LLCT10

SELF-STUDY CONTINUING PROFESSIONAL EDUCATION

## Companion to PPC's Guide to

# Limited Liability Companies

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# Interactive Self-study CPE

## Companion to PPC's Guide to Limited Liability Companies

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**To enhance your learning experience, the examination questions are located throughout the course reading materials. Please look for the exam questions following each lesson.**

# INTRODUCTION

*Companion to PPC's Guide to Limited Liability Companies* consists of one interactive self-study CPE course. This is a companion course to *PPC's Guide to Limited Liability Companies* designed by our editors to enhance your understanding of the latest issues in the field. To obtain credit, you must complete the learning process by logging on to our Online Grading System at **cl.thomsonreuters.com** or by mailing or faxing your completed **Examination for CPE Credit Answer Sheet** for print grading by **November 30, 2011**. Complete instructions are included below and in the Test Instructions preceding the Examination for CPE Credit Answer Sheet.

### Taking the Course

The course is divided into lessons. Each lesson addresses an aspect of limited liability companies. You are asked to read the material and, during the course, to test your comprehension of each of the learning objectives by answering self-study quiz questions. After completing each quiz, you can evaluate your progress by comparing your answers to both the correct and incorrect answers and the reason for each. References are also cited so you can go back to the text where the topic is discussed in detail. Once you are satisfied that you understand the material, **answer the examination questions which follow each lesson**. You may either record your answer choices on the printed **Examination for CPE Credit Answer Sheet** or by logging on to our Online Grading System.

### Qualifying Credit Hours—QAS or Registry

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CPE requirements are established by each state. You should check with your state board of accountancy to determine the acceptability of this course. We have been informed by the North Carolina State Board of Certified Public Accountant Examiners and the Mississippi State Board of Public Accountancy that they will not allow credit for courses included in books or periodicals.

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## COMPANION TO PPC'S GUIDE TO LIMITED LIABILITY COMPANIES

# Choosing or Converting to an LLC (LLCTG101)

## OVERVIEW

**COURSE DESCRIPTION:** This interactive self-study course provides an introduction to choosing an entity. Lesson 1 covers such topics as the advantages and disadvantages of operating as an LLC and whether or not some businesses may receive more favorable tax treatment by operating as an LLC. Lesson 2 discusses the tax year for an LLC which sometimes can become complex and confusing. Lesson 3 covers topics such as converting from another type of business entity to an LLC and the tax advantages of converting to an LLC.

**PUBLICATION/REVISION DATE:** November 2010

**RECOMMENDED FOR:** Users of *PPC's Guide to Limited Liability Companies*

**PREREQUISITE/ADVANCE PREPARATION:** Experience with the preparation of a variety of tax forms including Form 1065, 1120S, 1120 and Schedule C of Form 1040.

**CPE CREDIT:** 8 QAS Hours, 8 Registry Hours

8 CTEC Federal Hours, 0 CTEC California Hours

Check with the state board of accountancy in the state in which you are licensed to determine if they participate in the QAS program and allow QAS CPE credit hours. This course is based on one CPE credit for each 50 minutes of study time in accordance with standards issued by NASBA. Note that some states require 100-minute contact hours for self study. You may also visit the NASBA website at **www.nasba.org** for a listing of states that accept QAS hours.

**Enrolled Agents:** This course is designed to enhance professional knowledge for Enrolled Agents. PPC is a qualified CPE Sponsor for Enrolled Agents as required by Circular 230 Section 10.6(g)(2)(ii).

**FIELD OF STUDY:** Taxes

**EXPIRATION DATE:** Postmark by **November 30, 2011**

**KNOWLEDGE LEVEL:** Intermediate

**LEARNING OBJECTIVES:**

**Lesson 1—Choosing an LLC as the Business Entity**

Completion of this lesson will enable you to:
- Identify and evaluate the characteristics of operating as an LLC or LLP.
- Determine how marital and community property rules might affect an LLC or a Series LLC.
- Identify specific types of businesses that may receive more favorable tax treatment by operating as LLCs.

**Lesson 2—Choosing the LLC's Tax Year**

Completion of this lesson will enable you to:
- Select the required tax year of entities choosing LLC status.
- Describe the various methods to elect a nonconforming tax year and the impact on entities selecting LLC status.

**Lesson 3—Converting to an LLC**

Completion of this lesson will enable you to:

- Identify and determine the relative importance of issues that may arise when converting another type of business entity into an LLC.
- Identify and analyze the tax effects of converting a sole proprietorship or a partnership into an LLC.
- Determine whether converting from a C corporation or an S Corporation into an LLC is beneficial from a tax standpoint.

**TO COMPLETE THIS LEARNING PROCESS:**

Send your completed **Examination for CPE Credit Answer Sheet, Course Evaluation,** and payment to:

**Thomson Reuters**
**Tax & Accounting—R&G**
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**36786 Treasury Center**
**Chicago, IL 60694-6700**

See the test instructions included with the course materials for more information.

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# Lesson 1: Choosing an LLC as the Business Entity

## INTRODUCTION

One of the most critical decisions a practitioner helps a client make is how to structure a new business (or whether the form of entity in which an existing business is conducted should be changed). Because of the current complexity of the tax laws and the number of nontax factors that must be considered, the choice of business entity requires careful analysis. To ensure the client is making the right choice, the practitioner should be familiar with all aspects of the client's business and make sure all major tax and nontax issues have been addressed and all possible structures have been considered. Practitioners also need to guard against losing sight of the most important issue in making the choice of entity decision—*the client's business objectives*.

In the past, the choice of entity required a comparative analysis of C corporations, S corporations, partnerships (including general and limited partnerships), and sole proprietorships. Now the limited liability company (LLC) and limited liability partnership (LLP) are also alternative entity choices. The LLC offers many advantages to businesses. The LLC's major advantage is allowing owners to participate in management and take advantage of pass-through taxation while limiting their liability for debts and obligations of the business.

Because the LLC is a relatively new type of entity in the United States, there are some tax and nontax issues regarding LLC operations that are not yet resolved. Clients considering conducting business as an LLC must be aware of these uncertainties to make an informed decision.

**Learning Objectives:**

Completion of this lesson will enable you to:

- Identify and evaluate the characteristics of operating as an LLC or LLP.
- Determine how marital and community property rules might affect an LLC or a Series LLC.
- Identify specific types of businesses that may receive more favorable tax treatment by operating as LLCs.

## THE ADVANTAGES AND DISADVANTAGES OF USING AN LLC

There are advantages and disadvantages to conducting a business as an LLC (as opposed to a C corporation, an S corporation, a partnership, or a sole proprietorship). These advantages and disadvantages should be carefully analyzed when making the choice of entity. The discussion in this lesson addresses LLCs taxed as partnerships, unless otherwise indicated.

### Formation

**Articles of Organization Required.** LLCs are governed by state statute and accordingly the formation process varies from state to state. However, most LLCs are created when the articles of organization are filed with the Secretary of State. The articles of organization, which are similar to articles of incorporation, usually contain only general information about the LLC, including its name, its business purpose, registered agent and principal office. However, most states allow the organizers great latitude to include any provisions they desire in the LLC's articles of organization. States generally require the payment of a fee at the time the articles of organization are filed. The fee varies from state to state, but generally falls between $25 and $200.

By contrast, a C or S corporation is formed by filing articles of incorporation and bylaws, designating a board of directors and corporate officers, and conducting shareholder and board of directors meetings on a regular basis. Meeting these requirements involves considerable time and expense. Unlike the formation of a corporation, the formation of a general partnership generally does not require the filing of any formal documents. The partnership is governed by a written or oral partnership agreement. A general partnership is not required to file with the state authorities. The formation of a limited partnership, however, usually requires filing of a limited partnerships agreement and payment of a fee. A sole proprietorship does not require legal formation since it is not a separate legal entity from its owner.

**No Requirement for Operating Agreement.** Although not required in most states, an LLC usually has an operating agreement (similar to a partnership agreement) that outlines the duties, rights, and responsibilities of the members. Several states do not require that this agreement be in writing. Some states, while not requiring a written agreement, require that certain default provisions of the state LLC act can be overridden only by provisions in a written agreement. If the LLC has no operating agreement, the default provisions of the applicable state LLC statute govern the operations of the LLC (unless overridden by the LLC's articles of organization).

**Some States Restrict Purpose of LLC.** Most states require the LLC to state its purpose in the LLC's articles of organization. In states that restrict an LLC's business purpose, the businesses in which an LLC cannot participate usually are banking and insurance.

**No Restrictions on Ownership.** One of the primary advantages of LLCs is that, unlike S corporations, they do not restrict either the number or types of members that may own LLC interests. In most states, an unlimited number of individuals, general or limited partnerships, LLCs, LLPs, C corporations, S corporations, trusts, and estates can own LLC interests. There is also no limitation on foreign ownership.

An LLC with a single member is treated as the same tax entity as its owner (disregarded entity) or can elect to be taxed as a corporation. A business operated as an LLC and taxed as a disregarded entity is treated as a sole proprietorship if owned by an individual, or a division or branch if owned by a corporation, a partnership, or another LLC.

**Cost of Forming an LLC and Maintaining LLC Status.** In selecting the form of business enterprise, especially when the chosen entity will be used to operate a relatively small business, it is important not to overlook the cost of formation and the annual cost of maintaining the entity. The cost of forming an LLC varies from state to state. Fees are normally charged to file the articles of organization and, in some states, an LLC is required to publish a notice of formation in a newspaper for several weeks, which can be costly. Additionally, significant attorney's fees may be incurred to draft an operating agreement. Once an LLC is formed, the cost of maintaining the LLC generally is very low. Some states require an LLC to file an annual or biennial report and pay an annual fee, but this fee is usually $100 or less. If the filing is completed by an attorney an additional annual legal fee will also be incurred. The only significant ongoing expenses of an LLC are the costs of amending its articles of organization or operating agreement and any state taxes.

**State Taxes.** LLCs may incur a substantial state tax liability in states where they are taxed as a corporation. Conversely, operating as an LLC may reduce state taxes, particularly for corporations using wholly owned LLCs instead of subsidiaries to conduct business. Since many states prohibit the filing of consolidated returns, each subsidiary corporation is required to file a state return separate from its parent. A wholly owned LLC, on the other hand, does not have to make a separate filing. This can avoid situations where a subsidiary's NOL cannot be used to offset the parent corporation's earnings for state taxes. The use of an LLC instead of a subsidiary corporation can also beneficially impact the apportionment of income and the assessment of transfer taxes.

**Securities Registration May Be Required.** LLCs may be required to file under state securities or blue sky laws. Such registration may result in significant legal fees.

## Contributions

A member in an LLC can contribute cash, notes, property or services in exchange for a membership interest. Most state statutes require a member to make a contribution (or its cash equivalent) if the promise to make the contribution is set out in writing. Consequently, a member is liable for LLC debts to the extent he has an enforceable obligation to make a future capital contribution. Most states allow the compromise of a member's capital account obligation with the unanimous consent of the other members. An unresolved issue, however, is whether creditors of the LLC are bound by the members' compromise of an enforceable capital contribution obligation, or whether creditors can sue to enforce the obligation.

As a general rule IRC Sec. 721 provides that no gain or loss is recognized by an LLC taxed as a partnership or its members upon the contribution of *property* to the LLC in exchange for a membership interest. This same rule applies to partners and partnerships This general nonrecognition rule is subject to several exceptions. It does not apply (a) to contributions that do not consist solely of property or that are made to investment companies, (b) when the contributed property is subject to liabilities or the LLC otherwise assumes member liabilities in connection with the transaction, (c) to the receipt of a capital interest in exchange for the performance of services, or (d) to contributions that are deemed to be part of a "disguised sale" of property.

A nonrecognition rule similar to IRC Sec. 721 applies to a C or S corporation. However, the rule is more restrictive since it requires the transfer to be by one or more persons solely in exchange for stock in the corporation and, immediately after the exchange those persons must control the corporation.

Contributions of services to an LLC, partnership or corporation may be taxable since they are not contributions of property.

**Liability for LLC Debts**

One of the major advantages of a limited liability company is that members are not liable for the debts of the LLC. Creditors of the LLC have recourse only against the LLC's assets, not against the member's assets (except as discussed later in this lesson). (However, in several states, members can elect to assume liability for some or all of the debts and obligations of the LLC.) In a professional LLC, members have liability under tort law for their own negligence or the negligence of those they directly supervise, but are not liable for the negligence of other members. Limited liability is also available to shareholders in a corporation, limited partners in a limited partnership (although limited partners may be liable to the extent of their capital contribution obligations), and partners in an LLP (although partners in an LLP may not have complete liability protection).

**Need for Limited Liability.** Limited liability is probably a desirable characteristic for any business. However, limited liability is obviously more beneficial when the owners have significant exposure for business debts. The existence of any of the following indicates the need to minimize exposure to business liabilities:

a. The business will incur debts to creditors, vendors, and suppliers.

b. The business will have employees whose actions can create liabilities (for example, employees will drive vehicles to make deliveries).

c. The nature of the business itself is hazardous (for example, toxic chemicals are handled or heavy equipment is used).

d. Product liabilities exist (for example, the products are hazardous or can be mishandled in ways that can result in injuries or damage to property).

e. The business will have more than a few employees. (The mere existence of employees creates exposure to liability in many ways.)

f. The business is potentially exposed to environmental liabilities (for example, almost any manufacturing or processing business and any business that owns real estate that may be contaminated or polluted).

**Members' Financial Obligations.** Under most state LLC statutes, members have certain financial obligations to the LLC under the articles of organization, operating agreement, or applicable state laws. These obligations are generally (a) obligations to make capital contributions under an enforceable capital contribution obligation; and (b) obligations to return any distribution prohibited by the statute, the articles, or the operating agreement. Fulfillment of these financial obligations is usually enforceable by the LLC's creditors. Consequently, a member has liability for LLC debts to the extent of any financial obligation the member has to the LLC under the articles, operating agreement, or state law.

**Limits on Limited Liability.** In certain situations, limited liability may not be available to members of an LLC. For example, if a general partnership is converted to an LLC, the members of the LLC who were general partners of the partnership generally are liable for debts incurred before the conversion. Additionally, although there is very little guidance in this area, LLC members may be liable in the same situations where a shareholder in a corporation would be liable if the "corporate veil" were pierced. For example, shareholders and officers can be liable for certain environmental torts of the corporation and it seems likely that an LLC member (particularly one with management responsibilities) would be held liable in the same situation. Additionally, several state LLC statutes and state regulations have now established that LLC members are liable for state taxes owed by the LLC, including sales tax.

### Allocations of Income and Loss

LLCs taxed as partnerships have considerable flexibility in allocating income and losses among members. They can allocate income and loss based on any provision in the operating agreement that has substantial economic effect. This allows the LLC to make special allocations of items of income and loss among its members. S corporations, on the other hand, must allocate income and loss among shareholders according to the percentage of outstanding stock owned by each shareholder.

**General Rule for Allocating LLC Profits and Losses.** Profits and losses of an LLC taxed as a partnership are allocated among its members in accordance with its operating agreement. (A partnership allocates income and loss to partners according to its partnerships agreement under this same rule.) However, allocations are not respected unless they are in accordance with the members' interests in the LLC or have "substantial economic effect." If an LLC has no operating agreement, the default provisions of the applicable state statute apply (as modified by the LLC's articles of organization).

In general, an allocation is not considered to be in accordance with the members' interests in the LLC or to have substantial economic effect unless it complies with the underlying economic arrangements of the members. The substantial economic effect safe harbor requires the LLC to maintain capital accounts under the complex book capital account maintenance rules of Reg. 1.704-1(b)(2)(iv).

**Example 1-1: Determining if LLC allocations have substantial economic effect.**

Nan and Rae form Two Roses LLC with cash contributions of $40,000 each. The LLC then purchases a depreciable asset for $80,000. The LLC's operating agreement provides that Nan and Rae have equal shares of all income and loss computed without regard to cost recovery deductions. They will also share equally in the LLC's cash flow and proceeds upon liquidation. However, the operating agreement provides that cost recovery deductions will be allocated to Nan. Member capital accounts will be determined and maintained in accordance with the Section 704(b) regulations. The LLC does not make an election to be taxed as a corporation. Neither member has an obligation to restore a deficit capital account. In the first year, all cost recovery deductions are allocated to Nan.

The allocation of the cost recovery deductions to Nan lacks substantial economic effect under the safe harbor rules, because the allocation of 100% of the cost recovery deductions to Nan has no economic reality. Nan will not bear the full risk of the economic loss corresponding to the cost recovery deductions since the liquidation proceeds will be allocated equally between Rae and Nan. Since the allocation lacks substantial economic effect, the cost recovery deductions must be reallocated equally between Nan and Rae.

### Ability to Obtain Financing

One potential disadvantage to operating as an LLC may be the unwillingness of banks and major suppliers to extend credit. Because of the limited liability aspects of an LLC, the creditors may ask for additional collateral or for personal guarantees by the members. In addition, the loan documents may restrict the distributions members may receive in the course of a year. However, loans to an LLC should not require any higher collateralization than loans to a closely held corporation, since the scope of limited liability for these two types of entities is significantly the same from a lender's point of view.

### Deductibility of Acquisition Interest

IRS Notice 89-35 provides that to determine the deductibility of interest on member-level debt used to purchase an interest in an LLC from another member (i.e., the LLC does not receive the cash), the debt must be allocated to the LLC's assets using any reasonable method. Reasonable methods include using FMV, book value, or adjusted tax basis (reduced by LLC-level debt allocable to the assets). Once the debt has been classified in this manner, the owner's interest expense is classified as attributable to the underlying trade or business, passive, or investment activities of the entity. The owner's interest expense is then treated under the specific rules for those categories of interest expense. Accordingly, interest on debt used to purchase an interest in an LLC operating an active trade or business is deductible business interest.

**Determination of Basis**

A member in an LLC taxed as a partnership can generally deduct his share of LLC losses up to the amount of his basis in the LLC. Like a partner in a partnership, an LLC member includes in basis not only capital contributed (or the purchase price of an interest acquired in a sale or exchange), but also the member's share of LLC liabilities. Unlike an LLC member, an S corporation shareholder's basis includes only the capital contributed plus the amount loaned directly from the shareholder to the corporation.

