Articles

Lifting the veil on foreign tax flow-through companies: Could Australian closely held business benefit from their governance regimes?

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Much of the literature considering whether Australia should follow the international trend of introducing a tax flow-through company has, may be for obvious reasons, focused on the potential tax implications. However, there is more than tax when it comes to considering this international trend as tax flow-through companies are not identical. Particularly, some tax flow-through companies have been in conjunction with the introduction of new business forms. This article will focus on the governance laws of two foreign new form tax flow-through companies: the United States' Limited Liability Company; and the United Kingdom's Limited Liability Partnership to analyse whether their governance regimes could be beneficial to Australian closely held businesses. In isolation from their tax treatment, it will be argued that while such new form tax flow-through companies offer some advantages there are serious concerns about their suitability.

Introduction

Morse observed that following the early 1900s the creation of new business forms remained substantially free from parliamentary activity,[1] although the actual regulatory and tax regime(s) applicable to these traditional business forms did alter.[2] After this period of inactivity, there has recently been a considerable movement internationally towards providing alternative business forms, including some with tax flow-through treatment. To date this has only occurred in very restricted circumstances in Australia with the introduction of incorporated limited partnerships for venture capital investment.[3]

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1 G Morse, 'Limited Liability Partnerships and Partnership Law Reform in the United Kingdom' in J McCahery, T Raaijmakers and E Vermeulen (Eds), *The Governance of Close Corporations and Partnerships: US and European Perspectives*, Oxford University Press, Oxford, 2004, p 318. There was effectively four generic business forms: the sole trader, the general partnership, the limited partnership and the corporation. The introduction of Limited Partnerships the last one introduced around the turn of the twentieth century.

2 For example, Australia's regulatory laws governing corporations have been altered a number of times, with extensive reforms in the 1990s, which saw the introduction of such legislation as First Corporate Law Simplification Act 1995 (Cth).

3 Every state government except Western Australia has enacted legislation to establish a new business form, the venture capital Incorporated Limited Partnership (venture capital ILPs). New South Wales the Partnership Amendment (Venture Capital Funds) Act 2004 (NSW) amending the Partnership Act 1892 (NSW); Victoria the Partnership Venture Capital Funds

There has been interest in the overseas trend of introducing a broadly available tax flow-through company.[4] A tax flow-through company represents a business form that has separate legal entity status and limited liability protection for members, but with income and/or losses of the business allocated directly to members for tax purposes. An underlying reason for such a regime is based on economic principles of tax neutrality which argues that it is preferable for tax purposes to disregard the actual legal form of a business.[5] However, it is argued that the underlying governance regime of the business form is also an important consideration. This is particularly as Jordan has argued that Australia's other business form with separate legal entity status and limited liability — the corporation — continues to be problematic despite reforms to it over the last 15 years.[6] Other commentators agree with these sentiments especially as there are still criticisms that a corporation's internal governance rules are too onerous for closely held businesses,[7] as 'there is need to cater expressly for the governance needs of smaller companies'.[8] The current Australian corporation legislation has been described as:

> Complex, ungainly, badly drafted, internally inconsistent and conceptually troubled; it is a mishmash of old law, ad hoc amendments, provisions pulled willy-nilly from different legal systems, statements which are not law at all, ideological posturing, and drafting styles that swing wildly from the colloquial to the technical.[9]

The issues faced by closely held businesses were at one time sought to be addressed through a separate Close Corporation rules; however these were 'lost' after the suit of legislation was found to be unconstitutional.[10] Apart

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Act 2003 (Vic) amending the Partnership Act 1958 (Vic); and Queensland the Partnership and Other Acts Amendment Act 2004 (Qld) amending the Partnership Act 1891 (Qld); Australian Capital Territory the Partnership (Venture Capital Funds) Amendment Act 2004 (ACT) amending the Partnership Act 1963 (ACT); South Australia the Partnership (Venture Capital Funds) Amendment Act 2005 (SA) amending the Partnership Act 1891 (SA); and Northern Territory the Partnership Amendment (Venture Capital Funds) Act 2006 (NT) amending the Partnership Act 1997 (NT).

4 For example, as part of the Henry Tax Review, Treasury recently considered the proposal for the introduction of a tax flow-through entity. Institute of Chartered Accountants in Australia and Deloitte, *Entity flow-through (EFT) submission*, Institute of Chartered Accountants, Sydney, 2008 (the ICAA proposal).

5 M Benge and T Robinson, *How to Integrate Company and Shareholder Taxation*, Victoria University Press, Wellington, 1986, p 123.

6 C Jordan, 'Unlovely and Unloved: Corporate Law Reform's Progeny' (2009) 33 *MULR* 626 at 627. Others have criticised the size of the legislation: S Bottomley, 'Where did the law go? The delegation of Australian corporate regulation', (2003) 15 *AJCL* 105.

7 J H Farrar, *Corporate Governance in Australia and New Zealand*, Oxford University Press, South Melbourne, 2001; M J Whincop, 'Trivial Pursuit: A Theoretical Perspective on Simplification Initiatives' (1997) 7 *AJCL* 250.

8 J H Farrar, *Corporate Governance: Theories, Principles and Practice*, 2nd ed, Oxford University Press, South Melbourne, 2005, p 402

9 Jordan, above n 6, at 627. Similar comments have been made in: R Boxt, 'The necessity for appropriate reform' in *Collapse Incorporated: Tales, Safeguards and Responsibilities of Corporate Australia*, CCH Australia Ltd, Sydney, 2001, p 329. Also, Justice M Kirby, 'Corporate governance, corporate law and global forces' in I Ramsay (Ed), *Corporate Governance and the Duties of Directors*, The Centre for Corporate Law and Securities Regulation, Melbourne, 1997, p 55: 'complexity, unintelligibility and inefficiency of Australia's national regulation of corporations.'

10 In the late 1980s the Australian government attempted to introduce the Australian Close

from single member-manager corporations, the Corporations Act 2001 (Cth) does not specify internal governance rules, particularly for closely held corporations. Instead there is a set of replaceable rules in the Act that all corporations can adopt or, rather, alter through the adoption of their own specific internal constitutional rules.[11] For a single member-managed corporation[12] there are a specific set of mandatory rules that apply, with the replaceable rules excluded.[13] These mandatory rules include that the business of the corporation is to be managed by the director.[14]

Whether these reforms sufficiently address the concerns of closely held businesses is questionable, as the Australian corporate model is criticised as still providing an 'unsuitable framework' in cases where there are present member-management structures.[15] Part of this problem is that corporate law is generally written for larger operations characterised by separate membership to managers (manager-management) and a diverse membership base. This can result in problems just navigating around the legislation for the provisions applicable to small operations compared to large. This has been acknowledged

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Corporations Act 1989 (Cth), which provided for a distinct corporate model for closely held businesses. However, when the suite of legislation was ruled by the High Court as being unconstitutional, the Close Corporation legislation were subsequently removed in the negotiations that occurred between the states and the Federal Government: *New South Wales v Commonwealth* (1990) 169 CLR 482; 90 ALR 355; (1990) 8 ACLC 120; [1990] HCA 2. It is hard to ascertain whether the motivations behind this removal of the Close Corporation rules were based on considered argument or, rather, were a compromise to gain the states' agreement to a new unified corporate regime. The Close Corporations rules have been described as 'lost' in the negotiations after the High Court decision: J Freedman, 'Small Business and the Corporate Form: Burden or Privilege' (1994) 57 *ModLRev* 555 at 579.

11 P Hanrahan, I Ramsay and G Stapledon, *Commercial Applications of Company Law*, 6th ed, CCH, Sydney, 2004, at [4-500]. Corporations Act 2001 (Cth) s 140. The corporation's constitution (if any) and any replaceable rules that apply to the corporation have effect as a contract: (a) between the corporation and each member; and (b) between the corporation and each director and corporation secretary; and (c) between a member and each other member. A corporation limited by shares can be classified as either public or proprietary. There are some reporting concessions provided to proprietary corporations compared to public corporations. Proprietary corporations are not permitted to have more than 50 members and are not allowed to undertake certain fundraising activities that require the issue of a prospectus.

12 Since 1998 it is possible to have one member who can also be the director and secretary of the corporation: Corporations Act 2001 (Cth) s 114.

13 Corporations Act 2001 (Cth) s 135 provides that the replaceable rules do not apply to a proprietary corporation while the same person is both its sole director and sole member.

14 The mandatory rules that apply to a single member-director corporation include that Corporations Act 2001 (Cth); s 201F: The director may appoint another director by recording the appointment and signing the record; s 198E: The director may exercise all of the powers of the corporation except any powers that the Corporations Act or the corporation's constitution (if any) requires the corporation to exercise in general meeting; s 198E: The business of the corporation is to be managed by or under the direction of the director; s 198E: The director may execute a negotiable instrument such as a cheque, and may determine that a negotiable instrument may be executed in a different way; s 202C: The director is to be paid any remuneration for being a director that the corporation determines by resolution. The corporation may also pay director's travelling and other expenses properly incurred by the director in connection with the corporation's business; and s 249B: Where something must be done by the member of a single director/shareholder corporation in their capacity as a member, it can be done by the member recording a resolution in writing and signing it. The resolution must be recorded in the corporation's minute book: s 251A.

15 Farrar, above n 7.

with the introduction of the non-legislative small business guide for the Australian provisions.[16]

These inherent problems may require new ideas to solve these perennial issues. There have been numerous arguments that tax flow-through companies are advantageous for closely held businesses,[17] although this is questioned by some.[18] This includes calls in New Zealand for the introduction of a new form.[19] To this end, this article focuses on the internal governance regimes of two tax flow-through companies: the United States' Limited Liability Company (LLC); and the United Kingdom's Limited Liability Partnership (LLP). This is in part due to Darwinian claims that they represent an 'evolution' of the business form.[20] These two forms have been chosen as unlike other tax flow-through companies that provided tax flow-through to existing corporate forms,[21] LLCs and LLPs represent the introduction of a-whole new business form. The focus on the governance issues of these forms is important, as much of the Australian commentary has concerned their tax implications,[22] and it is important to consider whether there is more than 'tax arbitrage' occurring.

This analysis considers the following issues pertinent for closely held businesses: mandatory rules in terms of capital maintenance and single membership; the default governance rules; the concept of member-management; and transferability of membership interest.

Section two of this article will provide a broad summary of the tax flow-through companies studied and their utilisation. The third section will then provide an outline of the meaning and importance of Australian closely held businesses, and the issues that they can face. Section four will provide the analysis of the underlying governance regimes of the tax flow-through companies considering the issues of (a) mandatory rules of: capital

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16 Corporations Act 2001 (Cth) s 111J.

17 For LLCs see A Hicks, R Drury and J Smallcombe, *Alternative Company Structures for the Small Business*, ACCA Research Report No 42, Certified Accountants Educational Trust, London, p 53. For LLPs, see House of Commons — Select Committee, *Trade and Industry — Fourth Report: Draft Limited Liability Partnership Bill*, HC 59, 1999, at [65]; Morse, above n 1; J Birds, 'A New Form of Business Association for the Twenty-First Century' (2000) 21(2) *The Company Lawyer* 39; G Ward, *New Accounting Rules for Limited Liability Partnerships*, Press Release, Institute of Chartered Accountants, 20 July 2001.

18 V Finch and J Freedman, 'The Limited Liability Partnership: Pick and Mix or Mix-up?' (2002) Sept *J Bus L* 475. M Lower, 'What's on offer? A consideration of the legal forms available for use by small– and medium–sized enterprises in the United Kingdom' (2003) 24(6) *The Company Lawyer* 166 at 168.

19 D Goddard, 'Company Law Reform — Lessons from the New Zealand Experience' (1998) 16 *C&SLJ* 236 at 251. Dugan et al argue that an LLC based on the Wyoming LLC statue could provide the best alternative: R Dugan, P McKenzie and D Patterson, *Closely Held Companies: Legal and Tax Issues*, CCH New Zealand Ltd, Auckland, 2000, pp 700–1.

20 L E Ribstein, 'Statutory Forms for Closely Held Firms: Theories and Evidence from LLCs' (1995) 73(2) *Washington Uni LQ* 369 at 384.

21 For example, the S Corporation (USA) and the LAQC (NZ) which are special tax rule companies. See B Freudenberg, *Tax Flow-Through Companies*, CCH-ATTA Doctoral Series No 2, CCH, Sydney, 2011.

