

Legislative History for Connecticut Act

PA 97-70

AN ACT CONCERNING LIMITED LIABILITY COMPANIES

Act Number:	70	Year:	1997
Bill Number:	SB 1193	Pages	
Senate Pages:	1347, 1394-1396		4
House Pages:	2122-2127		6
Committee:	Judiciary: 2209-2212, 2227- 2233, 2358-2366, 2380, 2382		21
		Page Total:	31

Transcripts from the Joint Standing Committee Public Hearing(s) and/or Senate
and House of Representatives Proceedings

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S-406

CONNECTICUT
GEN. ASSEMBLY
SENATE

PROCEEDINGS
1997

VOL. 40
PART 4
1083-1433

Motion is to refer this item to the Committee on Appropriations. Without objection, so ordered.

SEN. JEPSEN:

Calendar 222, File 357, Substitute for SB1024 is to be marked Go.

Page 8, Calendar 223, File 351, Substitute for SB1193, I move to the Consent Calendar.

THE CHAIR:

Motion is to move this item to the Consent Calendar. Without objection, so ordered.

SEN. JEPSEN:

Calendar 227, is PR.

228, PR.

229, Files 253 and 383, Substitute for HB6554, be marked Go.

Calendar 232, is PR.

Calendar 233, File 131, Substitute for HB6567, is marked Go.

Page 9, Calendar 240, Files 204 and 385, Substitute for HB6574, I move referral to the Committee on Finance.

THE CHAIR:

Motion is to refer this item to the Committee on Finance. Without objection, so ordered.

SEN. JEPSEN:

UConn women are due momentarily, and I'd ask that this item be passed temporarily.

THE CHAIR:

This item will be passed temporarily.

SEN. JEPSEN:

So that we may have a full Chamber for the UConn women, I'd ask that we call the Consent Calendar at this time, and vote, and then greet the UConn women and the Chamber would stand at ease at that time.

THE CHAIR:

Senator Jepsen, do you request the call of the Consent Calendar?

SEN. JEPSEN:

Yes, request the call of the Consent Calendar.

THE CHAIR:

Mr. Clerk, would you please announce a roll call vote. Announce a Consent Calendar, and please call those items on the Consent Calendar.

THE CLERK:

Immediate roll call has been ordered in the Senate on the Consent Calendar. Will all Senators please return to the Chamber. An immediate roll call has been ordered in the Senate on the Consent Calendar. Will all Senators please return to the Chamber.

Madam President, the first Consent Calendar begins

on Page 3. Calendar 143, Substitute for HB6646.

Calendar Page 6, Calendar 204, SB974.

Calendar 206, SB879.

Calendar Page 7, Calendar 222, Substitute for
SB1024.

Calendar Page 8, Calendar 223, Substitute for
SB1193.

Calendar 229, Substitute for HB6554.

Calendar 233, Substitute for HB6567.

Calendar Page 12, Calendar 265, SB849.

Calendar Page 14, Calendar 280, Substitute for
SB1316.

Calendar Page 16, Calendar 291, HB6690.

Calendar Page 17, Calendar 292, Substitute for
HB5870.

Calendar 294, HB6886.

Calendar Page 19, Calendar 305, Substitute for
SB214.

Calendar Page 23, Calendar 88, Substitute for
HB5892.

Calendar 117, SB858.

Calendar Page 24, Calendar 120, SB1113.

Calendar Page 26, Calendar 181, Substitute for
SB1185.

Madam President, that completes the first Consent

Senate

Wednesday, April 30, 1990 001396

Calendar.

THE CHAIR:

Thank you Mr. Clerk. Would you once again announce a roll call vote. The machine will be open.

THE CLERK:

Immediate roll call has been ordered in the Senate. Will all Senators please return to the Chamber. An immediate roll call has been ordered in the Senate on the Consent Calendar. Will all Senators please return to the Chamber.

THE CHAIR:

Have all members voted? If all members have voted, the machine will be locked, Clerk please take a tally.

THE CLERK:

Consent Calendar No. 1.

Total Number Voting 36

Those Voting Yea 36

Those Voting Nay 0

Those absent and not voting 0

THE CHAIR:

Consent Calendar is adopted. Senator Jepsen.

SEN. JEPSEN:

I'd ask that the Chamber stand at ease at this time.

H-764

CONNECTICUT
GEN. ASSEMBLY
HOUSE

PROCEEDINGS
1997

VOL. 40

PART 6

1966-2338

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58

House of Representatives

Wednesday, May 7, 1997

Will the Clerk please call Calendar 465?

CLERK:

On page 20, Calendar 465, Substitute for Senate Bill Number 1193, AN ACT CONCERNING LIMITED LIABILITY COMPANIES. Favorable Report of the Committee on Judiciary.

DEPUTY SPEAKER HARTLEY:

Representative Landino. You have the floor, sir.

REP. LANDINO: (35TH)

Thank you, Madam Speaker. I move acceptance of the Joint Committee's Favorable Report and passage of the bill.

DEPUTY SPEAKER HARTLEY:

The motion is acceptance and passage. Will you remark?