Under the rules of IRC Sec. 722, the basis of a member's interest in an LLC taxed as a partnership is increased each year by the amount of money (including any increase in the member's share of LLC liabilities) and the tax basis of property contributed by that member *and* the member's share of LLC income (both taxable and tax-exempt). The basis of the member's interest is decreased each year by the amount of money (including any decrease in the member's share of LLC liabilities) and the tax basis of property distributed to that member *and* the member's share of LLC losses (whether or not deductible for tax purposes). A member's basis in an LLC interest cannot be reduced below zero.

A shareholder's basis in acquired stock is the amount paid for the stock or the amount of money plus the adjusted basis on any property contributed to the corporation in exchange for the stock. An S shareholder's basis is annually adjusted by various items of corporate income, loss, and deduction that pass through, as well as by, distributions to the shareholders. Conversely, the basis of stock in a C corporation is not affected by the profits and losses of the corporation.

**Basis from LLC Debt.** The calculation of a member's share of liabilities is critical in determining whether a member in an LLC taxed as a partnership will have enough basis to deduct allocated losses. There are different rules for allocating recourse and nonrecourse liabilities under IRC Sec. 752. Because of the limited liability afforded LLC members, an LLC will seldom have recourse liabilities. Most LLC debts will be nonrecourse debts secured by LLC property or exculpatory debts (debts that are recourse to the LLC or that are nonrecourse debts secured by all the LLC's assets, but for which no member has an economic risk of loss). Exculpatory debts generally are allocated under the rules for allocating nonrecourse debts.

Partners in a partnership include debt in the basis of their partnerships interests under the rules described previously (except partnerships generally do not have any exculpatory debt). Shareholders in an S corporation, however, can only include direct loans from the shareholder to the corporation in basis.

**Loans Made or Guaranteed by Members or Member Affiliates.** Special rules apply to nonrecourse loans that are made or guaranteed by members or affiliates of members in LLCs taxed as partnerships. If an LLC debt is owed to a member or an affiliate of a member, or is guaranteed by a member or an affiliate of a member, basis from the debt generally will be allocated 100% to the member who made or guaranteed the loan, or whose affiliate made or guaranteed the loan.

**Optional Basis Adjustment.** As discussed earlier in this lesson, an LLC taxed as a partnership can make an election under IRC Sec. 754 to adjust the basis of the LLC's assets in certain situations. The optional basis adjustment is available upon the transfer of an interest in the LLC (by sale or exchange or upon the death of a member) or when the LLC makes certain current or liquidating distributions. A mandatory basis adjustment may be required in certain circumstances. The optional basis adjustment is also available to partners and partnerships.

**Compensation of Owners and Fringe Benefits**

**Compensation of Members.** While a member of an LLC taxed as a partnership cannot be an employee of the LLC in which he owns an interest, he can perform services for the LLC either as a member or as an independent contractor. This same rule applies to partners in partnerships. The capacity in which services are performed is a question of fact. The structure and documentation of the arrangement are also important. If services are performed as a third party, the compensation received by the member is taxed under the rules that generally apply to payments to third parties, subject to limitations that apply to related party transactions. If services are provided in a member's capacity as an owner, the member can be compensated through special allocations of income or guaranteed payments.

**Member's Compensation May Be Self-employment (SE) Income.** Since a member's receipt of compensation for services as an independent contractor is generally treated the same as the receipt of compensation from an unrelated third party, it is subject to SE tax. Application of the SE tax rules to member compensation is governed by IRC Sec. 1402, including Prop. Reg. 1.1402(a)-2. Payments for services characterized as guaranteed payments are subject to self-employment tax. If a payment for member services is a special allocation of income, Prop. Reg. 1.1402(a)-2 provides that the allocated income is subject to SE tax if the member (a) has personal liability for debts, (b) has authority to contract on behalf of the LLC, or (c) participates in the LLC's trade or business for more than 500 hours during the tax year. This proposed regulation represents the current position of the service on an LLC member's liability for SE taxes.

Proposed Reg. 1.1402(a)-2 has not been finalized as of the completion date of this course. Given the criticism the IRS and Treasury received after the proposed regulations were issued, no new regulations are likely to be issued until after Congress addresses the issue. Consequently, the current climate for determining the SE income of LLC members is uncertain. In all likelihood, a set of rules similar to the proposed regulations will be issued. (In fact, an IRS spokeswoman indicated in June 2003 that taxpayers who conform to the proposed regulations will not be challenged.)

Accordingly, taking a position that active members of an LLC are not subject to SE tax risks the assessment of significant interest and penalties. Taking such a position also exposes the LLC to the risk of having the anti-abuse regulations invoked to impose the SE tax. Practitioners should be aware that claiming non-SE status for LLC members can result in the IRS arguing that the members are "limited entrepreneurs," making the cash method of accounting unavailable to the LLC. Excluding a member's LLC income from SE tax may also limit the member's retirement plan contribution. A significant advantage of operating as an S corporation rather than an LLC is that a shareholder's distributive share of S corporation income is not treated as SE income.

**Special Corporate Taxes**

C and S corporations are subject to some special taxes that do not apply to LLCs and their members. These taxes include the excess net passive income tax on S corporations (IRC Sec. 1375) and the personal holding company tax (IRC Sec. 541) and accumulated earnings tax (IRC Sec. 531) applicable to C corporations. See *PPC's 1120S Deskbook* and *PPC's 1120 Deskbook* for more information on when these taxes apply.

**Nontaxable Fringe Benefits Not Available to Members.** The Internal Revenue Code provides for a number of fringe benefits that are not taxable to employees and are deductible by a C corporation if the compensation can be characterized as an ordinary and necessary expense. LLCs are able to offer employees the same fringe benefits as other business entities. However, members generally are excluded from the definition of employee for fringe benefit purposes. Consequently, an LLC is not able to deduct certain fringe benefits payable to or on behalf of members without the members recognizing income. When several of the most common types of fringe benefits are provided to members, the costs are treated as guaranteed payments (assuming they are provided regardless of LLC income and for services rendered in the member′s capacity as a member). The LLC deducts the costs as guaranteed payment expenses, and the guaranteed payments represent income to the members for whom the benefits are provided. Unless the amounts qualify as medical expenses or other specifically deductible items at the member level, the members cannot deduct them in computing their individual taxable incomes.

IRS Pub. 15B, Employer's Tax Guide to Fringe Benefits, provides that fringe benefits covered by these rules (includable in the member's income) include (a) payments under accident and health plans (including contributions to Archer MSAs and HSAs, long-term care insurance, disability insurance, and payments under a medical reimbursement plan); employee achievement awards]; adoption assistance programs; group term life insurance up to $50,000; meals or lodging provided on the employer's premises; moving expense reimbursements; and qualified transportation benefits. These benefits are not excludable from the income of a member.

**Nontaxable Employee Benefits Available to Members.** IRS Pub. 15B provides that certain other nontaxable employee benefits are specifically available to members, including:

a. Athletic facilities (excludable by members who perform services for the LLC);

b. *De minimis* benefits (excludable by members who perform services for the LLC)—these include such things as death benefits, company parties or picnics, tickets for entertainment or sporting events, etc.);

c. Dependent care assistance (excludable by members who perform services for the LLC);

d. Educational assistance (excludable by members who perform services for the LLC);

e. Employee discounts (excludable by members who perform services for the LLC);

f. *De minimis* meals, which are also not subject to the 50% meals limitation (this includes meals furnished at certain employer-operated eating facilities, unless provided to a "highly compensated employee");

g. No-additional-cost services (excludable by members who perform services for the LLC)—these are services that do not cause the employer to incur any substantial additional costs and are offered to customers in the ordinary course of business;

h. Working condition benefits (excludable by members who perform services for the LLC)—this includes company cars and job-related education;

i. Retirement planning services;

j. Tuition reduction programs; and

k. Health savings accounts, which can be treated as either distributions or guaranteed payments.

**Special Deduction for Health Insurance.** LLC members generally may deduct 100% of the cost of medical insurance paid on their behalf as an "above the line" deduction.

**Management**

One major advantage of an LLC is its flexibility with regard to management of the entity. Most LLC statutes allow management of the LLC either by all the members or by appointed managers. (Appointed managers may or may not be members of the LLC.) This is similar to the way general partnerships or corporations are managed in that the owners (the partners or shareholders) can choose whether the partnership or corporation will be managed by the owners or by managers appointed or elected by the owners.

**Opportunity for Limited Liability Coupled with Management Participation.** An important advantage of doing business as an LLC over doing business as a limited partnership is the opportunity for all members to participate in management, while maintaining their limited liability. A *limited partner* who is involved in the management of the business of a limited partnership loses his limited liability shield.

**Taxation of Distributions**

Distributions from LLCs taxed as partnerships are usually nontaxable, while distributions by a C or S corporation can be taxable dividend income to the extent the corporation has accumulated earnings and profits. However, distributions from an LLC are not always nontaxable. Certain distributions of cash and marketable securities, distributions of hot assets, and some liquidating distributions can result in a member recognizing gain or loss. Distributions may also be taxed if made to a contributor of appreciated property or when previously contributed property is distributed to a member other than the contributing member. In addition, certain distributions may not be taxed as distributions if they are part of a "disguised sale" of property or of an LLC interest between the LLC and a member (or between two members). The rules discussed in this paragraph that apply to an LLC classified as a partnership also apply to general and limited partnerships.

Most state acts require that distributions be made to members in the manner and at the time provided for in the LLC's operating agreement, or if there is no provision in the operating agreement, distributions are required to be made at the time of a member's withdrawal or upon dissolution of the LLC. State LLC acts usually do not require that an LLC make any distributions prior to dissolution (or withdrawal by a member). Distributions generally are required to be allocated to members based on the relative values of their contributions. Under many state statutes, distributions from an LLC are *not* permitted if the LLC is insolvent or if the LLC would be rendered insolvent by the distributions. LLC statutes usually make members personally liable for the return of such improper distributions. Practitioners should also note that if management of the LLC has unfettered discretion to make or withhold distributions, any gift of an interest in the LLC may be treated as a gift of a future interest not qualifying for the annual gift tax exclusion.

**Retirement or Death of Owners**

Payments from an LLC taxed as a partnership to a retiring member (or deceased member's successor in interest) are subject to the provisions of IRC Sec. 736 (which also applies to partners and partnerships). These rules differentiate between the treatment of Section 736(a) payments for unrealized receivables and goodwill (which are deductible by the LLC and ordinary income to the retiring member), and Section 736(b) payments for the retiring member's share of LLC property (which are not deductible by the LLC and result in capital gain to the extent they exceed the retiring member's basis in the LLC). Payments made to a member retiring or dying on or after January 5, 1993, can be treated as deductible Section 736(a) payments only if the payments are made to a "general partner in a partnership in which capital is not a material income-producing factor" (generally, those in service businesses). It is not clear how this provision is applied to LLCs. Under state law a member in an LLC is not a general partner and as such there is some doubt that payments made to a retiring or deceased member of an LLC would qualify for this exception. However, members who participate in the management of or are active in an LLC will be treated as general partners for purposes of applying the Section 736 rules. The uncertainty in this area may make it less advantageous for professional service organizations to be organized as LLCs if members are considering retirement in the near future. It may be more advantageous for such organizations to organize as an LLP.

Most state LLC statutes are silent on the treatment of a retiring member, except to provide that members either cannot withdraw or that they can withdraw upon 30 days to six months written notice to the LLC. Most statutes require that, if withdrawal is permitted, the withdrawing member be paid the fair value of his interest within a reasonable period of time after his withdrawal. Generally, a reasonable time does not mean extended payments over several years. Clients should be advised to specifically provide an extended payout period for retirement payments in the operating agreement to prevent this issue from arising. The provisions of the applicable state act should be carefully reviewed when drafting the operating agreement provisions dealing with member withdrawals.

**Applicable Tax Rates**

In the past, by maximizing the use of the lower corporate rates, a C corporation and its shareholders could pay significantly less overall current tax than the shareholders alone would pay if all corporate income was passed through to them by an LLC, an LLC classified as a partnership, or an S corporation. This frequently made operation as a C corporation attractive, where the double tax on C corporation liquidation was far enough in the future to cause the present value of the additional tax on liquidation to be a small amount. However, with the reduction in individual tax rates, the maximum marginal rate for individual taxpayers was the same as that for corporations (although the tax brackets that apply to individuals and corporations were different). Accordingly, corporations did not pay tax at a lower rate than individuals.

Beginning in 2011, the top individual income tax rates are scheduled to increase to 39.6% and 36%. The maximum rate on adjusted net capital gain of an individual is scheduled to be 20% (18% for property purchased after 2000 and held more than five years). In addition, any adjusted net capital gain otherwise taxed at a 15% rate is scheduled to be taxed at a 10% rate (8% for property held more than five years). The tax rate on qualified dividend income will rise from its current 15% to ordinary income rates (and so up to 39.6%). When the 3.8% health care surtax on unearned income of individuals earning more than $200,000 per year ($250,000 for married couples) goes into effect in 2013, the dividend tax will become the highest income tax in the country. These increased rates will result in individuals paying significantly higher income taxes on the pass through of partnership and LLC income. It is uncertain if Congress will lower the scheduled rate increases. When making a choice of entity decision, practitioners should be aware of the uncertainty concerning tax rates in future years and monitor legislative activity in this area.

A Congressional Research Service (CRS) Report dated February 26, 2010, *Distribution of Small Business Ownership and Income by Individual Tax Rates and Selected Policy Issues*, examined whether an increase in marginal tax rates on high-income individuals without changing the top corporate or capital gains tax rates would increase the share of firms organized as C corporations rather than pass-through entities. The analysis indicates that few small business owners face the current top tax rates of 33% and 35%, and that less than 2% of tax filers in those brackets reported any small business income. Instead, a majority of small business owners are subject to marginal tax rates ranging from 0% to 15%. From this information, it would appear that only a small percentage of individual taxpayers who own and are actively involved in the management of small businesses would be affected by an increase in the top two individual tax rates.

The report presents an analysis constructed on a series of simplified investment scenarios involving a partnership and a C corporation, comparing their after-tax profitability. The analysis found that small business owners subject to the top individual and capital gains tax rates appear to be better off operating as a partnership or an LLC classified as a partnership rather than a C corporation under both current law and the proposed changes in the maximum individual, corporate, and long-term capital gains tax rates. Under current law, an LLC/partnership would earn an after-tax rate of return that is two percentage points greater over one year, 1.5 percentage points greater over five years, and 1.1 percentage points greater over 10 years.

Boosting the top individual rate to 39.6% while holding the other two rates constant narrows the gap significantly, but the partnership still comes out ahead over one year and 10 years. A partnership would realize a greater after-tax rate of return in all three periods when the top individual rate is 39.6%, the top capital gains rate is 20%, and the top corporate rate is 35%. A reduction in the corporate rate to 30.5%, coupled with no change in the other two rates, results in a greater after-tax rate of return over one year and five years for a partnership, although a corporation would gain a slight edge over 10 years.

### Liquidations and Terminations

**Liquidations.** Unlike the liquidation of a C corporation, which usually results in a tax liability at both the corporate and shareholder levels, the liquidation of an LLC taxed as a partnership generally is not a taxable event. (For an S corporation, the risk of double taxation results from the possible imposition of the corporate-level built-in gains tax.) Gain is not recognized on a liquidating distribution by an LLC to a member except to the extent any cash or marketable securities distributed exceeds the adjusted basis of the member's interest in the LLC immediately before the distribution. A loss is not recognized except in certain situations when only cash, receivables, or inventory are distributed in complete liquidation of the member's interest. There are also other exceptions to the nonrecognition rules including when the hot asset rules of IRC Sec. 751 apply to a disproportionate liquidating distribution (however, this exception does not apply to prorata distributions), when a distribution is to a member who previously contributed appreciated property or is a distribution of contributed property to a member other than the member who contributed it (unless certain exceptions to these rules apply), or when a distribution to a retiring member or deceased member's successor in interest is taxed as a Section 736(a) payment.

**Terminations.** The continuation or termination of an LLC for state law purposes has no effect on whether an LLC terminates for federal tax purposes. For tax purposes, the termination of an LLC taxed as a partnership occurs *only* upon the occurrence of one of the two following events described by IRC Sec. 708:

a. No part of any business, financial operation, or venture of the LLC continues to be carried on by any of the members as an LLC or partnership.

b. There is a sale or exchange of 50% or more of the total interest in LLC capital and profits within a 12-month period (a "technical termination").

The legal termination of a corporation results in a liquidation for tax purposes and the resulting recognition of gain or loss by the shareholders. C corporations are subject to two levels of tax upon liquidation. First, the corporation must recognize gain to the extent that the FMV of its assets exceeds their adjusted basis; and second, the shareholders must recognize gain to the extent that the amount they receive in liquidation exceeds the adjusted basis of their stock. Although C and S corporations are subject to a double tax on liquidation, the pass-through of income and loss to S corporation shareholders and related basis adjustment effectively result in the avoidance of double taxation. However, substantial tax may be incurred when the S corporation is subject to the built-in gains tax.

In recent years, the difference between individual and corporate rates has been negligible, minimizing any benefits that might have been realized from operation as a C corporation. (In the past, the cost of C corporation double taxation has been at least partially offset by generally lower corporate tax rates.) Beginning in 2011, the top individual income tax rates are scheduled to increase to 39.6% and 36%. The maximum rate on adjusted net capital gain of an individual is scheduled to be 20% (18% for property purchased after 2000 and held more than five years). In addition, any adjusted net capital gain otherwise taxed at a 15% rate is scheduled to be taxed at a 10% rate (8% for property held more than five years). Qualified dividend income will rise from its current 15% to ordinary income rates (and so up to 39.6%). These increased rates will result in individuals paying significantly higher income taxes on the pass through of partnership and LLC income. It is uncertain if Congress will enact legislation to lower the scheduled rate increases. Practitioners should monitor activity in this area.

**Technical Termination.** If an LLC taxed as a partnership terminates because of a 50% or more change in ownership, the LLC is deemed to transfer all of its assets and liabilities to a new LLC in exchange for all the ownership interests in the new LLC. Immediately thereafter, the terminated LLC is deemed to distribute interests in the new LLC to the acquiring member and the continuing members in liquidation of the terminated LLC. This deemed series of events protects members from certain adverse tax consequences that occurred under the regulations previously in effect. However, the short tax year created by termination of an LLC still may require certain members to report more than 12 months of LLC income in a single year. Because of the problems associated with the technical termination of an LLC, the LLC's operating agreement may provide that no transfer of an interest in the LLC is valid until the LLC's attorney provides an opinion that the transfer will not terminate the LLC.