22 See B Freudenberg, 'A Model Idea: Is the ICAA proposal for a tax transparent company the ideal model for Australia?' (2009) 38(3) *AT Rev* 161; B Freudenberg, 'The financing effect: Will a tax transparent form for closely held businesses in Australia assist with financing?' (2009) 4(1) *Jnl of the Australasian Tax Teachers Association* 121.

maintenance and minimum membership; (b) default rules of: standard constitution, member-management and transferability of membership interest. Through this analysis recommendations will be proposed in the fifth section of the article before concluding. It will be argued that the Darwinian claims are questionable and that there are serious issues that should be addressed with these underlying regimes to ensure that benefits would be realised for Australian closely held businesses.

Section two

In this section, it will be explained what is meant by tax flow-through companies and their current utilisation in the jurisdictions studied.

Academic focus on tax flow-through companies is not new, and reference to them can be found internationally[23] and in Australia.[24] More recently the Henry Tax Review recommended deferring the introduction of a flow-through company while the corporate imputation system continued.[25]

Flow-through companies can be seen as a hybrid of business forms, with the attributes of a corporation's separate legal entity status[26] and limited liability, with a general partnership's flow-through taxation treatment.[27] It is these three core characteristics that define the nature of a flow-through company (or transparent company). The term 'company' is adopted to indicate

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23 Canada, *Report of the Royal Commission on Taxation*, Carter Commission, vol 4, Queen's Printer, 1967, Ch 19; US Department of Treasury, *Blueprints for Basic Tax Reform (Treasury 1)*, US Treasury Department, 1991; Treasury, *Report of the Department of the Treasury on Integration of the Individual and Corporate Tax Systems: Taxing Business Income Once*, US Treasury Department, 1992. There is also an early Treasury document back in 1946/1948 that discussed transparency: G K Yin and D J Shakow, 'Taxation of Private Business Enterprises' in *Federal Income Tax Project*, The American Law Institute, 1999; Consultative Committee on the Taxation of Income from Capital, *Taxation of Distributions from Companies*, Auckland, November 1990, and Consultative Committee on the Taxation of Income from Capital, *Taxation of Distributions from Companies: Final Report*, Auckland, July 1991; R McLeod, D Patterson, S Jones, S Chatterjee and E Sieper, *Tax Review 2001 — Final Paper*, Wellington, 2001; Hicks, Drury and Smallcombe, above n 17, p 36.

24 Australia, *Taxation Review Committee Full Report*, (K W Asprey, Chairman), AGPS, Canberra, 31 January 1975, at [16.79]–[16.96]; Australia, *Committee of Inquiry into the Australian Financial System — Final Report*, (J K Campbell, Chairman), AGPS, Canberra, 1981, p 223; Australian Treasury, *Draft White Paper on the Reform of the Australian Tax System*, AGPS, Canberra, 1985; Australia, *A strong foundation*, Ralph Report No 1, AGPS, Canberra, 1998, at [277] of Overview; Australia, *Australia's Future Tax System — Consultation Paper*, (K Henry, Chairman), Attorney-General's Department, Barton, 10 December 2008, p 155; C Emerson (Minister of Innovation, Industry, Science and Research), *Media Release: Simplifying Small Business Taxation Under Consideration by Rudd Government*, Australian Government, Canberra, 2008.

25 Australia, *Australia's Future Tax System — Report to the Treasurer*, (K Henry, Chairman), Attorney-General's Department, Barton, December 2009, p 198 (Recommendation #38).

26 Or legal personality.

27 Tax flow-through treatment is argued to be an attribute of general partnerships, particularly in the Australian context. However, this has not always been the case as between 1915 to 1922 general partnerships (and trusts) were subjected to an entity tax treatment: C J Taylor, 'An Old Tax Is A Simple Tax: A Back To The Future Suggestion For The Simplification Of Australian Corporate-Shareholder Taxation' (2006) 2(1) *Jnl of the Australasian Tax Teachers Association* 30 at 34.

the characteristics of separate legal entity status and limited liability,[28] even though some jurisdictions have used the term 'partnership' in describing their flow-through company (as defined). The term 'member' is used in this article to describe an equity investor in the business form, even though they might be known as 'shareholder' or 'partner' or otherwise.[29]

For tax purposes all of the flow-through company's income (whether distributed to members or retained) is allocated and assessed to members. The flow-through company's losses, when deductions exceed assessable income, are similarly directly allocated to members. However, to be able to utilise losses members may need to satisfy a series of requirements, such as the outside cost basis rule, the at-risk rule, the passivity rule and the substantial economic effect rule.[30]

There are a number of jurisdictions with tax flow-through companies, including the United States' S Corporations and LLCs, the United Kingdom's LLPs and New Zealand's Loss Attribution Qualifying Companies (LAQCs) and Look-Through Companies.[31] It has been argued that the tax flow-through companies can be classified into two distinct paradigms.[32] The first classification pertains to when the flow-through company was produced by introducing a special set of tax rules to an existing business form, the corporation, referred to as 'special tax rule company'; and includes the S Corporation and LAQC. The second classification relates to the creation of an entirely new business form that is subjected to existing tax flow-through rules, referred to as a 'new form transparent company', and includes LLCs and LLPs. It is this second classification that forms the basis of analysis for this article to ascertain to what extent Australian closely held business might benefit from their introduction. This analysis will largely consider the governance regime, as the tax issues have been addressed elsewhere.[33]

LLCs where first legislated by Wyoming in 1977 and now exist in all

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28 Note the two features do not always exist with companies. For example in Australia it is possible to have unlimited companies were members do have liability exposure.

29 Other important terms associated with tax flow-through are 'allocations' and 'distributions'. 'Allocations' refer to the allocating of income or losses for tax purposes directly to members even though, legally, the income and/or loss may have been earned or been incurred by the business form. 'Distributions' refers to the payment or the transfer of assets (including money) to members of the flow-through company.

30 B Freudenberg, 'Losing my Losses: Are the loss restriction rules applying to Australia's tax transparent companies adequate?' (2008) 23(2) *ATF* 125.

31 The LAQC regime has been replaced by a 'look-through company' (LTC) regime commencing 1 April 2011: ITA 2007 (NZ), new subpart HB. Other tax transparent companies introduced around the world include Singapore's LLP [Introduced in April 2005 by the Limited Liability Partnership Act (Ch 163A)], Northern Ireland's LLP [which took effect from 13 September 2004] and Japan's LLP [Known as *Godo Kaisha* 'GK' commencing 1 May 2006. Note it is not clear whether such an entity for Japanese tax purposes has been granted tax transparent treatment] and LLC. Other jurisdictions have introduced entities with some of these attributes, but these entities currently lack the separate legal entity status. For example: (a) Germany the GmbH&Co.KG which uses a corporation (known as a GmbH) as the general member of a limited partnership (known as a KG); and (b) France the SAS.

32 For a full explanation see: Freudenberg, above n 22.

33 For a discussion about the tax issues that surrounded the introduction of these foreign tax flow-through companies see Freudenberg, above n 21, Ch 3.

American states.[34] There has been an attempt to provide consistency between the states with a recommended Uniform Act, which recently has been updated by the Revised Uniform Limited Liability Company Act 2006 (Revised ULLC Act) replacing the previous Uniform LLC Act 1996.[35] The legal characteristics of a LLC provide members with limited liability[36] and separate legal entity status.[37] This article will refer to the Revised ULLC Act as a consolidation of the LLC's governance provisions. Of course, it needs to be acknowledged that existing LLCs may have different governing rules, with attributes of the Revised ULLC Act only being adopted prospectively. In addition to the legislation, an LLC Operating Agreement (LLC Agreement) can be instrumental in governing the internal affairs of the LLC,[38] and so will form part of the analysis.

After a period of uncertainty about LLCs' tax treatment, from 1997 an LLC can simply 'Check-the-Box' for tax flow-through[39] provided it is not a state corporation (which by its nature it is not),[40] a publicly traded entity,[41] or certain foreign business forms.[42]

While the most popular business form in the United States for tax purposes are sole proprietors (22,659,976 filing tax returns in the 2009 year),[43] LLCs have quickly emerged as a popular business form. Figure 1 demonstrates that in the United States the most numerous business form are S Corporations followed by a similar number of LLCs and C Corporations. However, this data needs to be interpreted cautiously, as the tax figures could under-report the

34 Refer to the discussion in B Freudenberg, 'Are transparent companies the way of the future for Australia?' (2006) 35(3) *ATR* 200 at 203–4.

35 The Revised ULLC Act replaces the prior Uniform Act of 1996, the Uniform Limited Liability Company Act 1996 (ULLC Act). On 13 July 2006 the National Conference of Commissioner on Uniform State Laws approved the Revised ULLC Act. It is now being submitted to the states for approval.

36 Revised ULLC Act s 304.

37 Revised ULLC Act s 104.

38 Revised ULLC Act s 110 (previously ULLC Act s 103).

39 Technically by default a multi-member LLC would be classified as a general partnership: Treasury Regulation, s 301.7701-2(c)(1) and (2). A single-member LLC for tax purposes can be classified as a corporation [An association] or can elect for the LLC to be disregarded as an entity separate from its owner.

40 A state corporation would be taxed under subch C unless the entity qualifies and elects to be taxed under subch S: Treasury Regulation, 301.7701-2(b). State law corporations (are corporations formed under Corporation Acts such as one based on the Model Corporation Act).

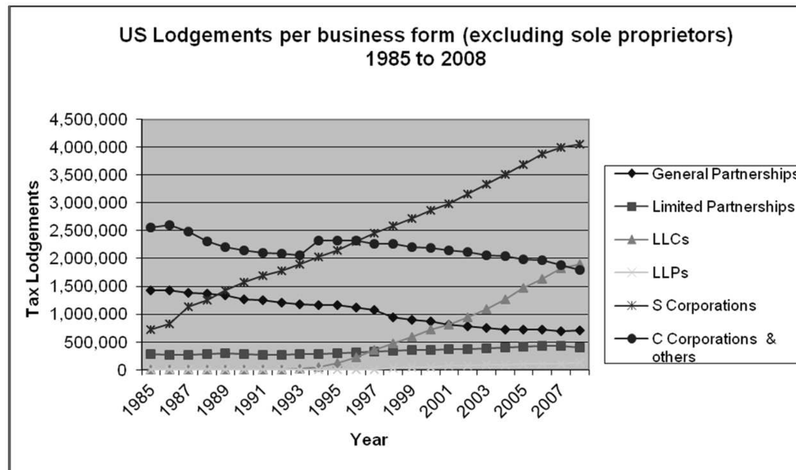
41 IRC 1986 (US) § 7704. An example of a 'publicly traded partnership' is one which has partnership interests that are either (a) traded on established securities markets, (b) readily traded on a secondary market. Regulations provide safe harbours for a partnership to avoid being classified as publicly traded one is (a) all interests issued in a transaction/s are not registered under the Securities Act of 1933, and (b) not greater than 100 members during the year: Treasury Regulation s 1.7704.

42 The United States lists a number of foreign entities which are always taxed as C Corporations. Normally, only one type of body is treated as a C Corporation in a particular country, for example, Australia: public limited company; Canada: corporation and company; France: SA and SAS; Germany: AG; ltaly: società per azioni; Japan: kabushiki-kaisha; Netherlands: NV; Sweden: publik.a aktiebolag, Switzerland: AG; United Kingdom: plc.

43 IRS Statistics of Income 23 January 2012. For 2008, it was 22,614,483 and the number of partnership returns filed for 2008, the latest data available was 3,146,006 while C corporation's accounted for 1,762,483 returns and S corporations 4,049,944.

number of LLCs.[44] Data which compares the tax filings to state registration of LLCs indicates that the number of LLCs may be more in the vicinity of 6 million compared to the 2 million in the tax filings.[45] Also data about asset holdings demonstrate that the favoured business form is the C Corporation.[46]

Figure 1: US: Business form tax returns



Source: Internal Revenue Service (US). (1986–2008) Tax Statistics Returns Filed for Individuals, Corporations and Partnerships. Available at: <http://www.irs.gov/taxstatsl>. The figure excludes the returns lodged for sole proprietors which amounted to 22,614,483 for the 2008 year.

