

Issues Arising upon the Death of the Sole Member of a Single-Member LLC

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ISSUES ARISING UPON THE DEATH OF THE SOLE MEMBER OF A SINGLE-MEMBER LLC

F. PHILIP MANN, JR. & TIMOTHY M. TODD*

Sole entrepreneurs overwhelmingly choose the single-member limited liability company (SMLLC) as the business entity for their operations. Consequently, simplicity of formation and operation of SMLLCs is highly desirable, both to facilitate entrepreneurship and to acknowledge that costs, lack of knowledge, bad advice, or a combination of them very often will cause sole entrepreneurs to forego professionally drafted documents and accept default SMLLC rules in the jurisdiction of formation.

The death of the sole member is always an anticipated, indeed inevitable, occurrence, so one would expect that the default statutory rules and the widely available forms for SMLLCs would address this eventuality adequately. Unfortunately, that is not the case. In this Article, we address how SMLLC organizational documents should always address the death of the sole member of an SMLLC, and we conclude that a provision for the nonprobate transfer on death of the sole member's interest should be included. We also address the federal tax consequences of death-time transfers of SMLLC interests, and we uncover a thorny conflict between federal income taxes, which disregard the entity, and federal transfer taxes, which regard the entity.

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I. INTRODUCTION

Suppose that Founder operates a substantial business enterprise through a limited liability company of which Founder is the sole member. Such single-member limited liability companies (SMLLCs) are a very

common form of business organization. The SMLLC has largely replaced the sole proprietorship,¹ principally because the sole member of an SMLLC bears no liability for entity debts whereas a sole proprietor bears full liability for any debts of the sole proprietorship. This protection from liability exists because, for purposes of creditor claims, the LLC is an entity separate from its owners, and a sole proprietorship is not. Yet, because LLCs are entities, they operate according to state statutes providing a complete set of default rules for governing the LLC.² Those LLC statutes also grant broad authority to vary the default rules within organizational documents.³ This is an important point because, although any entity can suffer from inadequately drafted organizational documents, the problem is more common and more acute with SMLLCs: inadequate business knowledge, bad advice, concerns about costs, or a combination of them may cause an entrepreneur to forego professionally drafted documents and accept the default SMLLC rules in the jurisdiction of formation.

Suppose Founder dies and the organizational documents governing his SMLLC have made no provisions addressing his death. As a result, the default rules for member death will govern. Because LLCs are governed by the statutes of the state under which the SMLLC was created, fifty-one variations of default rules exist in the United States. However, the states have largely patterned their LLC statutes on four models. Those four models handle the death of the sole member of an SMLLC in different ways.⁴

II. DEATH OF THE SOLE MEMBER OF AN SMLLC UNDER THE FOUR MODEL STATUTES

When considering the consequences of the death of the sole member of an SMLLC, two distinct steps of analysis arise—one related to the owner, the other related to the entity. First, does the death cause the decedent to lose his or her membership status (a process often referred

1. See Rodney D. Chrisman, *LLCs Are the New King of the Hill: An Empirical Study of the Number of New LLCs, Corporations, and LPs Formed in the United States Between 2004–2007 and How LLCs Were Taxed for Tax Years 2002–2006*, 15 FORDHAM J. CORP. & FIN. L. 459 (2010).

2. E.g., ALA. CODE §§ 10A-5A-1.01 to -12.05 (Supp. 2015); VA. CODE ANN. §§ 13.1-1000 to -1080 (2011 & Supp. 2015).

3. See, e.g., ALA. CODE § 10A-5A-1.08; VA. CODE ANN. § 13.1-1011(B) (2011).

4. See *infra* Part II.

to as dissociation)? Second, does the entity dissolve upon the member's dissociation (a process often referred to as dissolution)?

Four models of LLC statutes exist: the Prototype Limited Liability Company Act (ABA Prototype Act)⁵ (1992); the Uniform Limited Liability Company Act (ULLCA)⁶ (1996); the Revised Uniform Limited Liability Company (RULLCA)⁷ (2006); and the Revised Prototype Limited Liability Company Act (ABA Revised Prototype Act)⁸ (2011).

A. ABA Prototype Act (1992)

Under the default rules of the ABA Prototype Act, when the sole member of an SMLLC dies, both dissociation and dissolution occur. A member's death is an event of dissociation under section 802(A)(6).⁹ While that subsection does permit the operating agreement to provide otherwise,¹⁰ under our hypothetical, the operating agreement did not address the member's death.

Under section 901, an event of dissociation of any member causes dissolution of the LLC "unless (1) the business of the limited liability company is continued by the consent of all the remaining *members* on or before the 90th day following the occurrence of any such event or (2) otherwise provided in writing in an operating agreement."¹¹ Under our

5. PROTOTYPE LIMITED LIABILITY COMPANY ACT (AM. BAR ASS'N 1992), *reprinted in* 3 LARRY E. RIBSTEIN & ROBERT R. KEATINGE, RIBSTEIN AND KEATINGE ON LIMITED LIABILITY COMPANIES app. C (2d ed. 2015).

6. UNIF. LTD. LIAB. CO. ACT (UNIF. LAW COMM'N 1996), 6B U.L.A. 653 (2008 & Supp. 2015), <http://www.uniformlaws.org/shared/docs/limited%20liability%20company/ullca96.pdf> [<https://perma.cc/M5M8-58BE>]. The National Conference of Commissioners on Uniform State Laws (NCCUSL) "drafted the original *Uniform Limited Liability Company Act (ULLCA)* in 1992 and adopted it in 1994." Matthew D. Maser & Joseph R. Hefflinger, *Nebraska's New Limited Liability Company Act: A Welcome Improvement for Legal Guidance Concerning Limited Liability Companies*, 89 NEB. L. REV. 470, 471 (2011). NCCUSL thereafter amended the ULLCA in 1996 following promulgation of the "check-the-box" federal tax regulations. *Id.*

7. REVISED UNIF. LTD. LIAB. CO. ACT (UNIF. LAW COMM'N amended 2011), 6B U.L.A. 407 (2008 & Supp. 2015), http://www.uniformlaws.org/shared/docs/limited%20liability%20company/ullca_final_06rev.pdf [<https://perma.cc/95WV-NBKL>]. The RULLCA was adopted by NCCUSL in 2006 and amended in 2011 and 2013. UNIFORM LIMITED LIABILITY COMPANY ACT (2006) prefatory note (UNIF. LAW COMM'N amended 2013), http://www.uniformlaws.org/shared/docs/limited%20liability%20company/ULLCA_Final_2014_2015aug19.pdf [<https://perma.cc/5B7S-VAAW>].

8. REVISED PROTOTYPE LIMITED LIABILITY COMPANY ACT (AM. BAR ASS'N 2011), *reprinted in* 67 BUS. LAW. 117 (2011).

9. PROTOTYPE LIMITED LIABILITY COMPANY ACT § 802(A)(6)(I).

10. *Id.* § 802(A)(6).

11. *Id.* § 901(C) (emphasis added).

hypothetical, the operating agreement does not alter the default dissolution rule.

Consequently, if an SMLLC is formed under the 1992 ABA Prototype Act and lacks an operating agreement addressing dissociation or dissolution, dissolution is automatic when the sole member dies because it is impossible for “all the remaining members”—who do not exist—to consent to continuance.¹²

B. ULLCA (1996)

The default rules of the ULLCA create an entity adrift when the sole member of an SMLLC dies. Under section 601, a member’s death is an event of dissociation,¹³ but under section 801, a member’s dissociation does not dissolve the LLC unless the operating agreement says it does.¹⁴ According to the comments to the ULLCA, that act did not treat a member’s dissociation as a dissolution because of “[n]ew and important Internal Revenue Service announcements [that] clarify that the failure of member dissociation to cause or threaten dissolution of a limited liability company will not cause the company to be taxed like a corporation.”¹⁵ However, the ULLCA’s default anti-dissolution rule seemingly permits an LLC without a member and without a nonjudicial mechanism to dissolve the entity.

Under section 503, a transferee becomes a member only if all other members consent or the operating agreement provides otherwise.¹⁶ Without any members, such consent is impossible to achieve. Therefore, the now undissolved and member-less entity lacks a person to act for it.

The only mechanism to escape the entity-adrift problem under the ULLCA is for the transferee of the sole member’s interest to seek, under section 801(a)(5), “a judicial determination that it is equitable to wind up the company’s business.”¹⁷ Although section 803(b) provides that “[a]

12. *Id.*

13. UNIF. LTD. LIAB. CO. ACT § 601(a)(8)(i) (UNIF. LAW COMM’N 1996), 6B U.L.A. 653, 607–08.

14. *Id.* § 801, 6B U.L.A. at 619. “Unless member dissociation is specified as an event of dissolution in the operating agreement, such dissociation does not dissolve the company.” *Id.* § 801 cmt., 6B U.L.A. at 620.

15. *Id.*

16. *Id.* § 503(a), 6B U.L.A. at 603 (“A transferee of a distributional interest may become a member of a limited liability company if and to the extent that the transferor gives the transferee the right in accordance with authority described in the operating agreement or all other members consent.”).

17. *Id.* § 801(a)(5), 6B U.L.A. at 619.

legal representative of the last surviving member may wind up a limited liability company's business,"¹⁸ an SMLLC is not in dissolution when the sole member dies.¹⁹ Therefore, although section 803 would have provided authority had section 801 caused a dissolution, section 801 does not cause a dissolution when the sole member of an SMLLC dies. Consequently, the dissolution of an SMLLC upon the death of the sole member can occur only by a judicial determination sought by the transferee of the sole member's interest.

Curiously, if the "legal representative of the last surviving member" does "wind up a limited liability company's business,"²⁰ the legal representative must meet the "General Standards of Member's and Manager's Conduct."²¹ However, that legal representative apparently cannot exercise a member's authority to waive the winding up and continue the LLC's business.²²

Consequently, the default operation of the ULLCA produces a difficult-to-solve problem—a continuing entity without a member—that seemingly can be solved only by a judicial order of dissolution. Thus, the default operation of the ULLCA is suboptimal in two respects: Litigation is always necessary, and continuance is impossible.

C. RULLCA (2006)

The RULLCA cures the entity-adrift problem of the ULLCA by creating a mechanism for creating a new member. Under section 602, a member's death is an event of dissociation.²³ However, under section 701,

18. *Id.* § 803(b), 6B U.L.A. at 624.

19. *Id.* § 801 cmt., 6B U.L.A. at 620 ("Unless member dissociation is specified as an event of dissolution in the operating agreement, such dissociation does not dissolve the company.").

20. *Id.* § 803(b), 6B U.L.A. at 624. Section 803(b) is a particular application of the general rule of section 801(a)(5) that the transferee of any member's interest may seek "a judicial determination that it is equitable to wind up the company's business." *Id.* § 801(a)(5), 6B U.L.A. at 19. Note that if the winding up of a multi-member LLC (MMLLC) is occurring by other members, a "member's legal representative" may seek "judicial supervision of the winding up." *Id.* § 803(a), 6B U.L.A. at 624.

21. *Id.* § 409(g), 6B U.L.A. at 598.

