# Tax Considerations in Choice of Entity and Working with LLCs

*By George R. Goodman*

George R. Goodman examines tax considerations in choice of entity as well as the many roles that can be played by LLCs and the potential tax savings they offer.

## Introduction

A variety of business entities can be availed of to conduct a business. Choosing the best generally entails a two-tier analysis. First, the type of state law format or entity must be selected, from among a proprietorship or division, partnership, limited liability company, corporation, or trust. Both income and nonincome tax considerations play a role in that choice. Second, assuming a particular state law format or entity, then its income tax classification must be determined. Obviously, that determination is based solely or almost entirely on income tax considerations.

LLCs are the most versatile entity from an income tax standpoint. LLCs can generally elect between being classified as a disregarded entity or partnership on the one hand, or a corporation on the other. If corporate classification is chosen or otherwise applies, then it may be possible to further elect between an S or C corporation. It often makes sense to set up a new business or venture as an LLC, or to convert an existing entity into an LLC, to minimize both income and non-income taxes. LLCs open up new possibilities in structuring mergers and acquisitions. LLCs can also be used to further estate planning goals. A business owner, accountant or business law practitioner thus needs to have a good understanding of the many roles that can be played by LLCs and the potential tax savings they offer.

This article begins with a discussion of the nonincome tax considerations in making the initial choice between an LLC and a state law corporation. Then, given the ability of LLCs to be classified as any time of business entity for income tax purposes, it discusses the income taxation of an LLC under each classification and the considerations relevant to a U.S. person in choosing among the income tax classifications. The drafting of LLC agreements for LLCs is addressed, focusing on the tax-related provisions one would expect for an LLC classified under each income tax category. The participation of LLCs in M&A transactions is analyzed based on each type of income tax classification. Finally, self-employment tax compliance is analyzed for the different classifications of LLCs. At the state tax level, the primary focus is on Illinois taxes; however, the state tax analysis for LLCs organized or operating in other states would proceed along similar lines.



## Basic Filing Fees

Formation of limited liability business entities typically requires filings with the state along with payment of various fees. Such fees will have a bearing on which type of state law entity to use. In forming a business entity to operate in a state, there are two basic approaches. One can organize the entity under that state's own laws. Or, the entity could be organized under the laws of another state (Delaware being perhaps the most popular), and then qualified to do business in the state of operation.

For entities organized under Illinois law, Table 1 compares the Illinois Secretary of State filing fees for various types of entities. As one can see, the filing fees for an LLC are more than for a corporation, and for a tiny operation, might dictate use of a corporation.

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As noted, another popular strategy is to organize the entity in Delaware, and then qualify it to do business in the states where it operates. In that case, filings and filing fees would have to be made and paid in both Delaware and the states of operation. For Delaware entities operating in Illinois, the basic filing fees are shown in Table 2. Again, the basic filing fees tend to be a couple hundred dollars more per year for an LLC than a corporation.

**Table 1. Illinois Secretary of State Filing Fees**

| Domestic | LLC | Corporation | Ltd Partnership | LLP |
|---|---|---|---|---|
| Articles of Organization | $500 | $150 | $150 | $100 per partner, to $5,000 |
| Annual Reports | $250 | $75 | $100 | $100 per partner, to $5,000 |

**Table 2. Delaware Division of Corporations Filing Fees Plus Illinois Fees**

| Domestic | LLC | Corporation | Ltd Partnership | LLP |
|---|---|---|---|---|
| Articles of Organization | $90 | $89 | $200 | $200 per partner |
| Annual Reports | $200 | $25 | $200 | $200 per partner |
| Illinois Secretary of State Filing Fees | | | | |
| Foreign | LLC | Corporation | Ltd Partnership | LLP |
| Application to Transact Business in Illinois | $500 | $150 | $150 | $500 |
| Annual Reports | $250 | $75 | $100 | $300 |



## Corporate Franchise Taxes

In addition to the various filing fees, consideration should be given to applicable capital-based franchise taxes. In Illinois, corporations, both foreign and domestic, are subject to an initial franchise tax of 0.15 percent and an annual franchise tax of 0.10 percent of paid-in capital apportioned to Illinois (based on assets and income), in each case subject to a $25 minimum and $2 million cap, and an additional franchise tax of 0.15 percent of increases in paid-in capital. Delaware imposes an annual corporate franchise tax equal to the lesser of the amounts computed under the “authorized shares method” ($35 for 3,000 or less shares; $62.50 for between 3,001 and 5,000 shares; $112.50 for 5,001 to 10,000 shares, plus $62.50 for each additional 10,000 shares or portion thereof), or the “assumed par value method” ($250 per million of assumed par value), with a $35 minimum and $165,000 cap.

The Illinois franchise tax applies only to corporations. For entities with more than about $200,000 paid-in capital allocable to Illinois, the corporate franchise tax will more than offset the filing fee differences and make the corporate form more costly.

### Conversion to LLC to Eliminate Corporate Franchise Tax

Where an existing corporation is incurring substantial franchise tax, consideration should be given to converting it to an LLC to eliminate the franchise tax. The conversion could be effected by forming a new LLC and merging the corporation into it. A check-the-box election to treat the new LLC as a corporation for income tax purposes (described further below) is generally advisable to make the conversion tax-free for income tax purposes (as a reorganization under Code Sec. 368(a)(1)(F)). Absent the election, the LLC would likely be disregarded or classified as a partnership, causing the conversion to be viewed as a taxable liquidation of the corporation, with the tax on the gains at the corporate and stockholder levels being potentially catastrophic. However, if the corporation is a wholly-owned subsidiary of a parent corporation, conversion to a disregarded LLC could generally be accomplished as a tax-free liquidation under Code Sec. 332.

### Franchise Tax on Foreign Corporate Members of LLC

Where a foreign corporation is a member of an LLC doing business in a state, consideration should be given to whether the foreign corporation is considered to be transacting business in the state through the LLC and thereby brought within the state’s corporate franchise tax. In Illinois, a foreign corporate member in an LLC operating in Illinois does not appear to be automatically deemed to be doing business in Illinois through the LLC. However, the corporation could be considered doing business in Illinois as a result of its own activities on behalf of the LLC, such as if it opens an office in Illinois to manage the business.

### Texas Franchise Tax

Previously, Texas imposed a franchise tax on both corporations and LLCs (but not partnerships) that were doing business in Texas. The tax was the larger of two components: a tax on net taxable capital similar to a traditional capital-based franchise tax, and an earned surplus tax similar to an income tax. Since the tax did not apply to partnerships, it was common to conduct operations in Texas through a limited partnership.

Effective for reports due on or after January 1, 2008, this tax has been replaced by a "franchise margin tax."[1] The base has been broadened to generally include partnerships, as well as LLCs and corporations (with exemptions for passive entities and general partnerships among individuals). The new tax is imposed on the lesser of (1) 70 percent of total revenue and (2) a marginal income figure. In general, given the broader applicability of the new franchise margin tax to all types of entities, such tax should become less of a factor in choosing the type of entity to use in Texas, making LLCs more popular there.

## Income Tax Classification and Compliance

### In General

For federal income tax purposes, business entities, including LLCs, are classified under the check-the-box regulations, Reg. §§301.7701-1, -2 and -3.[2] Certain entities, such as corporations organized under the corporate statutes and insurance companies, are *per se* classified as corporations. All other entities, including LLCs, are eligible to elect their classification, and are thus referred to as "eligible entities."

