The Single-Member Limited Liability Company as Disregarded Entity

Now You See It, Now You Don’t

By Daniel S. Kleinberger and Carter G. Bishop

The shape-shifting nature of the single-member limited liability company depends upon the context in which the entity is viewed.

The power and complexity of the single-member limited liability company (SMLLC) comes from a conceptual contradiction: the conflation of owner and organization for federal income tax purposes and the separation of owner and entity for nontax, state law purposes. The contraction has significant practical consequences, which this article explores by first, explaining why federal regulators chose to disregard the existence of a class of valid and existing state law entities (i.e., SMLLCs) and then, providing several illustrations of the practical vagaries that can result.

Why a Disregarded Entity?

In 1996, as the Internal Revenue Service (IRS) prepared to revolutionize tax classification through its “check the box” regulations, the IRS’s lawyers and theoreticians faced a knotty conceptual problem. The essence of check the box was to accord partnership tax classification, and therefore flow-through tax status, to all noncorporate business entities organized under the law of a U.S. jurisdiction. This approach was destined to, and did, open the floodgates for LLCs having at least two members and, eventually, for limited liability partnerships and limited liability limited partnerships as well.

But what was the IRS to do with the “single-member LLC”—an LLC with only one owner? It is axiomatic under both state and tax law that a partnership has at least two owners. The IRS had neither the statutory nor the jurisprudential basis for announcing that an LLC with only one member would be taxed as a partnership.

The IRS’s solution was a tour de force; it cut the Gordian knot by declaring that a single-member LLC simply does not exist for federal income tax purposes. Put simply, under check the box, unless an SMLLC elects to be classified as a corporation, the SMLLC is a disregarded entity. The sole member of an SMLLC might paraphrase Louis XIV and say, “the entity, it’s me.”

Since the promulgation of “check the box,” the single-member LLC has become a centrally important aspect of LLC law and practice. Countless individuals use the SMLLC to provide a liability shield for entrepreneurial activity (activity that for tax purposes disappears into a Schedule C on the individual’s tax returns), and SMLLCs also figure prominently in more complicated contexts (ranging from simply serving as corporate subsidiaries to playing a pivotal role in structuring “bankruptcy remote” entities for securitization purposes).

The disregarded entity construct solved the IRS’s conceptual problems for federal income tax purposes. However, as discussed below, the new approach has occasioned considerable confusion in other contexts.

Illustration No. 1—The SMLLC in Federal Court

A pair of recent circuit court decisions illustrate the confusion, in the context of the right of a litigant to appear pro se in federal court. Lattanzio v. COMTA, 482 F. 3d 137 (2d Cir. 2007), and U.S. v. Hagerman, 545 F.3d 579 (7th Cir. 2008), both involved essentially the same legal question. In each case, an LLC’s sole owner attempted to appear pro se on behalf of the LLC.

In each case, the attempt failed. Although the right to appear pro se in federal court is of venerable origin, the right applies to individuals and not to juridical persons. As Chief Justice Marshall explained almost 200 years ago, “a natural person may appear for himself,” but “[a] corporation . . . can appear only by attorney.” Osborn v. Bank of the United States, 22 U.S. (9 Wheat.) 738, 830 (1824).

In the pro se context, an LLC is very much like a corporation. Conflation is not the paradigm; the owner and the organization are distinct conceptually and legally. Even when the entity is an LLC with only one member, for pro se purposes the entity may not be disregarded.

The right to appear pro se in federal court has been codified, 28 U.S.C. § 1654, but the codification leaves unchanged the “no conflation” analysis. In Lattanzio, for example, the court stated, “the [pro se representation] statute does not permit unlicensed laymen to represent anyone else other than themselves.” This limitation prevents “a layperson . . . [from] represent[ing] a separate legal entity such as a corporation,” and the limitation extends to “partnerships and single shareholder corporations” and to limited liability companies as well.

For the Lattanzio court, it was immaterial that the LLC had only one member. The court acknowledged that “some courts allow sole proprietors to proceed pro se” but sharply distinguished that situation from the situation of a single member LLC: “[A] sole proprietorship has no legal existence apart from its owner. Unlike a sole proprietorship, a sole member limited liability company is a distinct legal entity that is separate from its owner,” with, for example, the power to sue and be sued in its own name.