**State Law Provisions Regarding Dissolution.** Most state LLC statutes provide an LLC will terminate on the dissolution date specified in its organizational documents or upon the occurrence of an event specified in the LLC's articles of organization or operating agreement. In addition, some statutes require an LLC to dissolve upon the occurrence of an event of cessation of membership. Such events generally include the death, insanity, bankruptcy, retirement, resignation, or expulsion of a member. The LLC can usually be continued after an event of cessation of membership if the remaining members consent to the continuation within 90 days. This vote to continue may not be automatic if the LLC is experiencing difficulties. If the LLC is not continued, problems may arise regarding property title and rights to property. As previously discussed, the dissolution of an LLC for state law purposes does not cause the LLC's termination for tax purposes unless one of the two events described previously occurs. Consequently, the state statute provisions governing dissolution are not controlling for tax purposes. The default provisions regarding dissolution in the state statute can usually be easily overridden by provisions in the articles of organization or operating agreement. However, LLCs with operating agreements that include provisions to override dissolution provisions of the state LLC act should monitor amendments to the act so that those provisions can be removed if they become unnecessary under the revised state law.

### Availability of LLC Status

All 50 states and the District of Columbia have passed LLC legislation. Although a Uniform Limited Liability Company Act has been drafted and enacted in slightly differing forms by several states, it is unlikely the Act will be widely passed in the near future because of significant differences between the various state LLC acts. (Practitioners should be aware that a Revised Uniform LLC Act was issued in 2006, however, it has not yet been adopted by any state.)

### Tax Issues

One of the major problems in operating a business as an LLC is the unresolved or unusual issues related to the tax and nontax treatment of LLCs. A discussion of some of the unresolved tax issues with regard to LLCs and their members follows.

**At-risk Rules.** A member may deduct LLC losses only to the extent the member is at risk. A member is considered at risk for an activity with respect to the amount of money and the adjusted basis of other property contributed by the member to the activity. A member can also include in his amount at risk the share of LLC debts for which he is ultimately liable. However, under currently proposed regulations, a member's guarantee of LLC debt does not increase the member's amount at risk. (The provisions regarding loan guarantees are included in proposed regulations that have not been finalized since 1979. There is some thought that these regulations may no longer be valid or may not apply to guarantees by LLC members.) Nonrecourse debt of the LLC also does not increase a member's at-risk amount, unless it is qualified nonrecourse financing. Qualified nonrecourse financing includes certain types of nonrecourse debt secured by real estate and borrowed from a qualified person.

Because the debts of an LLC generally do not increase a member's amount at risk, many LLC members with enough basis to deduct their share of LLC losses may be unable to deduct the losses under the limitations imposed by the at-risk rules.

**Passive Activity Loss (PAL) Rules.** A member successfully negotiating the at-risk rules may still be unable to deduct all of his losses from the LLC because of the application of the PAL rules. Generally, IRC Sec. 469 defines a *passive activity* as (a) any activity that involves the conduct of a trade or business in which the taxpayer *does not materially participate* and (b) any rental activity.

The PAL rules separately address the participation of general partners and limited partners. Limited partners must meet more stringent requirements than general partners to demonstrate material participation. Based on Temp. Reg. 1.469-5T(e)(3)(i)(B) it appears that LLC members are treated as limited partners. The IRS Passive Activity Loss Audit Technique Guide (ATG) also indicates that LLC members should be treated as limited partners even if the taxpayer is a member-manager. However, under the material participation rules, the 500-hour test, 5-of-10-year test, and 3 prior years personal service test can be used to exempt the member from limited partner status. The ATG is not an official pronouncement by the IRS. Consequently, no formal guidance has been issued by the IRS in this area. However, in the *Gregg* decision, the U.S. District Court for Oregon held that an LLC member was not subject to the higher material participation standard applicable to limited partners, but only had to satisfy one of the regular seven material participation tests. Practitioners should note that Oregon's partnership law defines limited partners based on a limited partner's inability to control the partnership rather than the partner's limited liability.

**Tax Matters Partner.** The consolidated audit rules that apply to most LLCs require the designation of a Tax Matters Partner (TMP) to interact with the IRS on audits of LLCs. IRC Sec. 6231(a)(7) provides that the TMP is the general partner designated by the partnership or, if there is no general partner designated, the general partner holding the largest profits interest in the partnership at the close of the tax year involved. If neither of these rules can be applied, other provisions are made for the designation of the TMP.

If an LLC is treated as a partnership for tax purposes, the partnership audit procedures apply and a member-manager of the LLC should be designated as the TMP. The final regulations provide that, subject to certain restrictions, any member-manager of an LLC can be the TMP.

**Cash Method of Accounting.** The IRS has made several rulings on whether an LLC can use the cash method of accounting. These rulings are interpretations of how IRC Sec. 448 is applied to LLCs taxed as partnerships.

**Retirement Payments to Members.** The rules for taxing retirement payments to members in an LLC taxed as a partnership include provisions that allow deductible Section 736(a) payments for a member's interest in unrealized receivables and goodwill. However, this deduction is only available for certain payments made to a general partner in a partnership in which capital is not a material income-producing factor.

### Application of Electing Large Partnership Rules

If an LLC classified as a partnership meets certain requirements, the electing large partnership rules may apply. In general, an electing large partnership is defined as a partnership with 100 or more partners in the preceding partnership tax year that elects to be treated as a large partnership. The election to be treated as a large partnership is applicable for the year made and for all subsequent years unless revoked with the consent of the IRS. The election is not available for partnerships in which the partners (a) perform substantial services in connection with the partnership's activities; (b) are retired partners, who had performed such substantial services; or (c) are spouses of partners who are performing or had previously performed such services. Electing large partnerships file Form 1065B and are required to furnish Schedules K-1 to partners on or before the first March 15 following the close of the partnership's tax year.

### State Law Requirements

Specific state LLC statutes may impose requirements on LLCs and their members that are not imposed on shareholders in an S or C corporation or partners in a partnership. Specifically, the applicable state statute may limit the transferability of interests in the LLC, limit the ability of a member to withdraw from the LLC, or require the LLC to have a definite term of existence. Usually the default provisions in the applicable state LLC act can be overridden by provisions in the LLC's articles of organization or operating agreement, but this is not always the case.

### Availability to Creditors

A creditor of a member in an LLC taxed as a partnership has limited power to satisfy his claim with the member's interest in the LLC. The creditor can obtain a "charging order" from the courts against the interest. This charging order allows the creditor to receive the distributions that would have been made to the debtor-member. The creditor has no right to the LLC's assets nor can he have any effect on the LLC's management or operations. If the charging order does not satisfy the claim within a reasonable time, the creditor can obtain a permanent right to the LLC's distributions, which may exceed the amount of the debt in question. Practitioners should note that a Colorado Bankruptcy Court ruled that there was no charging order protection for a single-member LLC. Instead, the court allowed the Bankruptcy Trustee to take control of the single-member LLC and sell all of its assets. Single-member LLCs formed or operating in Colorado should take note of this decision if asset protection is of prime concern. Practitioners should monitor new rulings in Colorado and other states for more on this issue.

## THE LIMITED LIABILITY PARTNERSHIP (LLP) AS THE ENTITY OF CHOICE

Another type of limited liability entity is the limited liability partnership (LLP) or registered limited liability partnership (RLLP). This type of entity is similar in many respects to the LLC. All states now have LLP statutes.

### Differences between LLCs and LLPs

LLPs are special general partnerships (or limited partnership in some instances) that exist under state law. LLPs arose in response to the personal liability problems faced by partners in law and accounting partnerships, as a result of the many malpractice claims related to thrift and financial institution failures.

In some states, partners in an LLP are personally liable for the commercial and other general obligations of the partnership, and for their own errors and omissions and the errors and omissions of persons under their supervision, but are not liable for errors and omissions by their partners or by employees under another partner's supervision. However, in most states, LLP partners have the same blanket liability protection as LLC members. LLP partners in these states are not liable for the commercial or other obligations of the partnership (but remain liable for their own errors and omissions or those of employees under their supervision).

Because partners in an LLP generally enjoy a higher degree of limited liability than enjoyed by partners in a general or limited partnership, many state statutes require LLPs to carry a specific amount of liability insurance. The amount of insurance required can be as much as several million dollars.

The administrative burdens of converting an existing partnership to an LLP or adopting LLP status for a professional practice (for example, meeting the state board of accountancy rules) are minimal in comparison to converting to or forming an LLC.

### Key Tax and Nontax Considerations

LLPs are general partnerships under state law with modifications regarding personal liability. (Limited partnerships can also be LLPs in some states.) Consequently, LLPs have the benefits common to partnerships.

**Formation.** Unlike the formation of an LLC, which generally requires the filing of articles of organization and drafting of an operating agreement, an existing partnership can usually become an LLP by simply filing a registration statement. No amendment of the agreement is otherwise required. While the fee for filing an LLC's articles of organization is usually minimal, the fee for registering an LLP can be significant, particularly when the fee is a function of the number of partners.

**Insurance Requirements.** As previously mentioned, some states require LLPs to maintain a specific amount of liability insurance. The cost of maintaining such coverage may be substantial. However, partnerships formed to conduct a professional services business, such as an accounting firm, will generally already carry significant amounts of malpractice insurance.

**Liability for Debts.** In many states, partners in an LLP and members in an LLC enjoy the same type of liability protection—i.e., they have no liability for debts of the entity or for the wrongful conduct of another partner or member. In other states, however, an LLP member is only protected from liability for the wrongful conduct of another partner. In such states, an LLP partner remains jointly and severably liable for the LLP's debts and other contractual obligations. Most states provide that the liability protection afforded to a partner in a foreign LLP (i.e., an LLP formed in another state) is governed by the law in the state of formation. Like other business entities, partners in an LLP may be liable for certain debts of the partnership. For example, the partners may be liable for environmental torts or ERISA claims due to breaches of fiduciary relationship with respect to a qualified plan.

**Provisions of Governing Laws.** LLPs generally are formed and governed under the provisions of the version of the uniform partnership act adopted by the state of formation. LLCs, on the other hand, are formed and governed under the specific provisions of the state of formation's LLC act. Because different laws govern LLCs and LLPs, there may be significant differences in the rules pertaining to distributions, withdrawals, management, and many other matters. Practitioners should review state law provisions to determine the differences.

**Single-member Entities.** An LLP must have more than one member while an LLC can have a single member. Under the default rule in the regulations, a single-member LLC is not treated as an entity separate from its owner. Alternatively, a single-member LLC can elect to be taxed as a corporation.

**LLP Compliance Necessary.** It is unclear whether the limited liability available to partners in an LLP disappears if the LLP fails to comply with state requirements. Delaware has recently indicated that an LLP that fails to comply with the state LLP act or the state filing requirements returns to general partnership status (i.e., the partners lose their limited liability protection). Practitioners should make sure clients forming an LLP know the importance of continued compliance with state requirements.

## SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

1. Jack, an individual taxpayer, forms JJ Company; a single member LLC. He also owns all the shares of KK Corp., a C corporation. The single member LLC can do which of the following?

   a. Elect to be treated as a partnership.

   b. Elect to be treated as a branch of KK Inc.

   c. Elect to be treated as a corporation.

   d. Must be treated as a sole proprietorship.

2. Janet purchases a 50% interest in LL Company, an LLC that is treated as a partnership, for $20,000 cash. For the current year, LL passes through $15,000 of ordinary income, tax-exempt interest income of $12,000, and a capital loss of $5,000 to Janet. It also distributes $2,500 in cash to Janet during the year. LL has no liabilities at either the beginning or end of the year. What is Janet's basis in the LLC at the end of the year?

   a. $27,500.

   b. $30,000.

   c. $39,500.

   d. $41,500.

3. Taking the position that an active member of an LLC is **not** subject to self-employment taxes can cause the IRS to make which of the following rulings?

   a. The LLC has lost the right to use the cash method of accounting.

   b. The LLC has lost the right to use a fiscal year.

   c. The LLC has lost the ability to provide nontaxable fringe benefits to its members.

   d. The company is no longer eligible to operate as an LLC.

4. Some LLCs taxed as partnerships have no provision for distributions in their operating agreements. Which of the following statements relating to such LLCs is correct?

   a. Most states require that the LLC make distributions at least annually.

   b. Most states require distributions, even if it makes the LLC insolvent.

   c. Most states require that distributions be made when a new member is admitted to the LLC.

   d. Most states require that distributions be made when a member withdraws from the LLC.

5. Janet owns 50% of JJ Company (JJ), an LLC taxed as a partnership. Martin, one of Janet's creditors, obtains a judgment against her, and is granted a charging order that applies to JJ. Which of the following actions can Martin take?

    a. Martin can take enough of JJ's property to satisfy the judgment.

    b. Martin can receive distributions from JJ that otherwise would have been made to Janet.

    c. Martin can force changes in JJ's management team to increase his chances of recovering the amount owed to him.

    d. Martin can require JJ to remit to him JJ's share of the profits until the debt is satisfied.

6. Which of the following statements is the most accurate?

    a. All state laws allow LLCs and most, but not all, also have LLP statutes.

    b. Partners in an LLP generally are provided with a higher degree of limited liability than partners in a general or limited partnership.

    c. LLPs can be a general partnership, but not a limited partnership.

    d. All states that have LLP statutes provide LLP partners with the same blanket liability protection as LLC members.

## SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

1. Jack, an individual taxpayer, forms JJ Company; a single member LLC. He also owns all the shares of KK Corp., a C corporation. The single member LLC can do which of the following? **(Page 4)**

   a. Elect to be treated as a partnership. [This answer is incorrect. A single member LLC does not have the option of electing partnership treatment. However, a single member LLC is treated as a division or branch of a partnership if the LLC is owned by the partnership. In this scenario, the LLC is owned by an individual.]

   b. Elect to be treated as a branch of KK Inc. [This answer is incorrect. A single member LLC is treated as a division or branch of a corporation if the LLC is owned by the corporation. Here, the LLC is owned by an individual.]

   **c. Elect to be treated as a corporation. [This answer is correct. If no election is made, a single member LLC is treated as a disregarded entity, which means that the LLC is considered to be the same tax entity as its owner. However, the LLC can be treated as a corporation, if it so elects as stated in IRS code.]**

   d. Must be treated as a sole proprietorship. [This answer is incorrect. If no election is made, a single member LLC is considered to be a disregarded entity, i.e., the same tax entity as its owner. This means that JJ Company would generally be treated as a sole proprietorship. However, the LLC has the option of electing to be treated as a specific type of separate entity.]

2. Janet purchases a 50% interest in LL Company, an LLC that is treated as a partnership, for $20,000 cash. For the current year, LL passes through $15,000 of ordinary income, tax-exempt interest income of $12,000, and a capital loss of $5,000 to Janet. It also distributes $2,500 in cash to Janet during the year. LL has no liabilities at either the beginning or end of the year. What is Janet's basis in the LLC at the end of the year? **(Page 7)**

   a. $27,500. [This answer is incorrect. Even though it is tax-exempt, the $12,000 of interest income increases Janet's basis in the LLC.]

   b. $30,000. [This answer is incorrect. Janet's basis is increased by the $12,000 of tax-exempt interest income and reduced by the $2,500 distribution.]

   **c. $39,500. [This answer is correct. Janet's basis in the LLC is increased by the original purchase price of the LLC interest and the income items passed through to her. Basis is reduced by loss items and distributions.]**

   d. $41,500. [This answer is incorrect. The capital loss reduces the member's basis by $5,000, even though the entire capital loss may not be allowable at the individual level because of the $3,000 capital loss limitation.]

3. Taking the position that an active member of an LLC is **not** subject to self-employment taxes can cause the IRS to make which of the following rulings? **(Page 8)**

   **a. The LLC has lost the right to use the cash method of accounting. [This answer is correct. The IRS can argue that the members of the LLC are "limited entrepreneurs," which would mean that the LLC could not use the cash method of accounting.]**

   b. The LLC has lost the right to use a fiscal year. [This answer is incorrect. The IRS can assess significant penalties and interest when a taxpayer should have paid self-employment tax, but has not used loss of a fiscal year as a deterrent to avoiding that tax.]

c. The LLC has lost the ability to provide nontaxable fringe benefits to its members. [This answer is incorrect. The IRS has not used loss of nontaxable fringe benefits as a deterrent to avoiding self-employment tax, but may assess significant penalties and interest to taxpayers who do not pay self-employment tax as required.]

d. The company is no longer eligible to operate as an LLC. [This answer is incorrect. Loss of the ability to operate as an LLC is not one of the potential consequences of failing to pay self-employment taxes, but the IRS can assess significant penalties and interest for such failure.]

4. Some LLCs taxed as partnerships have no provision for distributions in their operating agreements. Which of the following statements relating to such LLCs is correct? **(Page 10)**

   a. Most states require that the LLC make distributions at least annually. [This answer is incorrect. Under these conditions, most states do not require specific times that distributions must be made, unless the LLC dissolves or other specific circumstances occur.]

   b. Most states require distributions even if it makes the LLC insolvent. [This answer is incorrect. Under many state statutes, distributions from an LLC are not permitted if the LLC is insolvent or if the LLC would be rendered insolvent by the distributions.]

   c. Most states require that distributions be made when a new member is admitted to the LLC. [This answer is incorrect. Most states do not carry such a requirement, but may require that distributions be made when the LLC dissolves or when other specific circumstances occur.]

   **d. Most states require that distributions be made when a member withdraws from the LLC. [This answer is correct. Under these conditions, most states require that distributions be made when a member withdraws or when the LLC dissolves per state statutes.]**

5. Janet owns 50% of JJ Company (JJ), an LLC taxed as a partnership. Martin, one of Janet's creditors, obtains a judgment against her, and is granted a charging order that applies to JJ. Which of the following actions can Martin take? **(Page 14)**

   a. Martin can take enough of JJ's property to satisfy the judgment. [This answer is incorrect. A creditor can recover from a LLC in certain ways, but has no right to the LLC's assets as defined in the charging order.]