Under the check-the-box regulations, a domestic LLC with a single owner member ("SMLLC") is disregarded as separate from its owner as the "default" classification, unless the owner files IRS Form 8832 with the IRS to elect to classify it as a corporation. A disregarded LLC owned by an individual is classified as a sole proprietorship of the individual, reportable on Schedule C of the individual's Form 1040 (if it operates a business). A disregarded LLC owned by a corporation is treated as a direct operating division of the corporation, and rolled up into the corporation's Form 1120 or 1120S tax return. A disregarded LLC owned by a partnership is treated as a direct operating division of the partnership, and rolled up into the partnership's Form 1065 tax return. It should be noted, however, that for collection, employment tax and excise tax purposes, an otherwise disregarded SMLLC may be respected and treated as a separate entity.

If a domestic LLC has more than one owner, then it is classified as a partnership for federal income tax purposes as the "default" classification, unless corporate classification applies as discussed in the next paragraph. An LLC classified as a partnership does not pay federal income tax but files a Form 1065 tax return to report its income, and reports its member partners' shares of its items of income, gain, loss, deduction and credit to them on Form 1065 K-1s.

A domestic LLC can be classified as a corporation as a result of (1) an affirmative election to treat it as such on IRS Form 8832, or (2) public trading of membership interests in the LLC under Code Sec. 7704. Further, an LLC classified as a corporation can elect to be taxed as an S corporation under Subchapter S of the Internal Revenue Code if it meets the definition of a "small business corporation," and it and all the members elect S status on IRS Form 2553. In that case, it would generally not pay federal income tax but would file a Form 1120S tax return to record its income, and provide each member stockholder with a Form 1120S K-1 showing his or her share of its items of income, gain, loss, deduction and credit.

Absent an S election, an LLC classified as a corporation is generally taxed under Subchapter C of the Internal Revenue Code as a regular C corporation, and files a Form 1120 tax return and pays the tax due thereon. It would generally report dividends paid to individual stockholders on IRS Form 1099.

### Foreign Eligible Entities

In general, the classification of foreign eligible entities is determined at the time its classification becomes relevant for federal tax purposes. Certain foreign corporate-type entities are classified as *per se* corporations. For a foreign eligible entity, default classification turns on whether the members have limited liability. If all members have limited liability, then corporate classification is the default classification. If at least one member has unlimited liability, the default classification is a partnership if the LLC has at least two members, or a disregarded entity if it has only one member. Like domestic eligible entities, foreign eligible entities can file Form 8832 to adopt a classification other than their default classification.

A foreign entity may be classified one way under U.S. tax laws and a different way under the foreign country's tax laws. These are known as "hybrid" entities, and a substantial amount of tax planning revolves around hybrid entities. One example of a hybrid entity is a Nova Scotia Unlimited Liability Company, which is treated as a corporation under Canada tax laws but is a disregarded entity or partnership under U.S. tax laws (absent a corporate election). Another example of a hybrid entity is a foreign partnership which is treated as such under the tax laws of the foreign country, but for which a check-the-box election is made to treat it as a corporation for U.S. tax purposes.

## Pre-Existing Eligible Entities

The default classification for eligible entities in existence prior to the November 29, 1999, effective date of the check-the-box regulations is the classification that they claimed immediately prior thereto (except that any single-member LLC previously treated as a partnership is treated as a disregarded entity).

## Husband-Wife Ownership

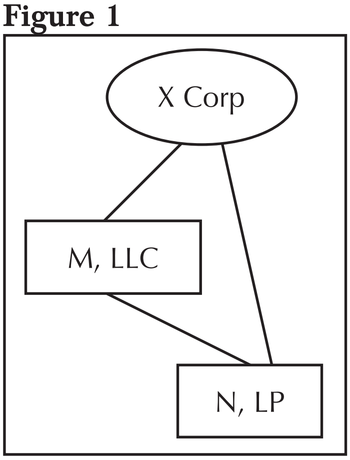
In the case of an LLC (for which a check-the-box election has not been made to treat it as a corporation) owned by a husband and wife as community property under the marriage laws of a state, foreign country, or U.S. possession, the spouses can choose to treat the LLC as either a disregarded entity or as a partnership, and the IRS will accept either position.[3]

## Tiered Structures

Despite the seeming simplicity of the check-the-box scheme, some tiered ownership structures can raise difficult questions. In Rev. Rul. 2004-77,[4] the IRS ruled that an eligible entity that has two members under local law, one of which is a disregarded entity for federal tax purposes that is owned by the other member, is considered to have a single owner, and is therefore disregarded unless an election is made to treat it as a corporation.

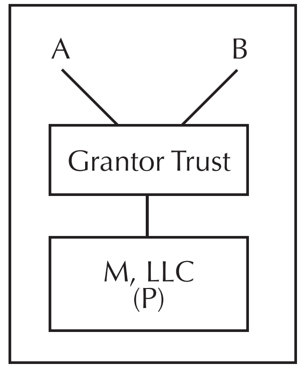
**Example 2.** X, a corporation, is the sole member of M LLC, and N is a partnership or LLC owned by X and M. Assuming M is disregarded, X is treated as the sole member and owner of N. Accordingly, both M and N are disregarded as separate from X under the default treatment. *See* Figure 1.

**Figure 1**




**Example 3.** Suppose T is a grantor trust owned by two grantor/beneficiaries, A and B, and T is the sole member of M LLC under state law, and M owns property P. *See* Figure 2.

**Figure 2**




This could be analyzed in either of two ways. Under a top-down approach, A and B could be treated as owners of the trust corpus, which is the M membership interest, causing M to have two owners, A and B. In that case, M cannot be disregarded, and is a partnership between A and B unless an election is made to treat it as a corporation.

Under a bottom-up approach, M could be viewed as owned solely by T, therefore causing M to be viewed as a disregarded SMLLC and effectively rolled up into T. T would be treated as owning the property P as the trust corpus. A and B would in turn be treated as owning the underlying property P as co-owners or tenants in common. Such co-ownership could be treated as mere co-ownership, or perhaps classified as a partnership depending how active A and B are in the ownership and management of property P. It is not entirely clear which approach applies.

## Illinois Classification

Illinois generally follows the federal classification of an LLC for Illinois income tax purposes.[5]

## Election out of Subchapter K

Under Code Sec. 761(a) and Reg. §1.761-2, an unincorporated organization may elect to be excluded from Subchapter K if it is availed of for investment purposes only and not for the active conduct of a business ("investment partnership"), or for the joint production, extraction or use of property, but not for the purpose of selling services or property produced or extracted ("joint operating agreement"), and certain other conditions are met. Under the election, Subchapter K does not apply, and the members compute and reflect their items of income individually as co-owners. Moreover, although partnership interests generally cannot be exchanged tax-free under Code Sec. 1031, if a valid election is made under Reg. §1.761-2, the members may treat their interests as interests in each of the underlying assets and thus as eligible for Code Sec. 1031 exchange rollover. However, for other purposes outside of Subchapter K and Code Sec. 1031, such as for self-employment tax purposes, the electing partnership remains a partnership.

One of the conditions for making the Reg. §1.761-2 election is that the participants own the underlying property as coowners. Because of this requirement, it is doubtful whether an LLC can make the election.[6]

## Income Tax Rates for Different Classifications

### Disregarded Entity vs. S or C Corporation

A single-member LLC can be classified as either a disregarded entity or a corporation. If it is a disregarded entity, its items of income, gain, loss, deduction or credit are reflected on the owner's tax return. If it is a corporation, then its items of income, loss, deduction or credit are reflected on its corporate tax return (Form 1120 or 1120S). If the corporation is a C corporation, then the income is taxed at the entity level. However, if the corporation is an S corporation, the income flows through and is taxed to the owner stockholder.