22. *Id.* § 802(b), 6B U.L.A. at 623 ("At any time after the dissolution of a limited liability company and before the winding up of its business is completed, the *members*, including a dissociated *member* whose dissociation caused the dissolution, may unanimously waive the right to have the company's business wound up and the company terminated." (emphasis added)).

23. REVISED UNIF. LTD. LIAB. CO. ACT § 602(a)(6)(A) (UNIF. LAW COMM'N amended 2011), 6B U.L.A. 407, 503 (2008) ("A person is dissociated as a member when . . . (6) in the case of an individual: (A) the individual dies . . .").

“[a] limited liability company is dissolved, and its activities must be wound up, upon the occurrence of any of the following: . . . (3) the passage of 90 consecutive days during which the company has no members”²⁴

But, under section 401(d),

[a]fter formation of a limited liability company, a person becomes a member: . . . (3) with the consent of all the members; or (4) if, within 90 consecutive days after the company ceases to have any members: (A) the last person to have been a member, or the *legal representative* of that person, designates a person to become a member; and (B) the designated person consents to become a member.²⁵

Thus, the default operation of the RULLCA creates a dissolution when the LLC has no members for 90 days but also creates a mechanism for the “legal representative of the last person to have been a member” to designate “a person” to become a member within that 90-day period.²⁶ If that designation and consent by the designated person occur within 90 days of the death of the sole member of the SMLLC, then the LLC continues because a dissolution after 90 days without a member necessarily will not occur.²⁷ Thus, the RULLCA provides both maximum flexibility and interpretive difficulty because there is disagreement over who can act as the “legal representative” of the last member. The discussion of the *Whitfield*²⁸ case below amplifies upon the latter point.²⁹

D. ABA Revised Prototype Act (2011)

The ABA Revised Prototype Act operates much like the RULLCA. Under the ABA Revised Prototype Act, death is an event of dissociation. Under section 602, “a person is dissociated as a member from a limited liability company when: . . . (f) in the case of a person who is an individual,

24. *Id.* § 701(a)(3), 6B U.L.A. at 506.

25. *Id.* § 401(d)(3)–(4), 6B U.L.A. at 478 (emphasis added). In addition, the comment to section 104 states as follows: “The dissociation of an LLC’s last remaining member does threaten dissolution. Section 701(a)(3) (stating, as a default rule, that a limited liability company dissolves ‘upon . . . the passage of 90 consecutive days during which the limited liability company has no members’).” *Id.* § 104 cmt. c, 6B U.L.A. at 438.

26. *Id.* §§ 701(a)(3), 702(c)–(d), 6B U.L.A. at 506–08.

27. *Id.* § 702(e), 6B U.L.A. at 508.

28. 150 So. 3d 171 (Ala. 2014).

29. *See infra* Part III.

the person dies . . . ”³⁰ That dissociation will cause a dissolution under section 706 by which “[a] limited liability company is dissolved, and its activities must be wound up, upon the occurrence of any of the following: . . . (d) the passage of 90 consecutive days after the occurrence of the dissociation of the last remaining member”³¹ However, continuation is possible under section 401, which provides:

After formation of a limited liability company, a person is admitted as a member of the limited liability company . . . if, within 90 consecutive days after the occurrence of the dissociation of the last remaining member: (A) all holders of the limited liability company interest last assigned by the last person to have been a member consent to the designation of a person to be admitted as a member; and (B) the designated person consents to be admitted as a member effective as of the date the last person to have been a member ceased to be a member.³²

In addition, section 712 permits reinstatement after dissolution but requires action by members.³³

Thus, the RULLCA and ABA Revised Prototype Act both provide a mechanism to continue an SMLLC after the death of the sole member by action within 90 days of the death.³⁴ The RULLCA requires action by the “legal representative of the last . . . member,”³⁵ while the ABA Revised Prototype Act requires consent of “all holders of the limited liability company interest last assigned by the last person to have been a member.”³⁶ Thus, under the ABA Revised Prototype Act two potential

30. REVISED PROTOTYPE LIMITED LIABILITY COMPANY ACT § 602(f) (AM. BAR ASS’N 2011).

31. *Id.* § 706(d).

32. *Id.* § 401(b)(4).

33. *Id.* § 712. Section 712 provides one default mechanism for reinstatement after dissolution as follows:

A limited liability company that has been dissolved may be reinstated upon compliance with the following conditions: (1) the affirmative vote or consent shall have been obtained from the members or other persons entitled to vote or consent at the time that is . . . sufficient for dissolution under this Act.

Id. § 712(a)(1)(ii). Section 712 provides other methods for reinstatement after dissolution, but those depend upon provisions having been included in the LLC’s operating agreement. *Id.* § 712(a)(1)(i).

34. *Id.* § 401(b)(4); REVISED UNIF. LTD. LIAB. CO. ACT § 403(d)(3)–(4) (UNIF. LAW COMM’N amended 2011), 6B U.L.A. 407, 478 (2008).

35. REVISED UNIF. LTD. LIAB. CO. ACT § 702(c), 6B U.L.A. at 507.

36. REVISED PROTOTYPE LIMITED LIABILITY COMPANY ACT § 401(b)(4)(A).

problems arise in causing a continuation: (1) determining the holders of the deceased member's interest and (2) meeting the requirement of unanimity. The *Whitfield* case discussed below highlights problems in satisfying those requirements.

III. A CASE STUDY: *L.B. WHITFIELD, III FAMILY LLC v. WHITFIELD*

L.B. Whitfield, III Family LLC v. Whitfield is the only reported appellate decision to consider the continuation of an SMLLC upon the death of the sole member.³⁷ The Alabama LLC statutes provided that a person ceased to be a member upon death,³⁸ thereby creating a dissociation. In addition, the death of the last member caused a dissolution unless

a. [t]he holders of all the financial rights^[39] in the limited liability company agree in writing, within 90 days after the cessation of membership of the last member, to continue the legal existence and business of the limited liability company and to appoint one or more new members [or]

b. [t]he legal existence and business of the limited liability company is continued and one or more new members are appointed in the manner stated in the governing documents.⁴⁰

In *Whitfield*, the governing documents did not address the matter, so the statutory default rules squarely applied.⁴¹

After an extended review of the facts, the Supreme Court of Alabama concluded that the holders of all the financial rights had not agreed in writing to continue the LLC.⁴² Apparently, the only document addressing the devolution of the sole member's interest in the SMLLC was his will, which "made specific bequests of certain property and provided that the residue . . . was to be divided in four equal shares."⁴³ The court found that (1) the "all" of the LLC continuation statute meant all four of the sole

37. 150 So. 3d 171 (Ala. 2014).

38. *Id.* at 184 (quoting ALA. CODE § 10A-5-6.06 (2010)).

39. In this regard, the Alabama statute is most like the ABA Revised Prototype Act, permitting dissolution negation by "holders of all the financial rights." *Cf.* REVISED PROTOTYPE LIMITED LIABILITY COMPANY ACT § 401(b)(4).

40. *Whitfield*, 150 So. 3d at 184 (quoting ALA. CODE § 10A-5-7.01).

41. *See id.* at 186 ("The Family LLC presents no argument as to subparagraph b. but does contend that the exception described in subparagraph a. is applicable.").

42. *Id.*

43. *Id.* at 176.

member's residual devisees so that (2) the consent of the personal representative of the sole member's estate was insufficient to trigger the Alabama continuation statute.⁴⁴

The court also rejected the personal representative's argument that he had the power to continue the LLC under the following statute:

(1) If a member who is an individual dies or if a court of competent jurisdiction adjudges a member to be incompetent to manage the member's person or property, the member's personal representative, conservator, legal representative, heirs, or legatees *may exercise all the member's financial rights for the purpose of settling the member's estate or administering the member's property*, including any power the member had to transfer the membership interest.⁴⁵

The court (1) stated that the statutory language does not make the personal representative a member of the LLC but states only that the personal representative may exercise the financial rights;⁴⁶ (2) stated that the power to transfer under the statutory language includes the power to transfer only the financial rights;⁴⁷ (3) quoted legislative commentary as follows: "The personal representative may exercise only the member's financial rights and does not have a right to participate in management [of the limited liability company]";⁴⁸ and (4) stated that the personal representative's rights under that statutory language did not include the power to negate dissolution because the more specific Alabama LLC-continuation statute applied instead.⁴⁹

The specific Alabama LLC-continuation statute provided that "[t]he holders of all the financial rights in the limited liability company [may] agree in writing, within 90 days after the cessation of membership of the last member, to continue the legal existence and business of the limited liability company and to appoint one or more new members."⁵⁰ This

44. *Id.* at 186 & n.10.

45. *Id.* at 184–85 (quoting ALA. CODE § 10A-5-6.04(a)(1)). Statutes of this type often are called twilight statutes because they provide rights to personal representatives during administration of the decedent's estate but not thereafter.

46. *Id.* at 185.

47. *Id.*

48. *Id.* (quoting commentary to ALA. CODE § 10-12-34(a)(1), which had been re-codified identically in ALA. CODE § 10A-5-6.04(a)(1) (LexisNexis 2010)).

49. *Id.* ("[T]he Family LLC misunderstands the relative roles of the provisions of § 10A-5-6.04 [twilight powers] and those of § 10A-5-7.01(3) [continuation powers].").

50. ALA. CODE § 10A-5-7.01(3)(a) (2010). The legislative comments to that section state

provision resembles section 401(b)(4) of the ABA Revised Prototype Act.⁵¹ Under both, a dissolution for lack of members can be negated by the creation of a new member within 90 days after the LLC ceased to have members.⁵² Under the ABA Revised Prototype Act, the continuation power belongs to “all holders of the limited liability company interest last assigned by the last person to have been a member” who must “consent to the designation of a person to be admitted as a member.”⁵³ Under the Alabama statute, the continuation power belongs to “[t]he holders of all the financial rights in the limited liability company” who must “agree in writing.”⁵⁴

In *Whitfield*, no problem existed in identifying holders of the deceased member’s LLC interest and no real controversy existed about whether the four residual beneficiaries under the will had agreed in writing to a continuation; they clearly had not.⁵⁵ However, difficulties can easily arise in identifying the holders of the deceased member’s SMLLC interest who jointly possess the continuation power under either the Alabama statute or the ABA Revised Prototype Act. Suppose that the former sole member died intestate and the identity of all intestate successors cannot be made within 90 days. Suppose further that the residual beneficiary of the former member’s will is the trustee of a trust. *Whitfield* seemingly

that the section was based on ABA Prototype Act section 901 and ULLCA section 801. ALA. CODE § 10A-5-7.01 (LexisNexis 2010). Section 901 of the ABA Prototype Act, as noted above, causes a dissolution on death of a member and permits continuation only by the consent of all of the remaining members within 90 days. PROTOTYPE LIMITED LIABILITY COMPANY ACT § 901 (AM. BAR ASS’N 1992). No provision was made for holders of financial interests to effect the continuation. Section 801 of the ULLCA does not cause a dissolution upon death (or any other dissociation of a member) and has no continuation provision (other than for dissolutions due to “event[s] that make[] it unlawful for all or substantially all of the business of the company to be continued”). UNIF. LTD. LIAB. CO. ACT § 801 (UNIF. LAW COMM’N 1996), 6B U.L.A. 653, 619. Consequently, notwithstanding the comments in the Alabama statute—about being based on the ABA Prototype Act and ULLCA—the Alabama continuation provision most closely resembles section 401(b)(4) of the ABA Revised Prototype Act.