REP. LANDINO: (35TH)

Thank you, Madam Speaker. This bill allows for the creation of single entity limited liability corporations. It's a great bill for small business in that it allows a single person to form an LLC which is now consistent with recent IRS rulings.

I move adoption.

DEPUTY SPEAKER HARTLEY:

Will you remark further on the bill? Will you remark further on the bill? Representative Prelli.

gmh

59

House of Representatives

Wednesday, May 7, 1997

REP. PRELLI: (63RD)

Thank you, Madam Speaker. Madam Speaker, through you, a question to the proponent of the --

DEPUTY SPEAKER HARTLEY:

Please frame your question, sir.

REP. PRELLI: (63RD)

Representative Landino, why would a company want to -- why would a person want to set up a limited liability company instead of being a class -- an S corporation or instead of being self-employed? What are the reasons and what are the protections they might get through this? Through you, Madam Speaker.

DEPUTY SPEAKER HARTLEY:

Representative Landino.

REP. LANDINO: (35TH)

Thank you. Through you, Madam Speaker, limited liability corporations are a recent vehicle that was passed into federal law that allows for the dual benefit of protection of liability in a corporation with the tax benefits of a partnership. As you know, Representative Prelli, in a corporation you have double taxation issues, but you have the protection of that corporation in terms of an asset liability. In a partnership you have the tax benefits of a partnership without the double taxation, but you don't have the

House of Representatives

Wednesday, May 7, 1997

benefit of corporate protection.

LLC's provide both. Historically, they've only been allowed to be formed with two people, with two individuals, and it prohibits small businesses and single owners from establishing a LLC without a shield, without, for instance, their wife or their husband or a friend to be the second member to form a LLC. This makes it legitimate. The IRS ruled that this was appropriate and other states are following suit and this would simply make us consistent with federal interpretation of the IRS and be very good for small businesses.

Through you, Madam Speaker.

DEPUTY SPEAKER HARTLEY:

Thank you, sir. Representative Prelli.

REP. PRELLI: (63RD)

Thank you, Madam Speaker and right now, through you, one more question, Madam Speaker.

DEPUTY SPEAKER HARTLEY:

Please frame your question.

REP. PRELLI: (63RD)

Right now there are none of these set up because they are not legal in this state. Do we have an idea of how many they are expecting to be set up? Through you, Madam Speaker.

gmh

61

House of Representatives

Wednesday, May 7, 1997

DEPUTY SPEAKER HARTLEY:

Representative Landino.

REP. LANDINO: (35TH)

No. The fiscal impact expects a revenue gain because they will likely be very popular. I believe about 23% of corporations in Connecticut are now LLC and I believe that many single owners starting businesses will now use this vehicle if it becomes law.

Through you, Madam Speaker.

DEPUTY SPEAKER HARTLEY:

Thank you, sir. Representative Prelli, you have the floor.

REP. PRELLI: (63RD)

Thank you, Madam Speaker. That's all the questions I have.

DEPUTY SPEAKER HARTLEY:

Thank you. Will you remark further on the bill? If not, staff and guests -- Representative Concannon of the 34th. You have the floor, Madam.

REP. CONCANNON: (34TH)

Thank you, Madam Chair. I speak in support of this bill. It is a timely initiative. Currently we have contradiction in our tax laws involving limited liability companies and where we allow a limited liability company to be created by one or more entities

gmh

62

House of Representatives

Wednesday, May 7, 1997

we only allow them to exist if there are two or more entities. So this will bring us in line with the federal code and is a timely bill.

Thank you.

DEPUTY SPEAKER HARTLEY:

Thank you, Madam. Will you remark further on the bill? If not, staff and guests, please come to the well. Members, take your seat. The machine is opened.

CLERK:

The House of Representatives is voting by roll call. Members to the Chamber. The House is voting by roll call. Members to the Chamber, please.

DEPUTY SPEAKER HARTLEY:

Have all the members voted? Is your vote properly recorded? If so, the machine will be locked.

The Clerk will please take a tally.

The Clerk will please announce the tally.

CLERK:

Senate Bill Number 1193, in concurrence with the
Senate

Total Number Voting	143
Necessary for Passage	72
Those Voting Yea	142
Those Voting Nay	1
Those absent and not voting	8

House of Representatives

Wednesday, May 7, 1997

DEPUTY SPEAKER HARTLEY:

The bill passes.

Will the Clerk please call Calendar 186.

CLERK:

On page 27, Calendar 186, House Bill Number 6714,
AN ACT CONCERNING DRAWSTRINGS ON CHILDREN'S OUTERWEAR.
Favorable Report of the Committee on Judiciary.

DEPUTY SPEAKER HARTLEY:

Representative Fox, you have the floor, sir.

REP. FOX: (144TH)

Thank you, Madam Speaker. I move acceptance of
the Joint Committee's Favorable Report and passage of
the bill.

DEPUTY SPEAKER HARTLEY:

The motion is acceptance and passage. Will you
remark?