**Example 3.** Individual A is the sole member of LLC M. M has $100 of ordinary income during the year, which is distributed to A (net of any taxes on M). Tax is determined at highest federal and state rates on ordinary income. *See* Table 3 below.

As can be seen from Table 3, the disregarded format is the best. It is a little better than the S corporation since Illinois imposes a 1.5-percent income tax at the corporate level on S corporations. The C corporation format is by far the worst, and note that the results would be even worse if the current 15-percent rate on dividends in increased.

### Partnership or S Corporation vs. C Corporation

An LLC with two or more members can be classified as a partnership or C or S corporation. Income taxation as a partnership or S corporation is similar (aside from differences relating to allocations, liabilities, and distributions), and less burdensome than taxation as a C corporation.

**Example 4.** Individuals B and C are members of LLC N. N has $100 of ordinary income during the year, which is distributed to B and C (net of any taxes on N). Tax is determined at highest federal and state rates on ordinary income. *See* Table 4.

**Table 3.**

| | Disregarded Entity | S Corporation | C Corporation |
|---|---|---|---|
| Pre-Tax Operating Income | $100 | $100 | $100 |
| Entity Level Taxes | | | |
| IL PPR Income Tax | | $1.5 | $2.5 |
| IL Reg Inc Tax (4.8%) | | | $4.8 |
| Fed Inc Tax (35%) | | | $32.45 |
| Total | | $1.5 | $39.75 |
| Distribution to A | $100 | $98.5 | $60.25 |
| Taxes on A | | | |
| On Operating Income | | | |
| IL (3%) | $3 | $3 | |
| Federal (35%) | $33.95 | $33.95 | |
| On Distribution | | | |
| IL (3%) | | | $1.81 |
| Federal (15%) | | | $8.77 |
| Total | $36.95 | $36.95 | $10.58 |
| Net to A after Taxes | $63.05 | $61.55 | $49.67 |

**Table 4.**

| | Partnership | S Corporation | C Corporation |
|---|---|---|---|
| Pre-Tax Operating Income | $100 | $100 | $100 |
| Entity Level Taxes | | | |
| IL PPR Income Tax | $1.5 | $1.5 | $2.5 |
| IL Reg Inc Tax (4.8%) | | | $4.8 |
| Fed Inc Tax (35%) | | | $32.45 |
| Total | $1.5 | $1.5 | $39.75 |
| Distribution to B and C | $98.5 | $98.5 | $60.25 |
| Taxes on B and C | | | |
| On Operating Income | | | |
| IL (3%) | $3 | $3 | |
| Federal (35%) | $33.95 | $33.95 | |
| On Distribution | | | |
| IL (3%) | | | $1.81 |
| Federal (15%) | | | $8.77 |
| Total | $36.95 | $36.95 | $10.58 |
| Net to B and C after Taxes | $61.55 | $61.55 | $49.67 |

Here, partnership and S corporation classification come out the same because Illinois imposes the same 1.5-percent entity-level tax on both classifications. Again, both are far better than C corporation classification.

## Low-Bracket Income Spreading Strategies

An individual already in a high tax bracket due to income from existing sources might consider setting up a new income-generating business as a C corporation so that the income from that business can be taxed in the C corporation's lower rate brackets. The current rate brackets for C corporations is shown in Table 5.

**Table 5.**

| Marginal Tax Rate | Income Bracket |
|---|---|
| 15% | $0-$50,000 |
| 25% | $50,000-$75,000 |
| 34% | $75,000-$100,000 |
| 39% | $100,000-$335,000 |
| 34% | $335,000-$10,000,000 |
| 35% | $10,000,000-$15,000,000 |
| 38% | $15,000,000-$18,333,333 |
| 35% | $18,333,333 and up |

However, a number of factors make this strategy difficult to profit from in practice. First, the C corporation rates quickly approach the 35-percent maximum federal rate for individuals, so the lower C corporation rates could cover only small amounts of income. Second, most states tax C corporations at higher rates than individuals (in Illinois, 7.3 percent versus three percent). Third, the individual must pay a second tax on realizing the earnings personally through a dividend or stock sale or redemption (unless the stock is held until death and a tax-free basis step-up is achieved, or the stock is donated to charity), so the strategy really only works if income is retained. Fourth, retention of the earnings to defer the double tax means that even a corporation that was small originally will eventually push into the higher brackets. Fifth, special rates or taxes apply to personal service corporations, Code Sec. 11(b)(2), and personal holding companies, Code Sec. 541. Finally, there are the filing fees, franchise taxes, and other costs associated with setting up the entity (although these costs (other than franchise taxes) would be incurred in setting up an LLC to achieve limited liability anyway).

Another strategy that is more promising is to spread the income among other family members in lower rate brackets, by setting up the business in an LLC in which they have interests. The benefit is that their shares of the income would be taxed in their lower brackets. If the LLC is supposed to be classified as a partnership for tax purposes, the family partnership limitation in Code Sec. 761(e) and related principles must be considered. Since the applicability of those doctrines to family S corporation stockholders is less apparent, it might be advantageous to implement this strategy by electing S corporation status. The so-called kiddie tax, under which a child under age 14 is taxed at his or her parents' marginal rate on his or her unearned income in excess of a threshold amount (generally, $1,700 in 2006, increased by inflation), may limit this strategy. This strategy could also be coupled with estate planning strategies to minimize estate and gift taxes and provide for succession.

The same analysis applies where there are multiple unrelated owners participating in the business. Spreading the income among all their separate tax brackets may result in lower tax rates than if it were taxed in a single C corporation return.[7]

## Differing Tax Treatments of Partnership and S Corporation Transactions

The common law and early partnership laws viewed partnerships as an aggregate of the partners with no separate legal existence, much like co-owners of property. This aggregate view informed the income tax treatment of partnership. Partners were not regarded as separate taxable entities and the partners were taxed on their share of the income as if earned directly. Although the Code now treats partnerships as separate entities in many respects, the aggregate theory continues to have considerable force. As a result, to a large extent partners are treated much as though they engaged in the partnership's activities directly and incurred and realized the underlying tax items directly.[8]

By contrast, in keeping with the state corporation laws, the tax law treats corporations as separate and distinct from their shareholders. Although items of S corporations pass through to their stockholders, this occurs more as a result of statutory assignment of the items to them than any fundamental theory that they incur or realize the items in any direct sense.

The aggregate approach to partnerships leads to different tax results in a number of areas than the separate entity approach to S corporations. Similarly, for a SMLLC, disregarded classification results in direct ownership, versus separate entity treatment if S corporation status is elected. Direct ownership or aggregate treatment produces more favorable tax consequences than S corporation classification in some contexts, less favorable in others, as seen below.

## Treatment of Indebtedness

One area where direct ownership or aggregate treatment under partnership or disregarded LLC classification produces more favorable tax results than S corporation status is where there is outside financing of the business. In the case of an entrepreneur, including one operating through a disregarded SMLLC, loan proceeds are not includible in income, and to the extent invested in property, create tax basis and generate direct deductions. In the case of a partnership, borrowings by the partnership are in effect treated as borrowings by the partners, by being included in their outside basis in their partnership interests. This both allows deductions from the debt to pass through to the partners, and for loan proceeds to be distributed tax-free, as if the partners incurred the debt directly themselves.