   **b. Martin can receive distributions from JJ that otherwise would have been made to Janet. [This answer is correct. A charging order allows the creditor to receive the LLC member's distributions. If the claim is not satisfied within a reasonable time, the creditor can obtain a permanent right to such distributions, even if the distributions exceed the debt owed to the creditor.]**

   c. Martin can force changes in JJ's management team to increase his chances of recovering the amount owed to him. [This answer is incorrect. The charging order gives the creditor certain rights, but the creditor has no right to have an effect on the LLC's management or management.]

   d. Martin can require JJ to remit to him JJ's share of the profits until the debt is satisfied. [This answer is incorrect. The charging order provides the creditor with certain rights, but taking a share of the LLC's profits is not one of these rights.]

6. Which of the following statements is the most accurate? **(Page 14)**

   a. All state laws allow LLCs and most, but not all, also have LLP statutes. [This answer is incorrect. All states recognize LLPs.]

   **b. Partners in an LLP generally are provided with a higher degree of limited liability than partners in a general or limited partnership. [This answer is correct. Because of this high degree of limited liability that most states provide to LLP partners, many states require LLPs to carry a specific amount of liability insurance.]**

c. LLPs can be a general partnership but not a limited partnership. [This answer is incorrect. LLPs are special general partnerships or, under some circumstances, limited partnerships.]

d. All states that have LLP statutes provide LLP partners with the same blanket liability protection as LLC members. [This answer is incorrect. The level of liability protection can differ from state to state.]

# MARITAL AND COMMUNITY PROPERTY CONSIDERATIONS

The rules governing marital property vary significantly between common law and community property states. Forty-one states (all states other than Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin) and the District of Columbia adhere to the common law rules.

In common law states, property is treated as it is titled, except when dividing marital property in a divorce proceeding. Property held concurrently (e.g., jointly) by spouses in common law states is under the control of each spouse, and either spouse can dispose of the entire amount of concurrent property, except in the case of tenancy by the entirety property, which requires the consent of both spouses. In common law states, property acquired in the name of one spouse (separate property) is under the exclusive control of the owner/spouse, and the other spouse has no rights in the separate property of the owner/spouse until a divorce occurs. Therefore, unless a divorce is imminent, the separate property of one spouse is not subject to the liabilities of the other spouse.

Generally, in community property states, married persons have two types of property: separate property and community property. Unlike common law states, community property states look to the source of the property (not the name in which it is titled) to determine the character of the property. In most community property states, the property statutes specifically describe the types of property that are separate property and define community property as all property other than separate property. Generally, each spouse has sole control over his or her separate property and the separate property is liable for the debts of the spouse who owns it but not the debts of the other spouse. In community property states, a spouse's separate property generally includes (a) property acquired prior to the marriage; (b) property acquired during the marriage by gift, inheritance, or personal injury damages award; and (c) property converted from community property to separate property by a written marital property agreement signed by both spouses. Earnings (e.g., rent, interest, and dividends) from separate property are generally considered community property unless otherwise provided in a written marital property agreement signed by both spouses.

Creditors of the community typically can reach community property and the separate property of the spouse responsible for incurring the debt. Creditors of one spouse (seeking to collect a separate debt of that spouse) cannot reach the other spouse's separate property. However, the other spouse's share of the community property may be vulnerable, particularly if the debt was incurred on behalf of the community (e.g, the purchase of a car which both spouses use).

The rules governing the vulnerability of community property to claims of one spouse's creditors vary substantially among the nine community property states. For example, in Texas, the portion of community property that is under the sole management and control of one spouse (e.g., the spouse's earnings and property acquired with her earnings) can only be reached by creditors of the other spouse if their claims are for torts (e.g., negligence, assault and battery) and the claim arose during the marriage. Creditors with contract claims, and claims arising prior to the marriage, cannot reach the other spouse's sole management community property. In California, community property can be reached by creditors of either spouse without regard for who has management control over the property. Unlike Texas, California places all community property at risk for the debts of either spouse.

Therefore, in California, there is substantial risk to holding property as community property. In most cases, community property should be avoided for wealth protection purposes because community property is available to satisfy the debts of either spouse to some degree. This is the opposite of the tenancies by the entirety (which are excellent wealth protectors) found in some common law states. Whereas creditors of one spouse cannot reach any portion of tenancy by the entirety property, creditors of either spouse (or both spouses jointly) can reach community property.

There are several methods for converting community property to separate property. However, dividing marital assets into separate property has permanent implications in the event of divorce, which makes such a separation undesirable to many clients. The easiest methods for converting community property to separate property are by outright gift or partition agreement. An outright gift is made when one spouse gives the other spouse a portion of community property under the donor spouse's control and expressly declares that he intends the gifted property to be the separate property of the donee spouse. A partition agreement is a contractual agreement between spouses, which transforms property from community to separate. Unfortunately, for either method to be valid (i.e., recognized by the courts), spouses cannot retain or exercise control over the property transferred to or received by the other spouse.

In Rev. Proc. 2002-69, the IRS clarified the treatment of certain entities owned solely by a husband and wife as community property. The procedure provides that a business entity (such as an LLC or partnership) owned wholly by a husband and wife as community property can be treated as either a disregarded entity or a partnership if no person other than one or both spouses would be considered an owner for federal tax purposes and the business is not treated as a corporation under the classification rules. The election to be treated as a disregarded entity or a partnership is made by filing the appropriate tax returns.

**SELF-STUDY QUIZ**

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

7. Jodie and Sam, a married couple, live in a community property state. Jodie and Sam brought into the marriage separate property and, since their marriage, have acquired community property. Jodie and Sam are under an obligation to settle various claims of creditors. Which of the following scenarios describes a legitimate settlement?

    a. Jodie and Sam live in Texas. Before their marriage, Jodie was sued in civil court over a contract dispute and the case was settled against her after she married Sam. The creditors want to take Sam's heirloom Rolex watch.

    b. Jodie and Sam live in California. After they were married, Sam acquired a fishing boat for use in his business and, when Sam's business went bad, Sam subsequently filed for bankruptcy. The creditors want to take Jodie's house that she owned before she married Sam.

    c. Jodie and Sam live in California. After they were married, Sam acquired a fishing boat for use in his business and, when Sam's business went bad, Sam subsequently filed for bankruptcy. The creditors want to take Sam's heirloom Rolex watch.

    d. Jodie and Sam live in Texas. Before they were married, Sam was sued for negligence. After they were married, Sam lost the case and the creditors want to attach Jodie's earnings which are significantly higher than Sam's.

8. An LLC owned wholly by a husband and wife as community property can be treated for federal tax purposes as which of the following?

    a. A partnership with the husband as the principal owner filing a Schedule C.

    b. A partnership, unless one of the spouses does not actively work in the business.

    c. A disregarded entity, with the husband and wife filing a Schedule C.

    d. A corporation, providing the husband and wife file the appropriate tax return in the first year of doing business.

**SELF-STUDY ANSWERS**

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

7. Jodie and Sam, a married couple, live in a community property state. Jodie and Sam brought into the marriage separate property and, since their marriage, have acquired community property. Jodie and Sam are under an obligation to settle various claims of creditors. Which of the following scenarios describes a legitimate settlement? **(Page 22)**

   a. Jodie and Sam live in Texas. Before their marriage, Jodie was sued in civil court over a contract dispute and the case was settled against her after she married Sam. The creditors want to take Sam's heirloom Rolex watch. [This answer is incorrect. The civil case arose before marriage and, therefore, the creditors cannot take Sam's watch because in the state of Texas, the portion of community property that is under the sole management and control of one spouse can only be reached by creditors of the other spouse if their claims are for torts.]

   b. Jodie and Sam live in California. After they were married, Sam acquired a fishing boat for use in his business and, when Sam's business went bad, Sam subsequently filed for bankruptcy. The creditors want to take Jodie's house that she owned before she married Sam. [This answer is incorrect. The creditors cannot take Jodie's separate property in settlement of Sam's bankruptcy since the house was owned by Jodie before she was married and is not community property.]

   **c. Jodie and Sam live in California. After they were married, Sam acquired a fishing boat for use in his business and, when Sam's business went bad, Sam subsequently filed for bankruptcy. The creditors want to take Sam's heirloom Rolex watch. [This answer is correct. The creditors can take Sam's separate property in settlement of his debt. Since creditors can reach separate property of the spouse responsible for incurring the debt.]**

   d. Jodie and Sam live in Texas. Before they were married, Sam was sued for negligence. After they were married, Sam lost the case and the creditors want to attach Jodie's earnings which are significantly higher than Sam's. [This answer is incorrect. The lawsuit arose before their marriage and, therefore, Jodie's earnings are not vulnerable.]

8. An LLC owned wholly by a husband and wife as community property can be treated for federal tax purposes as which of the following? **(Page 23)**

   a. A partnership with the husband as the principal owner filing a Schedule C. [This answer is incorrect. A partnership does not file Schedule C.]

   b. A partnership, as long as another person is considered the owner for federal tax purposes. [This answer is incorrect. Per Rev. Proc. 2002-69, a business entity owned wholly by a husband and wife as community property can be treated as a partnership if no other than one or both spouses would be considered an owner for federal tax purposes.]

   **c. A disregarded entity, with the husband and wife filing a Schedule C. [This answer is correct. Per Rev. Proc. 2002-69, a business entity owned wholly by a husband and wife as community property can be treated as a disregarded entity.]**

   d. A corporation, providing the husband and wife file the appropriate tax return in the first year of doing business. [This answer is incorrect. This is not allowed if the LLC is treated as a corporation under the classification rules.]

# THE USE OF SERIES LLCs

A number of states (including Delaware, Illinois, Iowa, Oklahoma, Nevada, Utah, Tennessee, and Texas) have enacted provisions allowing for the creation of series LLCs or partnerships. The statutes allow this type of LLC to designate separate series (or divisions) within the entity into which assets and ownership interests can be segregated. The series LLC can be structured to take advantage of the segregation possibilities under the statute, allowing each series to stand alone. Each series can have its own business or investment purpose, classes of ownership interest, and liability limitations.

Benefits of using a series LLC include—

a. avoiding the cost of forming multiple LLCs or subsidiaries;

b. the possibility of reducing administrative expenses and state filing fees, such as franchise tax fees required to be paid in some states for LLCs;

c. the ability to add new series within the LLC without additional filings with the Secretary of State;

d. the ability to dissolve a series within an LLC without affecting the other series within the LLC;

e. the ability to make tax-free transfers within the LLC; and

f. the ability to segregate liabilities within a series.

The last item in the preceding list is the most important. In general, the debts, liabilities and obligations incurred, contracted for, or existing with respect to a particular series are enforceable only against that series and not against the assets of the LLC generally or any other series. For example, according to the Delaware statute:

> . . . the debts, liabilities, obligations and expenses incurred, contracted for or otherwise existing with respect to a particular series shall be enforceable against the assets of such series only, and not against the assets of the limited liability company generally or any other series thereof, and, unless otherwise provided in the limited liability company agreement, none of the debts, liabilities, obligations and expenses incurred, contracted for or otherwise existing with respect to the limited liability company generally or any other series thereof shall be enforceable against the assets of such series.

However, to obtain this protection, a number of requirements must be met. While the particular provisions depend upon the state's statute, in general, the following steps must be taken:

a. The operating agreement of the master LLC must identify the series,

b. The operating agreement of the master LLC must call for the limitation of liability,

c. Separate records for each series must be maintained,

d. Assets of each series and the master LLC must be held separately, and

e. Notice of the limitation of the liability of the series must be provided in the master LLC's articles of organization.

**Example 1-2: Using a series LLC for asset protection purposes.**

Computers LLC is established to conduct a single unified business—the manufacture, sale, distribution, and repair of computers. The company will later develop in-house research and development capabilities. The assets of the company are divided among the following series: (a) internal-to-the-box manufacturing; (b) packing the case, keyboard, mouse, monitor, etc., for shipment; (c) distribution; (d) communications; and (e) office operations. Computers LLC acquires the assets for the internal-to-the-box manufacturing operation from Lender A, the assets for the packing operation from Lenders B and Ba, the assets for the distribution operation (trucks, loading equipment) from Lender C, the assets for the communications operation from Lender D, etc.

Computers LLC includes with its filing with the Secretary of State notice on its certificate of formation that the Series "a" assets are exclusively limited to liability for Lender A's debts, that the Series "b" assets are exclusively limited to liability for Lender B and Ba's debts, and so forth.

The end result is that creditors of Computers LLC may not be able to satisfy their claims from all of the company's assets. For example, a janitorial service with a breach of contract claim against Computers, LLC could not satisfy its contract claim against the Series a, b, c, or d assets. Its claim could only be satisfied by reference to the Series e (office operations) assets.

In its first ruling on the treatment of series LLCs , the IRS indicated that a separate series in an LLC (or "Portfolio" in this ruling) with more than one owner would be treated as a separate partnership if the election to be classified as a corporation is not made. A separate series with one owner is taxed as a disregarded entity. It is important to note that the ruling in this case was based on the following proposed structure (see the ruling for a complete description):

a. Each LLC Portfolio will consist of a separate pool of assets, liabilities, and stream of earnings.

b. The shareholders of an LLC Portfolio may share in the income only of that LLC Portfolio.

c. The ownership interest of the shareholders of an LLC Portfolio will be limited to the assets of that LLC Portfolio upon redemption, liquidation, or termination of such LLC Portfolio.

d. The payment of the expenses, charges, and liabilities of an LLC Portfolio will be limited to that LLC Portfolio's assets.

e. The creditors of an LLC Portfolio are limited to the assets of that LLC Portfolio for recovery of expenses, charges, and liabilities.

f. Each LLC Portfolio will have its own investment objectives, policies, and restrictions.

g. Shares of the LLC are not transferable by any shareholder without first obtaining the consent of the board of the LLC. The board cannot unreasonably withhold its consent to a proposed transfer.

**Proposed Regulations on Series LLCs**

Proposed regulations addressing the classification of a series of a domestic LLC for federal tax purposes were issued on September 13, 2010, and will become effective when finalized. The proposed regulations do not apply to the series of a foreign LLC unless it engages in an insurance business. (The remainder of this discussion does not address the rules that apply to insurance businesses.) According to the proposed regulations, a *series organization* is an entity that establishes and maintains a series, while a *series* includes a segregated group of assets and liabilities established under a state or foreign law that explicitly allows (a) each series to have separate rights, powers, or duties with respect to specified property or obligations; (b) the segregation of series assets and liabilities such that the assets of one series are not subject to claims by the other series or the series organization; and (c) the members or participants of a series organization to have certain rights, powers, or duties with respect to the series.

The failure to qualify for liability limitations under the authorizing series statute has no effect upon whether a series is a separate entity for federal tax purposes. Therefore, a series does not fail to qualify as a separate entity simply because an agreement or other arrangement permits debts and liabilities of other series or the series organization to be enforceable against the assets of a particular series. (So, a series generally will not cease to be an entity under the proposed regulations because it guarantees the debt of another series within the series organization.) Similarly, the failure to comply with recordkeeping requirements imposed by the relevant series statue will not prevent the series from being a separate entity.

A domestic series is considered a separate entity for federal tax purposes, whether or not considered a separate legal entity for local law purposes. The classification of a series that is recognized as a separate entity is determined under Reg. 301.7701-1(b), which provides the rules for classifying organizations that are recognized as separate entities for federal tax purposes. Consequently, a series with more than one owner is by default classified as a partnership or can elect to be taxed as a corporation, while a series with one owner is by default classified as a disregarded entity or can elect to be taxed as a corporation.

The ownership of interest in a series and of the series' assets is determined under general tax principles. Accordingly, the owners of a series are those that bear the economic benefits and burdens of ownership. For example, if a series organization holds legal title to a series' assets because the relevant series statute does not permit a series to hold assets in its own name, the series, and not the series organization, will be treated as the owner of the assets for federal tax purposes if it bears the economic benefits and burdens of the assets under general federal tax principles.

The proposed regulations require each series and series organization to file a statement each tax year containing certain identifying information. The statement must be filed on or before March 15 of the year following the period for which the return is made.

There is an exception to the general effective date for a series established prior to publication of the proposed regulations that treat all series and the series organizations as one entity. If the requirements for this exception are satisfied, the series may continue to be treated together with the series organization as one entity for federal tax purposes. These requirements are satisfied if:

a. The series was established prior to September 14, 2010;

b. The series (independent of the series organization or other series) conducted business or investment activity on and prior to September 14, 2010;

c. No owner of the series treats the series as an entity separate from any other series of the series organization or the series organization itself when filing any federal income tax returns, information returns, or withholding documents for any tax year;

d. The series and series organization had a reasonable basis (within the meaning of IRC Sec. 6662) for their claimed classification; and

e. Neither the series, any series owner, or the series organization was notified in writing on or before the date final regulations are published in the Federal Register that the classification of the series was under examination (in which case the series' classification will be determined in the examination).

The proposed regulations do not address several topics, including (a) whether a series organization should be recognized as a separate entity if it has no assets and engages in no activities independent of its series, (b) the appropriate treatment of a series that does not terminate under local law when it has no members, (c) how employment taxes will be assessed on each series, and (d) how each series is treated for employee benefit purposes.

Although the proposed regulations provide guidance on the tax treatment of series LLCs, a number of unanswered questions still remain. For example, will a court be willing to allow creditors to "pierce the veil" and, if so, under what conditions? Will the liability protection provided by a series LLC in one state be respected by another state that does not provide for series LLCs? How should the assets of a separate series be titled? Can one series in an LLC declare bankruptcy separately from the LLC's other series? Will each series be treated as a separate entity under securities laws?

It is also unclear how states will treat series LLCs for state tax purposes. The instructions to California's LLC return state that it will treat each series as a separate entity and each will be subject to the annual California LLC fee if it is registered or doing business in California. Additionally, in Ltr. Rul. 08-2 dated February 15, 2008, the Massachusetts Department of Revenue ruled that each series in a Delaware series LLC is treated as a separate entity following its federal classification for Massachusetts taxes.

# WHAT TYPES OF BUSINESSES MIGHT OPERATE AS AN LLC?

Certain types of businesses are more likely than others to operate as an LLC. A discussion of why operation as an LLC might appeal to some types of businesses follows.

### Natural Resources

Traditionally, oil and gas operations have been structured as corporations, general partnerships, or limited partnerships (with one owner acting as the general partner responsible for conducting all business operations). Since an LLC taxed as a partnership combines the flexibility of allocating income and loss under the partnership rules with the limited liability available to shareholders in a corporation, it may be a more desirable vehicle for conducting natural resource exploration and development. Another advantage of LLC status is that since no member is liable for the debts of the LLC, the basis from LLC debt is shared among all members. Since limited partners are not allowed to include shares of recourse debt in their basis, operation as an LLC may increase the basis of members that would have been limited partners in a limited partnership. However, application of the PAL rules may make operating an oil and gas business as an LLC unfeasible, since one requirement for deducting the losses as nonpassive is that the interest cannot be held through an entity that limits the owner's liability.