The creation of LLPs in the United Kingdom involved the introduction of the Limited Liability Partnerships Act 2000 (UK) (the LLP Act 2000 (UK)).[47] In addition to this, LLPs and their members are required to comply with modified sections of the Companies Act 2006 (UK), the Insolvency Act 1986 (UK), the Company Directors Disqualification Act 1986 (UK) and the Financial Services and Markets Act 2000 (UK). Additionally, the internal governance of an LLP can be influenced by an optional LLP Operating Agreement (LLP Agreement) which is entered into by members; and which is included in the analysis.

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44 This is because single-member LLCs with tax flow-through treatment are treated by the Internal Revenue Services (US) (United States IRS) as a 'disregarded entity'. Disregarded entities are not reported in this tax data as LLCs, but are instead included in the figures relating to the member's own status. This could mean that the single-member LLC is included in the figures as a sole proprietor, C Corporation, trust or a holding LLC. A compounding factor is that from 1997 LLCs may elect for tax treatment as a C Corporation or S Corporation, and would be reported as such, through a mechanism called 'check the box'. See Treasury Regulations 301.7701-3.

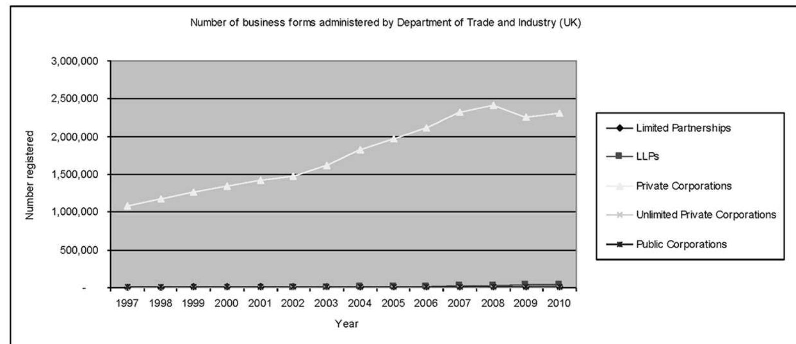
45 Freudenberg, above n 21, at [3-242].

46 Freudenberg, above n 21.

47 Commencing 6 April 2001. For Northern Ireland similar legislation took effect from 13 September 2004.

Once formed, the LLP is a body corporate which exists as a legal person separate from its members.[48] Since the LLP is essentially a body corporate, it is prima facie subject to UK corporation tax,[49] but this is qualified by legislation, so that for most tax purposes an LLP will be treated instead as a general partnership when the LLP carries on a trade, profession, or other business with a view to profit.[50]

Figure 2: UK: Business forms registered



Source: Department of Trade and Industry. (2001–2010). Reports for the year ended 31 March presented pursuant to the Companies Act 1985 s 729 and Companies House. (2007–2010). Statistical Tables on Companies Register Activities at <www.companieshouse.gov.au>.

In terms of the United Kingdom, Figure 2 demonstrates that, excluding sole proprietors, the private corporation predominates as the most popular organised business form, with 2.3 million registered in 2010. However, when private corporations are excluded it becomes clear that there is growing utilisation of LLPs since their introduction in 2001: Figure 3. There are a total of 40,584 LLPs registered in 2010. The United Kingdom's registration of LLPs spiked at a 129 per cent increase in 2003, with registration averaging 40 per cent per annum since. Even with these large increases, the total number of LLPs registered in 2010 represents less than 2% of the total number of private corporations.[51]

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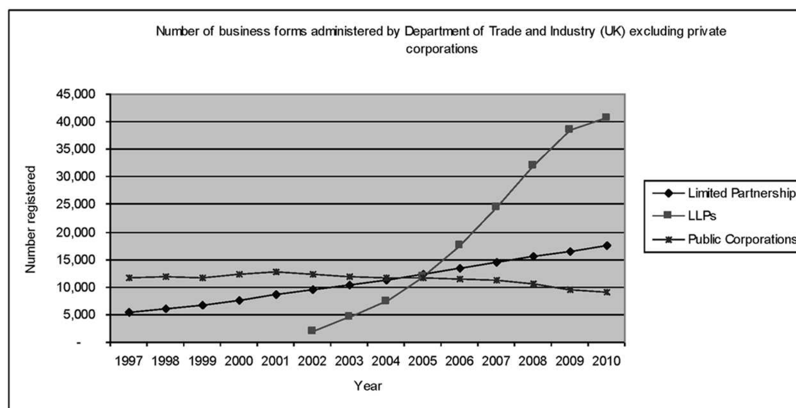
48 LLP Act 2000 (UK) s 1(2).

49 Income and Corporation Taxes Act 1988 (UK) s 832(1).

50 LLP Act 2000 (UK), the Finance Act 2001 (UK) and Income and Corporation Taxes Act 1988 (UK) s 114 provide that LLPs be classified as tax partnerships. Income and Corporation Taxes Act 1988 (UK) s 118ZA. This means for the LLP to be taxed as a general partnership a business must be carried on and not just have passive investments, also there must be a profit motive.

51 For the 2010 year the amount of LLPs registered represent 1.7% of private corporations registered. (40,584 LLPs: 2,310,700 corporations).

Figure 3: UK: Business forms (excluding private corporations)



Source: Department of Trade and Industry. (2001–2006). Reports for the year ended 31 March presented pursuant to the Companies Act 1985 s 729; and Companies House (2007–2010). Statistical Tables on Companies Register Activities at <www.companieshouse.gov.au>.

Section three

This section explores what is meant by closely held businesses, their importance to the economy and some of the issues they face in terms of governance.

Closely held businesses

Classifying businesses can be problematic. Businesses can be classified according to size, industry, membership structure or business form. The criterion of size may be further measured by such things as turnover, asset holdings, employee numbers or equity raising. Furthermore, closely held businesses are heterogeneous, and it can be misleading to represent them as anything else.[52] For example there can be different levels of member activity, ranging from a single-member coffee shop to a-ten member publicity firm or a 100 member accounting firm.[53]

For the purposes of this article, the qualitative characteristics inherent for a 'closely held business' is that membership interest is not widely dispersed, and that it is not publicly traded.[54] Normally, a closely held business is one that is

52 S Holmes and B Gibson, *Definition of Small Business*, The University of Newcastle, 2001, p 8; and J Freedman, 'Small Business Taxation: Policy Issues and the UK' in *Taxing Small Business: Developing Good Tax Policies*, Australian Tax Research Foundation, Sydney, 2003, p 18.

53 R W Hillman, 'Limited Liability and Externalization of Risk: A Comment on the Death of Partnership' (1992) 70 *Washington Uni LQ* 477 at 485.

54 Holmes and Gibson, above n 52, p 8; C Coleman and C Evans, 'Tax Compliance Issues for

independently owned and operated, with most, if not all, capital contributed by members and managers. Furthermore, members are likely to participate in the management of the business (member-management).[55]

While the qualitative characteristics of a closely held business may be explicit, there is a tendency to utilise quantitative measures to describe 'small' and 'medium' businesses, such as having gross operating revenue less than $10 million, gross assets less than $5 million or fewer than 50 employees.[56] It is acknowledged that 'closely held' and 'small business' are not per se interchangeable, although the vast majority of closely held businesses will nonetheless be small to medium enterprises.[57] However, there can be a number of closely held businesses that are large.[58] To the greater extent this article will focus on small and medium closely held businesses, although at times the implications for larger closely held businesses will be raised. This is important as there may be important differences between closely held businesses due to their size and relationship with transparent companies.

It is difficult to obtain data on the contribution of closely held businesses directly to Australia's economy, as much of the data on the significance of businesses is determined by their size rather than membership structure. However, if it is accepted that most small and medium enterprises are closely held, then when aggregated they can account for a large percentage of a country's economic activity. For example, it was estimated that in Australia there were 1,961,337 private sector small businesses[59] in 2008–09, representing 96% of all private sector businesses. Australian small business employs almost 3.6 million people, accounting for 49% of all private sector employment,[60] and around 30% of Australia's gross domestic product.[61]

Also, closely held businesses can have a range of advantages for the economy, as they can be flexible, perform important sub-contractor functions and be a source of new ideas and innovation.[62] It is argued, that due to their current and future influence on a country's economy, it is important to consider the issues confronting this sector. This is not to say closely held

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Small Business in Australia' in *Taxing Small Business: Developing Good Tax Policies*, Australian Tax Research Foundation, Sydney, 2003, p 149; Small Business Deregulation Task Force, below n 64, p 13.

55 P A Harris, *Corporate/Shareholder Income Taxation and Allocating Taxing Rights Between Countries: A Comparison of Imputation Systems*, IBFD Publications BV, Amsterdam, 1996, p 47.

56 Corporations Act (Cth) s 45A: regarded as small if satisfies at least two of these measures.

57 J Freedman and J Ward, 'Taxation of Small and Medium–Sized Enterprises' (2000) May *European Taxation* 158 at 159.

58 Also, corporate groups with subsidiary companies could themselves be regarded as closely held.

59 Defined to be businesses that employ less than 20 people. Australian Bureau of Statistics, *Counts of Australian Businesses, including entries and exits, June 2007 to June 2009*, 8165.0, AGPS, Canberra, 2010, Table 13. These figures are based on those businesses registered for GST.

60 Australian Bureau of Statistics, *Small Business in Australia 2001*, AGPS, Canberra, 2002.

61 Ibid; N Warren (Ed), 'Foreword' in *Taxing Small Business: Developing Good Tax Policies*, Australian Tax Research Foundation, Sydney, 2003, p 11; and Coleman and Evans, above n 54, at 147.

62 Holmes and Gibson, above n 52, p 1, and P Hendy, 'Threats to Small and Medium Enterprises from Tax and other Regulations' in *Taxing Small Business: Developing Good Tax Policies*, Australian Tax Research Foundation, Sydney, 2003, pp 116–17.

businesses are not without their advantages, such as being able to respond quicker to the market or accessing regulatory concessions.[63] The challenges that can face closely held businesses include complexity and governance.

Challenges faced

A problem that has been highlighted by research is that when closely held businesses operations are small they have the least capacity to cope with the burden of regulations.[64] This can lead to the compliance costs for small businesses being regressive.[65] Even if not regressive, compliance costs can detract from the economic efficiency of a business form, especially if there are insufficient benefits obtained from the compliance activity.[66] Also compliance costs are not just purely financial, as non-financial costs can include stress and lost time.[67] However, these findings need to be balanced against arguments that small businesses may have greater non-compliance, which to an extent, may offset the regressive nature of compliance costs.[68]

Compliance costs are an issue for all business and it appears that the choice of business form can have some relationship with compliance costs.[69] Another concern with compliance costs for closely held businesses is that regulations are likely to be dealt with by the principal decision-maker of the business, which can distract the person from the decision-maker's core role.[70] Also, the application of other regulations can increase overall compliance costs burden, such as employment issues, superannuation, occupation health and safety, and workplace relations legislation.[71]

A related issue for closely held businesses is compliance with the governance regime that regulates the business form. This can be because the governance regime can be drafted for when membership is widely held, with non-active members and a separation between management and members. Such characteristics are not indicative of many closely held businesses, and therefore they can be an 'ill fit'.

It needs to be acknowledged that the governance regime for a tax

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63 M Burton, 'The Australian small business tax concessions — public choice, public interest or public folly?' (2006) 21(1) *ATF* 71 at 119.

64 Small Business Deregulation Task Force, *Time for Business*, AGPS, Canberra, 1996, p 19.

65 C Evans, K Ritchie, B Tran-Nam and M Walpole, *A Report into Taxpayer Costs of Compliance*, AGPS, Canberra, 1997; Coleman and Evans, above n 54, at 147–82; K Ritchie, *New Zealand Small Business Tax Compliance Costs — Some Empirical Evidence*, Inland Revenue, Wellington, 2002.

66 F Chittenden, S Kauser and P Poutziouris, *Regulatory Burdens of Small Business: A Literature Review*, University of Manchester, 2000, p 10.

67 Board of Taxation, *Scoping study of small business tax compliance costs: A report to the Treasurer*, Attorney-General's Department, Canberra, December 2007, p 7, Finding 6. Other costs can include psychological, temporal, opportunity and transitional.