By contrast, in the case of an S corporation, borrowings by the corporation are not treated as borrowings by the stockholders and do not increase the stockholders' outside tax basis in their stock. As a result, S corporation losses financed by such debt cannot pass through to the S corporation stockholders. Moreover, a distribution of loan proceeds may generate capital gain to the stockholders. Thus, the likely use of debt financing, at the outset or in the future, may point towards disregarded entity or partnership classification rather than election to be an S corporation.

## Debt-Financed Loss Passthrough

**Example 5.** Individual A forms a new SMLLC, M, with a capital contribution of $100. M borrows $1,000 from independent Bank and generates a loss of $250 in the first year. The following table shows the extent to which M's $250 loss will flow through to A and be deductible on A's personal return (subject to at-risk, passive loss, and other possible limitations), depending on the classification of M. *See* Table 6.

In the S corporation case, A could increase the loss pass through by borrowing the $1,000 from Bank him or herself, and then contributing or loaning the money to M. In that case, the full $250 loss will pass through to A.

**Example 6.** The facts are the same as in Example (5), except that B joins A and they together form new LLC M with a capital contribution of $50 each. M borrows $1,000 from independent Bank and generates a loss of $250 in the first year. The following table shows the extent to which M's $250 loss will flow through to A and B and be deductible on their personal return (subject to at-risk, passive loss and other possible limitations), depending on the classification of M. *See* Table 7.

**Table 6. A's Deduction if M classified as**

| Disregarded | S Corp | C Corp |
|---|---|---|
| $(250) | $(100) | $0 |

**Table 7. A's and B's Total Deduction if M classified as**

| Partnership | S Corp | C Corp |
|---|---|---|
| $(250) | $(100) | $0 |

In the S corporation case, again, A and B could increase the loss pass through by borrowing the $1,000 from Bank themselves, and then contributing or loaning the money to M. In that case, the full $250 loss would passthrough to them.

## Debt-Financed Distributions

**Example 7.** Years ago, individual A contributed $100 to then newly formed LLC N, which purchased some vacant land. The land has appreciated in value to $1,000. A would like to get some cash out and to that end, has N borrow $500 against the land and distribute to A. If N is a disregarded entity, then A is treated as receiving the loan proceeds directly, which are tax-free. If N is an S or C corporation, the $500 distribution would return A's $100 basis in the stock tax-free, and the $400 balance of the distribution would be capital gain. The taxation of A's receipt of the $500 loan proceeds are summarized as follows. *See* Table 8.

In the corporation cases, A might be able to avoid the tax by borrowing him or herself against the stock, but that may be problematic.

**Example 8.** The facts are the same as in Example (7), except that A and B take the place of just A and together contributed a combined $100 to M. In that case, if M is a partnership, the $1,000 borrowing is allocated to A and B and increases their outside bases in their M partnership interests by $1,000, allowing them to receive the entire $500 distribution as a tax-free return of capital. The corporate results are the same as above. *See* Table 9.

**Table 8. A's Taxable Income if N classified as**

| Disregarded | S Corp | C Corp |
|---|---|---|
| Tax-Free | $400 | $400 |

**Table 9. A's and B's Total Taxable Income if M classified as**

| Partnership | S Corp | C Corp |
|---|---|---|
| Tax-Free | $400 | $400 |

## Debt Assumptions

The direct ownership and aggregate approaches under disregarded SMLLC and partnership classification produce more favorable tax results than separate entity S corporation treatment on an assumption of debt by the LLC as well. Assumptions of debt are common in the context of transferring an existing business to a new LLC. A disregarded SMLLC's assumption of a debt of its owner is a nonevent for tax purposes. An LLC partnership's assumption of debt of a partner is a nonevent to the extent the debt remains allocated to that partner, although it is treated as a distribution to the extent the debt is allocated to other partners. But an S corporation's assumption of a stockholder's debt in excess of the basis of the property contributed is generally treated as a taxable boot distribution. Thus, the extent of gain recognition upon transferring a business to an LLC may depend on the classification of the LLC.

**Example 9.** A incurs $100 debt to purchase depreciable property. After the tax basis has been depreciated to $20, A contributes the property subject to the $100 debt to SMLLC M. If M is disregarded, the transaction has no income tax consequences. However, if M is a C or S corporation, A must recognize $80 gain under Code Sec. 357(c), being the excess of the $100 debt assumed by M over A's $20 basis in the contributed property. *See* Table 10.

**Example 10.** The facts are the same as in Example 9 except that A contributes the property to new LLC, M, in exchange for M's assumption of the $100 nonrecourse liability and a 50-percent interest in M, while B contributes $50 cash in exchange for the other 50-percent interest. Implicitly, the property is valued at $150 on a gross basis. The debt assumption is assumed not to be a tax avoidance or deemed sale transaction under Code Secs. 357(b) or 707(a)(2)(B). $80 of the debt (equal to the built-in gain that would be allocated to A under Code Sec. 704(c) if the property were disposed of solely in satisfaction of the debt) would be allocated to A, and it is assumed the remaining $20 of debt would be allocated 50/50 between A and B. A is thus allocated $90 of the debt, and is considered relieved of only $10 of debt. Since A had a $20 basis in P, A can absorb the $10 debt relief and recognizes no gain on the transaction.

If M is an S or C corporation, A has the same $80 taxable gain under Code Sec. 357(c) as in Example 9. The results are shown in Table 11.

**Table 10. A's Taxable Income if M classified as**

| Disregarded | S Corp | C Corp |
|---|---|---|
| Tax-Free | $80 | $80 |

**Table 11. A's Taxable Income if M classified as**

| Partnership | S Corp | C Corp |
|---|---|---|
| Tax-Free | $80 | $80 |

## Transfers of Interests

Another area where the direct ownership and aggregate approaches for disregarded and partnership LLCs produce different tax results than separate entity corporate status is on transfers of interests. Here, disregarded or partnership classification may or may not produce the most favorable tax consequences, depending on the circumstances.

Under the separate entity approach to corporations, a sale of stock (membership interest in electing LLC) does not affect a C or S corporation's inside basis in its assets (unless the purchaser is another corporation and a Code Sec. 338(g) or 338(h)(10) election is made). Nor can a sale of corporation stock cause a C or S corporation to terminate as an entity (although a sale to a nonqualified S corporation shareholder would terminate the S election). The stock buyer simply takes a tax basis in the shares equal to the purchase price.

The stock seller generally realizes capital gain or loss. Under the only look-through rule currently in effect for stock sales, gain on a sale of S corporation stock is, to the extent attributable to collectibles held by the S corporation, treated as 28-percent collectibles gain.[9] Under Code Sec. 341 (currently repealed, but set to become effective again with the sunsetting of the repeal after 2008), gain on C or S corporation stock is recharacterized as ordinary income if the corporation is a collapsible corporation, meaning it is availed of to avoid ordinary income on certain types of underlying constructed ordinary assets.