REP. FOX: (144TH)

Yes, I will. Thank you, Madam Speaker. Madam
Speaker, this bill which has been before us last year
would prohibit the selling of children's outerwear in
sizes 2T through 12 with any hood or neck drawstring or
any waist or bottom drawstring beyond a certain length.

It is a bill which has had favorable support from
the General Law Committee, favorable support from the
Judiciary Committee. It is one which this body last

JOINT
STANDING
COMMITTEE
HEARINGS

JUDICIARY

PART 7

2156-2417

1997

is that sort of egregious conduct or egregious or failure to defer to, for an example, a judge who says this case is worth \$2 million and they won't offer \$500,000 policy. That sort of egregious situation is going to be the kind of thing that generates the kind of passion that would lead someone like Vivian Straub to say, I am going to go after that insurance company because they shouldn't have done it to us and they shouldn't do it to anybody else.

It is not going to be for the run of the mill kind of case where people simply agree or disagree about the value of the case, whether the liability is good or maybe not so good. And I really don't think it's going to be a problem with a proliferation of these cases because when you look at bad faith cases as I do and I look at claim files and I see that they put a reserve, they value the case for "x" and they offer one-half of "x" and they let the case go on for years with no reason at all because they haven't offered what they valued the case at, that's the kind of case that ought to result in a bad faith and a CUIPA case.

I don't think it is going to involve the run of the mill cases. I just don't see it happening because I don't the financial incentive for parties is there. I don't think lawyers are going to spin their wheels working on something that is meaningless.

REP. SCALETTAR: Thank you.

STEWART CASPER: Thank you.

REP. SCALETTAR: Allan Clavette followed by Dave Palozej followed by Rena Farber.

ALLAN CLAVETTE: Representative Scalettar, members of the Judiciary Committee, thank you for the opportunity to appear before you to testify regarding SB1193, AN ACT CONCERNING LIMITED LIABILITY COMPANIES.

I am Allan Clavette, CPA. A sole practitioner located in Newtown, Connecticut. I am also the

chair of the Connecticut Society of CPA's State Legislation Committee.

Consequently, while the view I present represent those of the state CPA society, they are also directly representative of a professional who would positively be affected by modification of Connecticut's existing LLC statutes to permit single member LLC's.

The Limited Liability Company has become a very attractive, even necessary form of practice for professionals operating in today's litigious environment. Adoption of the original LLC statutes was appropriate and necessary to keep Connecticut on equal footing relative to other states. Failure to do so would have placed Connecticut in a negative position relative to the business atmosphere of other jurisdictions.

The following statistics from the Connecticut Society of CPA's membership files underscores the desirability and popularity of the limited liability form of practice since the adoption of the LLP statutes just last year.

Twenty-three percent of the 671 firms with two or more members now practice as either an LLC (GAP IN TAPE)

Recently, the Internal Revenue Service ruled that a sole practitioner may operate as an LLC. Unfortunately, Connecticut law is not consistent with the federal law in this instance. Because of this inconsistency, another 834 sole practitioners who are CSCPA members cannot presently avail themselves of the LLC form of practice.

In light of the attractions afforded professionals by the LLC form of practice, this recent IRS ruling is likely to have profound consequences as individual professionals wish to avail themselves of the protections of the LLC organizational format.

This is particularly relevant in those situations whereby a multiple member LLC has dissolved either

through death or dissolution leaving a sole practitioner who has been utilizing the LLC form of practice in a difficult position, that of having to leave a preferred form of practice.

Currently, New York and Delaware already allow single member LLC's. And it appears to be only a matter of time before our remaining neighbor states will offer this preferred form of entity.

As circumstances and events outside of Connecticut occur, we must continually adapt and react, if not lead, in our efforts to enhance Connecticut's reputation as a business friendly state. The Connecticut Legislature can and should remove the barrier to allow single member LLC's.

In conclusion, amending Connecticut's statutes is appropriate and necessary in light of this IRS ruling. Moreover, allowing sole practitioners who survive from a larger practice to continue in the same form of practice promotes greater continuity and stability both for the individuals and their cliental.

I thank you for your time and consideration both personally and on behalf of the members of the Connecticut Society of CPA's who strong support adoption of this legislative initiative.

I would be glad to respond to any questions you may have.

REP. SCALETTAR: Thank you. Representative Farr.

REP. FARR: Just a question. The basic protection for an LLC in most organizations is that professionals wanted not to be at risk personally for the conduct of somebody else in the firm. In other words, when we first started this we looked at large -- the initiative with large firms coming in and saying you know, if I am a member of Arthur Anderson here in Hartford then suddenly Arthur Anderson gets sued because somebody did something in Texas and we all end up having \$1 million judgment against us, I don't want to do that anymore. And so the idea was that the LLC would go down -- you get a major

52
gmh

JUDICIARY COMMITTEE

March 24, 1997

judgment -- Arthur Anderson goes out of business, but the partners, the owners of it walk away.

ALLAN CLAVETTE: Right.

REP. FARR: But if it is a single member, what's the incentive to be in an LLC? You are not getting any protection because, in fact, any malpractice is against you, individually.