68 J Slemrod, 'Small Business and the Tax System' in H Aaron and J Slemrod (Ed), *The Crisis in Tax Administration*, Brookings Institute Press, Washington DC, 2004.

69 Evans, Ritchie, Tran-Nam and Walpole, above n 65; and D DeLuca, A Greenland, J Guyton, S Hennessy and A Kindlon, *Measuring the Tax Compliance Burden of Small Business*, Paper read at Internal Revenue Services' Research Conference, 7–8 June 2005, Washington DC, Table 5, p 83.

70 G Banks, *Reducing the Business Costs of Regulation*, Paper read at Address to Small Business Coalition, 20 March 2003, Brassey House, Canberra, p 5.

71 Board of Taxation, above n 67, pp 105–8.

flow-through company will necessarily be more complicated than for sole proprietorships and general partnerships, as it provides members with liability protection. When a business form provides limited liability, it is perceived as necessary to protect against potential abuse for the protection of creditors and tortfeasors, as well as other members. To what extent these are adequate is questionable. For example the use of phoenix companies has been raised as an area of concern in Australia as there is a perception that the corporate veil has been used by unscrupulous directors to transfer valuable assets out of corporations prior to winding up.[72] These governance rules may be mandatory or default rules that can be amended.

Mandatory rules can restrict distributions, require disclosure, impose duties on managers and/or members, and provide for unfair preference rules and the minimum (and/or maximum) membership number. Also rules have been introduced to protect members, particularly members who have no role in management (non-active members) to reduce agency costs.[73] It is argued that mandatory rules have the greatest impact on a business form's complexity and compliance cost, as they largely cannot be contracted around. This is because even if the firm can be seen as a series of contracts,[74] the governing legislation removes the ability for individual contracting in relation to mandatory rules.

The extent to which mandatory rules are required and/or are effective is contentious. In particular, mandatory rules could impose requirements that are not necessary or excessive, compared to the benefits they deliver for closely held businesses. For example, the rules to protect against agency cost may be superfluous when there are member-managers (active members), because in these circumstances the interests of the managers are more in line with the members. In relation to the characteristic of limited liability, Dugan et al argue that the minimum rules required are for the filing of the most basic information; and for distributions to be subject to a balance sheet solvency test.[75] The mandatory rules for the transparent companies studied extend well beyond this argued position. It is beyond the scope of this article to formulate the optimal minimum rules. Instead, this article will analyse the rules for the transparent companies studied and how they compare to each other, and their potential ramifications for Australian closely held businesses.

Business legislation can also provide default rules that can deal with such issues as management, membership interest and duties. These default rules can automatically provide a framework to govern the business form and the

72 There are estimates that this is costing the government revenue loss of $1.78 to $3.19 billion per annum: Australian Securities and Investment Commission, Insolvency Statistics: Series 3, 2013,, at <http://www.asic.gov.au/asic/asic.nsf/byheadline/Insolvency+statistics+-+series+3+external+administrator+reports?openDocument> (accessed 5 November 2013).

73 Agency theory applies where there is a separation of ownership and control and describes how misalignment can occur resulting in conflicts between the interests of those in control of the business form and the those who own it: A Berle and G Means, *The Modern Corporation and Private Property*, Harcourt Brace & World Inc, New York, 1952.

74 M C Jensen and W H Meckling, 'Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure' (1976) 3 *Jnl of Financial Economics* 305 at 305–60.

75 No information required of members, only managers. Subsequent filing is only required when there is a change in registered agent, registered office or dissolution: Dugan, McKenzie and Patterson, above n 19, p 700.

relationship of the parties involved and building networking benefits.[76] However, as previously noted, closely held businesses are heterogeneous so default rules are likely to require customisation. This necessarily involves cost and could diminish networking benefits if variations to the standard set of rules are substantial. If operations are small such customisation costs could be regressive. However, the alternative, of no default rules, means that businesses would be required to establish their own customised terms.[77] It is argued that such comprehensive customisation would involve higher drafting costs, risks of negotiating or drafting errors, uncertainty regarding certain terms' validity, lack of judicial precedent addressing a term's meaning or effect, and an ongoing lack of familiarity with the terms.[78] Also for third parties this could impose greater costs in dealing with the business, which could be reflected in higher charges.[79]

It is argued that the suitability of default rules can be of particular importance for closely held businesses when their operations are small. This is because it is questionable to what extent complete advice is obtained at the time of formation of the business. Research has demonstrated that small closely held businesses may not adopt tailored governance rules due to the limited availability of financial resources,[80] the uncertainty about future

76 Easterbrook and Fischel have argued that in the absence of transaction costs the supply of clear and simple default rules will be regarded as value enhancing: F H Easterbrook and D R Fischel, *The Economic Structure of Corporate Law*, Harvard University Press, Cambridge, 1991, cf with L E Ribstein, 'Efficiency, Regulation and Competition: A comment on Easterbrook & Fischel's Economic Structure of Corporate Law' (1992) 87(1) *NULR* 254. Even though their work mainly concerned widely held corporations, it is argued that similar principles apply to closely held firms. An advantage of default rules is the ability to develop 'network externality benefits': J W Callison, 'Venture Capital and Corporate Governance: Evolving the Limited Liability Company to Finance the Entrepreneurial Business' (2000-01) 26(Fall) *J Corp L* 97 at 117: that is, the build-up of precedent and decisions. This refers to the idea that enacting laws to govern business forms can reduce transaction costs. That is, as case law considering the standard set of rules develops, there is understanding and improved certainty about how the provisions will be applied in the future. These networking benefits extend to third parties, such as trade creditors, dealing with the business form as they have improved understanding about the governance of the business form.

77 Furthermore, in the absence of default rules, there may be no precise rules determining the resolution of disputes, which could lead to management paralysis, requiring courts to 'fill gaps' or impose expensive and lengthy periods of dispute or litigation: J A McCahery and E P M Vermeulen, 'The Evolution of Closely Held Business Forms in Europe' in J McCahery, T Raaijmakers and E Vermeulen (Eds), *The Governance of Close Corporations and Partnerships: US and European Perspectives*, Oxford University Press, Oxford, 2004, p 220 and Finch and Freedman, above n 18, at 490.

78 M Kahan and M Klausner, 'Path Dependence in Corporate Contracting: Increasing Returns, Herd Behavior and Cognitive Biases' (1996) 74 *Washington Uni LQ* 347 at 350.

79 Indeed, it may be preferable to have the blending of principles originating from the legislation that created the business form, rather than originating from separate and distinct members' agreements. If blending occurs within the legislation, then future networking benefits may be established when case law develops around a standard set of 'blended' legislated principles. However, it should be acknowledged that the market could provide template members' agreements, thereby providing partial standardisation, and the consequent potential for improved networking benefits. This needs to be balanced with the research discussed later by Dugan et al which would query whether this occurs in any meaningful way: Dugan, McKenzie and Patterson, above n 19, pp 119, and 274–5.

80 Hicks, Drury and Smallcombe, above n 17.

operations, the paucity of understanding about business forms[81] and the use of accountants for business formation.[82] In this way they can be seen as 'informal' even though a business form (such as a corporation) is used.

For example, in a United Kingdom study Hicks et al found that formal advice was received in only 36% of cases to incorporate for small businesses and 97% of this advice was from accountants, with the remaining 3% from solicitors.[83] Also, the study by Freedman and Godwin[84] found a lack of 'tailoring' of the corporate form to any individual needs: only 8% reported that articles (constitution) were tailored to their own requirements.[85] 25% indicated that they had standard form documentation with a few changes; 75% believed they had just an off-the-shelf standard form.[86] If similar trends exist in Australia, this may explain an OECD study of Australian businesses finding that 59–69% of businesses had trouble understanding regulations.[87]

It is argued that for closely held businesses it is preferable to have a number of default rules for a business form, particularly addressing the issues that commonly arise,[88] even though these may require customisation.

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81 The lack of understanding has been demonstrated in a number of studies and statements. See Great Britain, *Small Firms: Report of the Committee of Inquiry on Small Firms* (J E Bolton, Chairman), Secretary of State for Trade and Industry, London, 1971: point out that small business owners often have low levels of formal education. Warren, above n 61, p 11. CPA Australia, *Discussion Paper: Small Business Policy — Where to from here?*, CPA Australia, Melbourne, 2003, p 7.

82 B L Johns, W C Dunlop and W J Sheehan, *Small Business in Australia: Problems and Prospects*, George Allen & Unwin, Sydney, 1983, p 32: Limited financial resources of small firms can preclude the employment of experts to give the best management advice.

83 Hicks, Drury and Smallcombe, above n 17, p 16.

84 Freedman and Godwin conducted a survey in the early 1990's in the United Kingdom. They survey 429 firms, conducted 24 face-to-face interviews with small businesses, and 12 with auditors. While they didn't use a measure for 'small', they instead used the qualitative measure of closely-held, in that was management and ownership in the same hands: J Freedman and M Godwin, 'Incorporating the Micro Business: Perceptions and Misperceptions' in A Hughes and D Storey (Eds), *Finance and the Small Firm*, Routledge, London, 1994, p 108.

85 J Freedman, 'The Quest for an Ideal Form for Small Businesses — A Misconceived Enterprise?' in B A K Rider and M Andenas (Eds), *Developments in European Company Law: Volume 2/1997: The Quest for an Ideal Legal Form for Small Business*, Vol 2, Kluwer Law International Ltd, London, 1997, p 27.

86 Freedman, above n 85, p 27. Such findings are supported by a NZ study that questions whether the development of standard form constitutions by the market has occurred in a meaningful way. The review by Dugan et al of corporation constitutions concluded that the constitutions were 'replete with redundant material, errors and ambiguities and revealed no serious attempt to adopt the rules of the Act to the circumstances'. This could reflect the possibility that small business cannot afford to pay for tailored rules at the set-up stage, or perceive it to be too expensive: Dugan, McKenzie and Patterson, above n 19, pp 119, and 274–5.

87 OECD, *The OECD Public Management Services Multi-Country Business Survey: Benchmarking Regulatory and Administrative Business Environments in Small and Medium Enterprises*, OECD, 2000.

88 Goddard, above n 19, at 252. Dugan et al have argued that the following default rules are preferable for closely held business: unless all members consent to a transfer, the transferee is entitled only to the transferor's share of profits and not management rights, and unless the operating agreement provides for a manager, the management rest with members in

Section four — analysis

The analysis of the underlying governance regimes of the tax flow-through companies studied will consider the issues of mandatory rules (capital protection rules and single membership) and default rules (standard constitution, member-management and transferability of membership interest). These are explored below, considering whether they could be advantageous for Australian closely held businesses.

Mandatory rules

The mandatory rules that will be considered are capital protection and minimum membership.

Capital protection

When a business form provides members with liability protection it is perceived as necessary to ensure that the business is not utilised as a mechanism to defraud creditors. To this end, rules have been introduced to ensure that capital is maintained[89] and that insolvent trading is avoided.

A particular issue arising for tax flow-through companies is the appropriate treatment of 'unpaid allocations' to members as the tax laws can influence the underlying governance regime. 'Unpaid allocations' refer to the tax flow-through company allocating profit to the member which the member has been assessed on for income tax purposes but currently the profit remains within the transparent company. This issue is whether such 'unpaid allocations' represent further equity contributions or debt owing to the members (member loan).[90]

This distinction is of central importance because, if considered as a further equity contribution, an unpaid allocation can then be subject to capital protection rules that (in turn) restrict the ability for the amount to be subsequently withdrawn without obstruction.[91] The distinction is also of importance as it has potential to impact on the comparative ranking of creditors. For example, if an unpaid allocation is considered equity, then the member will have only a residual claim after secured and unsecured creditors have been satisfied. In comparison, if it is regarded as an unsecured member loan, then it can rank equally with other unsecured creditors. Determining the status of unpaid allocations is critical for closely held businesses, insofar as members may not demand the full payment of income allocations, in an endeavour to assist with the financing of the transparent company's operations.[92] Also, in terms of being able to utilise allocated losses, there

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proportion of their membership interest; default, and debts are contracted on behalf of the business by the manager, of if member-managed then members: Dugan, McKenzie and Patterson, above n 19.

89 For example, dividends are to be only paid out of profits: Corporations Act (Cth) s 254T.

90 Refer to the discussion about the potential influence of unpaid allocations on members' ability to utilise allocated losses see: Freudenberg, above n 30.