The aggregate approach to partnerships in this area leads to much different, and in many cases less favorable, results. On the seller's side, although the seller's gain or loss on a sale of a partnership interest is generally characterized as capital gain or loss, broad look-through rules apply, as discussed below. To the extent there is capital gain, unfavorable holding period rules can cause a disproportionately large percentage of the capital gain to be treated as short-term capital gain if the seller has made any contributions to the partnership within one year of the sale.[10]

Under broad look-through rules, amounts realized from the sale of a partnership interest that are attributable to unrealized receivables and inventory items of the partnership are treated as an amount realized from the sale of a noncapital, ordinary asset.[11] In addition, capital gain on a sale of an interest which is attributable to collectibles or real estate depreciation recapture is subject to the 28 percent and 25 percent rates applicable to such types of gain, respectively.[12] This aggregate approach applies only to hit the seller with ordinary income.

By contrast, on a sale of a partnership interest at a loss, the sale produces an unfavorable capital loss, even if the partnership has underlying ordinary loss property—the aggregate approach is not applied in the taxpayer's favor to characterize the loss as ordinary in part based on the partnership's underlying assets. Ordinary loss is obtainable only by having the partnership sell the underlying ordinary loss assets.

On the purchase of a partnership interest, the partnership can elect under Code Sec. 754 to adjust the buyer's share of the inside asset basis to reflect the amount paid for the interest. The effect is much as though the buyer purchased a direct share in the underlying assets. If the buyer purchases at a gain to the seller, the buyer will benefit from a step-up in his or her share of underlying asset basis. However, if the 754 election is in effect, a buyer who purchases at a loss to the seller will suffer a step-down in basis. In addition, to prevent duplication of loss on a sale of an interest in a partnership having a substantial built-in loss (tax basis exceeding value of assets by more than $250,000), a step-down in the buyer's share of inside basis in underlying assets is now required even if a 754 election is not in effect.[13]

Finally, a sale or exchange of more than 50 percent of the capital and profits interests in a partnership within a 12-month period will terminate its existence for income tax purposes, and assuming it continues to exist with at least two partners, cause it to be considered a new partnership. This is to some extent an aggregate concept. Although the termination and new formation is generally not a taxable transaction, it would close the partnership's tax year, potentially restart depreciation over longer recovery periods, and have other adverse consequences under certain circumstances.



## Other Income Tax Differences

A number of other differences exist in the tax treatment of entrepreneurships, partnerships, S corporations and C corporations as well. In some cases, the differences could be partially explained as resulting from an aggregate approach to partnership and entity approach to corporations. Very briefly, some other commonly encountered differences are as follows:

- On formation, a contribution of appreciated property to a corporation (whether S or C) in exchange for stock is tax-free only if the property transferors as a group are in "control" of the transferee corporation immediately afterwards, meaning they own 80 percent of the voting stock and 80 percent of each class of nonvoting stock.[14] By contrast, any contribution of property to a partnership for an interest therein is generally tax-free under Code Sec. 721, even if the property transferor(s) have only a small interest in the partnership afterwards—there is no "control immediately after" requirement. This makes it easier to use partnership interests as a tax-free acquisition currency.

- Partnerships can generally be liquidated on a tax-free basis, while liquidation of a corporation triggers gain or loss recognition at the corporate level on all its assets as well as at the stockholder level on all their stock. This is true of an S corporation as well, although there would be only one level of tax.
- A business can be acquired on a tax-free basis by an unrelated corporation much more easily if it is classified as a corporation than if it is a partnership. The tax-free reorganization rules under Code Sec. 368 apply only to combinations of corporations. Code Sec. 368 does not require that the acquired target corporation's stockholders own "control" of the acquiring corporation afterwards. Thus, a large corporation can acquire a much smaller corporation on a tax-free basis under those rules. If the acquired entity is a partnership, Code Sec. 368 does not apply. The transaction is viewed as a contribution of the LLC's business to the acquiring corporation, which can only be done tax-free under Code Sec. 351, which requires the LLC owners to own "control" of the acquiring corporation afterwards. Thus, if the exit strategy for a business is a tax-free acquisition by a large corporation, at some earlier time the business would need to be set up as a corporation to enable that to happen.
- Only a corporate purchaser can make a Code Sec. 338(g) or 338(h)(10) election on the purchase of the stock of another corporation. Thus, if corporation is to be acquired with a 338(g) or 338(h)(10) election, the acquiring entity must be classified as a corporation, including an LLC for which a check-the-box election is made.
- The rules governing equity-based compensation (options, restricted stock, *etc.*) are more highly developed and certain for corporations than they are for partnerships.[15] Thus, if equity compensation is to be used, partnership classification may entail more complexity and uncertainty.
- There may be differences available with regard to availability of pension plans, fringe benefits, *etc.*

# Tax Provisions in LLC Agreements

The tax provisions governing an LLC are typically found in its operating agreement. The extent and nature of the provisions will depend on whether the LLC is to be classified as a partnership, S corporation or C corporation.

## Disregarded SMLLC

Assuming an operating agreement is adopted, it would not really need anything in the way of tax provisions. However, it may nonetheless be useful to set forth the intention to be classified as disregarded, and the manner in which employment and excise tax compliance will be handled (*see* discussion below).

## LLC As C Corporation

In the case of an LLC classified as a C corporation, the operating agreement would likely not need much more in the way of tax provisions than is found in the typical certificate of incorporation and by-laws of a C corporation. In particular, there is no need for an article governing allocations of income among the members. Given the potential for confusion, however, it would be useful to make clear that the LLC will be classified as a C corporation for tax purposes and that the corporate tax laws will be complied with.

## LLC As S Corporation

If the LLC is to be classified as an S corporation, the operating agreement would be expected to contain a provision expressing the intent to be an S corporation and the terms and provisions common to S corporations.

Initially, the LLC must satisfy all the requirements for being a "small business corporation" under Code Sec. 1361, including the single-class-of-stock requirement. Thus, the distribution rights (currently and on liquidation) of all membership interests must be identical. In this regard, both Delaware and Illinois LLC statutes provide, in the absence of a different scheme in the operating agreement, for property on liquidation to be distributed first to members in repayment of their capital contributions, and thereafter pro rata.[16] Hence, unless all members contributed capital equally, the statutory liquidation scheme would not permit an S election. Thus, if an S election is to be made, the operating agreement should expressly provide that all distributions, including on liquidation, be *pro rata.* In addition, typical S corporation restrictions on transferring stock to ineligible shareholders (generally, any person other than a U.S. citizen or resident) may be included as well.

Since it is a flow-through entity, additional tax provisions related thereto are common, such as a requirement that the LLC provide K-1s to the members (possibly after input and feedback from members). As some states impose withholding taxes on S corporations in respect of nonresident stockholders, it may also be advisable to include a provision concerning compliance with any state withholding tax requirements.

## LLC As Partnership

For an LLC classified as a partnership, it will typically have more extensive tax provisions, such as the following:

- Statement that LLC will be classified as a partnership and no check-the-box election will be made to the contrary, as well as restrictions on becoming a publicly traded partnership
- A provision referencing the tax treatment of the formation transaction (or this may be stated in a separate formation agreement)
- In an LLC subject to the unified audit procedures (*see* Code Secs. 6221–6234), a provision designating one member as "Tax Matters Partner," which basically gives that member authority to handle tax audits. An LLC which is not otherwise within the unified audit procedures because it has 10 or fewer members each of whom is U.S. citizen or resident or a C corporation may elect application of unified audit procedures, Code Sec. 6231(a)(1)(B)(ii), so that may be stated as well
- If the LLC is a nonservice partnership with 100 or more members, statement whether it will elect to be an "electing large partnership" subject to Code Secs. 771 through 777 and 6240 through 6255
- Article governing allocations of income, loss, deduction, and credits among the members, which may be quite complex (*see* below)
- Provision concerning state withholding taxes in respect of nonresident partners, and U.S. federal withholding taxes under Code Sec. 1446 in respect of non-U.S. partners
- Statements regarding the making of various elections, including election to amortize organizational costs under Code Sec. 708, and the Code Sec. 754 election for a purchaser to step up its basis in underlying assets
- Provisions regarding issuance of K-1s to members
- Provisions requiring LLC to give members information necessary to enable them to comply with their own financial reporting requirements. In particular, query whether the recent FASB FIN 48 will require special reporting to GAAP members

## Partnership Allocations

A partnership agreement typically contains one article specifying distributions to be made to the partners, and another article specifying the allocation of items of income, gain, loss, deduction and credit to the partners for income tax purposes. It is important to grasp that these articles are separate and distinct in purpose and effect: One allocates distributions, the other only taxable income. Broadly speaking, the distribution article is the more important, as it represents the parties' "economic deal."