51. See REVISED PROTOTYPE LIMITED LIABILITY COMPANY ACT § 401(b)(4) (AM. BAR ASS’N 2011).

52. Compare ALA. CODE § 10A-5A-7.01 (2010), with REVISED PROTOTYPE LIMITED LIABILITY COMPANY ACT § 401(b)(4).

53. REVISED PROTOTYPE LIMITED LIABILITY COMPANY ACT § 401(b)(4)(A).

54. ALA. CODE § 10A-5-7.01(1)(a).

55. L.B. Whitfield, III Family LLC v. Whitfield, 150 So. 3d 171, 186 (Ala. 2014) (“Such principles require a rejection of the notion embedded throughout the Family LLC’s attempt to interpret those provisions differently—that somehow the sisters could agree to the continuation of the Family LLC and/or become members of it by implication or by [the personal representative’s] actions rather than their own actions and consent.”).

requires the consent of all of the beneficiaries of that trust.⁵⁶ Contingent beneficiaries exist in nearly all testamentary trusts.⁵⁷ Does this mean that the Alabama statute and the ABA Revised Prototype Act can never permit an agreed continuation in such situations?

In *Whitfield*, the personal representative argued that he had the power to continue the LLC, but the court easily decided he did not have that power under the Alabama LLC-continuation statute; instead, it rested in the holders of the financial rights.⁵⁸ However, under a RULLCA-based statute, the personal representative likely would have had the continuation power.⁵⁹ Under the RULLCA, the person with the power to designate a new member is “the last person to have been a member, or the legal representative of that person.”⁶⁰

The RULLCA leaves the operative term “legal representative” undefined. To identify the “legal representative,” presumably we determine the person to whom the former member’s rights in the LLC transferred. That, in turn, depends on the manner in which the former member owned his interest. If he owned it in his own name alone (as apparently did Mr. Whitfield), the rights in the LLC pass to the former member’s probate estate, in which case the “legal representative” would be the personal representative named in a will if the former member died with a valid will, or would be the administrator if the former member died without a valid will or with a valid will under which a personal representative was not effectively appointed. Of course, determining the identity of the personal representative(s) or administrator(s) within 90 days of the former member’s death can be problematic, especially if the will, the appointment of the personal representative, or the appointment of the administrator is contested. Further, even if the personal

56. *See id.*

57. If the testator wanted to make outright gifts at her death, she would name the devisees outright in her will. She will create a testamentary trust only if she wants to create less-than-outright gifts in her will. For any less-than-outright gift, a future interest near invariably arises in the person who will take after the termination of the interest of the donee of the less-than-outright gift. The gaining of possession under future interests typically is contingent on surviving until the time of possession, so future interests typically are contingent. This makes the identity of all of the beneficiaries difficult because some may not yet be born, or may be minors whose consent to continuation of an LLC is problematic. *See generally* F. Philip Manns, Jr., *New Reasons to Remember the Estate Taxation of Reversions*, 44 REAL PROP. TR. & EST. L.J. 323 (2009).

58. *Whitfield*, 150 So. 3d at 184–85.

59. *See* REVISED UNIF. LTD. LIAB. CO. ACT § 702(c) (UNIF. LAW COMM’N amended 2011), 6B U.L.A. 407, 507 (2008).

60. *Id.* § 401(d)(4), 6B U.L.A. at 478.

representative or administrator can be quickly identified and appointed, how is that person to make the continuation decision? How will the fiduciary duties of the personal representative or administrator apply to making the continuation decision?⁶¹

Thus, of the four model statutes, the RULLCA's default rule handles the matter the best: By placing the continuation power in one person, the RULLCA obviates the need for unanimous agreement of beneficiaries, some of whom may not be ascertainable within the 90-day period of the ABA Revised Prototype Act.⁶² Yet even this, which is the best solution under the four prevailing models, is suboptimal. Consequently, it is our view that relying on the default provisions for SMLLC succession is perilous and ill-advised. Therefore, we would expect that well-drafted governing documents would handle the matter. Surprisingly, the published forms of suggested governing documents either do not address the matter or address it in a suboptimal way.

IV. SUMMARY OF DEFAULT PROVISIONS ON SINGLE MEMBER'S DEATH

Model Statute	Dissociation	Dissolution	Continuation Possible?
ABA Prototype Act (1992)	Yes	Yes	No
ULLCA (1996)	Yes	No, but entity adrift; needs judicial dissolution	No
RULLCA (2006)	Yes	Yes	If legal representative acts in 90 days
ABA Revised Prototype Act (2011)	Yes	Yes	If all holders of the interest agree in 90 days

61. Consider that the personal representative or administrator will be under a fiduciary duty of care requiring him or her to acquire and assess a substantial amount of information about the business enterprise and then to decide whether to continue or dissolve it, all completed within 90 days. That fiduciary—who often is a family member—may lack the necessary skills to make the decision. As well, because of the family situation, the fiduciary's duty to avoid a conflict of interest may make the situation even more fraught with peril.

62. See REVISED UNIF. LTD. LIAB. CO. ACT § 702(d), 6B U.L.A. at 508.

V. WIDELY AVAILABLE FORMS DO NOT ADDRESS DEATH

Despite the substantial problems that arise upon the death of the single member, there is a dearth of discussion on the issue in academic and practitioner literature. Although some authorities recognize the issue,⁶³ the solutions posed are often suboptimal or create more paperwork than the transfer-on-death solution proposed by this Article. Cunningham and Proctor, for example, in their seminal LLC treatise, recognize the myriad of problems that arise when an individual serves as the single member.⁶⁴ They note that, at death, the LLC will have no member, perhaps causing the LLC to cease to exist as an entity; the business assets will pass under probate; and the probate process may freeze management over the business.⁶⁵

To avoid those issues,⁶⁶ some commentators propose a revocable trust structure in which the individual owns the SMLLC membership interest as the trustee of a revocable grantor trust.⁶⁷ In this scenario, at the death of the individual, the successor-trustee now controls both the membership interest and the entity. This solution undoubtedly works and, in some situations, may be optimal—particularly when other estate planning reasons make a trust advisable. But, for many clients—particularly those with the fledgling startup—a revocable living trust setup only compounds complexity.⁶⁸ That is, a whole new instrument must be drafted, explained to the client, and complied with.⁶⁹ On the other hand, by using a transfer-on-death provision—as this Article advances—the only additional drafting is the needed provisions in the operating agreement.⁷⁰ Thus, we

63. *See, e.g.*, JOHN M. CUNNINGHAM & VERNON R. PROCTOR, DRAFTING LIMITED LIABILITY COMPANY OPERATING AGREEMENTS § 15A.04 (3d ed. 2014-2 Supp.) (“Probate jurisdiction over the membership may effectively freeze the management and disposition of the LLC until the probate court approves the transfer of the membership.”).

64. *Id.*

65. *Id.*

66. Commentators also note that, for continuity of management purposes, a manager-managed SMLLC with a non-member assistant manager can help alleviate these issues as well. *See, e.g., id.* § 15A.07. While true, in part, the issues may not be totally avoided, particularly in states that have forced dissolution upon the death of the single member.

67. *E.g., id.* § 15A.04. Many LLC treatises and resources, however, ignore the issue entirely. *But see id.* § 25C.08 (2015-2 Supp.) (noting that TOD statutes, in some states, may apply to LLC interests).

68. *Id.*

69. *Id.*

70. *See infra* Part VI.C.1.

propose that, in a default or template SMLLC operating agreement, a transfer-on-death provision should be the norm.

VI. ADDRESSING DEATH IN SMLLC DOCUMENTS

A. Effectiveness of Transfer-on-Death Provisions in General

Well into the mid-1900s, courts decided that contracts, deeds, and other instruments could not make transfers effective only at death unless such instruments met the formalities requirements for a valid will, which, of course, they did not.⁷¹ Since then, the nonprobate “revolution” has occurred, and provisions for transfers on death are permitted in a wide variety of instruments in all jurisdictions.⁷² Section 6-101 of the Uniform Probate Code has been a model for many nonprobate “revolution” statutes.⁷³

Under section 6-101 of the Uniform Probate Code, “[a] provision for a nonprobate transfer on death” in any of seventeen types of named instruments plus “other written instrument[s] of a similar nature is nontestamentary.”⁷⁴ Oddly, a plain “contract” is not one of the seventeen named types, nor is an “operating agreement.”

However, included within the seventeen types are “certificated or uncertificated security, account agreement, custodial agreement, deposit agreement, compensation plan,” and “conveyance.”⁷⁵ An LLC operating agreement might be regarded as an “account agreement” because LLCs nearly always operate with an LLC owner having an “account” measuring

71. See *In re Estate of Atkinson*, 175 N.E.2d 548 (Ohio Prob. Ct. 1961) (“[A]n examination of the cases leads inevitably to the conclusion that . . . the registration of the certificates of deposit in this case is an ineffectual attempt at a testamentary disposition of the deposits involved.”).

72. JESSE DUKEMINIER & ROBERT H. SITKOFF, *WILLS, TRUSTS, AND ESTATES* 489 (9th ed. 2013) (“In 1969, the Uniform Probate Code authorized POD designations in all contracts, and almost every state has followed suit.” (citing JEFFREY A. SCHOENBLUM, *MULTISTATE GUIDE TO ESTATE PLANNING* tbl.5.01, Part 2 (2012))).

73. UNIF. PROBATE CODE § 6-101 (UNIF. LAW COMM’N amended 2010), 8 pt. 3 U.L.A. 1, 354 (2013), http://www.uniformlaws.org/shared/docs/probate%20code/2014_UPC_Final_2015dec31.pdf [<https://perma.cc/S7N4-B9C4>].

74. *Id.* (“A provision for a nonprobate transfer on death in [1] an insurance policy, [2] contract of employment, [3] bond, [4] mortgage, [5] promissory note, [6] certificated or uncertificated security, [7] account agreement, [8] custodial agreement, [9] deposit agreement, [10] compensation plan, [11] pension plan, [12] individual retirement plan, [13] employee benefit plan, [14] trust, [15] conveyance, [16] deed of gift, [17] marital property agreement, or other written instrument of a similar nature is nontestamentary.”).

75. *Id.*

her financial interest in the LLC.⁷⁶ Or, an LLC operating agreement might be regarded as a “deposit agreement,” a “compensation plan,” or a “conveyance” because such LLC operating agreements typically involve the conveyance of property by the owner to the entity, involve the entity’s compensating of its owners, or involve the deposit of property into the entity.

Yet the point remains that an LLC operating agreement does not squarely fall within any of the seventeen named categories in Uniform Probate Code section 6-101. However, only a trivial semantic objection supports the conclusion that an LLC operating agreement neither meets nor closely resembles several of the named categories,⁷⁷ so LLC operating agreements either actually meet the categories or constitute “other written instrument[s] of a similar nature.”⁷⁸ As such, LLC operating agreements likely fall within statutes that generally allow transfer-on-death provisions.