91 For example in Australia the share buy-back and reduction in capital rules: Corporations Act (Cth) Pt 2J.1.

92 Equity finance from active members can be an essential source of financing, especially in the early years of operation. In the years of operation the business may not have the 'track

could be a desire for members to have unpaid allocations treated as equity contributions to increase the membership cost basis and thereby the amount of allocated losses able to be utilised.[93]

If it is determined that an unpaid allocation is a member loan then the governing constitution of the transparent company would need to recognise and appropriately deal with the loan as a debt in its accounting books. Furthermore, managers of the transparent company would need to ensure that this debt was properly provisioned; otherwise general director duties and the associated obligations to avoid insolvent trading could be infringed by the incurring of this (or future) debts.[94] This means that the interplay between tax and capital protection rules needs careful consideration should a tax flow-through company be introduced in Australia.

In terms of insolvent trading, the protection of creditors is provided for with the United States' LLC by having mandatory rules that no distribution may be made if (after it) the LLC would not be able to pay its debts as they become due in the usual course of business,[95] or its total assets would be less than the sum of its total liabilities and the satisfaction of members' preferential rights upon dissolution.[96]

A member of a 'member-managed LLC' or a manager of a 'manager-managed LLC' who consents to an excess distribution is personally liable for the excess violation amount.[97] Accordingly, such provisions can prejudice a member's limited liability protection via the transparent company and could affect the ability to make a distribution to a member to satisfy a prior unpaid allocation.

The limited liability protection offered by the United Kingdom's LLP is problematic in a number of ways. First, the LLP Act (UK) has no express limitation of liability for members, compared to, for example, members of an Australian corporation where the liability of members is specified to be limited to the amount (if any) unpaid on the membership interests held by them.[98] However, the liability of LLP members is intended to be limited due to the corporate nature of the LLP,[99] but this liability limitation is not complete

record' to satisfy creditors, nor have tangible assets which can stand as security for the loans. A Hicks, 'Legislating for the Needs of the Small Business' in B A K Rider and M Andenas (Eds), *Developments in European Company Law: Volume 2/1997: The Quest for an Ideal Legal Form for Small Business*, Vol 2, Kluwer Law International Ltd, London, 1997, p 58.

93 Refer to the discussion of the loss utilisation rules in Freudenberg, above n 30.

94 Alternatively, members may prefer that the right to receive the allocation is stapled to the obligation to be paid the unpaid allocation of the transparent company's profit. Failure do this may cause systematic insolvency of the members.

95 Revised ULLC Act ss 405 and 406.

96 Revised ULLC Act ss 405 and 406.

97 Revised ULLC Act s 406. An action must be commenced within 2 years of the improper distribution. The Delaware code provides for a similar rule with a 3 year time limit: Del Code, s 18-607.

98 Corporations Act 2001 (Cth) s 9.

99 Explanatory Notes of LLP Act 2000 (UK), state that 'limited liability is possible because an LLP is a legal person separate from its members' and that this 'makes it more akin to a company than to a partnership'; *JH Rayner v Department of Trade* [1990] 2 AC 418; [1989] 3 All ER 523; [1989] 3 WLR 969; quoting the Australian decision *Chaff and Hay Acquisitions Committee v J A Hemphill and Sons Ptry Ltd* (1947) 74 CLR 375 at 385; Finch and Freedman, above n 18, at 481.

or certain, especially in relation to tortious claims.[100] Also, an LLP member is exposed to liability in the circumstances that the LLP carries on business with only one member for more than 6 months.[101]

Furthermore, members of an LLP have potential liability exposure through actions for misfeasance,[102] fraudulent trading,[103] wrongful trading,[104] and adjustment of withdrawals.[105] Currently, the adjustment of withdrawals — unlike other obligations — does not apply to corporations, thereby leading some commentators to state that 'LLP members face a more severe clawback than company [corporation] directors'. The adjustment of withdrawals rule was considered a necessary imposition as LLPs can distribute their profits 'without let or hindrance'.[106]

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100 This uncertainty is illustrated by some commentators specifying that LLP members retain unlimited liability for negligence: R Khiara, 'Over the limit' (2005) 5 *The Lawyer* 24, and P Shohet and A Jenner, 'Get your teeth into LLPs' (2005) May *Accountancy Magazine* 73 at 74; G Morse et al, *Palmer's Limited Liability Law*, Sweet & Maxwell, London, 2002, p 187. Whereas others specify that the LLP may provide some negligence protection: L Pinfold (Ed), *Tolley's Tax Planning 2005–06*, Vol 1, LexisNexis Butterworths, London, 2005, p 1360, and J Freedman, 'Limited Liability Partnerships in the United Kingdom — Do They Have a Role For Small Business?' (2001) 26(4) *J Corp L* 897 at 910–12.

101 Companies Act 1985 (UK) s 24. In these circumstances that single-member, if knowingly the only member, is liable, jointly and severally with the LLP, for payment of the LLP's debts contracted after the 6 months have passed.

102 Insolvency Act 1986 (UK) s 212. The provision provides that if a person has taken part in the management of a LLP and has misapplied, retained or become accountable for money or property of the LLP, or been guilty of misfeasance or breach of any fiduciary duty or other duty in relation to the LLP, then pursuant to subs (3) the court may on application of the receiver/liquidator/creditor compel the offender to repay, restore or account with interest.

103 Insolvency Act 1986 (UK) s 213. The provision provides that if in the course of winding-up it appears that an LLP's business was carried on with intent to defraud the LLP's creditors or other creditors, then pursuant to subs (2) the court may on application by the liquidator make a person make contributions.

104 Insolvency Act 1986 (UK) s 214. The 'wrongful trading' liability provides that if an LLP has become insolvent, and before commencement of winding-up the members knew or ought to have concluded that there was no reasonable prospect to avoid insolvency, then the court can order that members personally pay some contribution towards paying off the LLP's debts to its creditors. It is a defence to wrongful trading if the members took every step with a view to minimising the potential loss to the LLP's creditors: Insolvency Act 1986 (UK) s 214(3). The wrongful trading provisions include both a subjective and an objective judgment when considering directors' duties: Insolvency Act 1986 (UK) s 214(4).

105 Insolvency Act 1986 (UK) s 214A: Members may have to contribute on a winding up if they withdrew property from the LLP over the 2 years preceding winding up at a time when they knew or had reasonable grounds for believing that the LLP was or would thereby become unable to pay its debts. However, others have argued that creditor's protection may be weakened by LLP members pleading ignorance of the LLP's financial circumstances and consequently could not be said to have reasonable grounds for believing the LLP's insolvency. House of Commons — Select Committee, above n 17, at [48]–[51]. Finch and Freedman, above n 18, at 509.

106 House of Commons — Select Committee, above n 17, at [48]: referring evidence provided by the Department of Trade and Industry. The adjustment of withdrawal can result in a court ordering a past or present LLP member to make a contribution to the LLP's assets if in the prior 2 years they withdrew LLP property or had any other withdrawal: Insolvency Act 1986 (UK) s 214A. In this context, the term 'withdrawal' is defined widely and extends beyond a profit distribution and includes salary, principal and interest payments to a member: Regulations pursuant to Insolvency Act 1986 (UK) s 214A. It has been argued that this can mean that payments of allocations recognised as debt to members could be subject to this withholding adjustment even though they would not increase a member's ability to utilise

Consequently, the greater flexibility provided by a new form transparent company could result in the perceived need to ensure safeguards which then adds to the compliance burden. Also these rules increase members' risk exposure to the extent that they inhibit the distributions to satisfy unpaid allocations for which members have been previously assessed for tax purposes. It would appear the LLC model is superior to the LLP in this regard.

Minimum membership

A mandatory rule of importance for closely held businesses is the requisite minimum number of members, because the vast majority of businesses can be owned by one member.[107] However, whether the governing rules are drafted to adequately cater for single membership is debateable. That is do the governance rules cater for single membership in a meaningful manner or is it an 'add-on' imposed on a governance framework drafted for multiple members with provisions dealing with agency issues between members and/or managers?

For LLCs it is possible to have single membership,[108] although Ribstein questions whether a single member is appropriate, due to the default rules obviously being drafted for multiple members. Ribstein expresses concerns about interpretation problems that could arise from such a 'mismatch'.[109]

While single-member LLCs in the United States may not be perfect, they are preferable to the United Kingdom's LLP. This is because the LLP does not allow for single membership at all — requiring at least two members.[110] It is

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allocated losses. Also, concerns have been expressed about the lack of defences for withholding adjustment to LLPs that are available under other insolvent trading provisions: For example, the defence in wrongful trading of 'limiting the potential loss to creditors' does not appear in withdrawal adjustments: Insolvency Act 1986 (UK) s 214(3). This concern is exacerbated as there is no need to prove lack of good faith in carrying on business with a withdrawal action, with such a defence available against undervalued transactions proceedings: Insolvency Act 1986 (UK) s 238(4). *Re MC Bacon Ltd* [1990] BCLC 324; [1990] BCC 78; *Phillips v Brewin Dolphin Bell Lawrie Ltd* [2001] 1 WLR 143 (Lords); [1999] 2 All ER 844 (CA); *Re Barton Manufacturing Co Ltd* [1998] BCC 827; *Re Lewis of Leicester Ltd* [1995] BCC 514. Finch and Freedman, above n 18, at 503.

107 For example the vast majority of corporations in the United States are owned by one or a few members: H M Friedman, 'The Silent LLC Revolution — The Social Cost of Academic Neglect' (2004) 38(1) *Cre LR* 20. Similarly, especially as a large proportion of UK businesses have one member: Over 70% of corporations have only one or two members. Some 90% have fewer than five members: Department of Trade and Industry, *Modern Company Law for a Competitive Economy, Developing the Framework*, A Consultative Document from the Company Law Review Steering Committee, March, 2000, p 221.

108 LLC: Massachusetts changed its laws in 2003 to allow for a single member LLC, being the last American state to do so.

109 L E Ribstein and M A Sargent (Eds), 'Check-the-Box and Beyond: The Future of Limited Liability Entities' (1996) *The Business Lawyer* 52 at 638. This is because LLCs are built on a contractual model, which implies an agreement amongst members. In such circumstances, there is a danger that LLC default rules will be applied, for example, to give rights to non-owner associates such as managerial employees. To address this, Ribstein wonders whether a new non-corporate statutory form, the limited liability sole proprietorship would be a better alternative.

110 LLP Act 2000 (UK) s 2: must have two or more persons associated for carrying on a lawful business with a view to profit. LLP Act 2000 (UK) s 8(2): and must have at least two designated members. However, the legislation expressly envisages that the LLP can continue to carry on business although it has only one member: Companies Act 1985 (UK) s 24 —

argued that the requirement for two members is inconsistent with the overall corporate nature of LLPs. Even though the LLP's name — limited liability 'partnership' — connotes the impression that its governance is partnership based, it is argued that the LLP is essentially 'corporate' in nature.[111] Indeed, others have questioned whether the label 'partnership' is appropriate at all in describing the LLP.[112]

It is argued that the requirement for two members may frustrate closely held businesses and could thereby compel the utilisation of non-active members to fulfil the requisite condition.[113] However, enticing a person to become a non-active member of an LLP could be difficult due to the extensive obligations placed on members.[114]

Consequently, it is argued that LLCs are preferable to the LLP in terms of allowing one member, although there are the problems as the LLC governing rules are really drafted for multiple members. Consequently, if Australia were to introduce a new form transparent company it would be preferable that single membership is genuinely reflected in the governing rules. The rules would then have to accommodate the expansion from single membership to multi-membership.

Default rules

The default rules of the transparent companies studied are considered in terms of the provision of a standard constitution, member-management and transferability of membership interests.

Standard constitution

It has been argued that an important feature of the governing rules for a closely held business form is the provision of a standard set or framework of

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however this will lead to liability exposure for members. There is some relief for LLP membership falling to one member provided it is rectified within 6 months

111 This corporate context is illustrated by the fact that there is no expressed duty between the LLP members, compared to general partnerships. This is because a large volume of the corporation's law is included through regulations.