ALLAN CLAVETTE: Well, malpractice issues, yes. In other litigation areas it may not provide -- we do have some limited protection if it is not a malpractice issue. We are more interested in this in that when you do have a two-member or more organization that now dissolves, you have to literally dissolve the business entity.

REP. FARR: Okay. That makes sense.

ALLAN CLAVETTE: Whether that is a withdrawal of a partner, a death or a disability.

REP. FARR: Okay. That makes sense. It didn't make a lot of sense to me to create a single member for most purposes.

ALLAN CLAVETTE: I don't see that as happening in a professional practice. Right.

REP. FARR: Right. Okay. I follow you. It makes sense. Thank you.

REP. SCALETTAR: Thank you very much.

ALLAN CLAVETTE: Thank you.

REP. SCALETTAR: Dave Palozes followed by Rena Farber followed by Don Buck and the Farmington Woods panel.

DAVID PALOZES: Members of the Judiciary, good afternoon. My name is Doctor David Palozes. I am a past member of the Connecticut State Board for Optometry.

SB 1122

I currently practice in three offices in north

I would also urge you to adopt them effective on passage which is one of the requests that the Secretary of State's Office made this morning.

I am available to answer any questions that you may have.

REP. SCALETTAR: Thank you. Is this is the act that had the problem with respect to the "long arm" statute and service under the "long arm" statute?

JAMES LOTSTEIN: Not that I know of. The technical amendment that the Secretary of State's Office has asked for deals with registered agents and registered officers of the corporation.

REP. SCALETTAR: I thought there was a problem under the act as we passed it in terms of long arm service. You are not aware of that?

JAMES LOTSTEIN: If there is, I am just not aware of it.

REP. SCALETTAR: Okay. Any other questions? Thank you.

JAMES LOTSTEIN: Thank you.

REP. SCALETTAR: Richard Convicer followed by Bernadette Dillon and then Lois Pontbriant and Merit Lajoie.

RICHARD CONVICER: Good afternoon. My name is Richard Convicer and I am here on behalf of the Connecticut Bar Association to speak in favor of an amendment to the Connecticut Limited Liability Company Act.

I presently serve as Chairman of the Tax Section Subcommittee on Limited Liability Companies. It was our subcommittee that initiated the drafting of the act which became effective October 1, 1993.

The amendment -- I guess it is raised SB1193. The amendment provides some technical changes primarily to permit members to include a provision in their Articles of Organization or their Operating Agreement to override a default rule of dissolution by consent of a majority in interest. What that simply means is that right now you could have a -- the members agree amongst themselves that the

entity will last for a particular undertaking or a particular term and notwithstanding their agreement the act provides that a majority in interest could subsequently terminate earlier. So what we want to do is allow members to provide, in their Operating Agreement, a provision that states the finite period of time or a definite undertaking so that a majority cannot overrule a prior commitment made by everyone. And that is what we consider to be a really a technical amendment in nature.

By the way, I understand that there are -- there is a draft of an article I wrote regarding explaining this amendment as well as an explanation to the proposed amendment that was submitted to the CBA.

The major portion of the bill, however, deals with changes which come as a result of an IRS regulation which was finalized or issued last -- this past December. What the IRS has done is stated that entities will now be taxed as partnerships automatically without regard to whether or not the entity possesses or lacks certain corporate characteristics.

Until the issuance of this regulation it was essential that an entity lack certain corporate characteristics in order to achieve favorable tax treatment and consequently the Connecticut LLC Act has built into it certain default rules which were only put in there to satisfy the IRS, the old IRS regulations. Now that the IRS has basically thrown out and discarded those old regulations, it's no longer to have the statute possess this baggage, if you will, which was there only to satisfy a regulation which is no longer necessary to satisfy.

For example, the IRS, the old regulation used to provide that the entity had to potentially dissolve when a member left the entity and the rest of the members would have to common both to continue it. And that was there in order to ensure that the entity lacked the corporate characteristic of continuity of life. And so that's the default rule under the present statute.

Now that the IRS no longer is concerned about

whether an entity has to dissolve when a member leaves in order to consider -- in order for it to be taxed as a partnership, we feel that the Connecticut act should be amended to similarly eliminate that rule.

So one of the -- one aspect in the Connecticut amendment is eliminated namely that when a member leaves an entity, withdraws or dies or otherwise becomes dis-associated from the entity, the entity would still automatically continue. It would no longer potentially dissolve.

And we think that would make use of the LLC a lot more -- meet the expectations of the business people who form the LLC to begin with.

By adopting this amendment that namely in the event of dis-association of a member would not give rise to the dissolution of the entity, this would promote greater business continuity and greater business stability. Just as in the case of a corporation when a shareholder leaves, the entity still continues without the other shareholders having to do anything. The LLC would be put on the same level playing field. When a member leaves the entity, the LLC would not automatically dissolve unless the members decided to include a provision in their Operating Agreement providing for such dissolution.

Another aspect or another amendment also issued in response to the IRS regulation is it would change what a withdrawing member is entitled to upon leaving the entity. Under existing law when a member leaves the entity he is entitled to be paid out his interest. Now, that the entity is going to be automatically be continuing, we want to change the default rules so that unless the members provide in their Operating Agreement, the rule would be that when a member leaves the entity he would not automatically be entitled to be paid out his interest, but would simply be entitled to continue receiving his distributions as he otherwise would have.