Having in previous decisions “refus[ed] to distinguish between a single shareholder corporation and a multi-shareholder corporation,” the Lattanzio court saw “no reason to distinguish between limited liability companies and sole member or solely-owned limited liability companies.” Like the sole
shareholder of a corporation, “a sole member of a limited liability company must bear the burdens that accompany the benefits of the corporate [sic] form and may appear in federal court only through a licensed attorney.”

Lattanzio was a civil case. U.S. v. Hagerman was a criminal matter, but the Seventh Circuit used the same reasoning as the Second Circuit to reach the same conclusion. “[T]he right to conduct business in a form that confers privileges, such as the limited personal liability of the owners for tort or contract claims against the business, carries with it obligations one of which is to hire a lawyer if you want to sue or defend on behalf of the entity. Pro se litigation is a burden on the judiciary, and the burden is not to be borne when the litigant has chosen to do business in entity form. He must take the burdens with the benefits.” In other words, “now you see it, . . . now you see it.”

**Illustration No. 2—Liability for an SMLLC’s Employment Taxes**

As a matter of state, nontax law, “[a] limited liability company is an entity distinct from its members.” Revised Uniform Limited Liability Company Act (Re-UULLCA), § 104(a). As a result, even when an LLC has only one member, “the debts, obligations, or other liabilities of a limited liability company, whether arising in contract, tort, or otherwise: (1) are solely the debts, obligations, or other liabilities of the company; and (2) do not become the debts, obligations, or other liabilities of a member . . . solely by reason of the member acting as a member.” Re-UULLCA, § 304(a).

It would seem to follow, therefore, that, when an SMLLC fails to pay its federal employment taxes, the IRS, like any other creditor of the LLC, must content itself with the assets of the LLC to satisfy the entity’s obligations, or find a way to use the controlling person liability approach applicable to other state law entities, IRC § 6671(b), or pursue the elaborate and sometimes difficult path of piercing the veil of the LLC to reach the assets of the LLC’s owner.

Federal regulations effective in 2007 do indeed follow this approach, but the IRS’s path to this conclusion has been tortuous. An initial pronouncement, Notice 99-6, 1999-1 CB 321, contended that an SMLLC’s disregarded status meant that confusion was the rule for purposes of employment tax liability just as much as for pass-through tax status. “The Service recognized that, because the federal tax classification regulations essentially ignore the separate existence of a disregarded entity, the owner of the disregarded entity, and not the entity itself, is treated as the employer and that traditionally employment tax responsibilities rest with the employer.” Carter G. Bishop & Daniel Kleinberger, Limited Liability Companies: Tax and Business Law, ¶ 2.07[1][a][ii] (1994, Supp. 2010-1).

We criticized that approach as “lead[ing] to confusion” because, as a matter of state law, “the employees are actually employed by the [tax] disregarded entity.” Moreover, the approach conflicted with the IRS’s own recognition that it could not directly levy on the assets of an SMLLC to satisfy the separate tax debt of the LLC’s single member.

Nonetheless, in 2007, in Littriello v. U.S., 484 F.3d 372 (6th Cir. 2007), the Sixth Circuit approved the IRS’s approach and held a sole member automatically liable for the enterprise’s employment taxes. To reach this result, the court applied “Chevron deference”—i.e., the court followed the “directive” in Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc., 467 U.S. 837 (1984), “to give deference to an agency’s interpretation of statutes that the agency is entrusted to administer and to the rules that govern implementation, as long as they are reasonable.”

Under that approach, the court upheld the entire check the box regime, and that holding is Littriello’s enduring significance.

Ironically, however, on the employment tax/SMLLC issue, Littriello is moot. The case validated a regulatory approach that the IRS had already prospectively abandoned. In 2005, the IRS had announced its intention to jettison Notice 99-6 and had issued proposed regulations on the subject. The proposed regulations sought to treat an SMLLC as if it were a corporation for employment tax purposes.

The regulations became final on August 17, 2007. In the context of federal employment taxes, therefore, the disregarded entity has ceased to be transparent. In other words, “now you see it, . . . now you don’t; wait . . . now you do.”

**Illustration No. 3—SMLLCs and Transfer Taxes**

Suppose that a person becomes a member of a limited liability company and in connection with that event contributes land to the LLC (so as to “pay for” the membership). As a matter of state entity and property law, it seems self-evident that the contribution involves the transfer for value of the land from the would-be member to a separate legal person (i.e., the LLC). Under the laws of many states,
such a transfer triggers a transfer tax, and certainly under the LLC laws of all states the transfer severs the transferor’s ownership interest in the land.

