses to use its structure. The statute could be improved by allowing for statutory conversion and mergers of partnerships, limited partnerships and corporations into LLCs. The default provisions of the statute could also be amended to reflect the more lenient policy the IRS has demonstrated in the classification of LLCs for federal income tax purposes in Revenue Procedure 95-10. However, even as the statute is written, the LLC will prove to be a useful, if as yet uncertain, form of business association in Alaska.

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