### Real Estate

Typically real estate ownership and development activities have been conducted in the form of a partnership to take advantage of the favorable pass-through of losses without the restrictions placed on S corporation operations and ownership. Limited partnerships have frequently been used to protect the limited partners from liability for partnership debts. LLCs taxed as partnerships may provide a better alternative because they provide better liability protection for all members in the LLC, while maintaining the favorable tax treatment of a partnership. (Additionally, single-member LLCs taxed as sole proprietorships provide limited liability for single individual members.) This is increasingly important for real estate investors with potential exposure to environmental liabilities and liabilities resulting from accidents and injuries on the property. (However, members who participate in management may have liability for environmental torts.) In addition, the LLC format provides an opportunity to have investors involved in the management of the business. Although limited partners cannot participate in management without risking personal liability for partnership debt, LLC members are under no similar constraints.

Real estate brokers, property management companies, and leasing companies may also want to investigate operating as an LLC. The LLC can offer these businesses the same advantages of limited liability and flow-through taxation.

### Agriculture

Although some states have prohibited LLCs from holding agricultural-use property, LLCs should be considered for agricultural holdings where available. The availability of limited liability for all members and flow-through taxation are a very attractive combination in this type of industry where losses are regularly incurred. In addition, estate planning opportunities that have traditionally been available to family limited partnerships (such as partnership freezes and discounts for lack of marketability), are also available to LLCs and their members.

### Professionals

Clearly, professionals can benefit from operating as an LLC or an LLP. Many accountants and lawyers currently operate as general partnerships, limited partnerships, or professional corporations. Operation as an LLC or LLP allows the professional firm to maintain the flexibility of partnership taxation while enjoying a better form of limited liability.

The major advantage of LLC or LLP operation to a professional is the ability to avoid vicarious liability. As a result of the many malpractice suits that have been filed in recent years, partners in professional firms have been exposed to huge personal liability not only for their own malpractice, but also for the malpractice of their partners. Practicing as an LLC or an LLP allows the professional to avoid liability for the malpractice of his co-owners—the professional is liable only for his own malpractice and the malpractice of those he directly supervises. In addition, where a professional group practices as an LLC (or an LLP with blanket liability protection), only the assets of the LLC (and any capital contribution obligations of the members) are subject to claims by other LLC creditors.

A practitioner trying to determine if a professional can practice as an LLC or LLP in a specific state must review not only the LLC and LLP statutes, but also must ascertain if the State Supreme Court, the State Bar Association, or the State Public Accountancy Board bans practice as an LLP or LLC.

**International Activities**

Since LLCs have been a common form of business operation in other parts of the world for a number of years, it may be easier to structure foreign business ventures as LLCs. Because of this familiarity with the LLC concept it may also prove easier to form joint ventures as LLCs if the venture has foreign investors or is financed through foreign banks.

The LLC also offers an advantage over S corporations with regard to international activity, since there is no prohibition on foreign members in an LLC. An S corporation cannot have a foreign shareholder.

**Family Businesses**

Family businesses should consider operating as an LLC taxed as a partnership. The LLC allows the same flexibility in allocating income and loss and the same advantages for estate planning purposes as a partnership. However, the LLC offers family members an increased level of liability protection, particularly for parents who would be general partners in a family partnership. Additionally, operation as an LLC allows adult children to participate in management, where they would have been prohibited from participating in management as limited partners in a family limited partnership.

**High-tech Companies**

One of the major concerns of high-tech companies is the exposure to product liability and the failure of technology to function as advertised (which can result in significant losses). While S corporations provide adequate insulation with respect to this liability, some of the restrictions that apply to S corporations may not appeal to investors in high-tech companies. Operation as an LLC allows a high-tech company to function as a partnership (with the flexibility with regard to ownership, pass-through, and allocations allowed by the partnership rules), while achieving limited liability for all of its owners. If a high-tech company formed as an LLC subsequently wants to go public, the conversion of an LLC into a C corporation can be accomplished relatively easily, although there may be some tax consequences.

**Subsidiary Businesses**

A single-member LLC is frequently used to hold a subsidiary business of a corporation, partnership, or LLC. The LLC segregates the business in a separate entity, while providing limited liability for the owner. When the owner is a C corporation, the use of an LLC avoids the requirement to file a consolidated return (i.e., the business operations of the subsidiary are combined with those of the single member on the corporation's tax return). The use of an LLC subsidiary instead of another corporation also avoids the necessity to comply with corporate formalities (boards of directors, annual meetings, etc.) to maintain limited liability. Another advantage of using a single-member LLC subsidiary is that it prevents the recognition of gain when excess liabilities are contributed (which frequently may be a problem when the subsidiary is formed for creditor protection).

Generally, the favorable tax-free reorganization rules are not available to LLCs taxed as disregarded entities. However, Reg. 1.368-2(b)(1)(ii) allows a Type A merger of corporations into single-member disregarded entities (including single-member LLCs that do not elect corporate status) where the merger is the result of the operation of state law and the following events occur simultaneously at the effective time of the transaction:

a. All of the assets (other than those distributed in the transaction) and liabilities (except to the extent such liabilities are satisfied or discharged in the transaction or are nonrecourse liabilities to which assets distributed in the transaction are subject) of the corporation are transferred to the disregarded entity; and

b. The separate legal existence of the merged corporation ceases for all purposes.

### Joint Ventures between Corporations

A corporation entering into a joint venture with another corporation may find it beneficial to use an LLC rather than a partnership or a jointly-owned corporation. Use of an LLC allows each corporation to include its share of profit and loss from the joint venture in income (without the necessity of complying with the consolidated return rules), while enjoying the liability shield provided by the LLC.

### Joint Ventures with Tax-exempts

The IRS dislikes Section 501(c)(3) organizations serving as the general partner in a partnership or joint venture with a for-profit entity because of a concern the nonprofit will operate the partnership at least partly for the benefit of the other (for-profit) partners. However, an LLC may be more conducive to joint ventures between tax-exempt organizations and nonexempts than a general or limited partnership, because the tax-exempt entity receives the benefit of limited liability plus the ability to participate in management. The ability to participate in management helps the tax-exempt organization ensure the LLC will take no action that may endanger the tax-exempt organization's exempt status.

### Single-purpose Entities

Single-purpose entities (SPEs) got a bad reputation after the Enron collapse. However, SPEs are often used, especially to hold developed real estate, in efforts to create a "bankruptcy remote" vehicle to accommodate lender requirements. Lenders sometimes are unwilling to make loans when the assets securing the loans may be consolidated with the borrowing entity's other assets in a bankruptcy proceeding. To avoid this possibility, the borrower may place the property securing the loan in an SPE, usually a single-member LLC taxed as a disregarded entity, to ensure that if a default occurs, the property securing the debt is available to the lender. If an LLC is used as an SPE, the LLC's operating agreement should contain provisions prohibiting the members or managers from liquidating or otherwise changing the ownership entity, disposing of the property held by the LLC, or incurring any additional debts. In addition, the LLC's books and records should be separate from the books and records of any related entity.

### Retention of Family Vacation Home

While not a business purpose, the retention and "operation" of a family vacation home may be a perfect opportunity for using an LLC. The LLC may be formed during the lifetime of the parent/owners, or subsequent to their death. However, the drafting of the articles of organization and operating agreement of such an entity prior to the death of the parent/owners may avoid significant controversy between the children/beneficiaries over the disposition of a family vacation home. The LLC's organizational documents can establish the percentage ownership of each child/beneficiary, include a schedule for using the vacation home, make provisions for paying the taxes and maintenance on the property, and designate the manager of the property (or the method for electing the manager).

### Other Businesses

The types of businesses discussed above are some of the obvious choices for operation as an LLC. Other types of businesses may also be likely candidates, including securities broker/dealers, architects, restaurants, hotels/motels, aircraft owners, and theatrical producers. Cooperatives taxed under IRC Sec. 1381 may also operate as an LLC taxed as a corporation.

## SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

9. Trailers LLC is established to conduct a single unified business—the manufacture of boat trailers. The LLC designates four separate series, Series A through D, each with its own business purpose and sets of assets. The four series and the liabilities they are responsible for are set out in the LLC's filing with the California Secretary of State. Which of the following statements is the most accurate?

   a. The state will subject each of the four series to the annual LLC fee.

   b. Because the series are operated independently, the IRS treats each series as a separate entity for federal tax purposes.

   c. The liability protection provided by a series LLC in one state also applies in states that do not have statutes covering series LLCs.

   d. If Series A goes bankrupt, Series B, C, and D can continue to operate normally.

10. Which of the following is a benefit of conducting natural resource exploration and development as an LLC taxed under the partnership rules?

    a. The LLC passes through income and losses based on the percentage of each member's ownership only.

    b. Debt basis in an LLC is shared among all members.

    c. LLC members have personal liability protection, unless they participate in day-to-day operation and management of the LLC.

    d. The passive activity rules do not apply to an LLC.

11. Jack and Diane are professionals in a partnership who intend to become the members of an LLC. They have two employees, Phil who is under Jack's supervision, and Mary, who under Diane's supervision. While operating as an LLC, the firm is sued because of an error made by Phil. Who may be held liable for any damages?

    a. Jack and Diane.

    b. No one is liable, except to the extent of the LLC's assets.

    c. Phil.

    d. Jack and Phil.

12. Which of the following is an advantage of forming a single-member LLC to hold a subsidiary business of a corporation, partnership, or LLC?

    a. If a C corporation is the owner, the business operations of the subsidiary and the corporation are combined on the corporation's tax return.

    b. Favorable tax-free reorganization rules can be applied by LLCs taxed as disregarded entities.

    c. Assets can be contributed tax-free, so long as excess liabilities are not also contributed.

    d. Limited liability is maintained without the necessity to comply with corporate formalities.

## SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

9. Trailers LLC is established to conduct a single unified business—the manufacture of boat trailers. The LLC designates four separate series, Series A through D, each with its own business purpose and sets of assets. The four series and the liabilities they are responsible for are set out in the LLC's filing with the California Secretary of State. Which of the following statements is the most accurate? **(Page 29)**

   **a. The state will subject each of the four series to the annual LLC fee. [This answer is correct. California's LLC return instructions provide that the state will treat each series as a separate entity, subject to the annual LLC fee, if the LLC is registered or doing business in California.]**

   b. Because the series are operated independently, the IRS treats each series as a separate entity for federal tax purposes. [This answer is incorrect. Series LLCs are a relatively new concept and many questions remain unanswered. One of these questions is how the IRS will treat series LLCs although proposed regulations consider a domestic series a separate entity for federal tax purposes. These are not finalized yet.]

   c. The liability protection provided by a series LLC in one state also applies in states that do not have statutes covering series LLCs. [This answer is incorrect. Because LLCs are relatively new, the answers to many questions are yet unclear. How series LLCs will be treated in different states is one of those unanswered questions.]

   d. If Series A goes bankrupt, Series B, C, and D can continue to operate normally. [This answer is incorrect. Series LLCs are a relatively new concept and the answers to many questions remain unclear. How the series will be treated in a bankruptcy proceeding is one of those unanswered questions.]

10. Which of the following is a benefit of conducting natural resource exploration and development as an LLC taxed under the partnership rules? **(Page 30)**

   a. The LLC passes through income and losses based on the percentage of each member's ownership only. [This answer is incorrect. An S corporation must pass through income and losses based on ownership, but an LLC has the advantage of being able to allocate income and loss as a partnership does.]

   **b. Debt basis in an LLC is shared among all members. [This answer is correct. Even though no LLC member is liable for the debts, the basis is shared among all members.]**

   c. LLC members have personal liability protection, unless they participate in day-to-day operation and management of the LLC. [This answer is incorrect. LLC members do not have personal liability, even though they participate in the operations of the company. This differs from the treatment of limited partners, who risk personal liability if they participate in management.]

   d. The passive activity rules do not apply to an LLC. [This answer is incorrect. Actually, the onerous passive activity loss rules may make operating an oil and gas business as an LLC impractical.]

11. Jack and Diane are professionals in a partnership who intend to become the members of an LLC. They have two employees, Phil who is under Jack's supervision, and Mary, who under Diane's supervision. While operating as an LLC, the firm is sued because of an error made by Phil. Who may be held liable for any damages? **(Page 30)**

   a. Jack and Diane. [This answer is incorrect. Not all of an LLC's members are equally liable for malpractice claims.]

   b. No one is liable, except to the extent of the LLC's assets. [This answer is incorrect. Not all of the members can escape person liability for malpractice.]

c. Phil. [This answer is incorrect. One or more of the members are liable for malpractice.]

**d. Jack and Phil. [This answer is correct. Phil is liable because he committed the act leading to the suit; Jack, because he is liable for the acts of those he directly supervises.]**

12. Which of the following is an advantage of forming a single-member LLC to hold a subsidiary business of a corporation, partnership, or LLC? **(Page 31)**

a. If a C corporation is the owner, the business operations of the subsidiary and the corporation are combined on the corporation's tax return. [This answer is incorrect. The LLC operates as a separate entity, and consolidated returns are not required.]

b. Favorable tax-free reorganization rules can be applied by LLCs taxed as disregarded entities. [This answer is incorrect. There are exceptions, but generally these favorable rules do not apply to an LLC taxed as a disregarded entity.]

c. Assets can be contributed tax-free, so long as excess liabilities are not also contributed. [This answer is incorrect. The arrangement prevents the recognition of gain when excess liabilities are contributed.]

**d. Limited liability is maintained without the necessity to comply with corporate formalities. [This answer is correct. The single-member LLC is not required to have a board of directors, hold annual meetings, or comply with other corporate formalities due to the use of an LLC subsidiary.]**

## EXAMINATION FOR CPE CREDIT

### Lesson 1 (LLCTG101)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

1. Gain or loss is **not** recognized by an LLC taxed as a partnership or its members under which of the following circumstances?

   a. A capital interest is received in exchange for a contribution that consists of property and other items.

   b. A capital interest is received in exchange for a contribution that consists of property only.

   c. A capital interest is received in exchange for property that is subject to a liability.

   d. A capital interest is received in exchange for the performance of services.

2. Jack and Janet are setting up an LLC and are making the decision whether to be taxed as a partnership or an S corporation. If they elect to be taxed as an S corporation, the entity must do which of the following?

   a. Must require that allocations of income and loss to Jack and Janet have substantial economic effect.

   b. Must allocate income and loss to Jack and Janet based on each shareholder's outstanding stock.

   c. Can only allocate income and loss items to Jack and Janet in accordance with the operating agreement.

   d. Can specially allocate income and loss items to Jack and Janet.

3. A member of an LLC taxed as a partnership can perform services for the LLC, but the member **cannot** be compensated for services as which of the following?

   a. An employee of that LLC.

   b. An independent contractor.

   c. Through guaranteed payments.

   d. Through special allocations.

4. When an LLC makes distributions to its members, the LLC is generally required to allocate the distributions based on which of the following?

   a. The percentage of income or loss passed through to each member.

   b. The relative values of members' services performed for the LLC.

   c. The relative values of the members' capital accounts.

   d. The relative values of the members' contributions to the LLC.

5. What can cause the technical termination of an LLC?

   a. Sale or other disposition of 50% or more of a member's interest in the LLC within a 12-month period.

   b. Sale or exchange of one-third or more of the total interest in the LLC's capital and profits within a 12-month period.

   c. Sale or exchange of 50% or more of the total interest in the LLC's capital and profits within a 12-month period.

   d. Sale or exchange of 50% or more of the total value of the assets owned by the LLC within a 12-month period.

6. Which of the following statements relating to LLPs and LLCs is most accurate?

   a. An existing partnership that becomes an LLP must normally file articles of organization and draft an operating agreement.

   b. Many states require both LLPs and LLCs to carry substantial amounts of liability insurance.

   c. A single-member LLP is treated as an entity separate from its owner.

   d. Many states have laws that provide LLP partners and LLC members with the same type of liability protection.

7. Martin is planning to form an LLP or LLC in which he is the single member. Martin can form which of the following?

   a. Single-member LLP that is treated as an entity separate from its owner.

   b. Single-member LLP that elects to be taxed as a corporation.

   c. Single-member LLC that elects to be taxed as a partnership.

   d. Single-member LLC that is not treated as an entity separate from its owner.

8. Common law states are those states in which marital property generally is treated as which of the following?

   a. Property held in tenancy by the entirety.

   b. Property held by the spouse in whose name the property is titled.

   c. Property the disposal of which requires the consent of both spouses.

   d. Property acquired in the name of one spouse is under the control of both spouses.

9. The following are some examples of property that are held by one or both of the spouses together during their marriage. Which item is an example of community property?

   a. Property the husband acquired by gift during marriage.

   b. Rental income from separate real property of the wife.

   c. Property acquired by a personal injury damages award to the wife.

   d. Property converted from community property to separate property of the husband by agreement of the spouses.

10. What are the two types of property generally held by married persons in community property states?

    a. Tenancy in common and separate.

    b. Community and joint.

    c. Community and separate.

    d. Marital and separate.

11. Which of the following is a common-law state?

    a. Nevada.

    b. Texas.

    c. Oregon.

    d. Wisconsin.

12. Which of the following is a benefit of a series LLC?

    a. The primary entity remains responsible for the liabilities.

    b. The series is allowed to carry out the same business programs.

    c. The ability to make tax-free transfers within the LLC.

    d. The ability to keep all assets and liabilities of the series together.

13. Which of the following advantages to a series LLC or partnership is the most important?

    a. The ability to dissolve one or more series within an LLC without affecting the other series in the LLC.

    b. The ability to segregate liabilities within the series.

    c. The ability to add new series within the LLC.

    d. The ability to make tax-free transfers between the series in the LLC.

14. An LLC's ability to segregate various aspects of the business to a particular series is an important benefit of the series structure. Listed below are some attributes which may or may not be necessary for a Series LLC.