112 J F Avery Jones, L De Broe, M J Ellis, T Miyatake, S I Roberts, S H Goldberg, J Killius, G Maisto, F Giuliani, R J Vann, D A Ward and B Wiman, 'Characterization of Other States' Partnerships for Income Tax' (2002) July *Bulletin — Tax Treaty Monitor* 288 at 305, and J Freedman, 'Limited Liability Partnerships in the United Kingdom: Do They Have a Role for Small Firms?' in J McCahery, T Raaijmakers and E Vermeulen (Eds), *The Governance of Close Corporations and Partnerships: US and European Perspectives*, Oxford University Press, Oxford, 2004, p 295; G Morse, *Partnership Law*, 6th ed, Oxford University Press, Oxford, 2006. Such an observation is reinforced by the fact that it is expressly stated in the first section of the LLP Act that the law relating to partnerships does not apply to an LLP except so far as the LLP Act 2000 (UK) (or any other Act) provides: LLP Act 2000 (UK) s 1(5).

113 Other terms that could be used to describe non-active members are 'silent members' or 'nominee members'. It should be recalled that this is what occurred in the famous decision of *Salomon v Salomon & Co* [1897] AC 22 (HL), where six nominee members where utilised to ensure the minimum membership of seven at the time was satisfied.

114 The obligations for a non-active LLP member are explored later in this article.

rules that provide a default governance framework[115] — particularly to develop and facilitate 'networking benefits'.

The LLC statute does provide a number of default rules, although they are mainly for multi-members rather than specifically single membership. For example, the default rules include the provision that distributions are to be in equal shares among members[116] when the LLC is member-managed,[117] then management will be collective[118] — with equal rights,[119] majority votes to resolve differences[120] (although unanimous member consent is required for activities outside ordinary course of business)[121] and amendment to LLC Agreement.[122]

Even though the governance regimes applicable to LLCs were only recently introduced in many American states in the early 1990s, there has already been extensive reform to them.[123] Ribstein argued this reform suggests the influence of jurisdictional competition,[124] and the evolution toward more efficient provisions.[125] While such statements might be enticing, these reforms may have more to do with changes to the tax rules with Check-the-Box allowing LLC easy access to tax flow-through. This is because up until 1996, in drafting LLC legislation American state governments were likely to have considered the Kintner Regulation's corporate characteristics to ensure only two of the four were present to allow tax flow-through.[126] This means that the reforms that have occurred since 1997 may not be evolutionary, but amending legislation that was unduly restricted by previous tax provisions.[127]

115 Easterbrook and Fischel have argued that in the absence of transaction costs the supply of clear and simple default rules will be regarded as value enhancing: Easterbrook and Fischel, above n 76.

116 Revised ULLC Act s 404. Note the Act is silent in respect of 'allocations' as this is a tax term and its exclusion was intentional: Reporters Notes to the Revised ULLC Act for the February 2006 Draft Committee Meeting, National Conference of Commissioners on Uniform State Laws.

117 Revised ULLC Act s 407(a).

118 Revised ULLC Act s 407(b)(1).

119 Revised ULLC Act s 407(b)(2).

120 Revised ULLC Act s 407(b)(3).

121 Revised ULLC Act s 407(b)(4).

122 Revised ULLC Act s 407(b)(5).

123 While Wyoming was the first American state to introduce the LLC in 1977, it was not until after the 1988 tax ruling that other American states introduced similar LLC legislation (excluding Florida which introduced its LLC legislation prior to the ruling).

124 Ribstein, above n 20, at 412.

125 Ibid, at 384.

126 The four corporate characteristics were continuity of life, free transferability of interests centralised management and limited liability. In fact, the influence of the Kintner Regulations was explicit in many of the LLC acts. Some acts provided that they should be applied to 'permit a limited liability company to qualify for taxation as an entity that is not an association taxable as a corporation under the IRC (US) of 1986': Ribstein, above n 20, at 384: 15 PA CONS STAT 8915 (Supp 1994).

127 In this respect, Federow argues that the Kintner Regulation's influence compromised the drafting of the original LLC legislation: Ribstein and Sargent, above n 109, at 612 per Federow. This was reflected in Friedman's observation that after 1997 virtually all American states with Kintner compliant statutes subsequently transformed them into statutes that permitted greater flexibility in the LLC structure: Friedman, above n 107, at 20: States that originally had bullet-proof acts included Colorado, Michigan, Nebraska, Nevada, Michigan, Virginia and Wyoming.

Accordingly, these jurisdictional characteristics need to be kept in mind.[128]

Also, concerns have been expressed regarding the appropriateness of the changes to LLC's governance for closely held businesses. Commentators have argued that since the introduction of the Check-the-Box requirement, American state legislators have been convinced to move the LLC closer to the corporate mode by eliminating all dissociation rights for default provisions.[129] This is perceived to have had the ultimate consequence that LLCs may potentially be more 'perilous' for informal businesses.[130]

For the United Kingdom's LLP in the absence of an LLP Agreement, the LLP's internal operations are governed by the default rules in the regulations.[131] These default rules reflect some fundamental aspects of general partnership law, including the following elements: the equal sharing of capital and profits;[132] the requirement that every member may take part in management;[133] the requirement that matters are to be dealt with by majority vote;[134] and the requirement that specific duties imposed on directors/members to account for competing activities and for misapplication of LLP property.[135]

However, the LLP default rules have been criticised as 'rudimentary',[136] 'sketchy'[137] and unlikely to be adequate to deal with all the issues arising for a closely held business. Identified inadequacies include the absence of the power to expel a member and the power to amend on a majority vote,[138] as well as a failure to deal with corporate and insolvency laws that are applicable

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128 Vestal concluded that the 1990's reforms in the United States were of 'great change and little accomplishment': A W Vestal, 'Drawing Near the Fastness?: The Failed US Experiment in Unincorporated Business Entity Reform' in J McCahery, T Raaijmakers and E Vermeulen (Eds), *The Governance of Close Corporations and Partnerships: US and European Perspectives*, Oxford University Press, Oxford, 2004, p 357.

129 'Dissociation rights' is referring to what occurs on the withdrawal of a member: S P Hamill, 'The Story of LLCs: Combining the Best Features of a Flawed Business Tax Structure' in *Business Tax Stories: An In-depth look at ten leading developments in Corporate and Partnership taxation*, Foundation Press, 2005, p 314.

130 Hamill, above n 129, p 314.

131 LLP Act 2000 (UK) s 5(1).

132 LLP Regulations 2001 (UK) reg 7(1).

133 LLP Act 2000 (UK) s 15(c) and LLP Regulations 2001 (UK) reg 7(8).

134 LLP Act 2000 (UK) s 15(c) and LLP Regulations 2001 (UK) reg 7(6). Except for changes in the nature of the LLP business requires unanimous member consent.

135 LLP Act 2000 (UK) s 15(c) and LLP Regulations 2001 (UK) reg 7(9) and (10). Other default rules are: if a member, without consent of LLP, competes with LLP business, the member must account for and pay over to the LLP all profits made in that competing business [reg 7(9)]; and every member must account to the LLP for any benefit derived without consent of LLP from transaction concerning the LLP or use of LLP property, name or business connection: reg 7(10). Further default rules include: no automatic entitlement for remuneration: reg 7(4), members must render true account and full information of things affecting the LLP to any members: reg 7(8), no person to be introduced as a member without unanimous member consent: reg 7(5), availability of books and records for inspection by members: reg 7(7), and indemnification of members for payments and liabilities properly incurred: reg 7(2).

136 Finch and Freedman, above n 18, at 499.

137 Pinfold, above n 100, p 1361.

138 Finch and Freedman, above n 18, at 499. There is no power to expel a member; all that could be done would be to buy the member out or dissolve the LLP. It is also essential that it must contain the power to be amended on a majority vote.

to LLPs.[139] For example, the LLP Agreement will need to consider compulsory and voluntary winding-up procedures, which involve calling of members and creditors meetings.[140] Freedman argues that the absence of comprehensive internal governance rules is a negative factor that tends to diminish any networking benefits.[141] The absence of a standard constitution may, in this respect, explain why an LLP is more expensive to set up than a UK corporation, which is provided with a standard-form constitution.[142]

Also, it should be noted that the LLP's minimal default rules may lead to 'gaps' in governance arrangements, particularly where neither the default rules nor the LLP Agreement deals with a situation. Such gaps could produce expensive and lengthy periods of litigation, which would increase uncertainty and complexity for LLPs which rely on the minimal default provisions.[143] It is argued that given the extensive mandatory obligations placed on the LLP and its members, it would have been preferable to have a pre-existing comprehensive default governance framework. Without such complete default provisions it is questionable whether Australian closely held businesses would benefit from such a form.

Member-management (initially)

Research demonstrates that member-management is a common characteristic of closely held businesses,[144] and therefore it is important for default rules to accommodate this, as well as whether it impinges liability protection.[145]

The involvement of members in management does not of itself impact directly on liability protection directly in the transparent companies studied. However, members' activities — such as in the capacity of a manager — may potentially expose them to liability. In terms of LLCs, the major default rule

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139 R Linsell, 'Limited Liability Partnerships: Yes or No?' (2000) Nov *Solicitors Jnl* 994 at 994.

140 This is because the full corporate insolvency regime applies to winding-up of the LLP: Linsell, above n 139, at 997. Other things that would be expected in an LLP Agreement include: internal procedures to change the LLP's registered office, designated members appointment and responsibilities; the declaring of conflict of interests; duty of good faith between members (if desired); measures excluding unfair prejudice actions; expulsion of members; restrictive covenants procedures for later variations of the LLP Agreement and payments for exiting members. The LLP Agreement needs to deal with meeting notices, quorums, chairing, voting methods and majorities required for certain decisions; also intellectual property rights, member's capital contributions, terms and conditions for assignment of interest, rules for voluntary and compulsory removal of members, entitlements and obligations of outgoing members, ensuring new members bind themselves to the LLP Agreement and procedures for variations of the LLP Agreement, procedure for approval of annual accounts, limitations on member's authority, duties and obligations of members. Exiting members would need to consider part year profits and unrealised gains on LLP assets.

141 Freedman, above n 112, p 298.

142 An LLP is more expensive to set up than a corporation: as at 20 October 2006 the basic cost charge from Jordans for setting up an LLP (including draft LLP Agreement) is £213.87 (including VAT), whereas for a corporation the basic cost is approximately £139 (including VAT). The cost for LLPs appears to have reduced since 2002 when the cost of setting up a company through Jordans can be as little as £145 and the cost of a Jordans LLP is £488.75. Finch and Freedman, above n 18, at 499.

143 Finch and Freedman, above n 18, at 490.

144 Hicks, Drury and Smallcombe, above n 17, p 15.

145 Some business forms, such as the limited partnership, remove liability protection if a member is active in the management of the business.

(and to an extent mandatory as it cannot be eliminated if manifestly unreasonable to do so)[146] are the duties of loyalty,[147] care[148] and the obligations of good faith and fair dealing.[149] In the circumstances that the LLC is manager-managed, then these duties (loyalty, care and good faith and fair dealing) apply to the manager(s) and not to the members.[150]

While the LLC can allow for member-management, the default position under the Revised ULLC Act is now for manager-management,[151] and that the member is not automatically an agent of the LLC.[152] This means that for many closely held businesses this default rule would require amendment. It is argued that this further evidence of how the LLC revisions are more focused on larger businesses with potential problems for informal businesses.

In contrast, every member of the United Kingdom's LLP is assumed to be a manager, as every member of an LLP is an agent of the LLP,[153] and every LLP member can take part in management.[154]

Manager-management (on expansion)

It is argued that it is preferable that the governance rules allow for the growth of the business form from single-member-management to multi-member manager-management. In such circumstances having management separate from members (manager-management) can be beneficial and can account for the potential agency costs. In this respect, the LLC is able to adopt separate managers from members if required, with consequent different duties.[155] This flexibility allows the LLC to be more partnership-like or more corporate-like,

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146 Revised ULLC Act ss 110(c)(4) and (d)(1). Identify specific activities that do not violate the duty of loyalty [Revised ULLC Act s 110(c)(4) and (d)(2)] and/or provide for their later ratification: Revised ULLC Act s 110(c)(4) and (e).

147 The duty of loyalty of a member in a member-managed LLC includes the duty to account [Revised ULLC Act s 409(b)(1)], to refrain from dealing adversely to the LLC [Revised ULLC Act s 409(b)(2)] and to refrain from competing with the LLC: Revised ULLC Act s 409(b)(3).