Again, we believe that this promotes business

continuity since the business would not now be obligated to come up with cash when a member leaves. Of course, the members are able, in their Operating Agreement, to provide otherwise.

Finally, the amendment provides for single-member LLC's and the reason -- I should say, under existing law, there is a requirement there be at least two members in order to form a valid LLC. And the reason we had that original rule, again, was to satisfy the IRS that if we are going to be -- if the LLC is looking to be taxed as a partnership -- in other words, to be taxed only at the individual partner level and not as a separate taxable entity, you had to have two partners or two in order to be taxable partnerships. You could not have a single person partnership. And that was the reason we required two members.

The IRS, in this regulation that I referred to in December, 1996, stated that single member entities will be disregarded unless the individual elects to be taxed as a corporation. So now the IRS has made clear that if state law permits a single member LLC, it will still grant favorable tax treatment to that single member by disregarding the LLC. That is the first evidence that the IRS has given to tell the tax paying public that there will be favorable tax treatment.

Accordingly, we feel now that we ought to make the Connecticut statute more flexible in order to permit single person LLC's. This will eliminate the practice of bringing in a second member solely to satisfy the two-person requirement which is widespread now. Many people, many practitioners advise their clients to bring in a 1% interest holder solely to satisfy the two-person requirement and there is really no economic substantive reason for doing that.

Now that we have the go ahead with the IRS, it would make much more sense to have single person LLC's.

I would just add that it is my belief that many states are amending their LLC statutes as we are

trying to today in light of these favorable IRS regulations.

I would be glad to answer any questions.

REP. SCALETTAR: Thank you. Representative Farr.

REP. FARR: I am not sure if it is in this statute or it is the practice that normally the LLC has a definite term of life. In other words, usually they are set up for 60 years or 50 years, whatever the -- is that in the statute? I don't --

RICHARD CONVICER: That is currently in the statute that when you file the Articles of Organization, the present law states that you have to provide a particular time -- a maximum time --

REP. FARR: Time certain.

RICHARD CONVICER: -- length of time and now, as a result of the IRS regulation, that's no longer necessary.

REP. FARR: And that's being deleted from here because I didn't see --

RICHARD CONVICER: That's correct. That is being deleted in --

REP. FARR: Do you know what section?

RICHARD CONVICER: Yes, I do. That's in --

REP. FARR: I thought that was what we were doing, but I couldn't find the section.

RICHARD CONVICER: It is in Section 3 of the amendment. You will see under subsection -- existing subsection 2, you will see that bracket or deletion mark for parentheticals. The latest data from which the LLC is to dissolve, that is now deleted.

REP. FARR: Okay. I've got it. So in effect now, when we pass this, LLC's have the same corporate life as any other corporation?

RICHARD CONVICER: That's correct.

REP. FARR: And you no longer have to recite any of that in there?

RICHARD CONVICER: That's correct.

REP. FARR: And in terms of other states then, other states will recognize the -- our LLC's even though they have an indeterminate life? This won't effect the ability of our LLC's to deal with other states. Is that right?

RICHARD CONVICER: That's correct. Most states have a foreign LLC recognition provision. As long as it is valid under our law, they would recognize that. So I don't see that as a problem.

REP. FARR: Okay. I can see this is just going to grow like crazy. It's funny. I talked to somebody the other day from Florida. They were saying in Florida everybody is getting out of LLC's into subchapter S and I said why in the world would anybody do that? And he said, "well in Florida, if you have an LLC there is a special income tax on the members of the LLC that doesn't exist if it is subchapter S because there is no income tax and they don't tax the income of --". So it is sort of the opposite of what happens in Connecticut and the tax law is driving people out of LLC's and into subchapter S's in Florida.

RICHARD CONVICER: Florida is one of the few states, I believe, that imposes an entity level tax on the LLC. The vast majority of the states follow the federal tax treatment. Not all do, however. I believe California, I believe is still retaining the old IRS, an old classification test similar to the rules that the IRS have discarded.

REP. FARR: But with the adoption of this law, I mean, is there any reason anybody would set up a small business that was solely owned and use the corporate law now? Is there any advantage that you can think of?

RICHARD CONVICER: I think one is hard pressed to come

up with a reason to choose a corporation over an LLC. Occasionally, if you have an existing client or an existing taxpayer that's in a regular corporation already and they want to eliminate the potential double tax in the future, they might consider to a sub-chapter S because they can at least stop the future double level tax on future appreciation whereas for them to convert they would, of course, have to liquidate and pay a tax, but there maybe scenarios where there is going to be a merger once there is a corporate business and a new business wants to merge into that and take over their assets and their corporate characteristics. In that case, there maybe a corporation.

But I think it is going to be the exception rather than the rule.

REP. FARR: The only thing that strikes me or concerns me with the LLC is that there is no ongoing registration, as I understand it, with the Secretary of State. So we set it up and then 50 years from now it is still in existence. I mean, it never -- we don't know that -- since there is no tax on them, I would assume that any LLC that is set up is just going to stay on the books.