    1. Separate books and records must be maintained.

    2. The series must be identified in the operating agreement of the master LLC.

    3. The LLC generally must assume liability for the debts, liabilities and obligations of each of its series members.

    4. The series members must generally pay separate fees to the state of organization that allows this organization.

    5. The assets of each series member must be treated as separate assets from any other holdings.

    Based on the items above, which of the following answer choices properly reflect the requirements of a Series LLC?

    a. 1, 4, and 5.

    b. 2, 3, and 4.

    c. 1, 2, and 5.

    d. 2, 4, and 5.

15. What is a benefit of an agricultural-use property being set up into an LLC?

    a. The ability to avoid vicarious liability in the LLC.

    b. No member is liable for the debts of the LLC.

    c. The estate planning opportunities that are available to a LLC.

    d. Maintain the flexibility of partnership taxation in the LLC.

# Lesson 2: Choosing the LLC's Tax Year

## INTRODUCTION

The principal purpose of forming an LLC is usually to shield the members from liability while providing them the tax benefits of a pass-through of LLC income or loss. Classification as a pass-through entity provides significant benefits when combined with limited liability but has some drawbacks. The LLC becomes subject to the often complex and confusing partnership rules governing tax year, accounting methods, and elections. This lesson examines those rules and their application to LLCs.

**Learning Objectives:**

Completion of this lesson will enable you to:

- Select the required tax year of entities choosing LLC status.
- Describe the various methods to elect a nonconforming tax year and the impact on entities selecting LLC status.

## HOW TO DETERMINE THE LLC'S TAX YEAR

An LLC taxed as a C corporation can choose any year-end as the tax year-end (an LLC classified as an S corporation generally must use a calendar year-end). If an LLC is classified as a partnership for federal income tax purposes, however, its tax year is governed by IRC Sec. 706(b). Generally, this Section provides that the tax year of a partnership must conform to that of its partners or, for an LLC, to that of its members. (A single-member LLC's required tax year is the tax year of the owner unless corporate classification is elected.) However, if certain requirements are met, there are exceptions to this rule. To determine the tax year-end options of an LLC taxed as a partnership, the following steps must be performed in order:

a. Determine the "required year" of the LLC. Even if the LLC's required year is not used as its tax year, several rules and limitations are based on the required year, such as the allowable year-end when making a Section 444 election. Since changes in member status can cause changes in the LLC's required year, the required year must be determined annually.

b. Determine if the LLC can elect a "nonconforming" tax year (i.e., a year other than the required year) under the natural business year or business purpose exceptions.

c. If the natural business year or business purpose exceptions do not apply, determine if the LLC can elect a nonconforming tax year under IRC Sec. 444. As the price for making this election, the LLC may be required to make prepaid tax deposits with the IRS. Also, significant additional compliance work will result.

A tax year is adopted by filing the first federal income tax return using that tax year. Accordingly, filing an application for an employer identification number, filing an extension, or making estimated tax payments indicating a particular tax year does not constitute adoption of that year.

**The Required Year Rules**

The required year is generally the tax year of the members who own, in the aggregate, more than 50% of the interests in the capital and profits of the LLC. This provision is the "majority interest" rule. If there is no member or combination of members with the same tax year owning more than 50% of profits and capital, the LLC's required year is the tax year of its principal members. Principal members are those owning 5% or more of either profits or capital. This provision is the "principal members" rule. If neither the majority interest rule nor the principal members rule applies, the LLC's required year is the year-end resulting in the least aggregate deferral of income to the members. This provision is the "least aggregate deferral" rule.

### Majority Interest Required Year Rule

The majority interest rule is applied first when determining an LLC's required year. If an LLC's ownership permits a year-end determination under the majority interest rule, this is the LLC's required year. There is no application of the principal members rule or the least aggregate deferral rule. Under the majority interest rule, an LLC must adopt the same tax year as that of its member or members who cumulatively own more than 50% of the LLC's profits and capital interests. In determining if the majority interest rule can be applied, the test date is the first day of the LLC's tax year.

When determining an LLC's tax year, the tax year of a tax-exempt member is disregarded if the member was not subject to tax on its distributive share of income from the LLC in the immediately preceding year. Likewise, the tax year of a tax-exempt entity that was not a member during the immediately preceding tax year is disregarded if the member is not expected to be subject to tax on its share of the LLC's current year income. Similar rules apply to foreign entities not subject to U.S. tax.

An LLC may be required to change its tax year to comply with the majority interest rule if changes in ownership occur. If a tax year is changed for this reason, no further change (due to changes in majority members' tax years) in the LLC's tax year is required for the two tax years following the year of change.

**Example 2-1: Majority interest rule applies.**

Stooge LLC is comprised of three members. Larry, Inc. owns 40% of the LLC's capital and profits, and Curly, Inc. and Moe, Inc. each own 30%. Larry, Inc. and Curly, Inc. each have a May 31 fiscal year-end; Moe, Inc. has a July 31 fiscal year-end. Since members owning more than 50% of the capital and profits interests in the LLC have the same fiscal year, the LLC's required year ends on May 31.

**Example 2-2: Majority interest rule does not apply.**

Rockford Investors LLC has four members (Able Co., Baskin, Inc., Conrad Co., and Disch, Inc.), each owning a 25% interest in the LLC's capital and profits. Able and Baskin have June 30 fiscal year-ends; Conrad and Disch have September 30 fiscal year-ends. Since members with the same tax year do not own more than 50% of the capital and profits interests in the LLC, the majority interest rule does not apply, and the required year of the LLC must be determined using either the principal members rule or the least aggregate deferral of income rule.

When determining an LLC's tax year, a member's interest in LLC profits is generally the member's percentage share of LLC net income for the current tax year. If the LLC does not expect to have income for the current tax year, the member's interest in LLC profits is the member's percentage share of LLC net income for the first tax year in which the LLC expects to have net income. A member's share of LLC net income is the ratio of the member's distributive share of LLC income (taking into account all rules and regulations affecting that determination) to the LLC's net income for the tax year. A member's interest in LLC capital is determined by reference to the LLC assets the member would be entitled to upon withdrawal from the LLC or liquidation of the LLC. If the LLC maintains capital accounts under the substantial economic effect safe harbor rules of Reg. 1.704-1(b)(2)(iv), a member's interest in capital is assumed to be equal to the ratio of the member's capital account to all members' capital accounts.

### Principal Members Required Year Rule

If the majority interest rule cannot be used, an LLC must try to determine its required year based on the tax year of its principal members. A principal member is any member with a 5% or more interest in profits or capital. However, the tax year of a tax-exempt member is disregarded if the member was not subject to tax on its distributive share of income from the LLC in the immediately preceding year. Likewise, the tax year of a tax-exempt entity that was not a member during the immediately preceding tax year is disregarded if the member is not expected to be subject to tax on its share of the LLC's current year income. Similar rules apply to foreign entities not subject to U.S. tax.

**Example 2-3: Principal members with identical year-ends.**

Mega LLC has 22 members. Five members each own 10% of the profits and capital of the LLC and have April 30 year-ends. Sixteen members, each owning 3% of the LLC, have calendar year-ends. The remaining member, with a 2% LLC interest, has an October 31 year-end. Since all principal members (those owning more than 5% of the profits or capital interests) have the same year-end, the LLC's required year-end is April 30. This is true even though the principal members do not own a majority interest in capital or profits.

**Example 2-4: Principal members with different year-ends.**

Mini LLC has four members, each owning 25% of both capital and profits. Two members have fiscal year-ends of May 31. The other two members have fiscal year-ends of September 30. Since not all principal members have the same year-end, the LLC cannot determine its required year based on the principal members rule. (The LLC also cannot use the majority interest rule discussed earlier.) Accordingly, the LLC must determine a required year resulting in the least aggregate deferral of income to its members.

**Example 2-5: Principal members own minority interest.**

Odd LLC has one member with a 35% interest in profits and capital and a July 31 year-end. The other members each own less than 3% of the LLC's capital and profits and have a calendar year-end. Since the sole principal member's year-end is July 31, it may initially appear the LLC's required year-end should be July 31. However, the interests in profits and capital of the other members exceed 50% of total LLC profits and capital. Since these members have a majority interest and all have calendar year-ends, the majority interest rule applies rather than the principal member rule. Consequently, the LLC's required year ends on December 31.

### Least Aggregate Deferral of Income Required Year Rule

If an LLC cannot use either the majority interest rule or the principal members rule, it must select a required year-end (from among the members' year-ends) resulting in the least aggregate deferral of income to the members. In determining the appropriate year-end under this rule, the year-end and profits interest of each member must be considered. However, any tax-exempt member that was not subject to tax on its distributive share of income from the LLC in the immediately preceding year is disregarded. Likewise, a tax-exempt entity that was not a member during the immediately preceding year is disregarded if the member is not expected to be subject to tax on its share of the LLC's current year income. Similar rules apply to foreign entities not subject to U.S. tax.

The least aggregate deferral of income is determined by multiplying each member's percentage of LLC profits for the year by the number of months of deferral that would arise through selection of the proposed year-end. Months of deferral for this purpose are counted by going forward from the proposed LLC year-end to the members' year-ends, using the information available at the beginning of the current tax year (unless the members have made voluntary changes in their year-ends). After testing each proposed tax year, the year producing the least aggregate deferral of income is the required year. If the test produces more than one qualifying tax year, the LLC can select any one of those years. However, under the special consistency rule, if one such year-end meeting the test is the LLC's existing year-end, the LLC must retain its existing tax year.

If the tax year with the least aggregate deferral produces a difference in aggregate deferral less than .5 (see following examples for computation) in comparison to the aggregate deferral of the LLC's existing tax year, a *de minimis* rule is applied. The LLC's existing tax year is treated as the tax year with the least aggregate deferral and no change in tax year is necessary or permitted.

**Example 2-6: Least aggregate deferral calculation with two members.**

Tom Co. and Jerri Co. form a new LLC classified as a partnership and must determine the required year. Tom Co.'s fiscal year ends May 31. Jerri Co.'s fiscal year ends August 31. Each will own 50% of the LLC. Since the LLC cannot determine its required year under either the majority interest rule or the principal members rule, it must determine which of the possible tax years will yield the least aggregate deferral of income. The determination is made as follows:

| Member | Member's Year-end | Profits Interest | Months Deferred | Deferral |
|---|---|---|---|---|
| Test Tom Co.'s May 31 year-end: | | | | |
| Tom Co. | 5/31 | .5 | 0 | 0.0 |
| Jerri Co. | 8/31 | .5 | 3 | 1.5 |
| Aggregate deferral | | | | 1.5 |
| Test Jerri Co.'s August 31 year-end: | | | | |
| Tom Co. | 5/31 | .5 | 9 | 4.5 |
| Jerri Co. | 8/31 | .5 | 0 | 0.0 |
| Aggregate deferral | | | | 4.5 |

The months of deferral are calculated by counting forward from the test year-end to the member's year-end. For example, when testing the May 31 year-end, there are three months of deferral from May 31 until Jerri Co.'s year-end of August 31.

Since the May 31 year-end yields an aggregate deferral of 1.5 (clearly less than the aggregate deferral of the August 31 year-end), the LLC must use May 31 as its required year.

**Example 2-7: Least aggregate deferral calculation with four members.**

Fred Co., Ricky Co., Lucy Co., and Ethel Co. operate an LLC taxed as a partnership. Fred Co. has an April 30 year-end, Ricky Co. has a July 31 year-end, Lucy Co. has a November 30 year-end, and Ethel Co. has a December 31 year-end. Fred Co., Ricky Co., and Lucy Co. each own 30% of the LLC; Ethel Co. owns 10%. The determination of the LLC's required year is made as follows:

| Member | Member's Year-end | Profits Interest | Months Deferred | Deferral |
|---|---|---|---|---|
| Test Fred Co.'s April 30 year-end: | | | | |
| Fred Co. | 4/30 | .3 | 0 | 0.0 |
| Ricky Co. | 7/31 | .3 | 3 | 0.9 |
| Lucy Co. | 11/30 | .3 | 7 | 2.1 |
| Ethel Co. | 12/31 | .1 | 8 | 0.8 |
| Aggregate deferral | | | | 3.8 |
| Test Ricky Co.'s July 31 year-end: | | | | |
| Fred Co. | 4/30 | .3 | 9 | 2.7 |
| Ricky Co. | 7/31 | .3 | 0 | 0.0 |
| Lucy Co. | 11/30 | .3 | 4 | 1.2 |
| Ethel Co. | 12/31 | .1 | 5 | 0.5 |
| Aggregate deferral | | | | 4.4 |
| Test Lucy Co.'s November 30 year-end: | | | | |
| Fred Co. | 4/30 | .3 | 5 | 1.5 |
| Ricky Co. | 7/31 | .3 | 8 | 2.4 |
| Lucy Co. | 11/30 | .3 | 0 | 0.0 |
| Ethel Co. | 12/31 | .1 | 1 | 0.1 |
| Aggregate deferral | | | | 4.0 |

| Member | Member's Year-end | Profits Interest | Months Deferred | Deferral |
|---|---|---|---|---|
| Test Ethel Co.'s July 31 year-end: | | | | |
| Fred Co. | 4/30 | .3 | 4 | 1.2 |
| Ricky Co. | 7/31 | .3 | 7 | 2.1 |
| Lucy Co. | 11/30 | .3 | 11 | 3.3 |
| Ethel Co. | 12/31 | .1 | 0 | 0.0 |
| Aggregate deferral | | | | 6.6 |

Since the April 30 year-end yields the least aggregate deferral of income, the LLC must select an April 30 year-end as its required year.

**Example 2-8: Special *de minimis* rule prevents change in year-end.**

Assume the same facts as Example 2-7, except the listed ownership is the result of Fred Co. and Ricky Co. buying the interests of two former members. The LLC has been in operation for a number of years and has an existing November 30 year-end. Under the special *de minimis* rule, the tax year will not change, since the tax year resulting in the least aggregate deferral (April 30) produces a difference in aggregate deferral that is less than .5 in comparison to the aggregate deferral of the LLC's current tax year (November 30). This is calculated as follows:

| Member | Member's Year-end | Profits Interest | Months Deferred | Deferral |
|---|---|---|---|---|
| Existing tax year deferral: | | | | |
| Fred Co. | 4/30 | .3 | 5 | 1.5 |
| Ricky Co. | 7/31 | .3 | 8 | 2.4 |
| Lucy Co. | 11/30 | .3 | 0 | 0.0 |
| Ethel Co. | 12/31 | .1 | 1 | 0.1 |
| Aggregate deferral | | | | 4.0 |
| Year-end with least aggregate deferral of income (April 30) | | | | 3.8 |
| Difference (less than .5) | | | | 0.2 |

**Example 2-9: Several year-ends with least aggregate deferral.**

Wilma and Betty, Inc. want to form an LLC classified as a partnership. Wilma has a calendar year-end, and Betty, Inc. has a fiscal year ending June 30. Each will own 50% of the LLC's capital and profits. Since both members' tax years produce the same aggregate deferral (3.0), the LLC can use either member's year-end as its required year-end.

**Example 2-10: LLC must continue to use current year-end under consistency rule.**

Assume the same facts as Example 2-9, except the LLC has been in operation for a number of years and presently has a June 30 year-end. Since the LLC has an existing year-end that is one of the permitted least aggregate deferral year-ends, the LLC must continue to use the June 30 year-end.

### Tax Years of LLCs with Foreign Members

The interests of disregarded foreign members are not taken into account in determining the tax year of an LLC classified as a partnership. A foreign member is disregarded unless it is allocated gross income of the LLC that is effectively connected (or treated as effectively connected) with the conduct of a trade or business within the U.S. during the LLC's tax year immediately preceding the current tax year (or if the member was not a member during the immediately preceding tax year, the LLC reasonably believes that the member will be allocated any such income during the current tax year) and taxation of that income is not otherwise precluded under any U.S. income tax treaty.

A foreign member is any member that is not a U.S. person (other than a controlled foreign corporation or a foreign personal holding company). However, if each member that is not a disregarded foreign member (regarded member) holds less than a 10% interest in the LLC, and the regarded members, in the aggregate, hold less than 20% of the LLC's capital or profits, then the interests of the disregarded foreign members are taken into account in determining the LLC's tax year.

In determining ownership under this minority interest rule, each regarded member is treated as owning any interest in the LLC owned by a related member. Relationship is determined under the rules of IRC Sec. 267(b) or 707(b) (using 10% instead of 50% each place it appears). However, in determining if members hold less than 20% of the LLC in the aggregate, the same interests are not considered as being owned by more than one regarded member. This rule does not apply to LLCs formed prior to September 23, 2002 (existing LLCs). If an existing LLC terminates under the technical termination rules of IRC Sec. 708(b)(1)(B), or changes its tax year, it becomes subject to these provisions.

Proposed regulations that will be effective when finalized (but not before tax years beginning after 2009), amend the minority interest rule to provide that regarded members have a minority interest only if they each have less than a 10% interest in capital and profits, and the regarded members collectively have less than a 20% interest in LLC capital and profits. This modification means that the interests of foreign members will be taken into account in determining the tax year of the LLC only if the regarded members have interests below the stated thresholds in both LLC capital and profits, rather than the current rule which requires only an interest below the threshold in either capital or profits.

# CHANGES IN TAX YEARS

Certain situations may require LLCs to change their tax year. Alternatively, in certain situations LLCs may want to change to a more desirable tax year. Special rules govern these types of situations.

**Procedures and Required Statement When LLC's Required Year Changes**

An LLC's required year can change for three reasons:

a. The members holding majority interests change or their year-ends change. (However, a consistency rule may prevent a change in some cases.

b. The principal members or their year-ends change.

c. The year-end with the least aggregate deferral changes. (However, a consistency rule or a *de minimis* rule may prevent a change in some cases.

A change in the LLC's required year is treated as automatically approved by the IRS. Annualization of the short period income is not required [Reg. 1.706-1(b)(8)].

**Impact of Members' Year-end Changes on LLC's Required Year**

A change in a member's year-end often will force an LLC to change its tax year. However, an LLC using a required year may be able to retain its year-end after such a change under the consistency or *de minimis* rules. Also, an LLC that has made a previous Section 444 election may be able to retain its existing year-end or adopt a new "nonconforming" year-end if its required year changes. An LLC that has obtained IRS approval for its natural business year or business purpose year does not have to change year-ends because of a change in a member's year-end.

**Example 2-11: Required change of year-end under the majority interest rule.**

Big Tex LLC is classified as a partnership and has been using its June 30 required year-end. All three members have a June 30 year-end. Two members obtain permission to change their year-ends to May 31. Since members owning more than 50% of capital and profits now have a May 31 year-end, Big Tex is required to change its year-end as well. Because the change is made under the majority interest rule, no further change in tax year (due to changes in majority members' tax years) will be required for the two tax years following the year of change.