However, when the LLC has only one member, under the statutes of some states it is possible to reframe the arrangement to avoid the transfer tax. A Connecticut case shows how.

Mandell v. Gavin, 816 A.2d 619 (Conn. 2003), involved a transfer tax applicable only to transfers made for “consideration,” a term that the court stated “has been used in a specific, legal sense for centuries.” In that sense, “[t]o constitute consideration, a performance or a return promise must be . . . sought by the promisee in exchange for his promise and is given by the promisee in exchange for that promise.”

Timing is therefore everything in a consideration analysis. “Past consideration” is no consideration because the subsequent promise cannot have been exchanged for an action already performed. Through good advice or good fortune (or both), Mr. Mandell got the timing just right. “The plaintiff formed his company soon after the effective date of [Connecticut’s LLC] legislation, naming himself the sole member. The plaintiff then transferred the real property to his company by quitclaim deed. In the deed, the plaintiff recited that the transfer was ‘for NO CONSIDERATION . . .’”

Given this sequence, Mr. Mandell’s transfer of land to his LLC could seem gratuitous. After all, his admission into the LLC as its sole member provided him with all the economic and governance rights a person could have as a member. His subsequent contribution of the land did nothing to increase his rights as a member.

Of course, anyone who actually believes that Mr. Mandell’s admission as the LLC’s member occurred without contemplation of the land transfer has (1) never heard of the “step transaction” doctrine and (2) like the White Queen in Through the Looking Glass, can “believe[] as many as six impossible things before breakfast.” Indeed, Mr. Mandell contested the transfer tax on an entirely different basis. He argued that “he and his single-member limited liability company should be considered a single entity for taxation purposes, and that any transfer of property between them would fail to satisfy the requirement . . . that transfers be for ‘consideration’ to be taxable . . . because he, as an ‘individual, owns the real estate both before and after the purported transfer . . .’”

Although the Connecticut Supreme Court chose not to follow Mr. Mandell’s suggested “disregarded entity” approach, the fact that the LLC was an SMLLC was crucial to the court’s decision. If, for example, the LLC had had just one additional member, it would have been impossible to pretend that the members (1) had first agreed to become members, with an understanding as to how to share governance rights and allocate profits, and then (2) had just happened to make contributions of property to the LLC—fortuitously, gratuitously, and not in furtherance of their agreement as to membership. But with an SMLLC, “now you see it, . . . now you see it, but it doesn’t matter.”

**Warning: It’s All How You Look at It**

All transfer tax cases depend heavily on the language of the applicable statute, so the Mandell analysis might not apply generally. Nonetheless, the case helps illustrate why lawyers must pay careful attention to the shape-shifting nature of the SMLLC.

Other illustrations are easy enough to find. For example, in Olmstead v. FTC, __ So.3d __, 2010 WL 2518106 (Fl. 2010), the Florida Supreme Court spent more than a year considering an SMLLC question certified by the Eleventh Circuit: do membership transfer restrictions, which were built into LLC statutes in order to prevent the separate creditors of any one LLC member from intruding into the business of a multimember LLC, permit a sole member to shelter assets from the claims of the sole member’s legitimate creditors? The issue is a cause célèbre among LLC practitioners and “asset protection” maven, and in July a sharply divided court reformulated the certified question, opined in favor of the creditor, and left practitioners and scholars wondering whether the decision undermines transfer restrictions for multimember as well as single member LLCs. In another controversial case, the Tax Court recently held that an SMLLC is not a disregarded entity for the purposes of gift tax law. Two vehement dissenters argued that the plain language of the check the box regulations makes them applicable “for [all] federal tax purposes.”

In sum, practitioners must take great care when working with an SMLLC because how separate an SMLLC is from its owner depends on how one looks at the situation. Depending on which legal regime applies, the SMLLC may be as visible and substantial as a stone wall or as diaphanous and prone to disappearance as the Cheshire Cat.


Carter G. Bishop is a co-author of Foreclosure and Dissolution Rights of a Member's Creditors: No Cause for Alarm, a downloadable article available through the ABA Web Store.

While the thought of a judgment creditor of an LLC member petitioning the court for judicial dissolution may strike fear in the minds of lawyers and LLC members everywhere, there is little cause for alarm. Both state and federal law uniformly provide that a member’s transferee may not exercise any of the member’s rights to participate in management, including the statutory right to petition for judicial dissolution. This article was originally published in Probate & Property, Volume 21, No. 3 May/June 2007 by the American Bar Association.

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