Unlike S corporations, partnerships afford a great deal of flexibility in allocating tax items among the partners, although that flexibility is not unlimited. Code Sec. 704 sets forth standards that must be met in order for an allocation of tax items among partners to be respected for tax purposes. It provides that a partner's share of tax items is determined by the partnership agreement, unless the allocation under the agreement does not have "substantial economic effect," in which case the partner's share is determined in accordance with the "partner's interest in the partnership." For example, these principles preclude allocating 99 percent of the taxable income to a tax-exempt partner that has only a one-percent interest in the economic capital and profits of an enterprise. Nor could all losses be allocated to one partner and income to another while distributions are to be made equally.

Reg. §§1.704-1 and -2 flesh out the Code Sec. 704 standards. Under the regulations, an allocation generally has "substantial economic effect" if it (1) has "economic effect" and (2) such economic effect is "substantial." In general, "economic effect" means that the partner receiving a tax allocation of an item bears the corresponding economic benefit or burden of the item, and requires that the partnership agreement provide (1) for maintenance of capital accounts, (2) that liquidating distributions be made in accordance with positive capital account balances, and (3) that partners have deficit capital account restoration obligations. In general, economic effect is considered substantial if there is a reasonable possibility that the allocation will affect substantially the dollar amounts to be received by the partners from the partnership, independent of tax consequences (thus, "shifting" and "transitory" allocations will not be respected). An LLC agreement adopting this approach must contain provisions for maintaining capital accounts in accordance with the regulations, as well as requiring liquidating distributions to be made in accordance with positive capital accounts.

Under the "partner's interest in the partnership" standard, a tax item will be allocated in accordance with the manner in which the partners have agreed to share the corresponding economic benefit or burden of the item, determined from all the facts and circumstances. Relevant factors include the partners' relative contributions to the partnership; the interests of the partners in economic profits and losses; the interests of the partners in cash flow and other nonliquidating distributions; and the rights of the partners on liquidation.

Special rules apply to items attributable to nonrecourse financing. If the financing is provided by a partner, then the items attributable thereto (*e.g.*, depreciation) are allocated to that partner.

Otherwise, because risk of loss on property financed by nonrecourse debt is borne only by the unrelated creditor, allocations of deductions from the property among the partners cannot have economic effect. Such allocations must therefore be made in accordance with the partners' interest in the partnership. If the partnership otherwise complies with the substantial economic effect requirements, an allocation of nonrecourse deductions will be deemed to be in accordance with the partners' interest in the partnership if (1) it is reasonably consistent with the allocation of some other item from the property that has substantial economic effect, and (2) gain from disposing of the property for an amount equal to the nonrecourse debt will be charged back to the partners in the same manner in which the nonrecourse deductions were allocated.



### Substantial Economic Effect vs. Independent Distribution and Tax Allocation Articles

Since the distributions article specifies the amounts actually distributed to the partners, it represents the "economic deal" between the partners. It is essential that the distribution article properly implement the partners' economic deal.

The substantial economic effect approach requires distributions to be made in accordance with capital accounts. The capital accounts are in turn determined by the tax allocations, which can be exceedingly complex. Under the substantial economic effect approach, then, an error in the tax allocations article goes beyond a misallocation of income among the partners for tax purposes, and could corrupt the actual distributions. Although the economic deal itself may be complex and difficult to encapsulate, tax allocations typically incorporate an additional layer of even greater complexity. Moreover, if distributions are determined with reference to tax-based capital accounts, those endeavoring to understand the economics of the operating agreement need to understand the tax allocations, which may not be possible for non–tax experts.

To reduce the risk that the economic deal will be skewed, as well as to enable non–tax people to understand the economic distribution scheme, one may consider divorcing the distribution scheme from the tax allocation scheme, and have each operate independently. On the other hand, this approach may increase the risk of an IRS reallocation of tax items, since it is outside the substantial economic effect safe harbor. In the end, the choice of approach may require a balancing, with some opting to "just make sure the cash comes out right." Note however that in some deals, special rules may mandate compliance with the substantial economic effect requirements.[17]

## LLCs in M&A Transactions

### Single-Entity LLCs

A transfer of assets between a disregarded SMLLC and its owner is generally disregarded for income tax purposes. Where the owner of a disregarded SMLLC sells his or her entire interest in the SMLLC to another party, the transaction would be treated for federal income tax purposes as a sale and purchase of the underlying assets of the SMLLC.

If the owner of a disregarded SMLLC sells only a portion of his or her interest in the LLC to one or more buyers, the LLC converts to a partnership (assuming a corporation election is not made) since it would then have at least two owners. In that case, the original owner is treated as selling an undivided interest in the underlying assets to the buyer(s), immediately followed by a contribution by the parties of their respective shares in the underlying assets to the new partnership LLC under Code Sec. 721.[18] If a corporate classification election is made for the LLC, presumably the same deemed structural format would apply except that the contribution of assets to the new LLC corporation would be governed by Code Sec. 351.

If an existing disregarded SMLLC issues new interests to new members for consideration delivered to the LLC, then once again a partnership (or corporation) springs into existence since it then has multiple owners.

Here, the original member is treated as contributing the LLC's pre-existing assets and the new members the new consideration to the new LLC partnership under Code Sec. 721 (or to the new LLC corporation under Code Sec. 351 if a corporate election is made).

If one member of an existing LLC partnership buys all the other members' interest therein, the LLC partnership converts to a disregarded SMLLC since it then has only one member (unless it elects corporate status). In this case, a hybrid tax treatment is applied. The sellers are deemed to sell their interests in the LLC under Code Secs. 741 and 751. However, on the buyer's side, the LLC is deemed to have liquidated, with the buyer receiving the share of assets attributable to its previously owned interest in liquidation of that interest and as purchasing the remaining shares of the assets from the sellers.[19] If the buyer owned no interest in the LLC beforehand, the buyer would be treated as purchasing the entirety of the assets.

### Partnership Transactions

A partnership (including an LLC) may combine by merger or other transaction with another partnership (including LLC), with the resulting entity continuing as a partnership (including LLC). In that case, the partnership merger regulations, Reg. §1.708-1(c) would govern the tax treatment. A partnership (including an LLC) could also spin-off or split-up into two or more entities classified as partnerships (including LLCs), in which case the transaction would be governed by the partnership division regulations, Reg. §1.708-1(d).

### Corporate Transactions

An LLC classified as a corporation can be organized, or merge or otherwise combine with another entity classified as a corporation, or split up into two or more corporate entities, or liquidate, under Subchapter C of the Internal Revenue Code just like a regular corporation formed under the corporation laws.