**Example 2-12: Required change of year-end under the principal members rule.**

An LLC having several members is classified as a partnership. The LLC has been using a required year-end of March 31 because its principal member, with a 50% interest in capital and profits, has a March 31 year-end. None of the remaining members owns more than 3% of the LLC, and they have several different tax year-ends. For valid business reasons, the principal member elects to change his tax year to June 30. Since the principal member has changed his tax year, the LLC must also change to a June 30 year-end.

**Example 2-13: Existing year-end retained for valid business purpose.**

Assume the same facts as Example 2-12, except the LLC has obtained IRS approval to retain the March 31 year-end for a valid business purpose. With IRS approval, the LLC is not required to change its year-end even though the principal member's year-end has changed. The same is true if the LLC uses a natural business year.

### Automatic Approval Process for Adoption, Change, or Retention of Tax Year

Rev. Proc. 2006-46 contains the exclusive procedures under which the IRS will grant an LLC automatic approval for an adoption, change, or retention of a tax year. An LLC complying with the provisions of the revenue procedure is deemed to have established a business purpose and obtained the approval of the Commissioner to adopt, change, or retain its tax year. The procedure generally provides that an LLC has automatic approval of a change in its tax year in the following circumstances:

a. The LLC wants to change to its required tax year or to a 52-53 week tax year ending with reference to the required year.

b. The LLC wants to change to or retain a natural business year that satisfies the 25% gross receipts test or to a 52-53 week tax year ending with reference to that year.

c. The LLC wants to change from a 52-53 week tax year that references a particular calendar month to a tax year that ends on the last day of the same calendar month, or vice versa.

d. The LLC is required to concurrently change its annual accounting period as a term and condition for the approval of a related taxpayer's change of accounting period.

Rev. Proc. 2006-46 does not apply in certain situations—for example, if the LLC is under examination. A change of tax year under the revenue procedure is also not available if the LLC has changed its tax year within the 48-month period ending with the last month of the requested tax year. For this purpose, a change to the required year (or ownership tax year) or a change to or from a 52-53 week year ending with reference to the same calendar month does not constitute a change in tax year.

To comply with the terms of the revenue procedure, the LLC must complete and file a Form 1128 and should write at the top of the form "FILED UNDER REV. PROC. 2006-46." The completed form must be mailed to Director, Internal Revenue Service, Attention: ENTITY CONTROL, where the LLC files its federal income tax return no earlier than the day following the end of the first effective year and no later than the due date (including extensions) for filing the federal income tax return for the first effective tax year. A member-manager who has personal knowledge of the facts must sign the Form 1128. A user fee is not required. The LLC also must timely file a tax return for the short period required to effect the change and attach a copy of the Form 1128. The LLC then must file subsequent tax returns for full 12-month periods ending on the last day of the requested tax year. A change in tax year that does not qualify for automatic approval under this revenue procedure must be made under Rev. Proc. 2002-39.

An LLC filing for an automatic change in tax year under Rev. Proc 2006-46 must satisfy several other conditions, including compliance with the provisions requiring maintaining books and records (including financial statements and reports to creditors) on the basis of the requested tax year.

In Information Letter 2009-0122, the IRS determined that a foreign partnership seeking to change its tax year under Rev. Proc. 2006-46 to conform to the new tax year of its majority interest corporate partner as a term and condition of the corporate partner's change under Rev. Proc. 2006-45, must make the change concurrently with the corporate partner's change in tax year, i.e., for the same "first effective year."

**SELF-STUDY QUIZ**

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

13. James, a business owner, is contemplating starting a new business that is organized as an LLC. He asks his CPA which type of LLC will offer him the most flexibility in terms of selecting a year-end for the business. In general, which is the most flexible form of LLC in terms of selecting a year end?

    a. An LLC taxed as a C corporation.

    b. An LLC taxed as an S corporation.

    c. An LLC taxed as a partnership.

    d. An LLC taxed as a disregarded entity.

14. Which of the following scenarios accurately reflects the rules regarding the selection of a tax year-end by an LLC taxed as a partnership?

    a. JKL LLC wants to establish its tax year-end during its first year of operation. JKL makes a timely election for its tax year-end when it files for its employer identification number.

    b. RST LLC maintains its financial records on a calendar year basis. RST may use the calendar year as its required year based on the default rule exception contained in IRC Sec. 706(b).

    c. ABC LLC undergoes a change in ownership structure in the current year by admitting several new members. ABC's required tax year-end might change due to the entrance of new members.

15. Which of the following statements accurately reflect the required year rules related to the tax year-end of an LLC taxed as a partnership?

    a. ABC LLC uses the "principal members" rule to determine its required tax year. Based on this rule, ABC's members that have at least a 10% interest in the capital and profits of ABC will determine its required tax year.

    b. JKL LLC is owned by several members, one of which is a tax-exempt organization that owns a 60% interest in the capital and profits of JKL. The tax-exempts organization is not subject to taxes on its distributive share from JKL. JKL will use the "majority interest" rule in determining its required tax year.

    c. RST LLC has three members, all of whom have equal interests in profits and capital. Two members share the same tax year. RST will be able to use the "majority interest" rule in determining its required tax year.

    d. XYZ LLC has five members, each of whom have equal interest in profits and capital. No member shares the same year-end. XYZ will use the "principal members" rule to determine its required tax year.

16. Which of the following scenarios accurately depicts the rules regarding changes in tax years relating to LLC taxed as partnerships?

    a. JKL LLC has three members: J who owns 50% and whose year-end is June 30, K who owns 40% and whose year-end is June 30, and L who owns 10% and whose year-end is September 30. L sells his 10 % share during the current year. JKL's required tax year will not change due to the sale of L's interest.

    b. RST LLC has three members, all of whom share an equal interest in profits and capital. RST is currently under examination by the IRS related to a previous year's filings. Because of the investigation, RST may only change its required tax year by application pursuant to Rev. Proc. 2006-46.

    c. XYZ LLC wants to change its required tax year and meets all the requirements to do so. In order to file its request in a timely manner, it must file Form 1128 by the first day following the end of the first effective tax year.

17. ABCD LLC is owned by four members: A, B, C, and D. A has a 40% profits interest and a February 28 year-end; B, a 30% profits interest and an April 30 year-end; C, a 20% profits interest and an August 31 year-end; and D, a 10% profits interest and a November 30 year-end. What is the aggregate deferral if ABCD uses D's year-end of November 30?

    a. 4.2.

    b. 4.5.

    c. 5.1.

    d. 5.5.

## SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

13. James, a business owner, is contemplating starting a new business that is organized as an LLC. He asks his CPA which type of LLC will offer him the most flexibility in terms of selecting a year-end for the business. In general, which is the most flexible form of LLC in terms of selecting a year end? **(Page 41)**

    **a. An LLC taxed as a C corporation. [This answer is correct. An LLC taxed as a corporation may select any year-end. While this type of LLC provides flexibility in this area, the LLC taxed as a C corporation limits the options to the business owner in terms of the method of accounting used in the business.]**

    b. An LLC taxed as an S corporation. [This answer is incorrect. In general, an LLC that elects S corporation status must use a calendar year-end.]

    c. An LLC taxed as a partnership. [This answer is incorrect. The year-end of an LLC taxed as a partnership is determined by IRS Sec. 706(b). While exceptions are available, certain requirements generally must be met to select a different tax year.]

    d. An LLC taxed as a disregarded entity. [This answer is incorrect. Generally, a single-member LLC may be taxed as a disregarded entity. In this case, the year-end of the LLC must be that of the member, eliminating flexibility in the selection of a tax year end.]

14. Which of the following scenarios accurately reflects the rules regarding the selection of a tax year-end by an LLC taxed as a partnership? **(Page 41)**

    a. JKL LLC wants to establish its tax year-end during its first year of operation. JKL makes a timely election for its tax year-end when it files for its employer identification number. [This answer is incorrect. An LLC's required tax year-end is established when it files its first federal tax return for the tax year. For example, if JKL files its tax return on March 15, it has established a calendar year as its tax year.]

    b. RST LLC maintains its financial records on a calendar year basis. RST may use the calendar year as its required year based on the default rule exception contained in IRC Sec. 706(b). [This answer is incorrect. An LLC taxed as a partnership must determine its required tax year based on several steps. While in many cases a calendar year will be the required year for an LLC, this is not always the case. RST should base its tax year-end on the composition of its members following the rules outlined in IRS Sec. 706(b).]

    **c. ABC LLC undergoes a change in ownership structure in the current year by admitting several new members. ABC's required tax year-end might change due to the entrance of new members. [This answer is correct. An LLC taxed as a partnership must determine its required year-end. This must be determined annually based on the members of the LLC. Since ABC admitted new members in the current year, it must ensure that its required tax year has not changed.]**

15. Which of the following statements accurately reflect the required year rules related to the tax year-end of an LLC taxed as a partnership? **(Page 42)**

    a. ABC LLC uses the "principal members" rule to determine its required tax year. Based on this rule, ABC's members that have at least a 10% interest in the capital and profits of ABC will determine its required tax year. [This answer is incorrect. The "principal members" rule takes into account members whose interest in profits and capital is *at least 5*%.]

    b. JKL LLC is owned by several members, one of which is a tax-exempt organization that owns a 60% interest in the capital and profits of JKL. The tax-exempts organization is not subject to taxes on its distributive share from JKL. JKL will use the "majority interest" rule in determining its required tax year. [This answer is incorrect. Since a tax-exempt entity owns 60% of JKL and is disregarded since its distributive share is not taxed, the "majority interest" rule cannot be used as it requires a common year-end of at least 50% of the owners of the LLC.]

c. **RST LLC has three members, all of whom have equal interests in profits and capital. Two members share the same tax year. RST will be able to use the "majority interest" rule in determining its required tax year. [This answer is correct. An LLC taxed as a partnership must determine its required year-end. Using the "majority interest" rule, if the combination of members with the same tax year owning more than 50% of profits and capital has the same tax year-end, the year-end of these members will be the required year-end. In this example, since two members each own 1/3 of RST and have the same year-end, the "majority interest" rule will apply.]**

d. XYZ LLC has five members, each of whom have equal interest in profits and capital. No member shares the same year-end. XYZ will use the "principal members" rule to determine its required tax year. [This answer is incorrect. Since all five members own 20% of XYZ and have different tax year-ends, the "principal members" rule cannot be followed. An alternate method must be employed to determine the tax year-end of XYZ.]

16. Which of the following scenarios accurately depicts the rules regarding changes in tax years relating to LLC taxed as partnerships? **(Page 42)**

a. **JKL LLC has three members: J who owns 50% and whose year-end is June 30, K who owns 40% and whose year-end is June 30, and L who owns 10% and whose year-end is September 30. L sells his 10 % share during the current year. JKL's required tax year will not change due to the sale of L's interest. [This answer is correct. Based on this example, JKL may retain its required tax year because prior to and after the sale of L's interest, a majority of JKL's members, 90%, use the same tax year, June 30. Regardless of the new members tax year, June 30 will remain JKL's required tax year.]**

b. RST LLC has three members, all of whom share an equal interest in profits and capital. RST is currently under examination by the IRS related to a previous year's filings. Because of the investigation, RST may only change its required tax year by application pursuant to Rev. Proc. 2006-46. [This answer is incorrect. LLCs who are under investigation *may not* avail themselves of Rev. Proc. 2006-46 and its automatic approval provisions.]

c. XYZ LLC wants to change its required tax year and meets all the requirements to do so. In order to file its request in a timely manner, it must file Form 1128 by the first day following the end of the first effective tax year. [This answer is incorrect. XYZ has until the due date of the federal tax return, including extensions, related to the effective tax year to file the appropriate form.]

17. ABCD LLC is owned by four members: A, B, C, and D. A has a 40% profits interest and a February 28 year-end; B, a 30% profits interest and an April 30 year-end; C, a 20% profits interest and an August 31 year-end; and D, a 10% profits interest and a November 30 year-end.

What is the aggregate deferral if ABCD uses D's year-end of November 30? **(Page 43)**

a. 4.2. [This answer is incorrect. 4.2 is not the aggregate deferral using any of the members' tax years in this example.]

b. **4.5. [This answer is correct. Using D's year-end of November 30, the aggregate deferral is 4.5, calculated as follows: Deferral on A, 40% × 3 months, or 1.2; B, 30% × 5 months, or 1.5; C, 20% × 9 months, or 1.8; and D, 10% × 0 months, or 0 (1.2 + 1.5 + 1.8 + 0 = 4.5).]**

c. 5.1. [This answer is incorrect. Using C's year-end of August 31, the aggregate deferral is 5.1, calculated as follows: Deferral on A, 40% × 6 months, or 2.4; B, 30% × 8 months, or 2.4; C, 20% × 0 months, or 0; and D, 10% × 3 months, or .3 (2.4 + 2.4 + 0 + .3 = 5.1).]

d. 5.5. [This answer is incorrect. Using B's year-end of April 30, the aggregate deferral is 5.5, calculated as follows: Deferral on A, 40% × 10 months, or 4.0; B, 30% × 0 months, or 0; C, 20% × 4 months, or .8; and D, 10% × 7 months, or .7 (4.0 + 0 + .8 + .7 = 5.5).]

# THE *NONCONFORMING* TAX YEAR RULES

Exceptions to the required year rules allow LLCs taxed as partnerships to use a *nonconforming* tax year. A nonconforming tax year is one *other than* the required year. The exceptions are as follows:

a. An LLC can use a tax year other than its required year by establishing the alternative year is a natural business year. Rev. Proc. 2002-39 establishes the general rule and safe harbors for determining if an LLC qualifies to adopt a tax year based on a natural business year.

b. If an LLC cannot meet the natural business year exception, it can attempt to establish a business purpose [under Reg. 1.706-1(b)(2)(ii) and Rev. Proc. 2002-39] for the use of a year other than its required year. The determination of whether a business purpose exists is based on all relevant facts and circumstances, including tax consequences of electing the alternative year. Rev. Proc. 2002-39 establishes the general rule and safe harbors for determining if an LLC qualifies to adopt a tax year based on a business purpose.

c. A new LLC can make a Section 444 election to use a nonconforming year if the deferral period is not more than three months.

d. An existing LLC using its required year cannot make a Section 444 election to change to a nonconforming year. However, the LLC may be able to make a Section 444 election to retain its existing year if the required year changes.

e. An existing LLC that has made a previous Section 444 election may be able to retain its existing year or adopt a new nonconforming year when its required year changes.

f. An LLC may have a taxable year other than its required year if it elects to use a 52-53 week tax year that ends with reference to its required year.

# EXCEPTION FOR A NATURAL BUSINESS YEAR

An LLC can apply for a nonautomatic change in tax year if it can show it has a natural business year. An LLC has a natural business year if it qualifies under any of the three following tests:

- The annual business cycle test described below.
- The seasonal business test described below.
- The 25-percent gross receipts test described below.

If an LLC has a natural business year under any of these three tests and agrees to comply with the terms and conditions outlined in Rev. Proc. 2002-39, the request for a change to the LLC's natural business year will be approved. This revenue procedure does not apply to certain LLCs—for instance, those under examination by the IRS (unless permission is received) or those with members under examination (if the LLC's tax year is an issue under consideration).

### Annual Business Cycle Test

If an LLC's gross receipts for the short period ending with the requested year-end and the three immediately preceding tax years indicate that the LLC has a peak and non-peak period of business, the LLC's natural business year is deemed to end at, or soon after, the close of the highest peak period of business. An LLC that has not been in existence for a sufficient period to provide gross receipts information may provide information other than gross receipts to demonstrate a peak and non-peak period of business, such as a description of its business or reasonable estimates of future gross receipts. In applying this test, a safe harbor provides that "soon after" is deemed to be one month after.

**Example 2-14: Qualifying a natural business year under the annual business cycle test.**

Dad's Ties LLC (DT) is a retail business selling men's neckwear. Its peak sales occur in June with the Father's Day rush. In July, a significant amount of the merchandise that was purchased in June is either returned or exchanged. DT's natural business year is deemed to end at June 30 at the close of the highest peak period of business, or soon after (July 31 under the safe harbor) under the annual business cycle test. A request by DT for a June 30 or July 31 year-end under Rev. Proc. 2002-39 would be granted, subject to the general terms and conditions outlined in the procedure.

**Seasonal Business Test**

An LLC also is deemed to have a natural business year if its gross receipts for the short period ending with the requested year-end and the three immediately preceding tax years indicate that the LLC's business is operational for only part of the year, resulting in insignificant gross receipts in the remainder of the year. (A safe harbor provides that an amount equal to less than 10% of the LLC's total gross receipts is deemed to be insignificant.) This may, for example, result from the LLC's business being dependent on certain types of weather, as in the case of a ski resort. If an LLC meets the seasonal business test, its natural business year is deemed to end at, or soon after, the operations end for the season. If the LLC has not been in business long enough to provide gross receipts information for the required period, it may provide information other than gross receipts to demonstrate that it satisfies the requirements of a seasonal business, such as a description of its business or reasonable estimates of future gross receipts. As with the annual business cycle test, the term "soon after" is deemed to be one month after.

**Example 2-15: Qualifying a natural business year under the annual business cycle test.**

Agua Caliente LLC (AC) operates a water park that is open from May through August each year. During April, the employees inspect the attractions and ready the park for opening. In September, the employees clean up the park and prepare it for the winter. The park earns less than 10% of its annual gross receipts during the period from September through April, when it is closed to the public. AC's natural business year is deemed to end on August 31 when the park ceases operations for the year, or soon after (September 30). A request by AC for an August 31 or September 30 year-end under Rev. Proc. 2002-39 would be granted, subject to the terms and conditions outlined in the procedure.

**Gross Receipts Test**

An LLC's natural business year can also be determined by applying a mechanical 25% gross receipts test over a three-year period (unless the LLC is part of a tiered structure). The gross receipts test is based on the three most recent 12-month periods ending with the last month of the requested fiscal year. For example, if an LLC wants to change to an August 31 year-end in 2011, the "three most recent years" are the three years ending on August 31, 2009, 2010, and 2011. To pass the test, more than 25% of the LLC's gross receipts for each of the three 12-month periods must have occurred in the last two months of each respective period. If the LLC qualifies for more than one natural business year, the year-end with the highest three-year average percentage of gross receipts in the final two months is the LLC's natural business year.