148 Revised ULLC Act s 110(c)(4): and any other fiduciary duty (previously s 409 ULLC Act). The duty of care involves the member of a member-managed LLC to act with reasonable care and in what the member believes is the best interest of the LLC: Revised ULLC Act s 409(c).

149 Revised ULLC Act s 110(c)(5) per s 409(d).

150 Revised ULLC Act s 409(g).

151 Revised ULLC Act s 407(a).

152 Revised ULLC Act s 301(a).

153 LLP Act 2000 (UK) s 6(1). However, this agency can be limited: LLP Act 2000 (UK) s 6(2): sets out circumstances in which the LLP will not be bound by the acts of a member. It provides that, although every member of an LLP is the agent of the LLP, an LLP is not bound by anything done by a member in dealing with a third party if (a) the member has no authority to act for the LLP by doing that thing, and (b) the third party either knows that the member has no authority, or does not know or believe him to be a member of the LLP. J Whittaker and J Machell, *Limited Liability Partnerships: The new law*, Jordans, Bristol, 2001, p 46: This provision is similar to the second part of Partnership Act 1890 (UK) s 5: 'unless the partner so acting has no authority to act for the firm in the particular matter, and the person with whom he is dealing either knows that he has no authority, or does not know or believe him to be a partner'.

154 LLP Act 2000 (UK) s 15(c) and LLP Regulations 2001 (UK) reg 7(3). However, a member-manager is not automatically entitled to remuneration for this. LLP Act 2000 (UK) s 15(c) and LLP Regulations 2001 (UK) reg 7(4).

155 If the LLC is to be manager-managed, then the default rules provided is that the majority of members appoint the manager(s) [Revised ULLC Act s 407(c)(5)], that activities are

depending on the needs of the members.[156] It could be that more corporate-like features are warranted when the LLC is manager-managed, as members may be passive in the LLC's operations.

Even though the LLP has a corporate character, the LLP does not automatically provide for a separate or discrete board of directors,[157] although there are 'designated members'.[158] However, designated members have additional responsibilities beyond those normally reserved for a director: for example, the disclosure and notification requirements to the Registrar.[159] Designated members could be better perceived as fulfilling the role of a corporation's secretary.[160] However, this is not in itself entirely accurate. The default rule is that every member is a designated member;[161] and at least two of the LLP members must be nominated as designated members.[162] Given that designated members do have a greater liability exposure for breaches of their duties, the lack of clarity for their role is cause for significant concern.[163]

Consequently, in view of the above considerations, the LLP legislation is drafted on the assumption of member-management by all members, with a minimum of two members. While the LLP does not expressly require that every member take part in the management, this is the overall effect of the LLP legislation.[164] It is argued that by not making members' assumed participation in LLP management explicit it could, in effect, 'trap' investors. This is especially the case if members of a closely held business have not obtained comprehensive advice, or who do not completely understand their obligations — a characteristic that may frequently arise for closely held businesses.[165]

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exclusively decided by managers [Revised ULLC Act s 407(c)(1)], with each manager with equal rights [Revised ULLC Act s 407(c)(2)], and majority votes to resolve manager's differences: Revised ULLC Act s 407(c)(3). However, the default rules provide that the consent of all members is required for such things as the conduct of activities outside ordinary business, mergers and amend the LLC Agreement: Revised ULLC Act s 407(c)(4). There is nothing to stop the LLC Agreement to include a Board of Directors, which is what has occurred with the LLC Agreement for AOL Holdings LLC. See: Amended and Restated Limited Liability Company Agreement of AOL Holdings LLC, s 4.01 Board of Managers, at <http://contracts.onecle.com/google/aol.llc.2006.shtml> (accessed 5 November 2013).

156 Friedman, above n 107, at 18.

157 Or the equivalent thereof. This is unlike the special tax rule companies studied, which have corporate governance rules.

158 LLP Act 2000 (UK) s 8.

159 Such as the notification of auditor appointment: Companies Act 1985 (UK) s 391A. Other duties include (a) notice of changes of members and the registered office, (b) signing and delivery of the Annual reports to the Registrar, (c) the **[Q: to?]** appoint auditors and (d) circulate auditors' representations: Companies Act 1985 (UK) ss 233, 242, 244, 363 and 385.

160 House of Commons — Select Committee, above n 17, at [71].

161 LLP Act 2000 (UK) s 8(2).

162 LLP Act 2000 (UK) s 8(2).

163 Commentators argue that there needs to be more of a 'distinguishing thread' running through the functions of designated members: J Whittaker, J Machell and C Ives, *The Law of Limited Liability Partnerships*, 2nd ed, Jordan Publishing Ltd, Bristol, 2004, p 121.

164 This is because with the LLP Act 2000 (UK)'s inclusion of other acts, the references to 'directors' in the Companies Act 2006 and 1985 (UK) and Insolvency Act 1986 (UK) are replaced with the term LLP 'members', and not 'designated members': LLP Regulations 2001 (UK) reg 4(1)(g).

165 Investors may not appreciate the difference in the obligations imposed by becoming a

Such a clear and discrete delineation between managers and non-active members does not appear possible for the LLP even though there is no upper limit on membership. This is because there are several duties imposed on members regardless of their involvement in management.[166] Unlike for a corporation, there is no distinction built into the LLP between the roles of members and managers (directors).[167] This may mean that non-active members would require certain safeguards or guarantees to be included in an LLP Agreement to mitigate the agency costs that may result by the member relying on other members or managers to ensure strict compliance.[168] Although, such contractual provisions would only mitigate as oppose to eliminate the members' duties.

Nevertheless, it should be acknowledged that there are current examples of LLPs being utilised for widely held operations, particularly as a property investment vehicle, apparently because of LLP's flexibility, although it could be more due to tax arbitrages.[169]

Consequently, it appears that the LLC form provides the more appropriate rules compared to the LLP, although it is suggested that it would be beneficial if the starting default position was member-management.

Transferability of membership interest

A stated reason for the success of corporations is, in part, due to membership interests being transferable,[170] assisting with the raising of equity and liquidity. However, a particular issue that can arise for tax flow-through treatment is that the tax rules can inhibit the transferability of membership interests. For example, for transparent companies the tax implications on the issue or transfer of membership interest may impose transaction costs that could hinder the transferability of membership interests.[171] That is, is the

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member of an LLP compared to being a shareholder in a corporation. In this regard, the LLP obligations are more akin with those of a general partnership.

166 The initial source of members' potential liability is if they fail to comply with their statutory responsibilities, which are generally collective. For example, members are collectively responsible for appointing auditors and preparing accounts: Companies Act 1985 (UK) s 384(1). Designated members have additional responsibilities for the disclosure and notification requirements to the Registrar, such as the notification of auditor appointment: Companies Act 1985 (UK) s 391A. For a comprehensive listing of members' duties refer to Whittaker, Machell and Ives, above n 163, pp 142–7.

167 Whittaker and Machell, n 153, p 1.

168 However, these safe guards would manifest themselves only in the form of private contracts between members, and would not absolve non-active members from their statutory obligations. Also, for an LLP to avoid being subject to the restrictions placed on collective investment schemes in attracting new members, LLP members together must have day-to-day control over the management of the LLP property: Financial Services and Markets Act 2000 (UK) s 235(2).

169 Whittaker, Machell and Ives, above n 163, p 290. In the *Cabvision* case there was a plan for the LLP to raise capital to finance a project in the vicinity of £22.5 million by the issue of membership interests: *Cabvision Ltd v Feetum, Marsden and Smith* [2006] Ch 585; [2006] 3 WLR 427; [2006] 2 BCLC 102; [2005] EWCA Civ 1601 at [15].

170 S Elias, *Contemporary Issues in Company Law*, J Farrar (Ed), CCH, New Zealand, 1987. The other important corporate characteristics are the characteristics of limited liability and continuity.

171 For a discussion about the potential tax consequences when there are changes to the

membership interest treated as its own discrete tax asset[172] or does its transfer produce the resultant 'tax' disposal of fractional interests in the underlying assets held 'legally' by the tax flow-through company.[173] For the LLC it is possible to transfer the membership interest without a disposal of the underlying assets, whereas for the LLP an aggregate approach applies — therefore disposal of fractional interests in the underlying assets.

Furthermore, eligibility requirements for transparency can reduce the ability to raise equity as there may be restrictions on the number of members, the types of members or the classes of membership interest.[174] Additionally, the notion of membership interest can be important in determining the ability to utilise allocated losses for tax purposes.[175] Such tax implications could tarnish this important characteristic and would need to be considered carefully.

Each of the transparent companies studied provide for a separate membership interest which is potentially transferable. The default position for LLCs is that membership interests are freely transferable, whereas for LLPs, transfers require membership consent.[176] This means that the rules applying to LLCs could require rules to be drafted to restrict transfers, as members of closely held businesses may prefer restrictions to be put in place on the issuing and/or transferring of membership interests.[177]

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membership, see B Freudenberg, 'Fact or Fiction? A sustainable tax transparent form for closely held businesses in Australia' (2009) 24(3) *ATF* 375.

172 Referred to as: entity acknowledgment.

173 Referred to as: aggregate approach. This is what occurs in Australia with the introduction of new members into a general partnership.

174 B Freudenberg, 'The financing effect: Will a tax transparent form for closely held businesses in Australia assist with financing?' (2009) 4(1) *Jnl of the Australasian Tax Teachers Association* 121.

175 Freudenberg, above n 30.

176 The default rule of the Revised LLC Act is for the right of members to transfer membership interest [Revised ULLC Act s 502(a)], with transferee's retaining the right of the member [Revised ULLC Act s 502(g)]. However, a transfer is ineffective if it is in violation of a restriction in the Operating Agreement [Revised ULLC Act s 502(f)]. The default rules also provides grounds for a member to be dissociated from a LLC, including pursuant to the LLC Agreement [Revised ULLC Act s 602(b)(2),(3)], because of death or dissolution of the member [Revised ULLC Act s 602(4)(C),(6)] or wilful or persistent breach of duties of loyalty, care and fiduciary duties [Revised ULLC Act ss 602(5)(B) and 409]. The default rules for the UK's LLP provides that consent of all members is required for a person to be introduced or assigned a membership interest [LLP Act 2000 (UK) s 15(c) and LLP Regulations 2001 (UK) reg 7(5)], and reasonable notice to other members (not LLP) is required for a member to cease being a member [LLP Act 2000 (UK) s 4(3)].

177 Restrictions may be preferable due to the high degree of trust (or non trust) between members, the members' reduced diversification opportunities [This is referring to the fact that members may have invested all of their capital (human and/or financial) into the business operations, and do not have remaining resources to diversify their risk. Due to this there can be greater imperative to have control] and the desire to retain control: The notion of control was an important characteristic desired by closely held businesses: Hicks, Drury and Smallcombe, above n 17. Indeed, the transfer of membership interests and the exercise of voting rights can be matters that figure prominently in litigation relating to members' agreements: Dugan, McKenzie and Patterson, above n 19, p 189 referring to *Hallam v Ryan* (1990) 5 NZCLC 66 at 123; *Mercury Energy Ltd v Utilicorp NZ Ltd* (1996) 7 NZCLC 261 at 230 and *Macalister v Ishizuka* (1998) 9 NZCLC 261 at 663. Depending upon members' objectives, these restrictions may aid or hinder the raising of equity. For example the existence of unanimous members' agreement for the transfer or issuing of membership

Section Five — Overall observations and conclusion

In assessing the overall potential benefit of new form transparent companies for Australian closely held businesses there are a number of observations including partnership governance, unfamiliarity, unclear policies and popularity; each of which is explored below.

Partnership governance

While historically partnership principles have been stated to be beneficial for closely held businesses, it is argued that this can be inherently problematic when there is only one member. This is a factor acknowledged by Ribstein with his arguments for a company form which genuinely starts from a single member perspective.[178]

To this extent both LLCs and LLP are problematic as they are based (to an extent) on partnership principles in terms of governance.[179] It is argued that for a new business form to have substantial improvements for Australian closely held businesses, the governance framework needs to be sincerely based on single membership, and that the form allows for the membership expansion with appropriate modification of default rules for multi-membership.