Nevertheless, to avoid that semantic objection, a drafter may prefer to rely upon one of the enumerated interests and not the catchall language of “other written instrument of a similar nature.” The best fit of those listed would be “certificated or uncertificated security.”

1. Is an SMLLC Interest a Security Under Uniform Probate Code Section 6-101?

The Uniform Probate Code defines a security as, among other things, “any note, stock, treasury stock, bond, debenture, evidence of indebtedness . . . [or] any interest or instrument commonly known as a security.”⁷⁹ It would then be reasonable to turn to the 1933 Securities Act⁸⁰ to inform the catchall “instrument commonly known as a security.”⁸¹ Under the 1933 Securities Act, the only way an LLC could be a security would be as an “investment contract.”⁸²

76. *See id.* § 6-101, 8 pt. 3 U.L.A. at 354.

77. *See id.*

78. *See id.*

79. *Id.* § 1-201(43), 8 pt. 1 U.L.A. 1, 49 (2013).

80. Securities Act of 1933, ch. 38, 48 Stat. 74 (codified as amended at 15 U.S.C. §§ 77a–77aa (2012)).

81. UNIF. PROBATE CODE § 1-201(43), 8 pt. 1 U.L.A. at 49.

82. 15 U.S.C. § 77b(a)(1) (2012) (defining the term “security” to include, *inter alia*, an “investment contract”).

Under the infamous *Howey* test,⁸³ an investment contract has four elements: (1) an investment of money, (2) in a common enterprise, (3) with an expectation of profit, and (4) based solely on the efforts of others.⁸⁴ The issue with LLC interests generally is element four—profit seeking based on the efforts of others, i.e., control.⁸⁵

In an SMLLC, however, element two—common enterprise—is also problematic because there is no pooling of interests between investors.⁸⁶ Consequently, for our purposes, an SMLLC is not an investment contract regardless of how it is managed, so it is likely not a security under the Uniform Probate Code section 6-101 or the 1933 Securities Act.

2. Is an SMLLC Interest a Security Under Other Uniform Acts?

Another way to argue that an SMLLC is a “security” under section 6-101 of the Uniform Probate Code is to use Uniform Commercial Code (UCC) section 8-102(15), which, as relevant here, defines a security as “an interest in an issuer” that (1) is registered on the books maintained by the issuer, (2) is by its terms divisible into interests, and (3) is a medium for investment and it expressly provides to be governed by Article 8.⁸⁷ By fitting within this definition, it can be argued that the LLC interest satisfies the Uniform Probate Code definition of “commonly known as a security.”⁸⁸ The downside to this approach, of course, is the imposition of UCC Article 8 obligations upon the issuer—here, the SMLLC.

83. See *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946).

84. *Id.* at 298–99.

85. See, e.g., CARTER G. BISHOP & DANIEL S. KLEINBERGER, LIMITED LIABILITY COMPANIES: TAX AND BUSINESS LAW ¶ 11.03 (2016); CUNNINGHAM & PROCTOR, *supra* note 63, § 25B.02, at 25B-8 (2015-2 Supp.) (“Much litigation about whether an LLC membership interest is a security focuses on the control element of the *Howey* test.”).

86. This pooling requirement normally requires either horizontal or vertical commonality. “[H]orizontal commonality requires a pooling of investors’ contributions and distribution of profits and losses on a pro-rata basis among investors.” Maura K. Monaghan, *An Uncommon State of Confusion: The Common Enterprise Element of Investment Contract Analysis*, 63 FORDHAM L. REV. 2135, 2152–53 (1995) (footnotes omitted); see also CUNNINGHAM & PROCTOR, *supra* note 63, § 25B.02, at 25B-9 to -11, (2015-2 Supp.). As commentators have noted, “[a]s long as an LLC has two members, it has horizontal commonality.” BISHOP & KLEINBERGER, *supra* note 85, ¶ 11.03[1][a]. Vertical commonality requires a showing “that the fortunes of the investors are linked with those of the promoters.” *SEC v. Goldfield Deep Mines Co. of Nev.*, 758 F.2d 459, 463 (9th Cir. 1985).

87. U.C.C. § 8-102(a)(15) (AM. LAW. INST. & UNIF. LAW COMM’N 2014).

88. UNIF. PROBATE CODE § 1-201(43) (UNIF. LAW COMM’N amended 2010), 8 pt. 1 U.L.A. 1, 49 (2010).

Another uniform statute to consider is the Uniform TOD Security Registration Act (TOD Act).⁸⁹ It allows a security registered in beneficiary form to pass to that beneficiary at the owner's death.⁹⁰ Here, a "security" is defined as "a share, participation, or other interest in property, in a business, or in an obligation of an enterprise or other issuer, and includes a certificated security, an uncertificated security, and a security account."⁹¹ Although this definition is based on UCC section 8-102,⁹² it is broader, as not all "interest[s] . . . in a business"⁹³ would be a security under other statutory schemes.⁹⁴ An SMLLC interest is likely covered because it is an interest in a business.

The additional key terms to consider are the TOD Act's use of the words "register" and "beneficiary form." To register means, *inter alia*, to initiate an account showing ownership of securities.⁹⁵ Beneficiary form means "a registration of a security which indicates the present owner of the security and the intention of the owner regarding the person who will become the owner of the security upon the death of the owner."⁹⁶ The TOD Act provides further that "[a] security, whether evidenced by certificate or account, is registered in beneficiary form when the registration includes a designation of a beneficiary to take the ownership at the death of the owner or the deaths of all multiple owners."⁹⁷ This registration may be "shown by the words 'transfer on death' or the abbreviation 'TOD,' or by the words 'pay on death' or the abbreviation 'POD,' after the name of the registered owner and before the name of a beneficiary."⁹⁸ It seems, then, that the requirements of the TOD Act can be satisfied by certificating the LLC interest and by providing a space within which to make the designation. Another option, indeed the one preferred by this Article, is to use the LLC operating agreement, as this approach obviates the need to certificate the interest.

89. *Id.* §§ 6-301 to -311, 8 pt. 3 U.L.A. 1, 382-91.

90. *Id.* § 6-307, 8 pt. 3 U.L.A. at 386.

91. *Id.* § 6-301(4), 8 pt. 3 U.L.A. at 382.

92. *Id.* § 6-301 cmt., 8 pt. 3 U.L.A. at 382.

93. *Id.* § 6-301(4), 8 pt. 3 U.L.A. at 382.

94. For example, as described earlier, a member-managed LLC interest likely falls short of the *Howey* test because of significant member control. *See supra* Part VI.A.1.

95. UNIF. PROBATE CODE § 6-301(2), 8 pt. 3 U.L.A. at 382.

96. *Id.* § 6-301(1), 8 pt. 3 U.L.A. at 382.

97. *Id.* § 6-304, 8 pt. 3 U.L.A. at 384.

98. *Id.* § 6-305, 8 pt. 3 U.L.A. at 385.

B. Do LLC Statutes Permit Transfer-on-Death Provisions in LLC Operating Agreements?

No express provision of the Uniform LLC Acts or typical state LLC statutes forbids the use of transfer-on-death provisions in an LLC operating agreement. Consequently, as long as the member complies with the jurisdiction's transfer-on-death statute, no barrier seemingly exists to this technique. To implement the strategy, however, general LLC compliance matters must be addressed.

1. State Law Consequences of a Transfer of the Entire Interest in an SMLLC

Because a transfer of a member's entire interest in an SMLLC to another person is a transaction to which the entity is not a party, the transfer triggers very few—if any—state law consequences to the entity. The parties should consult the entity's articles of organization to see if any information furnished at formation needs to be changed, the principal concerns being the entity's registered agent, registered office, and principal office. The former member may have been the entity's registered agent. If so, the registered agent will need to be changed from the now-former member.⁹⁹ Similarly, the registered office will likewise need to be changed if the registered agent was the former member.¹⁰⁰ Some states allow these items to be changed by using a simple form without the need to formally amend the articles of organization.¹⁰¹ Finally, the principal office may need to be changed as well.¹⁰² It is important to attend to these changes in a timely fashion because the failure to have a proper registered agent or registered office can lead to the involuntary cancellation of the LLC's existence.¹⁰³

99. See, e.g., VA. CODE ANN. § 13.1-1016 (2011). Under some state LLC statutes, non-members can be registered agents only if they are attorneys. See, e.g., *id.* § 13.1-1015(A)(2)(a).

100. See, e.g., *id.* §§ 13.1-1015 to -1016.

101. See, e.g., *id.* § 13.1-1016(A); see also Statement of Change of Registered Office and/or Registered Agent of a Limited Liability Company, Va. SCC Form LLC 1016, https://www.scc.virginia.gov/clk/dom_llc.aspx [<https://perma.cc/AAW2-MU6S>].

102. See, e.g., VA. CODE ANN. § 13.1-1018.1; see also Statement of Change of the Principal Office Address of a Limited Liability Company, Va. SCC Form LLC 1018.1, https://www.scc.virginia.gov/clk/dom_llc.aspx [<https://perma.cc/AAW2-MU6S>].

103. See, e.g., VA. CODE ANN. § 13.1-1050.3(A)(2).

2. *Ott v. Monroe*: Judicial Barriers to Transfer Planning

We recommend that SMLLC operating agreements generally include a provision that causes a nonprobate transfer on death of the single member's membership interest.¹⁰⁴ However, at least one state supreme court decision portends problems for their use.¹⁰⁵ In *Ott v. Monroe*,¹⁰⁶ the Supreme Court of Virginia construed the Virginia LLC Act to preclude a member in a multi-member LLC (MMLLC) from assigning his membership interest in the LLC.¹⁰⁷

Although *Ott* addresses an MMLLC, it is relevant to single-member LLCs because *Ott* flatly prohibited any operating agreement from causing an at-death transfer of the member's membership interest.¹⁰⁸

In *Ott*, a husband and wife formed an LLC that they owned 80% and 20% respectively and entered into a written operating agreement.¹⁰⁹ The salient provisions of the operating agreement were as follows: Paragraph 2 provided, "Except as provided herein, no Member shall transfer his

104. See *infra* Part VI.C.1.

105. See F. Philip Manns & Rodney D. Chrisman, *The Disastrous Dicta of Ott v. Monroe, 2011 Va. LEXIS 214 (Nov. 4 2011)*, LIBERTY LEGAL J., Fall 2012, at 16 (discussing the problems inherent in the *Ott* decision).

106. 719 S.E.2d 309 (Va. 2011).

107. *Id.* at 312–13.

108. *Ott* addresses a Virginia MMLLC. See *id.* at 310. For SMLLCs, Virginia is of the "entity-adrift" type, as described earlier in the Article, meaning that when the single member of an SMLLC dies and the organizational documents do not address the matter, the entity continues but without a member. See *supra* Part II. Under Virginia law, where organizational documents do not address the matter, the death of an individual member is an event of dissociation. VA. CODE ANN. § 13.1-1040.1(7)(a). However, a member's dissociation does not cause dissolution. *Id.* § 13.1-1040.2(B). The "successor in interest [to the deceased member] shall continue to hold a membership interest and shall have the same rights that an assignee of the membership interest would have under subsection A of § 13.1-1039." *Id.* § 13.1-1040.2(A). However, under section 13.1-1039(A), "[e]xcept as provided in subsection A of § 13.1-1040, an assignment does not entitle the assignee to participate in the management and affairs of the limited liability company or to become or to exercise any rights of a member." *Id.* § 13.1-1039(A) (Supp. 2015). And, under section 13.1-1040(A),

an assignee of an interest in a limited liability company may become a member only by the consent of a majority of the member-managers (other than the assignor member) of a manager-managed limited liability company of which one or more members is a manager, or by a majority vote of the members (other than the assignor member) of any other limited liability company.