In addition, recent regulations under Code Sec. 368 have created a place for disregarded SMLLCs in corporate reorganizations as well. Under Code Sec. 368(a)(1)(A), a target corporation can merge directly into an acquiring corporation in a tax-free "statutory merger" reorganization. Under Code Sec. 368(a)(2)(D), the target corporation could also merge into a corporate subsidiary of the acquiring corporation in a tax-free forward triangular "statutory merger" reorganization. However, the Code Sec. 368(a)(2)(D) forward triangular merger has additional requirements beyond Code Sec. 368(a)(1)(A), in particular a requirement that substantially all the assets of the target be acquired.

Now, under Temporary Reg. §1.368-2T(b)(1), a target corporation can be merged into a disregarded SMLLC owned by the acquiring corporation, which is treated as a direct Code Sec. 368(a)(1)(A) merger of the target into the acquiring corporation. Since this straight Code Sec. 368(a)(1)(A) merger format has fewer requirements than a forward triangular merger into a corporate subsidiary under Code Sec. 368(a)(2)(D), this can be a useful structure. For example, if the target has recently made or is concurrently making a substantial distribution of assets, such that it is questionable whether the substantially all requirement of Code Sec. 368(a)(2)(D) can be met, but a direct merger into the acquiring corporation is not desired as it will expose the acquiring corporation directly to target's liabilities or require a vote by the shareholders of the acquiring corporation, then a merger of the target into a disregarded SMLLC of the acquiring corporation may work beautifully.

## Self-Employment Taxes

### FICA Employment Taxes

Chapter 21, Federal Insurance Contributions Act, of Subtitle C, Employment Taxes, of the Internal Revenue Code, imposes FICA employment taxes with respect to wages paid in an employment context. An employee is required to pay old-age, survivors and disability insurance (Social Security) taxes equal to 6.2 percent of wages received up to a maximum base amount of wages ($94,200 for the 2006 tax year), and hospital insurance (Medicare) taxes equal to 1.45 percent of all wages received. These taxes are collected through withholding. The employer must also pay Social Security taxes of 6.2 percent on wages paid to the employee up to the base amount, and Medicare taxes of 1.45 percent on all wages paid. On a combined basis, the Social Security tax is 12.4 percent on the first $94,200 of an employee's wages, and the Medicare tax is 2.9 percent of all wages.

### Self-Employment Tax

Chapter 2, Tax on Self-Employment Income, of Subtitle A, Income Taxes, of the Internal Revenue Code imposes as part of the income tax a tax on the self-employment income of self-employed individuals. This tax parallels the FICA taxes imposed in the employment context, and funds Social Security and Medicare for self-employed individuals. Under Chapter 2, an individual is subject to a 12.4-percent Social

Security tax on self-employment income up to the same base amount as applies for FICA Social Security tax purposes ($94,200 in 2006), and a 2.9-percent Medicare tax on all self-employment income.

Self-employment income is generally defined as "net earnings from self-employment," which in turn is generally defined as:

> [T]he gross income derived by an individual from any trade or business carried on by such individual, less the deductions allowed by this subtitle which are attributable to such trade or business, plus his distributive share (whether or not distributed) of income or loss described in section 702(a)(8) from any trade or business carried on by a partnership of which he is a member.[20]

The term "trade or business" as used above has the same meaning as when used in Code Sec. 162 (relating to the deduction of ordinary and necessary business expenses), except that it generally does not include the performance of services by an individual as an employee.[21] Rentals from real property, dividends, interest on corporate bonds, gains and losses from sales of property other than inventory are generally excluded from self-employment income.[22] Pensions and annuities are also generally not considered self-employment income.[23]

## Self-Employment Taxation of Partners

As noted above, a partner must generally include in self-employment income his or her distributive share under Code Sec. 702(a)(8) of income or loss from a partnership engaged in a trade or business. Code Sec. 702(a)(8) is the partnership's taxable income or loss, exclusive of items required to be separately stated (capital and Code Sec. 1231 gains and losses, charitable contributions, dividends, foreign taxes and other items specified in Reg. §1.702-1). Payments received by a partner for services rendered to the partnership or for the use of capital by the partnership that are determined without regard to the income of the partnership (*i.e.*, guaranteed payments) are generally considered self-employment income.[24] For purposes of the self-employment tax rules, a partnership is any entity, joint venture, or other arrangement classified as a partnership for federal income tax purposes.[25]

A general partner's entire distributive share of a partnership's ordinary income may be much greater than the partner could expect to receive as salary in an employment relationship. For example, a general partner in a large and successful carpet cleaning business, which operates through a large staff of cleaning employees, might have a distributive profit share as a general partner of $1 million due to the entrepreneurial success of the business (including a return on invested capital) and the partner's status as an owner. In that case, the entire $1 million would be subject to the 2.9-percent Medicare tax even though the value of the general partner's actual personal services to the partnership for the year is only $100,000. But this would also be true if the individual conducted the business directly as an entrepreneur as well.

Code Sec. 1402(a)(13) excludes from self-employment income:

> ... the distributive share of any item of income or loss of a limited partner, as such, other than guaranteed payments described in section 707(c) to that partner for services actually rendered to or on behalf of the partnership to the extent that those payments are established to be in the nature of remuneration for those services.[26]

Under this provision, a partner's distributive share attributable to a limited partnership interest is exempt from self-employment tax, and this is so even if the partner also has a general partnership interest or receives guaranteed payments for services. In addition, under a separate exemption, certain retirement annuity payments received by a partner are excluded from self-employment income if the partner rendered no services during the year and the partner's capital has been paid to him before the end of the year.[27]

It should be noted that if a business generates a loss, then its treatment as self-employment income can beneficially reduce self-employment income from other sources. In particular, if an individual has a loss from a partnership, he or she may prefer to be treated as a general rather than limited partner in respect thereof so as to be able to offset that loss against self-employment income from other sources.

## Self-Employment Taxation of LLC Members

If an LLC engaged in a trade or business is classified as a partnership for federal income tax purposes, the members therein are regarded as partners for tax purposes and subject to self-employment tax on their shares of its ordinary income, unless one or more can come within the limited partner exemption in Code Sec. 1402(a)(13).[28]

In 1997, the IRS issued Proposed Reg. §1.1402(a)-2(h) to define "limited partner" for purposes of the

Code Sec. 1402(a)(3) exemption. Under the proposed regulation, an individual may be considered a limited partner in respect of all or part of his or her interest in an entity classified as a partnership (including an LLC), and the distributive share with respect thereto is not self-employment income, in one of three circumstances:

- **Pure Limited Partner**. The individual (i) does not have (A) personal liability for the debts of the partnership by reason of being a partner, or (B) authority to contract on behalf of the partnership; and (ii) does not participate in the partnership's business for more than 500 hours during the year.
- **General and Limited Partner.** An individual who fails one of the above tests but owns more than one class of interest in the partnership may be treated as a limited partner in respect of a specific class of partnership interest if immediately after acquisition of that interest, pure limited partners who do meet the above tests own a substantial amount of that same class of interest with the same rights and obligations.
- **Service Provider Limited Partner.** An individual who fails only the 500-hours test may be treated as a limited partner in respect of his or her interest if immediately after acquisition of that interest, pure limited partners who do meet all the above tests own a substantial amount of that same class of interest with the same rights and obligations.