RICHARD CONVICER: There is a requirement that an annual report be filed with the Secretary of State. So I believe, I am not certain, but I believe that a failure to file an annual report or to respond to an inquiry from the Secretary of State on an absent report may result in a forfeiture. I say I am not certain because I know there had been a law to that effect and I don't recall whether or not --

REP. FARR: I didn't realize it affected LLC's. I will have to check.

RICHARD CONVICER: There had been, but I say I don't know whether or not there were subsequent changes to that.

REP. FARR: Thank you.

REP. SCALETTAR: Thank you very much.

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TO: Ina Forman, CBA Legislative Liaison

FROM: Richard G. Convicer *for*
 Chairman of Tax Section LLC Subcommittee

DATE: January 22, 1997

RE: EXPLANATION TO PROPOSED AMENDMENTS TO CONNECTICUT LIMITED LIABILITY COMPANY ACT *SB 1193*

The attached amendments address three specific objectives which the LLC Subcommittee believes appropriate. These objectives include:

- (1) permitting members to include a provision in their articles of organization or operating agreement which overrides the default rule of dissolution by consent of a majority in interest;
- (2) providing for single member limited liability companies; and
- (3) eliminating events of dissociation as events of dissolution, thereby promoting greater stability and continuity of the business enterprise.

The first objective addresses the problem of premature termination existing under current law. Although members of an LLC may contract to conduct the business of an LLC for a fixed term, under present law a majority in interest of the members may elect to dissolve the entity at any time, notwithstanding a contrary provision in the operating agreement. The amendment permits members to include a provision in their articles of organization or operating agreement eliminating this default rule of dissolution by consent of a majority in interest. This change should, therefore, more closely meet the members' expectations as to the duration of the enterprise.

The latter two objectives were proposed as a response to the more liberal rules provided by the "check-the-box" classification regulations. The IRS has published final regulations on this subject and, consequently, Connecticut, by adopting the proposed amendments, will be in a position to take advantage of the increased flexibility now permitted by the IRS.

It should also be noted that under the proposed amendment, Section 34-159 will change the default rule upon an event of dissociation. The amendment will entitle the dissociating member to receive distributions he was entitled to receive prior to dissociation. Upon the event of dissociation, the dissociating member will no longer be entitled to receive the fair value of his interest unless otherwise provided in the operating agreement. The Subcommittee believed that since dissociation will no longer be an event of dissolution, restricting a dissociating member's right to "cash out" will promote greater business continuity. This, in effect, mirrors the treatment of a minority shareholder of a corporation who has no right, in the absence of a shareholder agreement, to require the corporation to buy his shares. This change will also provide greater illiquidity, thereby enhancing valuation discounts under IRS Sec. 2704(b).

Special rules are provided for events of dissociation affecting one-member LLCs. Under Sec. 34-173(b), in a single-member LLC which undergoes an event of dissociation (other than voluntary assignment), the legal representative or the successor in interest may become a member.

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**NEW IRS "CHECK-THE-BOX" REGULATIONS
AND
PROPOSED AMENDMENTS TO CONNECTICUT LLC ACT
GUARANTEE FAVORABLE TAX TREATMENT**

by
Richard G. Convicer

On December 17, 1996, the IRS adopted as final the "check-the-box" regulations, replacing the long-standing entity classification test.¹ This development had been eagerly awaited by many practitioners. As a result of the IRS action, effective January 1, 1997, Connecticut attorneys can form LLCs for their clients and be assured that the entity will be taxed as a partnership (i.e., income taxed once only at the member level), and not as a corporation, without regard to whether the entity possesses or lacks certain corporate characteristics. In addition, the regulation makes clear that single member entities will be taxed as sole proprietorships. These developments are welcome news to counsel who structure new businesses.

Previously, to qualify for favorable tax treatment as a partnership, the entity had to satisfy the IRS classification test. Under this test, the entity had to lack at least two of the four following corporate characteristics: (1) limited liability; (2) centralization of management; (3) free transferability of interests; and (4) continuity of life. Since limited liability companies, by definition, possess the corporate characteristic of limited liability, the entity has had to lack two of the remaining three characteristics. If the entity were managed by one or more managers, the LLC possessed the corporate characteristic of centralization of management. In such case, the LLC would have to lack both free transferability of interests and continuity of life in order to avoid being taxed as a corporation.

Under the existing Connecticut LLC Act (the "Act")², an entity lacks these latter two characteristics automatically, unless the members expressly adopt different provisions in the operating agreement.

Under the Act, a member may not transfer his membership interest without the consent of a majority in interest of the other members, unless the members otherwise provide. This rule was adopted, in part, to comply with the classification test, to ensure that the entity lacked the corporate characteristic of free transferability of interest. Similarly, the Act currently provides that, unless otherwise provided in the operating agreement, if a member withdraws from membership for any reason, the entity dissolves, unless a majority in interest of the remaining members consent to continue. This rule also was enacted to comply with the former IRS regulation, to ensure that the entity would lack the corporate characteristic of continuity of life.