Id. § 13.1-1040(A) (2011). Thus, death causes a dissociation but not a dissolution, and the LLC lacks a member because the successor in interest to the deceased member of the SMLLC may become a member only with the consent of the members other than the assignor member, of which there are none.

109. *Ott*, 719 S.E.2d at 310.

membership or ownership, or any portion or interest thereof, to any non-Member person, without the written consent of all other Members, except by death, intestacy, devise, or otherwise by operation of law.”¹¹⁰ Paragraph 10(B) provided, in relevant part, “[N]o Member shall, directly or indirectly, transfer, sell, give, encumber, assign, pledge, or otherwise deal with or dispose of all or any part of his Membership Interest now owned or subsequently acquired by him, other than as provided for in this Agreement.”¹¹¹ Paragraph 10(C) provided that “any Member . . . may transfer all or any portion of the Member’s Interest at any time to . . . [o]ther Members [or] [t]he spouse, children or other descendants of any Member.”¹¹²

The husband died, and his will left his entire estate to his daughter.¹¹³ The daughter asserted ownership of her deceased father’s 80% interest in the LLC.¹¹⁴ She held a meeting in which she purported to remove the wife as manager of the LLC and install herself, the daughter, as manager.¹¹⁵ The wife then sued the daughter, arguing that the daughter acceded only to her late husband’s financial rights in the LLC.¹¹⁶ The trial court agreed with the wife by holding that the husband was dissociated from the company at his death, which terminated his control rights, and, therefore, the daughter received only the father’s financial rights in the LLC.¹¹⁷ The daughter appealed to the Supreme Court of Virginia.¹¹⁸

The Supreme Court of Virginia affirmed the trial court.¹¹⁹ The court noted that, except as provided in the articles of organization or operating agreement, section 13.1-1040.1(7)(a) of the Code of Virginia dissociates a member upon the member’s death and terminates the member’s control rights in the company.¹²⁰ The court rejected the daughter’s assertion that Paragraph 2 of the operating agreement countered section 13.1-1040.1(7)(a)’s default rule because, according to the court, Paragraph 2

110. *Id.*

111. *Id.*

112. *Id.* (alteration in original).

113. *Id.*

114. *Id.*

115. *Id.*

116. *Id.*

117. *Id.*; *see also* Ott v. Monroe, No. CL08-1269, 2010 WL 8749605 (Stafford Cty. Cir. Ct. June 23, 2010).

118. *Ott*, 719 S.E.2d. at 310.

119. *Id.* at 313.

120. *Id.* at 312.

“lack[ed] specific language that would constitute an exception to the rule of dissociation.”¹²¹ Consequently, the daughter became a “mere assignee,” i.e., acceded to the financial interest only.¹²²

So far, so good—this is a correct and proper interpretation of Virginia law and general LLC law regarding multi-member LLCs.¹²³ That is, without specific language in an organizational document to the contrary, death dissociates a member, his remaining interest is only a financial interest and not a managerial interest, and that financial interest is subject to disposition as personal property.¹²⁴ Despite having completely resolved the case at that point, the Supreme Court of Virginia proceeded to further elucidate (disastrously so) the Virginia LLC Act.

The court noted that, even if Paragraph 2 had superseded the default death-dissociation rule, “it is not possible for a member unilaterally to alienate his personal control interest in a limited liability company.”¹²⁵ The court reasoned that because the words “[u]nless otherwise provided in the articles of organization or an operating agreement” did not appear in the same statutory sentence that regards an assignee becoming a member,¹²⁶ the assignee-admission rule is a mandatory rule that cannot be changed.¹²⁷ This dicta is completely wrong.¹²⁸

First, the *Ott* dicta runs counter to the Virginia LLC Act because it reads section 13.1-1039 in isolation and, therefore, fails to consider the effect of section 13.1-1040.¹²⁹ Section 13.1-1040—the assignee-admission rule—expressly contemplates that an organic document can change the

121. *Id.*

122. *Id.*; see also VA. CODE ANN. § 13.1-1040.2 (2011) (noting that, despite dissociation, a member’s financial interest remains intact); *id.* § 13.1-1039 (Supp. 2015) (providing that a member’s financial interest is assignable in whole or in part).

123. As noted earlier, with an SMLLC, upon death of the sole member, dissolution looms upon dissociation without an effective mechanism to create a new member. By contrast, with an MMLLC, dissociation does not trigger dissolution because other members exist. See *supra* Part II.

124. See VA. CODE ANN. § 13.1-1038 (2011) (“A membership interest in a limited liability company is personal property.”).

125. *Ott*, 719 S.E.2d at 312.

126. *Id.* At the time of *Ott*, section 13.1-1039(A) read, in relevant part, “[a]n assignment does not entitle the assignee to participate in the management and affairs of the limited liability company or to become or to exercise any rights of a member.” *Id.* 312–13 (quoting VA. CODE ANN. § 13.1039(A) (2006)).

127. See *id.* at 312–13.

128. See Manns & Chrisman, *supra* note 105, at 18.

129. *Id.* at 16.

process by which a financial assignee becomes a management member.¹³⁰ Second, the *Ott* dicta runs counter to general partnership law principles, which serve as the theoretical underpinning of state LLC law. For example, the Virginia Uniform Partnership Act permits the partnership agreement to override the default rule and provide that control rights transfer to assignees.¹³¹ Third, the *Ott* dicta “trumps the freedom of contract theory, which is the underlying policy of virtually all LLC statutes.”¹³²

Although *Ott* did not address TOD designations, its rationale is problematic for the deathtime planning of LLC control rights, regardless of the form, e.g., testamentary or non-testamentary transfer. If the *Ott* reasoning is sound—which the authors contend that it is not—then even if an SMLLC member makes a TOD designation, the donee arguably

130. Section 13.1-1040 provides:

Except as otherwise provided in writing in the articles of organization or an operating agreement, an assignee of an interest in a limited liability company may become a member only by the consent of a majority of the member-managers (other than the assignor member) of a manager-managed limited liability company of which one or more members is a manager, or by a majority vote of the members (other than the assignor member) of any other limited liability company.

VA. CODE ANN. § 13.1-1040 (2011) (emphasis added).

131. *See id.* §§ 50-73.81, .99(I), .106 (2009); *see also* UNIF. P’SHIP ACT §§ 105, 402, 502, (UNIF. LAW COMM’N amended 2013), 6 U.L.A. 1, 27–29, 89–90, 109 (2015), http://www.uniformlaws.org/Shared/Docs/Partnership/UPA%20_Final_2014_2015aug19.pdf [<https://perma.cc/X4V8-W2CX>].

132. Manns & Chrisman, *supra* note 105, at 17; *see also* Mohsen Manesh, *Delaware and the Market for LLC Law: A Theory of Contractibility and Legal Indeterminacy*, 52 B.C. L. REV. 189, 225 (2011) (“Delaware LLCs are regarded as ‘creatures of contract,’ representing a voluntary, contractual relationship among private parties.”). Moreover, “limited liability companies are creatures of contract, ‘designed to afford the maximum amount of freedom of contract, private ordering and flexibility to the parties involved.’” *TravelCenters of Am., LLC v. Brog*, No. 3516-CC, 2008 WL 1746987, at *1 (Del. Ch. Apr. 3, 2008) (quoting *In re Grupo Dos Chiles, LLC*, No. Civ.A. 1447-N, 2006 WL 668443, at *2 (Del. Ch. Mar. 10, 2006)).

accedes only to the financial rights.¹³³ This, of course, is problematic because who—if anyone—is in control of the entity?¹³⁴

C. Recommended Provisions in SMLLC Operating Agreements

Widely available forms for SMLLCs do not address the death of the sole member of an SMLLC.¹³⁵ We propose the following transfer-on-death provision for a form SMLLC Operating Agreement.

1. Suggested Form Language

Article xx. Transfer on Death.

Sole Member designates, pursuant to <cite to state version of Uniform Probate Code section 6-101>, the following transfer-on-death beneficiaries to acquire, upon *Sole Member's* death, *Sole Member's* entire Interest existing at the time of *Sole Member's* death: *TOD1*, if *TOD1* survives *Sole Member* by *y* hours [days], and if not, then to *TOD2*, provided *TOD2* survives *Sole Member* by *z* hours [days]. “Interest” means the ownership interest of a Member in the Company, including, without limitation, management rights, financial rights, and other benefits under this Operating Agreement and the <state LLC Act>.

Article xy. Tax Treatment.

The Company intends to be a single-member LLC and a “disregarded entity” for income tax purposes, so that Company’s activities will be reflected on the sole member’s individual income tax return. If at any time there are two or more Members, this Agreement must be revised to address the relative rights and obligations of such other Members and to address any change in the status of the Company for income tax purposes.

Sole member = the name of the sole member

TOD1 = name of primary transfer-on-death beneficiar[ies]

TOD2 = name of contingent transfer-on-death beneficiar[ies]

133. In the wake of *Ott*, the Virginia General Assembly amended section 13.1-1039 by adding the magic language required by the Supreme Court of Virginia. Act of April 3, 2013, ch. 772, 2013 Va. Acts 1529, 1530. Section 13.1-1039 now reads, in relevant part, “Unless otherwise provided in the articles of organization or an operating agreement, such an assignment entitles the assignee to receive, to the extent assigned, only any share of profits and losses and distributions to which the assignor would be entitled.” VA. CODE ANN. § 13.1-1039(A) (Supp. 2015) (emphasis added). The reasoning of *Ott's* dicta—that the magic statutory language is needed on a rule-by-rule basis to make any rule non-mandatory—has not been rebuffed, however. At least in Virginia, then, the *Ott* dicta now lies in wait for other statutory provisions and related organic document clauses to be challenged.

134. See *supra* Part III.

135. See *supra* Parts IV, V.

2. Discussion

a. *Negating the Uniform Simultaneous Death Act*

The Uniform Simultaneous Death Act (USDA), or its functional equivalent, has been adopted in all states.¹³⁶ Under the USDA, the beneficiary of a transfer-on-death provision must survive the transferor by 120 hours.¹³⁷ Such a gap is not optimal with an SMLLC because during the gap no member would exist. Consequently, when authority to act may be required immediately upon the death of the single member, the drafter may want to negate the 120-hour rule by expressly requiring survival but expressly shortening the survival period. By contrast, if the need to act immediately is not expected, the drafter may want to lengthen the survival period to obviate the need for a probate in the estate of the TOD beneficiary if she dies soon after the original sole member.

b. *Provision Addressing Income Tax Treatment*

The default income tax treatment for SMLLC operations is simple: the activities are reported on the sole member's individual income tax return.¹³⁸ By contrast, the default income tax treatment for MMLLC operations is quite complex: The entity is taxed as a partnership.¹³⁹ The purpose of the tax treatment article in our proposed form language is to alert the member(s) to consider the federal tax consequences of transferring SMLLC interests, which are considered in the next part.¹⁴⁰

However, because the federal gift and federal estate tax consequences of transfers of SMLLC interests have not been resolved, we first consider the tax consequences of transfers of SMLLC interests by sale and then by lifetime and deathtime gift.