According to the IRS, these rules exclude from self-employment income "amounts that are demonstrably returns on capital invested in the partnership."[29] IRS partners in service partnerships are excluded from limited partner treatment under the proposed regulation.

Although Proposed Reg. §1.1402(a)-2(h) has not been finalized, it seems reasonable to rely on it.[30] However, the proposed regulations are not binding on the IRS and do not afford absolute protection against challenge.

Under the proposed regulations, an LLC member is generally not going to have personal liability, and so would be considered a limited partner unless he or she is a manager (or otherwise has authority to contract on behalf of the LLC) or spends more than 500 hours working for the LLC. In such cases, one strategy to reduce self-employment tax would be to own separate classes of interests, with the bulk of the income allocable to a class of limited interests owned substantially by pure limited partners.

### Alternative Strategies

An alternative strategy that does not rely on Proposed Reg. §1.1402(a)-2(h) is for the LLC to elect to be classified as an S election, as S corporation shareholders are not subject to self-employment tax on their shares of the S corporation's income.[31] However, the LLC/S corporation should pay an appropriate level of salary subject to FICA and FUTA wage taxation, as otherwise the IRS can recharacterize distributions as taxable wages, and penalties can result.[32] However, this strategy may not be available if the rigid S corporation requirements cannot be met, or may be undesirable based on disadvantageous tax treatment of S corporations in other respects as discussed herein.

Another strategy is to instead use a limited partnership, and still achieve limited liability by holding the general partnership interest through a C or S corporation. The individuals could render services as employees of the corporate general partner. Although there would be FICA and FUTA wage taxation on their compensation from the C or S corporation for such services, they could rely on their status as limited partners under traditional law to escape self-employment taxation on the income allocated to them as such. Again, the general partner's share of income and the salaries paid to the individual service providers should be reasonable in relation to the services provided.

### Legislative Proposals

As a means of helping close the tax gap, improving compliance, and promoting tax neutrality among choice of entities, the Joint Committee has proposed reforming the self-employment tax regime.[33] One proposed approach would be to extend the current treatment of general partners to the owners of any type of passthrough entity, including limited partners, S corporation stockholders and LLC members. Under that approach, S corporation stockholders would be subject to self-employment tax on their distributive shares of S corporation income to the same extent they would be as a general partner under the current rules. Another, more-targeted approach would limit such general partner treatment to owners of passthrough entities engaged in service businesses.

Business owners should consider the possibility of such legislation in structuring their affairs. In particular, an S corporation's ability to shelter income from self-employment tax may be short-lived.

## Unemployment Taxes

Unemployment taxes are also assessed at both the Federal and state levels on wages paid to employees. Unemployment taxes should generally not be assessed with respect to partners in a partnership, including members in an LLC classified as such. However, wages paid to employees (including officers) of a C or S corporation, including an LLC classified as such, generally would be subject to unemployment taxes.

## Disregarded SMLLC Employment and Excise Taxes

In Notice 99-6,[34] the IRS announced that until additional guidance is issued, employment tax compliance for employees of a disregarded SMLLC could be handled by the SMLLC's owner as though they were employees of the owner and using the owner's name and EIN, or by the SMLLC under its own name and EIN.

However, because of administrative difficulties that have arisen in applying the disregarded entity approach for federal employment and excise tax purposes, the IRS has proposed regulations under which SMLLCs that are generally disregarded for income tax purposes will nonetheless be treated as separate taxable entities for purposes of the federal employment and excise taxes.[35] As proposed, the regulations would be effective for wages paid or excise taxes incurred on or after January 1 following the date the regulations are finalized.

## Conclusion

A number of income and non-income tax considerations need to be weighed in deciding what type of state law entity to use to operate a business, and in determining its income tax classification. Although the set-up that will work best in a given situation depends on the particular facts and circumstances, in general LLCs classified as disregarded entities or partnerships will be the most tax-efficient.

### Endnotes

1. *See* Tex. Tax Code Ann. §§171.001 *et seq.* (effective 2008).
2. *See Littriello v. U.S.,* 95 AFTR2d 2005-2581, *rehearing denied*, 96 AFTR2d 2005-5764 (D.C.Ky. 2005) (regulations upheld as valid, although taxpayer has appealed to 6th Circuit).
3. Rev. Proc. 2002-69, 2002 CB 831.
4. Rev. Rul. 2004-77, IRB 2004-31, 119.
5. 35 ILCS §§5/102, and 5/1501(a)(4) and (16); Ill. Dep. Rev. Reg. §§100.4500(a)(3)(A) and 100.9750.
6. *See* Rev. Rul. 2004-86, IRB 2004-33, 99 ("because the assets of Delaware Statutory Trust will not be owned by the beneficiaries as coowners under state law, DST will not be able to elect to be excluded from the application of subchapter K"); Notice 2004-53, IRB 2004, 209 (IRS soliciting comments on circumstances under which participants should be treated as owning the property as coowners in order to be able to elect out of Subchapter K).
7. *See generally* Goodman, *Employing a Corporation and Other Strategies to Reduce Taxes*, 72 Taxes 4 (1994).
8. *See* Goodman, *Corporate and Partnership M&A Tax Laws: Is it time to Merge Subchapters C and K?* 95 Tax Notes 1497 (June 3, 2002).
9. *See* Code Sec. 1(h)(5); Reg. §1.1(h)-1.
10. *See* Reg. §1.1223-3.
11. Code Sec. 751.
12. Code Sec. 1(h)(5).
13. *See* Code Sec. 741(b).
14. Code Sec. 351.
15. *See* Rev. Proc. 93-27, 1993-2 CB 343 and Rev. Proc. 2001-43, 2001-2 CB 191; Proposed Reg. §1.83-3(e) and (l); §1.721-1(b).
16. 6 Del. C. §18-804; 805 ILCS 180/35-10.
17. *See, e.g.,* Code Sec. 514(c)(9)(E) ("fractions rule" applicable to certain deals between taxable and tax-exempt investors).
18. *See* Rev. Rul. 99-5, 1999-1 CB 434.
19. Rev. Rul. 99-6, 1999-1 CB 432.
20. Code Sec. 1402(a).
21. Code Sec. 1402(c).
22. Code Sec. 1402(a).
23. Rev. Rul. 58-359, 1958-2 CB 422.
24. Reg. §1.1402(a)-1(b). *See* also Rev. Rul. 69-184, 1969-1 CB 256 (*bona fide* partner in partnership is not an employee and remuneration received is not "wages" with respect to "employment" so FICA and FUTA taxes and withholding provisions do not apply).
25. Reg. §1.1402(a)-2(f).
26. Code Sec. 1402(a)(13).
27. Code Sec. 1402(a)(10); Reg. §1.1402(a)-17.
28. LTR 9432018 (May 16, 1994).
29. Preamble to Proposed Reg. §1.1402(a)-2(h), 62 FR 1702 (Jan. 13, 1997).
30. *See, e.g.,* Business Entities, *IRS to Follow 1997 Proposed Regs in Applying Self Employment Tax Rules to LLC Members* (Sept./Oct. 2003).
31. Rev. Rul. 59-221, 1959-1 CB 225.
32. Rev. Rul. 74-44, 1974-1 CB 287.
33. *See Additional Options to Improve Tax Compliance,* JCT Report (Aug. 3, 2006).
34. Notice 99-6, 1999-1 CB 321.
35. *See* Proposed Reg. §301.7701-2(c)(2)(iv) and (v).