

may have resulted from the fact that those characteristics have evolved over time.¹¹ However, it has been traditionally recognized that there are four attributes of a corporation that distinguish it from other forms of business entities; those attributes are: perpetual succession, centralized management, limited liability, and free transferability of interests.

Perpetual succession (also sometimes known as continuity of life) is not generally construed to mean immortality; rather perpetual succession means that the entity continues to exist independent of its owners. For example, the death or withdrawal of a shareholder of a corporation does not terminate the existence of the corporation. Perpetual succession is an attribute that distinguishes corporations from partnerships because partnerships are created and exist by agreement of the owners (the partners). The death or withdrawal of a partner generally terminates the partnership. A corporation, on the other hand, is created and exists by virtue of a grant of authority from the State, and the death or withdrawal of a shareholder does not terminate the corporation.

Centralized management generally means that continuing, exclusive authority to manage the entity is vested in a group of individuals appointed or elected by the owners. The owners, therefore, do not have the exclusive authority to directly manage the entity. For example, the shareholders of the corporation elect a group of individuals (who may or may not be owners) to be its Board of Directors, and the Board of Directors manages the corporation. In a partnership, the general partner(s) have the exclusive authority to manage the affairs of the partnership.

Limited liability generally means that an owner of the entity is not personally liable for the debts of the entity; rather, the maximum potential liability of an owner is limited to the owner's investment in the entity. For example, the shareholders of a corporation are generally not liable for the corporation's debts, and the maximum amount that a shareholder could lose if the corporation incurs liabilities beyond its assets is his or her investment. This attribute also distinguishes a corporation from a partnership because in a partnership the general partners typically are fully liable for the debts of the partnership.

Free transferability of interests generally means that an owner of the

entity may transfer an ownership interest in the entity without the consent or approval of the other owners. For example, a shareholder of a corporation can generally transfer all or a part of his or her shares to another person without the consent or approval of any other shareholder. However, in closely-held corporations, it is a common practice for shareholders to enter into agreements requiring a selling shareholder to obtain the prior approval of the remaining shareholders. In partnerships, a partner generally cannot transfer his or her interest without the consent of the other partners. This is so because partnerships exist by virtue of an agreement among all of the owners. However, even when the other partners consent, the original partnership technically is terminated, and a new partnership is created.¹²

Tax Treatment of Corporations vs. Partnerships

As noted above, a key distinction between a corporation and a partnership is that a corporation is created by a grant of authority from the State, whereas a partnership is created by agreement among the co-owners. A corporation, unlike a partnership, is a legal entity separate and apart from its owners, and the Federal income tax laws reflect that separate existence. As a result, a corporation's income is effectively taxed twice, once at the corporation level, and again at the shareholders' level when the shareholders receive the corporation's income as dividends. However, because a partnership is not a legal entity separate from its owners, a partnership's income is not taxed at the partnership level, but is attributed directly to the partners and taxed only at the individual partners' level. This feature of a partnership is sometimes called "pass-through tax treatment," and is generally considered to be a significant advantage over the tax treatment of a corporation's income.

Since the characterization of a business entity as a "corporation" has significant tax implications, the Internal Revenue Service (IRS) established rules to determine whether an entity would be taxed as a corporation or a partnership. Prior to its amendment in 1997, Treas. Reg. § 301.7701-2 classified an association of two or more persons who had the purpose of carrying on a business and dividing the profits as either a partnership or a corporation depending upon whether the association possessed more corporate characteristics than noncorporate

characteristics that the IRS utilized were: continuity of life (perpetual succession), centralized management, limited liability, and free transferability of interests. Under the former IRS regulations, if an association possessed at least three of the four corporate characteristics, it would be treated as a corporation for federal income tax purposes. As noted above, after 1996 the IRS no longer utilized the corporate characteristics test and now permits business entities that are not specifically classified as corporations in the regulation to elect partnership tax treatment.¹³ In that regard, we note that one of the entities specifically classified as a corporation in the regulation is a "[s]tate-chartered business entity conducting banking activities, if any of its deposits are insured under the Federal Deposit Insurance Act."¹⁴ As a result, an FDIC-insured, State bank that is chartered as an LLC would not qualify under existing IRS regulations for partnership tax treatment. Nevertheless, proponents of permitting Federal deposit insurance for Bank-LLCs argue that if the FDIC determines that Bank-LLCs are eligible for Federal deposit insurance, they would then seek a change in the IRS regulations. The proponents argue that they have considered subchapter S status but found it too limiting.

In August 1996 Congress amended the Internal Revenue Code to allow eligible financial institutions to elect subchapter S status for federal income tax purposes.¹⁵ A principal advantage of such status is that a subchapter S corporation is taxed the same as a partnership, *i.e.*, a subchapter S corporation is entitled to pass-through tax treatment. There are, however, limits on both the number and type of shareholders permissible for a subchapter S corporation. The maximum number of shareholders of a subchapter S corporation is 75, and only individuals, estates, certain trusts, and certain tax-exempt organizations may be shareholders.¹⁶ Furthermore, there can only be one class of stock in a subchapter S corporation, and no nonresident aliens may be shareholders.¹⁷

These limitations on the number and type of permissible shareholders have been cited as principal reasons why subchapter S status does not provide banks with a practical way of gaining

¹³ See Treas. Reg. §§ 301.7701-2, 7701-3 (1997).

¹⁴ Treas. Reg. § 301.7701-2(b)(5) (1997).

¹⁵ See Small Business Job Protection Act, Pub. L. 104-188 § 1315, 26 U.S.C. 1361(b) (1996).

¹⁶ See 26 U.S.C. 1361(b) (1996).

¹⁷ See *Id.*

¹¹ See Douglas Arner, Development of the American Law of Corporations to 1832, 55 SMU Law Review 23, 43-54, 2002.

¹² See Fletcher, *supra* note 8, § 20.