136. The Uniform Simultaneous Death Act was originally promulgated in 1940 and was adopted in forty-nine states. *Simultaneous Death Act*, UNIFORM L. COMMISSION, <http://www.uniformlaws.org/Act.aspx?title=Simultaneous%20Death%20Act> [<https://perma.cc/Z3NJ-HXJS>] (last visited Mar. 18, 2016).

137. UNIF. SIMULTANEOUS DEATH ACT § 2 (UNIF. LAW COMM'N 1993), 8B U.L.A. 315, 324 (2014), http://www.uniformlaws.org/shared/docs/simultaneous%20death/USDA_2011_Final%20Act_2014sep10.pdf [<https://perma.cc/DFT5-MVYF>].

138. See Treas. Reg. § 301.7701-3(b)(1)(ii) (2015).

139. See *id.* § 301.7701-3(b)(1)(i).

140. See *infra* Part VII.

VII. FEDERAL TAX CONSEQUENCES OF TRANSFERRING SMLLC INTERESTS

In business entity taxation, ownership interests in entities are nearly always treated separately from the interests that the entity has in its assets and operations. However, under the check-the-box regulations, an SMLLC, by default, is “[d]isregarded as an entity separate from its owner.”¹⁴¹ In other words, the entity does not exist for classification purposes, and its owner is treated as operating a sole proprietorship.¹⁴²

A. *Income Taxation of Transfers of SMLLC Interests*

Because the SMLLC is a disregarded entity for income tax purposes, the sale of an entire interest in an SMLLC, unlike other transfers of business interests, constitutes a sale of each of the underlying assets of the entity.¹⁴³ If the sole member of an SMLLC sells his entire interest in the SMLLC to another person, the member-seller calculates the gain or loss from the sale based on the difference between the sales price of the interest (known as the amount realized)¹⁴⁴ and the constituent income tax basis¹⁴⁵ of each of the entity’s assets.¹⁴⁶ The character of gain on the sale of each asset would depend on the nature of the underlying asset (e.g., capital or ordinary).¹⁴⁷ The gain or loss would be long- or short-term based on the holding period that the member (entity) held each asset.¹⁴⁸ The buyer takes a basis in the purchased assets based on the consideration paid for those assets,¹⁴⁹ which should be allocated in the purchase

141. Treas. Reg. § 301.7701-3(b)(1)(ii). The SMLLC may elect to be taxed as an association (i.e., a corporation). *See id.* § 301.7701-3(a) (“[A]n eligible entity with a single owner can elect to be classified as an association or to be disregarded as an entity separate from its owner.”).

142. *Id.* § 301.7701-2(a) (“[I]f the entity is disregarded, its activities are treated in the same manner as a sole proprietorship, branch, or division of the owner.”).

143. *See id.* § 301.7701-3; Rev. Rul. 99-5, 1999-1 C.B. 434. Although, the sale of a partnership interest and S corporation stock can also result in a partial asset look-through in certain instances (e.g., for collectibles gain). *See* I.R.C. §§ 1, 741, 751 (2012); Treas. Reg. § 1.1(h)-1. The check-the-box regulations were designed to simplify the tax classification of LLCs. *See, e.g.,* Roger F. Pillow et al., *Simplified Entity Classification Under the Final Check-the-Box Regulations*, 86 J. TAX’N 197, 208 (1997).

144. I.R.C. § 1001(b).

145. *See id.* §§ 1011–12, 1016.

146. *Id.* § 1001; *see also* Rev. Rul. 99-5, 1999-1 C.B. 434.

147. I.R.C. § 1221.

148. *Id.* § 1223.

149. *Id.* §§ 1011–12.

agreement.¹⁵⁰ If there is no allocation agreement, the allocation rules of § 338(b)(5) of the Internal Revenue Code¹⁵¹ control (by virtue of § 1060, discussed next).

The sale of an entire interest in an SMLLC triggers the applicable asset acquisition rules of § 1060 of the Internal Revenue Code.¹⁵² An “applicable asset acquisition” is any transfer of assets that meets two requirements: (1) the assets “constitute a trade or business” and (2) “the transferee’s basis in such assets is determined wholly by reference to the consideration paid for such assets.”¹⁵³ In our hypothetical, when the entire interest in an SMLLC is transferred, an applicable asset acquisition occurs. First, the SMLLC’s assets constitute a trade or business.¹⁵⁴ Second, because the SMLLC is disregarded, the purchaser is, in the tax sense, buying the individual assets from the seller; thus, his basis in those assets is determined by the consideration paid.¹⁵⁵ Under § 1060, the parties may agree in writing about the allocation of the consideration and the fair market value of the entity’s assets.¹⁵⁶ The agreement binds both the transferee and the transferor unless the Internal Revenue Service (Service) determines that such allocation is not appropriate.¹⁵⁷ In the absence of an allocation agreement—or if the Service rejects the proffered allocation—the rules of § 338(b)(5) govern.¹⁵⁸

150. See *id.* § 1060(a).

151. See *id.* Section 338 is another instance in which a sale of an interest in an entity—corporate stock—is treated as a sale of assets by the entity. *Id.* § 338. An asset sale is normally preferable to a stock sale because the purchaser obtains a stepped-up basis in the purchased assets; by contrast, in a straight stock sale, the purchaser takes a cost basis in the purchased securities, with no change in the basis of the company’s assets. *Id.* § 338(b).

152. See, e.g., BISHOP & KLEINBERGER, *supra* note 85, ¶ 8.07[1][a][iii].

153. I.R.C. § 1060(c).

154. See Treas. Reg. § 1.1060-1(b)(2)(i) (2015); *id.* § 1.355-3(b)(2)(ii) (defining “trade or business”). The activities of an SMLLC might not rise to the level of a trade or business, if for instance it only held property for investment. However, in our hypothetical, the SMLLC is operating a business.

155. See I.R.C. §§ 1011–12.

156. *Id.* § 1060(a) (flush language).

157. *Id.*

158. *Id.*; see also Treas. Reg. § 1.338-6. Section 338 operates by using a residual method of calculation that allocates the stock purchase price to assets in seven asset classes. Treas. Reg. § 1.338-6(b). Class I assets are cash and general deposit accounts, other than certificates of deposit; Class II assets are actively traded personal property, certificates of deposit, and foreign currency; Class III assets are “assets that the taxpayer marks to market at least annually for [f]ederal income tax purposes and debt instruments”; Class IV assets are stock in trade of the taxpayer and inventory; Class V assets are all assets other than Class I, II, III, IV, VI, and VII assets; Class VI assets are § 197 intangibles other than goodwill and going concern value; Class

B. Gift Taxation of Transfers of SMLLC Interests

If the SMLLC interest is instead transferred by lifetime gift, two mutually exclusive tax scenarios potentially arise.

1. Disregarding the SMLLC: Analogy to Income Tax

First, under the check-the-box regulations, the Service's rationale in Revenue Ruling 99-5,¹⁵⁹ and analogy to the sale of an SMLLC member's interest, the gift of an SMLLC interest would be deemed a transfer of each of the entity's assets. Thus, the member-donor does not have a realization event, and the donee recognizes no income upon receipt of the gift.¹⁶⁰ The donee will take a transferred basis in the assets,¹⁶¹ except that if the donor's basis of an asset is less than its fair market value, then for purposes of determining loss, the basis in the hands of the donee for that asset will be limited to the fair market value on the date of gift.¹⁶²

The second tax scenario is that the SMLLC—notwithstanding the check-the-box regulations—will be regarded for federal gift tax purposes, and the transaction will be considered a transfer of the actual SMLLC interest, not the underlying assets. Under this scenario, the donor-member still does not have a realization event, and the donee still recognizes no income upon receipt of the SMLLC-interest gift.¹⁶³ However, the donee will take a transferred basis in the SMLLC interest (not the underlying assets), except that if the basis of the SMLLC interest is less than its fair market value, then for purposes of determining loss, the basis in the hands of the donee of the SMLLC interest will be limited to the fair market value on the date of gift.¹⁶⁴ Scenario two potentially exists because of the U.S. Tax Court's controversial decision in *Pierre v. Commissioner*.¹⁶⁵

VII assets are goodwill and going concern value. *Id.* In effect, therefore, typically the purchaser will take a fair market value basis in all non-goodwill, non-going concern assets. *See id.* Any residual consideration that remains (after valuing the Class I through Class VI assets) will be allocated to goodwill and going concern value. *Id.*

159. Rev. Rul. 99-5, 1999-1 C.B. 434.

160. *See* I.R.C. § 102.

161. *Id.* § 7701(a)(43) (“The term ‘transferred basis property’ means property having a basis determined under any provision of subtitle A (or under any corresponding provision of prior income tax law) providing that the basis shall be determined in whole or in part by reference to the basis in the hands of the donor, grantor, or other transferor.”).

162. *Id.* § 1015.

163. *Id.* § 102.

164. *Id.* § 1015.

165. 133 T.C. 24 (2009).

2. Regarding the Disregarded SMLLC: *Pierre v. Commissioner*

In *Pierre*, Ms. Pierre organized an SMLLC in New York and contributed \$4.25 million to it.¹⁶⁶ A few days later, she transferred her interest in the SMLLC to two trusts,¹⁶⁷ and both trusts were treated as entities separate from Pierre.¹⁶⁸ Pierre filed a gift tax return, treated the gifts as transfers of interests in the entity (rather than gifts of the entity's assets), and applied valuation discounts typically used when valuing gifts of interests in entities.¹⁶⁹ The Service, however, determined that the transfer was properly treated as gifts of proportionate shares of the underlying assets, not as interests in the SMLLC.¹⁷⁰

The Service argued that the check-the-box regulations require that the SMLLC be disregarded for federal gift tax purposes so that "petitioner's transfers of interests in [the SMLLC] should be 'treated' as transfers of cash and marketable securities" (which were the assets of the SMLLC).¹⁷¹ Pierre argued that, for federal gift tax purposes, state law, rather than the federal tax check-the-box regulations, determined the nature of interest in property transferred and the legal rights inherent in that gifted property.¹⁷² Because New York state law classified an LLC interest as personal property and provided that an LLC member has no discrete property interest in the entity's assets,¹⁷³ Pierre argued that she did not transfer the entity's assets but instead transferred an SMLLC interest for which lack of control and lack of marketability discounts were appropriate when valuing her gifts.¹⁷⁴

The Tax Court first examined the history of the gift tax valuation regime. It noted that the amount of a gift of property "is the value of the

166. *Id.* at 25.