These rules worked fine as long as the members did not override them by providing otherwise in the operating agreement. Unfortunately, of course, business exigencies of many transactions warrant departures from these default rules. For example, the members may not want to risk the dissolution of the entity when a member leaves, or perhaps the members wish to freely transfer their interests to a certain class of transferees such as family members for estate planning purposes.

Through private letter rulings and revenue procedures, the IRS provided guidance as to which departures from the default rules could be adopted without causing the entity to possess the forbidden corporate characteristics. The problem has been that the general practitioner has had to become immersed in arcane tax rules if he or she wished to override the default rules provided in the statute.

The IRS has recognized that the classification test has caused practitioners to spend an inordinate amount of time and effort to ensure the entity lacked two corporate characteristics. The classification test afforded an advantage to those taxpayers who were well-advised, and stung those who were not. While the race will always go to the swift, in this case no one could understand why there was a race. Which aspects of these characteristics were so critical as to cause the entity to be subject to the corporate income tax? Since no one had a good answer to this question, the IRS abolished the classification test and in its place simply provided that unincorporated entities (such as LLCs) will automatically be taxed as partnerships, unless they affirmatively "check-the-box" and elect to be taxed as corporations.³

**Proposed Amendments to LLC Act
Respond To New IRS Regulation**

Since an LLC is no longer required as a matter of federal tax law to possess continuity of life to be taxed as a partnership, there is little reason to have, as a default rule, a potential dissolution when a member leaves. Consequently, a bill amending the Act has been introduced to the General Assembly reversing the default rule. Under this bill, dissolution will not arise upon dissociation of a member, unless the members expressly so provide. The LLC will thus have the same continuity of business life as a corporation, unaffected by membership changes. This amendment should help eliminate inadvertent dissolutions with the attendant loss of the limited liability shield.

The bill also changes the amount distributable to the withdrawing member. Under the bill, unless otherwise provided in writing, a dissociating member will only receive the distributions he was entitled to prior to dissociation. Absent express written agreement, upon the event of dissociation the dissociating member will no longer be entitled to receive the fair value of his interest.⁴ Since dissociation will no longer be an event of dissolution, restricting a dissociating member's right to "cash out" will promote greater business continuity. This, in effect, mirrors the treatment of a minority shareholder of a corporation who has no right, in the absence of a shareholder agreement, to require the corporation to purchase his shares.⁵

As to transferability of interests, the bill leaves unchanged the default rule that new members may only be admitted with the consent of a majority in interest of the other members, unless the members otherwise provide. The rationale for continuing this rule, despite the demise of the classification test pertaining to free transferability of interests, is the substantial non-tax objective of members having a say regarding with whom they wish to become associated.

Finally, the new IRS regulation clarifies the treatment to be afforded a single member entity. For tax purposes, the entity will be disregarded, absent an election, and the member will be taxed as a sole proprietor. Prior to this regulation, there was no published authority on this point, and substantial doubt existed as to whether such an entity would be ignored for tax purposes or taxed as a corporation. Since favorable tax treatment was clearly only available for partnerships, the Connecticut LLC Act has required that there be at least two members.⁶ With the uncertainty dispelled, the bill would amend the definition of an LLC to mean an organization with one or more members. This change will eliminate the practice of bringing in a second member with a nominal interest solely to satisfy the two member requirement.

Just over three years ago, many practitioners were entirely unfamiliar with the LLC. The flexibility, informality, and ease of operation of the LLC have resulted in the proliferation of the entity, replacing the corporation as the prevailing form of entity for new businesses. With the adoption of the "check-the-box" regulation and, if enacted, amendments to the Act, practitioners will likely choose the LLC even more often.

¹ Treas. Reg. Sec. 302.7701-1, -2, -3.

² Conn. Gen. Stats. Sections 34-101 et seq.

³ Perhaps the regulation should be referred to as "don't-check-the-box", since it will be the rare case when an election to be taxed as a corporation is made and the box is checked.

⁴ Existing LLCs will still be governed by the fair value rule, unless the members unanimously adopt, in writing, the provisions of the bill.

⁵ An additional advantage of this new rule may be the enhancement of valuation discounts for federal gift and estate tax purposes due to the greater illiquidity of the interest. See Internal Revenue Code Section 2704(b).

⁶ Although one or more persons may form an entity under Conn. Gen. Stats. Section 34-110, the definition of an LLC at Conn. Gen. Stats. Section 34-101(9) requires "two or more" members.

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Connecticut Society of Certified Public Accountants

**Testimony Concerning SB1193,
An Act Concerning Limited Liability Corporations (LLCs)**

**Respectively Submitted to the
Judiciary Committee
March 24, 1997**

Senator Williams, Representative Lawlor and members of the Judiciary Committee, thank you for the opportunity to appear before you to testify on SB 1193, An Act Concerning Limited Liability Companies. I am Alan J. Clavette, CPA, a sole practitioner located in Newtown, CT. I am also the chair of the Connecticut Society of CPAs State Legislation Committee. Consequently, while the views I present represent those of the State CPA Society, they are also directly representative of a professional who would be positively affected by a modification of Connecticut's existing Limited Liability Corporation (LLC) statutes to permit single member LLCs.