Unfamiliarity

It needs to be acknowledged that if a new form transparent company was introduced into Australia, an issue is that as a 'new' business form, there would be initially unfamiliarity with the governing laws. Additionally, the determination of the governance rules could require the 'blending' of existing principles originating from partnership and corporation law. This 'blending' may serve to create further uncertainty as to how courts will interpret and resolve governance issues, as well as potential confusion in the business community.[180]

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interest clearly restricts the obtaining of new equity. However, existing equity holders may not have become members without the existence of such restrictions.

178 Ribstein and Sargent, above n 109, at 638. This is because LLCs are built on a contractual model, which implies an agreement amongst members. In such circumstances, there is a danger that LLC default rules will be applied, for example, to give rights to non-owner associates such as managerial employees. To address this, Ribstein wonders whether a new non-corporate statutory form, the limited liability sole proprietorship would be a better alternative.

179 It would appear that the LLC origins are from the Panamanian '*Limitada*': C R Goforth, 'The Rise of the Limited Liability Company: Evidence of a Race Between the States, But Heading Where?' (1995) 45 *Syracuse L Rev* 1193 at 1201; R Johnson, 'Comment: The Limited Liability Company Act' (1983) 11 *Fla St U L Rev* 387 at 387. The Floridian committee reports discussing LLCs specifically noted that LLCs were similar to a form of business organisation prevalent in Central and South America's and might therefore be particularly attractive to international investors. However, this origin of the LLC is not universally accepted as Wood states that the LLC origins is German GmbH or the French SARL: Hicks, Drury and Smallcombe, above n 17, p 52, referring to Wood 1993. Alternatively, Carney considers the LLC's origin stems from the English joint stock company: W J Carney, 'Limited Liability Companies: Origins and Antecedents' (1995) 66(4) *University of Colorado L Rev* 855.

180 J Bankman, 'The Structure of Silicon Valley Start-Ups' (1994) 41 *University of California*

While 'unfamiliarity' with the governing law applying to new form transparent companies may be argued as 'theoretically suspect',[181] in the early years of the regime it is suggested that some uncertainty may be manifest until case law develops and clarifies the situation. However, this concern about unfamiliarity could be mitigated by the enacting legislation utilising governance provisions from existing business forms, thereby providing some indication about the potential interpretation of the new governing law. This use of prior law could, to a certain extent, utilise the networking benefits of established prior case law precedents. However, this may in turn produce potential 'blending' problems insofar as prior law is applied to a business form with different characteristics. Such blending problems have been identified in respect of the LLPs whereby partnership type provisions may be interpreted differently by a court given the LLP's overall corporate characteristics,[182] as well as the awkward legislative drafting used.[183] Overall, it needs to be acknowledged in the initial years of introduction there would be increased complexity although this should decrease with time.[184]

Los Angeles L Rev 1737; J Freedman, 'Limited Liability: Large Company Theory and Small Firms' (2000) 63(3) *MLR* 317 at 324. Morse, above n 1, p 329. For example, to date there have been only a few cases that have considered LLPs, although none have undertaken a thorough investigation into the nature of an LLP itself: *Cabvision Ltd v Feetum, Marsden and Smith* [2006] Ch 585; [2006] 3 WLR 427; [2006] 2 BCLC 102; [2005] EWCA Civ 1601 per Lord Justice Jonathan Parker; *Marchands Associates LLPs v The Thompson Partnership LLP* [2004] EWCA Civ 878 (28 June 2004) at [1] per Lord Justice Lloyd: 'No point turns on the fact that it is an LLP rather than a company'; *Keydon Estates Ltd v Eversheds LLP* [2005] EWHC 972 (Ch) (20 May 2005); *Tower Taxi Technology LLP v Marsden and Smith*, (unreported, CA, Civ Div, 14 October 2005).

181 L E Ribstein, 'The Important Role of Non-Organization Law' in *Illinois Law and Economics Working Paper Series: Working Paper No LE05-014*, University of Illinois College of Law, Champaign, 2005, p 16.

182 Freedman, above n 112, p 298.To illustrate this, if the general partnership default provisions are relied upon by an LLP and its members, courts may not interpret them in the same way as they do for a general partnership. This is because the LLP default provisions have to be read subject to the rest of the LLP legislation 'as the context requires', and this context is largely corporate and not general partnership based: LLP Regulations 2001 (UK) regs 3(2)(c), 4(1)(i) and 5(2)(g). Morse provides an illustration of the potential uncertainty, as courts may have to relate the general partnership concept of 'expulsion exercised in good faith' with the corporate concept of 'unfairly prejudice'.

183 The drafting method adopted for the UK LLP is not preferable as 'modified sections' of other acts are added on top of the LLP Act 2000 (UK), as it does not contain a discrete set of governing rules for this particular entity. Instead the navigation through various provisions in several statutes is required to determine the basic governance rules of the LLP: P Shohet and A Jenner, 'Get your teeth into LLPs' (2005) May *Accountancy Magazine* 73 at 74. In view of this, it has been suggested that firms may find it necessary 'to seek legal advice on fairly straight forward points lest they should misinterpret the legislation', leading to increased cost: House of Commons — Select Committee, above n 17, at [78]: referring to ACCA submission. In ascertaining the LLPs governing rules, an initial comment is that the brevity of the LLP Act 2000 (UK), with its 19 sections and a Schedule, is illusionary, as the regulations made under ss 14 to 17 add an array of statutory provisions. The author calculates that the number of sections applying would more correctly be estimated in excess of 478 sections.

184 For a discussion of transitional issues with the introduction of the goods and services tax see: J Glover and B Tran-Nam, 'The GST recurrent compliance costs/benefits of small business in Australia: a case study approach' (2005) 1(2) *Jnl of Australasian Tax Teachers Association* 237.

Unclear policy

While both the LLC and LLP offer potential benefits for closely held businesses their introduction lacked systematic and clear policy objectives which can reduce their benefit. Indeed, while there was been subsequent praise for both LLCs and LLPs as potential assistance to small closely held businesses — both new forms were the result of lobbying by larger businesses.

For example, the introduction of LLCs does not represent a systematic reform to address problems of small closely held businesses; instead it was the result of the lobbying of one large (closely held) oil company of a small accessible jurisdiction (Wyoming).[185] Which then lead to jurisdictional competition amongst American states, especially spurred on by the tax arbitrages that tax flow-through afforded compared to C Corporations subject to a classical corporate tax system.

In a similar vein, LLPs were introduced in the United Kingdom at essentially the bequest of large professional firms (accounting and law) who initially convinced a small accessible jurisdiction (Jersey) to introduce the regime and then used this as a leverage on the UK government to introduce a similar regime otherwise face large professional firms relocating.[186] While originally, the LLP was to be available only to professional firms, this was subsequently altered due to definitional issues and it was hard to justify such a restriction.[187] Consequently, all businesses, including small and medium enterprises, could utilise the LLP business form.

If Australia was to introduce a new form transparent company it would be preferable that there is clear policy objectives from the start as to whether it is to assist small closely held businesses and the issues that they face. This includes considering simultaneously the tax treatment of such a form as this can influence the underlying governance regime. It is such a comprehensive policy setting which was absent for both LLCs and LLPs.

Popularity

While both LLCs and LLP have grown in numbers in their jurisdictions (particularly LLCs), this popularity does not of itself prove an improved governance regime. For example, it is understood that the majority of LLPs are vehicles for professional firms (lawyers and accountants)[188] and while they are closely held businesses it is suggested that they are more sophisticated than average (particularly small) closely held businesses.

Also, the popularity of tax flow-through companies may be attributed to tax arbitrages in their particular jurisdictions. For LLCs this can be related to only

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185 Hamill, above n 129.

186 This is supported by the observation that some of the professional firms actually drafted the relevant legislation for Jersey: P Sikka, 'Globalization and its Discontents: Accounting Firms Buy Limited Liability Partnership Legislation in Jersey' (2008) 21(3) *Accounting, Auditing and Accountability Journal* 398. A similar argument is made by Freedman: Freedman, above n 100, at 898.

187 House of Commons — Select Committee, above n 17, at [38].

188 By 2006 it was reported that nearly half of the top 60 accountancy firms operating in the United Kingdom had converted to LLPs, with others incorporating: S Percy, 'Partners: an endangered species?' (2006) July *Accountancy Magazine* 40.

one level of taxation (compared to C Corporations in the United States) and flexibility in distributions.[189] For LLPs this could relate to the application of National Insurance Contributions (NIC) when there is member-management there.[190] Such is the concern in the United Kingdom that the government is currently reviewing the taxation of partnerships (which covers LLPs) as the HM Revenue and Customs considers that the avoidance of taxes is risking as much as UK £20 billion in tax revenue.[191] Consequently, there needs to be caution about coming to conclusions of success based on numbers only. Also, Australia has a number of unique tax characteristics, such as the imputation system for corporations, which may reduce the potential tax benefits obtained by tax flow-through as opposed to the United Kingdom and the United States.[192] However, it has been argued that there may be sufficient Australian demand for a partial loss transparent company even if the imputation system for the taxation of corporations is retained.[193]

That is not to say there are potential advantages that these forms represent. Particularly, the LLC has several characteristics which can be beneficial for, and facilitative of, closely held businesses — including extensive default rules that appear to have been drafted to take into account issues that are likely to arise. While Karjala and others argue that the LLC 'provides nothing (besides uncertainty) not already available under partnership and corporation statutes';[194] this nevertheless fails to acknowledge that the LLCs to a large part automatically provide more appropriate governance rules for closely held businesses, whereas corporations require extensive drafting to achieve this.

Conclusion

The notion of tax flow-through companies is to disregard the legal form for tax purposes and to allocate income and/or losses to members. However, in determining the appropriateness of tax flow-through companies for Australian closely held businesses it is important to consider the characteristics of this 'legal form' being disregarded for tax purposes.

The introduction of the new transparent business forms, LLCs and LLPs, was accompanied by the implementation of new governance regimes through

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189 For a discussion about the various areas of concern about the tax treatment of LLCs see: M A Sullivan, 'Passthroughs Shrink the Corporate Tax by $140 Billion' (2011) 130 *Tax Notes* 987; and K C Burke, 'Passthrough Entities: The Missing Element in Business Tax Reform' (2012–13) 40 *Pepperdine Law Review* 1329.

190 Freudenberg, above n 21, at [7-300].

191 The areas of concern include the presumption of self-employment for LLPs, company loans and the manipulation of the allocation of profits and losses. See the recent case of *Vaccine Research LP v HMRC* [2013] UK FTT 73 (TC), at <https://www.gov.uk/government/consultations/a-review-of-two-aspects-of-the-tax-rules-on-partnerships> (accessed 5 November 2013).

192 For a discussion of how these Australian tax characteristics may reduce the 'tax popularity' of tax flow-through companies in Australia see: Freudenberg, above n 21, at [7-300].

193 Freudenberg, above n 21, at [7-440].

194 D S Karjala, 'Planning Problems in the Limited Liability Company' (1995) 73 *Washington Uni LQ* 455. Indeed, critics of LLCs argue that there are now too many choices to be made between different types of entity and that the result could be confusion, a case of 'hyperlexis': Freedman, above n 180, at 324. Other commentators argue that it is possible to obtain most of the informalities offered by an LLC in a closely held corporation through properly drafted close corporation agreements: Friedman, above n 107, at 28.

the lobbying of large closely held businesses. The United Kingdom's LLP appears to be affected by a policy switch during its implementation which has resulted in a cumbersome regime. It is questionable how suited the LLP governance is for closely held businesses, particularly unsophisticated ones, due to the lack of any substantial default rules, the assumed member-management and the requirement for at least two members.

The LLC appears to provide the best governance rules that automatically apply to closely held businesses; however recent reforms to LLC appear to be taking on more widely rather than closely held characteristics.[195] Also it is questionable whether the governance regime with partnership concepts really accommodates single membership (as opposed to multi-membership).

Through this analysis it has been demonstrated that there is more to tax flow-through companies than their tax treatment, as there is a divergence in their governance frameworks. It is argued that any jurisdiction introducing a tax flow-through company should have a holistic approach that considers whether the governance regime carters for characteristics exemplified by closely held businesses. This includes considering how the tax law will interact with these governance rules. It is argued that the LLC model particularly offers a new model for govern closely held businesses; however there are a number of ways it could be improved.

195 However, the LLC's improved governance regime for closely held businesses may be diminished when other regulatory rules are considered, particularly tax compliance costs.