167. *Id.* The actual transaction occurred in several steps that resulted in a complete transfer of the entire SMLLC interest. *Id.*

168. Certain trusts are not regarded as an entity separate from the person who creates the trust. See I.R.C. § 671. Often called "grantor trusts," they are defined in subpart E of subchapter J of the Internal Revenue Code. *Id.* §§ 671–79. A revocable living trust is the archetypal grantor trust. *Id.* § 676. When a revocable living trust owns the sole interest in an SMLLC, there is a double look through (once through the trust and once through the LLC) to treat the trust's grantor as the owner of the LLC's assets. That double look through is one of the strategies to address the death of the sole member. See *supra* Part V.

169. *Pierre*, 133 T.C. at 26.

170. *Id.*

171. *Id.* at 27.

172. *Id.*

173. N.Y. LTD. LIAB. CO. LAW § 601 (McKinney 2007).

174. *Pierre*, 133 T.C. at 27.

property at the date of the gift”¹⁷⁵ and that “[i]t is the value of the property passing from the donor that determines the amount of the gift.”¹⁷⁶ The court then turned to Supreme Court case law and noted that the gift tax is an excise tax, not a direct tax.¹⁷⁷ Further synthesizing the Supreme Court’s transfer tax cases, the Tax Court noted that “[a] fundamental premise of transfer taxation is that State law creates property rights and interests, and Federal tax law then defines the tax treatment of those property rights.”¹⁷⁸ Consequently, “the Internal Revenue Code creates ‘no property rights but merely attaches consequences, federally defined, to rights created under state law.’”¹⁷⁹ The Tax Court described the process of determining the nature and amount of a gift under federal gift tax law as follows: “(1) [determine] under State law . . . the property interest that the donor transferred, (2) [determine] the fair market value of the transferred property interest and the amount of the transfer to be taxed, and (3) [calculate] the Federal gift tax due on the transfer”¹⁸⁰

Applying that process, the Tax Court held that the taxpayer did not have a property interest in the underlying SMLLC assets and federal law could not create taxable property rights in those assets.¹⁸¹ Therefore, “pursuant to the historical Federal gift tax valuation regime, petitioner’s gift tax liability is determined by the value of the transferred interests in [the SMLLC], not by a hypothetical transfer of the underlying assets of [the SMLLC].”¹⁸²

The Tax Court then examined whether the check-the-box regulations changed the historic gift tax valuation approach. Treasury Regulation section 301.7701-1(a)(1) provides:

Classification of organizations for federal tax purposes. . . . The Internal Revenue Code prescribes the *classification* of various organizations for federal tax purposes.

175. *Id.* at 28 (citing I.R.C. § 2512(a) (2006)).

176. *Id.* (citing Treas. Reg. § 25.2511-2(a) (2009)).

177. *Id.* (citing *Bromley v. McCaughn*, 280 U.S. 124 (1929)).

178. *Id.* at 29 (citing *Morgan v. Comm’r*, 309 U.S. 78 (1940)).

179. *Id.* (quoting *United States v. Nat’l Bank of Commerce*, 472 U.S. 713, 722 (1985)); *see also Morgan*, 309 U.S. at 80–81 (“State law creates legal interests and rights. The federal revenue acts designate what interests or rights, so created, shall be taxed. Our duty is to ascertain the meaning of the words used to specify the thing taxed. If it is found in a given case that an interest or right created by local law was the object intended to be taxed, the federal law must prevail no matter what name is given to the interest or right by state law.”).

180. *Pierre*, 133 T.C. at 35.

181. *Id.* at 36.

182. *Id.* at 30.

Whether an organization is an entity separate from its owners for federal tax purposes is a matter of federal tax law and does not depend on whether the organization is recognized as an entity under local law.¹⁸³

Section 301.7701-3(a) and (b), entitled “Classification of certain business entities,” provides:

(a) . . . A business entity . . . can elect its classification *for federal tax purposes* as provided in this section. . . . [A]n eligible entity with a single owner can elect to be classified as an association or to be disregarded as an entity separate from its owner. Paragraph (b) of this section provides a default classification for an eligible entity that does not make an election. . . .

(b) *Classification of eligible entities that do not file an election—*
(1) . . . Except as provided in paragraph (b)(3) of this section, unless the entity elects otherwise, a domestic eligible entity is—

. . . .
(ii) Disregarded as an entity separate from its owner if it has a single owner.¹⁸⁴

As the Tax Court noted, “the default *classification* for an entity with a single owner is that the entity is disregarded as an entity separate from its owner.”¹⁸⁵ The Service cited cases that it believed supported its position that “valid State law restrictions must be ignored for the purpose of determining the interest being transferred under the Federal estate and gift tax regime.”¹⁸⁶ The Tax Court distinguished these cases, however, and did not find them controlling.¹⁸⁷ The Tax Court thus emphasized that

[n]either the check-the-box regulations nor the cases cited by [the Service] support or compel a conclusion that the existence of an entity validly formed under applicable State law must be ignored in determining how the transfer of a property interest in that entity is taxed under Federal gift tax provisions.¹⁸⁸

183. Treas. Reg. § 301.7701-1(a)(1) (2015) (emphasis added).

184. *Id.* § 301.7701-3(a), (b) (emphasis added).

185. *Pierre*, 133 T.C. at 32.

186. *Id.* at 32 (citing *McNamee v. Dep’t of the Treasury*, 488 F.3d 100 (2d Cir. 2007); *Shepherd v. Comm’r*, 115 T.C. 376 (2000), *aff’d*, 283 F.3d 1258 (11th Cir. 2002); *Senda v. Comm’r*, 433 F.3d 1044 (8th Cir. 2006), *aff’g* 88 T.C.M. (CCH) 8 (2004)).

187. *Id.* at 32–33.

188. *Id.* at 35.

In sum, the Tax Court held that, although the check-the-box regulations govern how a single-member LLC will be taxed for federal income tax purposes, the regulations do not “apply to disregard the LLC in determining how a *donor* must be taxed under the Federal gift tax provisions on a transfer of an ownership interest in the LLC.”¹⁸⁹ Adopting the Service’s position—that the SMLLC be disregarded for gift tax purposes—would, according to the Tax Court, result in federal law defining property rights and would go “far beyond *classifying* the [SMLLC] for tax purposes.”¹⁹⁰ Moreover, “[t]o conclude that because an entity elected the *classification* rules set forth in the check-the-box regulations, the long-established Federal gift tax valuation regime is overturned as to [SMLLCs] would be ‘manifestly incompatible’ with the Federal estate and gift tax statutes as interpreted by the Supreme Court.”¹⁹¹

Pierre was a fractured decision;¹⁹² it generated a concurring opinion and two dissenting opinions. Judge Cohen wrote a concurring opinion with the express purpose of squaring *Pierre* with the court’s earlier decision in *Medical Practice Solutions, LLC v. Commissioner*,¹⁹³ which had applied the check-the-box regulations to employment taxes.¹⁹⁴ The first dissent in *Pierre*, written by Judge Halpern, argued that the check-the-box regulations created a “rule of unity” between the proprietor and

189. *Id.*

190. *Id.*

191. *Id.* On this point, *Pierre* raises an interesting issue of administrative law. By stating that applying the check-the-box regulations to the long-established federal gift tax valuation regime would be “manifestly incompatible” with the federal estate and gift tax statutes as interpreted by the Supreme Court, the Tax Court likely forecloses Treasury’s power, at least before the Tax Court, to clarify by regulation that SMLLCs are disregarded for federal estate and gift tax purposes. Under *National Cable & Telecommunications Ass’n v. Brand X Internet Services*, 545 U.S. 967 (2005), an agency usually can adopt an interpretation of a statute contrary to prior judicial decisions, with one glaring exception. “[A] judicial precedent holding that the statute unambiguously forecloses the agency’s interpretation, and therefore contains no gap for the agency to fill, displaces a conflicting agency construction.” *Id.* at 982–83. *Pierre* would appear to be a judicial precedent unambiguously foreclosing the Service’s argument that the disregarded entity rule of the check-the-box regulations applies to the federal estate and tax statutes.

192. The decision was nine to six: Judges Cohen, Foley, Vasquez, Thornton, Marvel, Goeke, Wherry, Gustafson, and Morrison in the majority; and Judges Halpern, Kroupa, Holmes, Colvin, Gale, and Paris dissenting. *Pierre*, 133 T.C. at 36, 41, 52, 60.

193. *Med. Practice Sols., LLC v. Comm’r*, 132 T.C. 125 (2009).

194. *Medical Practice Solutions, LLC* held that the check-the-box regulations were valid insofar as they allowed the collection of employment taxes against the sole member of an SMLLC. *Id.* at 126, 130.

the SMLLC, which dictated the result advanced by the Service.¹⁹⁵ The second dissent, written by Judge Kroupa, argued that the majority opinion ignored the plain text and effectively invalidated the check-the-box regulations because those regulations require that the SMLLC be disregarded *for federal tax purposes*, i.e., the entire tax code (including federal gift taxation).¹⁹⁶

C. Estate Taxation of SMLLC Interests

Although *Pierre* dealt with gift tax valuation,¹⁹⁷ *Pierre*'s rationale could apply equally to estate tax valuation and taxation. The estate tax is separate from the income tax and from the gift tax: Income taxes are addressed in chapter 1 of the Internal Revenue Code,¹⁹⁸ gift taxes in chapter 12,¹⁹⁹ and estate taxes in chapter 11.²⁰⁰ However, gift tax and estate tax provisions typically are construed in the same manner.²⁰¹ Thus, *Pierre* may apply in the estate tax context.

However, for an SMLLC under our hypothetical, the Service, not the estate, typically would prefer the *Pierre* rule. *Pierre* makes valuation discounts available, but such discounts will be optimal only for taxpayers whose federal taxable estates exceed the applicable exclusion amount,²⁰² now \$5.43 million.²⁰³ In our hypothetical SMLLC, Founder operates a substantial business enterprise with minimally tailored organizational documents. In this Article we address how the optimal, minimally tailored organizational documents would address the death of the sole member of an SMLLC. If a sole member's wealth exceeded \$5 million, we would expect him to obtain more sophisticated documents and advice, which likely would result in structures in which valuation discounts would be pursued when making lifetime gifts and estate tax valuations. Conversely, Founder of our hypothetical SMLLC, with wealth below \$5

195. *Pierre*, 133 T.C. at 43 (Halpern, J., dissenting).

196. *Id.* at 52–53 (Kroupa, J., dissenting).

197. *Pierre*, 133 T.C. 24.

198. I.R.C. §§ 1–1400U-3 (2012).

199. *Id.* §§ 2501–24.

200. *Id.* §§ 2001–10.

201. *Harris v. Comm'r*, 340 U.S. 106, 107 (1950) (“The federal estate tax and the federal gift tax, as held in a line of cases ending with *Commissioner v. Wemyss*, and *Merrill v. Fahs*, are construed *in pari materia*, since the purpose of the gift tax is to complement the estate tax by preventing tax-free depletion of the transferor’s estate during his lifetime.” (citations omitted)).