The limited liability corporation has become a very attractive, even necessary, form of practice for professionals operating in today's litigious environment. Adoption of the original LLC statutes was appropriate and necessary to keep Connecticut on an equal footing relative to other states. Failure to do so would have placed Connecticut in a negative position relative to the business atmosphere of other jurisdictions.

The following statistic from the Connecticut Society of CPAs membership files underscores the desirability and popularity of the limited liability form of practice, since the adoption of limited liability partnerships (LLPs) just last year.

- 23% (157) of the 671 firms with two or more members now practice as either an LLC or LLP.

Recently, the Internal Revenue Service (IRS) ruled that a sole practitioner may operate as an LLC. Unfortunately, Connecticut law is not consistent with federal law in this instance. Because of this inconsistency, another 834 sole practitioners (who are CSCPA members) cannot presently avail themselves of the limited liability form of practice.

In light of the attractions afforded professionals by the LLC form of practice, this recent IRS ruling is likely to have profound consequences as individual professionals wish to avail themselves of the protections of the LLC organizational format. This is particularly relevant in those situations whereby a multiple member LLC has dissolved, either through death or dissolution, leaving a sole practitioner who has been utilizing the LLC form of practice in a difficult position: that of having to leave a preferred form of practice.

Currently, New York and Delaware already allow single member LLCs and it appears to be only a matter of time before our remaining neighbor states offer this preferred form of entity. As circumstances and events outside of Connecticut occur, we must continually adapt and react, if not lead, in our efforts to enhance Connecticut's reputation as a "business-friendly" state. The Connecticut legislature can and should remove the barrier to allow single member LLCs.

In conclusion, amending Connecticut statutes is appropriate and necessary in light of the IRS ruling. Moreover, allowing sole practitioners who survive from a larger practice to continue in the same form of practice promotes greater continuity and stability both for the individual and their clientele.

I thank you for your time and consideration, both personally and on behalf of the members of the Connecticut Society of Certified Public Accountants, who strongly support adoption of this legislative initiative.

I would be glad to respond to any questions you may have.

TESTIMONY
ELIZABETH E. GARA
ASSISTANT COUNSEL
CONNECTICUT BUSINESS & INDUSTRY ASSOCIATION
BEFORE THE
JUDICIARY COMMITTEE
LEGISLATIVE OFFICE BUILDING
MARCH 24, 1997

HB 7033 SB 1310 SB 1193 SB 1079 HB 5074

Good afternoon. My name is Elizabeth E. Gara, Assistant Counsel for the Connecticut Business & Industry Association (CBIA). CBIA represents over 10,000 businesses across Connecticut, the vast majority of which are small employers with less than 100 employees.

I am here today to comment on a variety of proposals impacting the business community. CBIA opposes SB-1306, An Act Establishing Criminal Penalties for Anti-Competitive Practices.

The state Attorney General's Office already has a considerable arsenal of antitrust weapons to deter and sanction anti-competitive behavior and there is nothing to suggest that current civil sanctions are in any way inadequate. These sanctions include treble damages, attorney's fees and costs, substantial individual and corporate civil penalties, injunctive relief, forfeiture of corporate charter rights and corporate dissolution.

In addition, the state Attorney General's Office works extensively with the Antitrust Division of the US Department of Justice and presently defers cases to that division for criminal prosecution. The Antitrust Division of the US Justice Department vigorously pursues criminal enforcement of antitrust violations, prosecuting a wider variety of violations in a larger number of geographic areas and involving more diverse types of companies. Their staff is rigorously trained in criminal investigation, interrogation techniques, use of body wires and fingerprint analysis.

codifies what the courts have construed as per se violations of antitrust law, a literal interpretation of Section 38-28, C.G.S. would render certain conduct felonious under state law which is not prosecuted as such at the federal law. For these reasons, we urge the committee to oppose SB-1306.

Creating a business court, as called for under HB-7033, certainly merits consideration by the committee. The legislature should begin to explore voluntary efforts to reduce court backlogs and improve efficiency. New York, for example, has initiated a specialized business court which provides efficient, cost-effective and timely processing of commercial cases and has improved the quality and predictability of judicial decisions. More than 15 states are currently considering creating business courts to dispose of cases efficiently. We would welcome serious discussion regarding the creation of such courts in Connecticut.

CBIA also *supports* SB-1310 An Act Concerning the Connecticut Business Corporation Act and the Connecticut Revised Nonstock Corporation Act. and SB-1193 An Act Concerning Limited Liability Companies which were initiated by the Connecticut Bar Association to keep our corporate governance laws current with modern corporate law.

CBIA *opposes* SB-1079 which is part of package of bills opposed by a coalition of business groups that will ultimately tilt the playing field in favor of plaintiffs. Over thirty states in the last two years have passed measures to reduce employer liability costs, including competitor states such as North Carolina, Ohio, Illinois, Wisconsin and Michigan. Some states even use tort reform as a marketing tools to attract businesses to