202. See I.R.C. § 2010(c).

203. Rev. Proc. 2014-61, 2014-47 I.R.B. 860, 867 (providing inflation-adjusted amounts).

million, does not need (or want) a valuation discount.²⁰⁴ A valuation discount, moreover, does not benefit an estate not subject to estate tax, and it actually works against the beneficiary of that estate who suffers a lower income tax basis than when *Pierre* applies.²⁰⁵

Although the Service has not made this argument (yet), the estate tax consequences to an SMLLC after *Pierre* are murky. While it would seem simplest to apply Revenue Ruling 99-5 and value each underlying SMLLC asset on the estate tax return of the deceased member, the rationale of *Pierre* cuts against this.²⁰⁶ If we are to value the SMLLC interest in the gift tax context, it would seem as though that rationale ought to apply in equal measure in the estate tax context. Consequently, the personal representative would need to value and report the SMLLC interest on the estate tax return.²⁰⁷

D. Transfer-on-Death Designation Taxation

1. Transfer-on-Death Designation in Favor of One Beneficiary

If a single member makes a transfer-on-death designation for his or her SMLLC interest, there are no immediate tax consequences. The reason for this is twofold: First, the designation does not act as a sale or other disposition of property because there is no realization event.²⁰⁸ Second, there are no gift tax consequences because the designation is not a completed gift, as the designation remains revocable.²⁰⁹ Consequently,

204. Conversely, when an owner of an LLC expects to have a taxable estate, she typically desires valuation discounts, and usually can obtain them, provided she avoids § 2036(a) of the Internal Revenue Code. See Brant J. Hellwig, *On Discounted Partnership Interests and Adequate Consideration*, 28 VA. TAX REV. 531, 579 (2009) (citing *Estate of Bongard*, 124 T.C. 95, 133 (2005)) (“The judicial standard articulated in *Estate of Bongard* for satisfying the adequate and full consideration exception to section 2036(a) therefore turns on the credibility of the purported non-tax reasons for the entity’s formation.”).

205. See I.R.C. § 1014(f) (West Supp. 2015).

206. See *Pierre v. Comm’r*, 133 T.C. 24 (2009).

207. We note that there is also a dearth of commentary on the effect of *Pierre* on the estate tax scheme. We hope to elucidate this in future scholarship.

208. See, e.g., I.R.C. § 1001(a) (2012) (noting that a realization event normally requires a “sale or other disposition of property”); see also *Cottage Sav. Ass’n v. Comm’r*, 499 U.S. 554, 561–62 (1991) (citing *Marr v. United States*, 268 U.S. 536, 540–42 (1925); *Weiss v. Stearn*, 265 U.S. 242, 253–54 (1924); *United States v. Phellis*, 257 U.S. 156, 173 (1921); *Eisner v. Macomber*, 252 U.S. 189, 207–12 (1920)) (“[A] taxpayer realizes taxable income only if the properties exchanged are ‘materially’ or ‘essentially’ different.”).

209. See I.R.C. §§ 2501, 2511; see also Susan N. Gary, *Transfer-on-Death Deeds: The Nonprobate Revolution Continues*, 41 REAL PROP., PROB. & TR. J. 529, 549 (2006).

all of the tax consequences of a TOD designation arise at the death of the donor.

Property that is subject to a transfer-on-death designation is included in a decedent's federal gross estate under § 2038 of the Internal Revenue Code.²¹⁰ Section 2038 includes “the value of any interest in property transferred by the decedent . . . if the enjoyment of the interest was subject at the date of the decedent's death to any change through the exercise of a power by the decedent to alter, amend, revoke, or terminate”²¹¹ The donee will not recognize income upon receipt,²¹² and because the interest was included in the decedent's federal gross estate, the donee will take a basis of the interest's fair market value on the date of death.²¹³

However, when determining the donee's income tax basis, we again are confronted with the *Pierre* conundrum: What is deemed transferred for federal income tax purposes—the SMLLC interest (à la *Pierre*) or the underlying assets (à la Revenue Ruling 99-5)? This is a paramount distinction for basis purposes. What will accede to the coveted step-up in basis,²¹⁴ the underlying assets or the SMLLC interest?

If Revenue Ruling 99-5 governs, then the SMLLC assets are deemed transferred, and those assets receive the step-up in basis provided by § 1014 of the Internal Revenue Code.²¹⁵ If, however, *Pierre*'s rationale can be imported to the transfer-on-death context, the transfer of an SMLLC interest *might* be treated as a transfer of the ownership interest, not the underlying assets (contrary to the rationale of Revenue Ruling 99-5). And there is, in fact, a cogent argument to import *Pierre*. First, the federal gift tax is an excise tax on the ability to transfer property *during life*.²¹⁶ Similarly, the federal estate tax is an excise tax on the ability to transfer property *at death*.²¹⁷ Second, the state law interest that the

210. See Gary, *supra* note 209, at 549. Section 2036 also would include property subject to a TOD designation. I.R.C. § 2036.

211. Treas. Reg. § 20.2038-1(a) (2015).

212. I.R.C. § 102.

213. *Id.* § 1014.

214. Although § 1014 can cause a step-down in basis, business assets nearly always have bases less than their value, principally because of accelerated depreciation. See I.R.C. §§ 167-68, 179, 1016(a)(2); Rev. Proc. 87-57, 1987-2 C.B. 687.

215. See I.R.C. § 1014; Rev. Rul. 99-5, 1999-1 C.B. 434.

216. *Dickman v. Comm'r*, 465 U.S. 330, 340 (1984) (“The gift tax is an excise tax on transfers of property”); *Bromley v. McCaughn*, 280 U.S. 124, 138 (1929).

217. *United States v. Wells Fargo Bank*, 485 U.S. 351, 355 (1988) (“The estate tax is a form of excise tax.”); *U.S. Trust Co. v. Helvering*, 307 U.S. 57, 60 (1939) (noting that the federal

decendent owned is the SMLLC interest, not that of the underlying assets.²¹⁸ Thus, the decedent possessed no direct property rights in those underlying assets to which the federal estate tax could attach. Third, the historical estate tax scheme is very similar—if not identical, except with respect to the lifetime vs. deathtime distinction—to the gift tax regime in *Pierre*.²¹⁹

Note that if *Pierre* applies, then a mismatch could occur between the basis of the one new owner of the SMLLC in her SMLLC interest and the entity's basis in its assets. In the partnership context, the mismatch could be cured with a § 754 election.²²⁰ However, in the nebulous twilight zone of *Pierre* and the check-the-box regulations, no such adjustment mechanism exists.

2. Transfer-on-Death Designation in Favor of Multiple Beneficiaries

A TOD designation can be made in favor of multiple beneficiaries.²²¹ The most analogous authority on point for the taxation of this situation is Revenue Ruling 99-5, which describes “the federal income tax consequences when a single member limited liability company that is disregarded as an entity separate from its owner under [the check-the-box regulations] becomes an entity with more than one owner that is classified as a partnership for federal tax purposes.”²²² Revenue Ruling 99-5 describes two situations: first, an unrelated person, *B*, purchases 50% of an SMLLC from the then-single member, *A*, and the two continue to operate the LLC; second, an unrelated person, *B*, contributes money to the LLC in exchange for a 50% interest in the entity, whose operations continue.²²³

estate tax “is an excise imposed upon the transfer of or shifting in relationships to property at death”); *Walker v. United States*, 83 F.2d 103, 107 (8th Cir. 1936) (“An estate tax is an excise tax upon the privilege of transferring or transmitting property by reason of death and is not a tax on the property itself.”).

218. *See Pierre v. Comm’r*, 133 T.C. 24, 29–30 (2009).

219. In other words, the process for applying the federal estate tax is identical to the gift tax process identified in *Pierre*; that is: (1) determine under state law the property interest that the decedent transferred; (2) determine the fair market value of that transferred interest; and (3) calculate the federal *estate* tax due on that transfer. *See id.* at 35.

220. I.R.C. § 754.

221. *See* UNIF. PROBATE CODE § 6-307 & cmt. (UNIF. LAW COMM’N amended 2010), 8 pt. 3 U.L.A. 1, 386 (2010).

222. Rev. Rul. 99-5, 1999-1 C.B. 434.

223. *Id.*

Situation 1 closely resembles the state law transaction being effectuated by a multi-beneficiary TOD designation—i.e., the SMLLC is being converted into a MMLC by the transfer of LLC interest from the single member. According to the Revenue Ruling, *A* (the single member) is deemed to be selling the underlying assets to *B*, the unrelated person; *A* and *B* are then deemed to contribute the underlying assets to a new partnership under § 721 of the Internal Revenue Code, and the traditional partnership contribution rules apply.²²⁴

With a multi-beneficiary TOD designation, the problems in the twilight zone of *Pierre* and the check-the-box regulations continue. What will be the respective bases of the TOD beneficiaries, as they contribute the assets to the new partnership?

3. Transfer-on-Death Designation for an SMLLC That Has an S-Corporation Election in Effect

Not all SMLLCs are classified as disregarded entities. For example, some SMLLCs elect to be taxed as S corporations to, *inter alia*, save on self-employment taxes.²²⁵ If an SMLLC makes an election to be taxed as a C or S corporation, the *Pierre* tension seemingly does not exist because the entity is not treated as a disregarded entity—the SMLLC is a corporation for federal tax purposes. Consequently, a transfer of the SMLLC interest, which is now effectively stock for tax purposes, is valued, rather than valuing the entity's assets. The personal representative would value the LLC interest (i.e., stock equivalent) for estate tax purposes. The beneficiaries would recognize no income upon receipt²²⁶ and would take a basis in the interest of its fair market value on the date of death.²²⁷ In this case, a multi-beneficiary TOD designation

224. See I.R.C. §§ 721–23, 1223. The possible broader application of *Pierre*, however, makes the ultimate analysis uncertain. Applying *Pierre* broadly, Revenue Ruling 99-5 falls apart in the multiple-beneficiary TOD situation, even though the fact scenario is roughly equivalent. Applying *Pierre*'s rationale, it seems that the effect of a multiple-beneficiary TOD designation results in the following consequences: (1) the beneficiaries have no gross income upon receipt of the LLC interest; (2) the beneficiaries take a basis in their LLC interest of the fair market value at the date of death; (3) the SMLLC is converted to a partnership by operation of law and application of the check-the-box regulations; and (4) the partnership's inside basis in the various assets will remain the same as that which the SMLLC had.

225. See, e.g., Timothy M. Todd, *Multiple-Entity Planning to Reduce Self-Employment Taxes: Recent Cases Demonstrate the Pitfalls & How to Avoid Them*, J. TAX PRAC. & PROC., Apr.–May 2011, at 31.

226. I.R.C. § 102.

227. *Id.* § 1014.

effectuates no change in entity but rather adds shareholders to the “corporation.”

VIII. CONCLUSION

The forms from which SMLLC organizational documents are routinely drawn do not address the death of the sole member. The default statutory rules, which apply when the organizational documents are silent on the subject, do not handle the matter well either. The four models upon which the default statutory rules are based cause a dissolution from which continuation is either impossible or difficult to implement. In order to ensure optimal operation of the SMLLC’s business, continuation should occur, yet neither existing forms nor default rules reach that result.

Consequently, we conclude that a provision for the nonprobate transfer-on-death of the sole member’s interest in an SMLLC should be included in the LLC’s organizational documents. Obviously, as the SMLLC’s value and the sophistication of its owner increase, other transfer-on-death strategies should be pursued or implemented. Our focus is on the routine SMLLC, which presently lacks a good result when the sole member dies.