Certain special rules apply in determining if an LLC meets the 25% of gross receipts test as follows:

- The LLC must compute its gross receipts under the method of accounting used to prepare its federal income tax return.
- Regardless of the LLC's method of accounting, the LLC's share of income from a pass-through entity generally must be reported as gross receipts in the month that the pass-through entity's tax year ends. (This test does not appear to apply to gross receipts calculations under the automatic approval procedure of Rev. Proc. 2006-46.)
- If the LLC has a predecessor organization and is continuing the same business as its predecessor, the LLC must use the gross receipts of the predecessor in testing the LLC's gross receipts.
- If the LLC (including any predecessor organization) does not have a 47-month period of gross receipts (36-month period for requested tax year plus additional 11-month period for comparing requested tax year with other potential tax years), then it cannot establish a tax year using the 25% gross receipts test.

- If the requested year is a 52-53 week year, the calendar month ending nearest to the last day of the 52-53 week year is treated as the last month of the requested tax year for purposes of applying the 25% gross receipts test.

**Example 2-16: Natural business year 25% mechanical test.**

Ace LLC was formed more than three years ago and is classified as a partnership for federal tax purposes. The LLC was required to adopt a March 31 year-end. The LLC now wants to adopt an August 31 year-end. The gross receipts for the three most recent years are:

| Year | Period | Gross Receipts |
|---|---|---|
| 1 | 9/1/08 to 8/31/09 | $ 270,000 |
| | 7/1/09 to 8/31/09 | 73,000 |
| 2 | 9/1/09 to 8/31/10 | 310,000 |
| | 7/1/10 to 8/31/10 | 80,000 |
| 3 | 9/1/10 to 8/31/11 | 340,000 |
| | 7/1/11 to 8/31/11 | 86,000 |

Since more than 25% of the gross receipts (27%, 25.81%, and 25.29%, respectively) occurred in the last two months for all three 12-month periods, the LLC's natural business year-end is August 31. An August 31 year-end can be requested. A short period return is required for the period beginning on April 1 and ending on August 31.

**Example 2-17: LLC fails 25% mechanical test for a prior year.**

Assume the same facts as Example 2-16, except the 25% test is not met in the third 12-month period. In this case, the Ace LLC has not met the natural business year mechanical test and must retain its March 31 year-end unless it can demonstrate a business purpose for selecting another year-end.

An LLC filing for a change in tax year based on the gross receipts test may qualify for the automatic approval procedures of Rev. Proc. 2006-46.

## FACTS AND CIRCUMSTANCES BUSINESS PURPOSE EXCEPTION

LLCs that do not have a natural business year can attempt to establish a business purpose for using a tax year other than its required year. In reviewing a request for a tax year based on the business purpose exception, the Service considers all relevant facts and circumstances including the tax consequences of permitting the requested tax year. IN REV. PROC. 2002-39, THE SERVICE INDICATES THAT A TAXPAYER WILL BE GRANTED PERMISSION TO ADOPT, CHANGE, OR RETAIN A TAX YEAR UNDER THE FACTS AND CIRCUMSTANCES TEST ONLY IN RARE AND UNUSUAL CIRCUMSTANCES. This is basically the same rule that applied to requests for business purpose year-ends under the rules in effect prior to the issuance of Rev. Proc. 2002-39.

Specifically, the following reasons are not considered business purposes:

a. To use a year-end that defers income to members.

b. To use the same year-end used for regulatory or financial accounting purposes.

c. To use a year-end that reflects hiring patterns of a business.

d. To use a year-end that reflects other administrative concerns such as retirement of members, admission of members, promotion of staff, compensation or retirement arrangements with members or staff, etc.

e. To use a year-end that reflects the date of the publication of price lists, model changes, or similar events occurring on an annual basis.

f. To use a year-end that reflects the year-end used by a related entity.

g. To use a year-end that reflects the year-end used by a competitor.

**Example 2-18: Qualifying a business year under the facts and circumstances test.**

Whitewash LLC has a required year ending September 30 and has no natural business year. The LLC wants to change to a July 31 year-end because:

1. Its inventories are at the lowest level at that time and are easier to count.

2. August 1 is the start of the new model year.

3. The firm's tax practitioner will reduce his audit fee by 10% if Whitewash changes its year-end.

Additionally, all the members will be able to defer significant tax liabilities.

The business purpose test probably is not met because the reasons given are of the type the IRS will not consider acceptable as outlined in Rev. Proc. 2002-39. Consequently, Whitewash probably is stuck with its September 30 required year unless it makes a Section 444 election.

**Requesting a Year Based on a Business Purpose**

An LLC seeking to retain a tax year, change its tax year, or adopt a tax year on the basis of the business purpose test, including the natural business year tests, must complete, sign, and file Form 1128 in accordance with the form's instructions. A member-manager must sign the form on behalf of the LLC. If the LLC changed its tax year at any time within the most recent 48-month period ending with the last month of the requested tax year, a copy of the application for the previous change, the ruling letter, and any other related correspondence from the Service should be attached to the application. If a prior application was withdrawn, not perfected, or denied, or if the change in tax year was not made, and the LLC files another application to change its tax year within the most recent 48-month period ending with the last month of the requested tax year, a copy of the earlier application, together with any related correspondence with the Service must be attached to the application. The filer should also attach an explanation of why the earlier application was withdrawn or not perfected or why the change was not made. If the LLC requests a natural business year under the annual business cycle test or the seasonal business test, it must provide its gross receipts and approximate inventory costs (where applicable) for each month in the requested short period and each month in the three immediately preceding tax years. If the LLC requests a natural business year under the 25% gross receipts test, it must supply the gross receipts for the most recent 47 months for itself (or any predecessor).

**When to File.** An LLC requesting a new tax year under the provisions of Rev. Proc. 2002-39 must file Form 1128 no earlier than the day following the end of the first effective tax year (the short tax year). Form 1128 must be filed no later than the due date (not including extensions) of the federal income tax return for the short year. However, the Service recommends that the Form 1128 be filed as early as possible to provide the Service adequate time for a response. [In the case of a change to or from a 52-53 week year that results in a short year of six days or less, Form 1128 must be filed no earlier than the day following the end of the short period and no later than the due date (not including extensions) of the federal income tax return for the short year, even though the short period is not treated as a separate tax year under Reg. 1.441-2(b)(2).] A taxpayer that fails to file a Form 1128 within the prescribed time period may request an extension of time to file under Reg. 301.9100-1 through Reg. 301.9100-3. Under Reg. 301.9100-3, a Form 1128 filed within 90 days after the filing deadline may be considered timely filed if the LLC establishes that it acted reasonably and in good faith and that granting relief will not prejudice the interests of the government. If a Form 1128 is filed more than 90 days after the filing deadline, it will be approved only in unusual and compelling circumstances. If an incomplete Form 1128 is filed, the Service will inform the applicant of the information required to complete the form and the applicant will be given 21 days from the date of notification to provide the information.

**Where to File.** LLCs requesting an automatic approval of a tax year change should file Form 1128 with the Internal Revenue Service Center, Attention: Entity Control where the LLC's income tax return is filed. (The applicant must also attach a copy of the completed Form 1128 to the federal income tax return for the short period required to effect the change.) LLC's requesting nonautomatic approval of a change in tax year should mail Form 1128 along with any required attachments to: Internal Revenue Service, Associate Chief Counsel (Income Tax and Accounting), Attention: CC:PA:LPD:DRU, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044.

**User Fee.** An LLC filing for a change in tax year under the provisions of Rev. Proc. 2002-39 must include a user fee with Form 1128. The amount of the fee is $3,200 (Rev. Proc. 2010-1). However, a reduced fee of $625 may apply to LLCs with gross income of less than $250,000 ($2,000 if the LLC's gross income is more than $250,000, but less than $1 million). The user fee for filing an extension of time to file Form 1128 under Reg. 301.9100-3 is $2,800 (unless the reduced fees for small LLCs apply).

**Audit Protection.** Generally, an LLC that applies for a change in tax year under Rev. Proc. 2002-39 and complies with all the procedure's terms and conditions will not be required to change its tax year for a taxable period prior to the first effective year of the change.

## NONCONFORMING YEAR BASED ON A SECTION 444 ELECTION

The final alternative to using an LLC's required year is to elect a year-end by filing a Section 444 election. Under IRC Sec. 444, an LLC can elect to adopt, change to, or retain a tax year other than its required year. New LLCs can elect to adopt a tax year other than the required year if the deferral period of the elected year is not more than three months. An existing LLC not using its required year can elect to change its year-end if the deferral period of the elected tax year is no more than the shorter of (a) three months or (b) the deferral period of the tax year being changed. For example, an LLC using a natural business year can change its tax year if it satisfies these conditions.

Under IRC Sec. 444, the term "deferral period" means the number of months from the end of the elected tax year forward to the end of the required year. The "deferral period of the tax year being changed" means the deferral period of the LLC's existing tax year with respect to the current required year.

**Example 2-19: Section 444 election for LLC using a natural business year.**

Tricom LLC adopted a July 31 year-end under the natural business year rule. It now wants to elect under IRC Sec. 444 to change to an October 31 year-end. (All members have calendar year-ends, so the required year is December 31.)

Since the deferral period of the proposed new year with respect to the required year (two months) is shorter than the lesser of (a) three months or (b) the deferral period of the existing tax year (five months), the election can be made.

**Example 2-20: Section 444 election not allowed because it would lengthen deferral period.**

Assume the same facts as Example 2-19, except Tricom wants to elect a May 31 year-end. Since the deferral period of the proposed year with respect to the required year is longer than the current deferral period, the election cannot be made.

**Example 2-21: LLC using required year cannot change to a new year under IRC Sec. 444.**

Uh-Oh LLC failed to make a Section 444 election in its initial year. The LLC's first-year return was filed using its required year of December 31. Uh-Oh cannot make a later Section 444 election to change to a nonconforming year because any other year-end would result in a greater deferral period than the existing calendar year (which has a deferral period of zero). Even if its required year changes, Uh-Oh cannot make a Section 444 election to change its tax year. However, Uh-Oh may be able to elect to retain its old required year.

**Example 2-22: Section 444 election to retain old required year when required year changes.**

Star Properties LLC uses its required year ending November 30. Because of a change in year-ends of the principal members, Star's required year-end changes to December 31. Star can make a Section 444 election to retain its November 30 year-end, since the deferral period is only one month with respect to the new required year-end of December 31. Star should file Form 8716 (Election to Have a Tax Year Other Than a Required Tax Year) to retain the November 30 year-end.

**Example 2-23: New Section 444 election when required year changes after an earlier Section 444 election.**

Hutch Investors LLC made a prior year Section 444 election to use a nonconforming year-end of September 30. Its required year-end was December 31. Now Hutch's required year-end has changed to January 31. Hutch cannot retain its existing year-end because the deferral period would exceed three months. However, Hutch could make a new Section 444 election to choose either October 31, November 30, or December 31 as its new year-end.

### When Is a Section 444 Election Beneficial?

A Section 444 election results in a tax deferral as long as the LLC's taxable income increases from year to year. This is because the required payment for the current year is based on the income of the prior year. However, with the maximum 2010 individual rate at 35% (resulting in a required payment percentage of 36%) and the possibility of increased rates in 2011, it may no longer be beneficial to keep a Section 444 election in place. Even if the LLC's income is increasing, the required payment may be prohibitive, particularly when members are in lower tax brackets. Furthermore, the required payment is, in effect, prepaid tax on which no interest is earned, making the cost of the Section 444 election even higher. Some factors to consider in deciding whether to make or keep a Section 444 election are:

a. The length of the deferral period versus the amount of the payment.

b. Whether the increase in income will continue at the present rate, or will stop or decrease.

c. The impact of the election on state tax deferral. (If the state has no required payment rules, the state tax deferral alone might make the Section 444 election attractive.)

d. The prospect of continuing income versus loss from the LLC.

e. The members' current and projected tax rates compared to the required payment percentage.

f. The fact the Section 444 election cannot be made again if it is terminated. (Practitioners may want to think twice before recommending termination of the election—with the frequent changes Congress has made to the tax rates, just because the required payment may seem prohibitive now, does not mean that it will be in two years time.)

g. The failure of the LLC to qualify for the Section 444 election because of its ownership structure. (Temp. Reg. 1.444-2T provides that no Section 444 election is available to an LLC that is part of a tiered structure that consists entirely of partnerships and LLCs taxed as partnerships.

### Electing a Tax Year under IRC Sec. 444

A Section 444 election is made by filing Form 8716 (Election to Have a Tax Year Other Than a Required Tax Year). Form 1128 is not required. Form 8716 must be filed by the earlier of (a) the 15th day of the fifth month following the month that includes the first day of the tax year for which the election will first be effective, or (b) the due date, without extensions, of the income tax return for the first year resulting from the Section 444 election. Additionally, a copy of Form 8716 must be attached to the LLC return for the first tax year the election is made. Furthermore, Form 8752 (Required Payment or Refund Under Section 7519) must be filed for each year the Section 444 election remains in effect.

If the automatic extension provisions of Reg. 301.9100-2 are used, all members must report their income consistently with the election for the year the election is made and for all subsequent years.

**Example 2-24: Due date of Form 8716 to make Section 444 election.**

Anderson & Bonwit LLC (A&B) has an existing year-end of July 31. Its required year ends on November 30. In 2011, A&B wants to elect an October 31 year-end under IRC Sec. 444. This is allowed because it results in a shorter deferral period (when compared to the November 30 required year) than A&B's existing year-end.

Per Temp. Reg. 1.444-3T, Form 8716 must be filed by January 15, 2012 [the 15th day of the fifth month following August, which includes the first day (August 1, 2011) of the short period ending on October 31, 2011]. This date is earlier than the due date of the return for the first year resulting from the election, which is February 15, 2012.

Now assume A&B wants to use an August 31 year-end. Form 8716 must be filed by December 15, 2011, which is the tax return due date (without extensions) for the short period return covering August 1–31, 2011. This is an earlier date than January 15, 2012, the 15th day of the fifth month following August 2011 (which includes the first day of the short period).

### Backup Section 444 Elections

Newly formed LLCs attempting to obtain approval for a nonconforming tax year on the basis of a business purpose can make a backup Section 444 election. The backup election, which becomes effective if the requested business purpose year-end is denied, is made by filing Form 8716 and typing or printing "BACKUP ELECTION" on the top of the form. However, if the Form 8716 is filed on or after the date Form 1128 is filed, "FORM 1128 BACKUP ELECTION" must be printed or typed across the top of Form 8716.

If the requested business purpose year-end is denied, the backup election is activated by filing Form 8752 (Required Payment or Refund Under Section 7519) and making the required payment. The form must be filed and the required payment made by the later of (a) the normal due date of the required payment, or (b) 60 days from the date the IRS denies the business purpose year-end request.

### Terminating a Section 444 Election

Once a Section 444 election is made, it remains effective until one of the following occurs:

a. The LLC voluntarily or involuntarily changes to its required tax year-end. The termination is effective on the first day of the short year resulting from the change.

b. The LLC actually liquidates or is deemed to be liquidated under IRC Sec. 708. The termination is effective on the date the liquidation is completed.

c. The LLC willfully fails to make the necessary required payments under IRC Sec. 7519. The termination is effective on the first day of the LLC's tax year (determined as if a Section 444 election had not been made).

d. The LLC becomes a member of a tiered structure. The termination is effective on the first day of the tax year in which the LLC is considered a member of the tiered group.

If a Section 444 election is terminated, the LLC is again subject to the required year rules. The LLC must file a short period return for the required year by the appropriate due date (including extensions). The return should have "SECTION 444 ELECTION TERMINATED" written or typed across the top of page 1. Per IRC Sec. 444(d)(2)(B), once a Section 444 election has been terminated, the LLC cannot make another Section 444 election for any future period.

**Example 2-25: Termination of Section 444 election with a short year.**

XYZ LLC has an August 31, 2011, year-end. XYZ wants to terminate its Section 444 election in 2011 and have a December 31 year-end. The election can be terminated by filing a tax return for the short year ended December 31, 2011, by the due date or extended due date. When the tax return is filed, "SECTION 444 ELECTION TERMINATED" should be typed or written across the top of page 1.

As previously discussed, an LLC cannot make a Section 444 election if it previously terminated such an election. The practitioner may have difficulty in determining how to apply this rule when:

a. *An LLC That Has Made a Section 444 Election Terminates under the Technical Termination Provisions of IRC Sec. 708.* Under the Section 708 regulations, the existing LLC terminates upon certain changes in ownership. In this situation, the new LLC is not precluded from making a Section 444 election. The IRS treats an entity formed after a Section 708 termination as a new entity that, for example, must make a new Section 754 election.

b. *A Partnership with a Previous Section 444 Election Is Converted into an LLC.* In such cases, the form of the conversion determines whether the partnership's previous Section 444 election will preclude the LLC from making a Section 444 election. If the LLC is deemed to convert to LLC status by means of a merger or certificate of conversion, the LLC will not be able to make the election. Under the guidelines of Rev. Rul. 95-37, such a conversion of a partnership into an LLC is treated like the conversion of a general partnership into a limited partnership. The conversion does not cause the termination of the existing partnership under IRC Sec. 708, the partnership's tax year does not end, and the LLC is not required to apply for a new federal identification number.

**Terminating a Section 444 Election for Tax Planning Reasons**

LLCs with nonconforming year-ends may need or wish to change their tax year to a required year for tax planning reasons. Since terminating a Section 444 election means no future election can be made, the use of this planning technique has some risk. However, certain circumstances may demand a change in year-end, such as when the LLC experiences an unusually large loss in the first few months of a year or when the LLC has unusually high income early in the year and its members have expiring loss carryforwards.

**Example 2-26: Automatic change as a tax planning technique.**

Ralph, Potsy, and Richie own an LLC with a Section 444 fiscal year-end of September 30. The LLC's required year-end is December 31. All three members meet the material participation standard for the LLC's business, so the passive loss limitations do not apply. Because of extraordinary circumstances, the LLC is expected to have a $600,000 loss from October 1–December 31, 2011. If the Section 444 election is terminated, and the LLC adopts its required year-end of December 31, 2011, the members can deduct their proportionate shares of the short year loss on their 2011 tax returns.

**Effect of Tiered LLCs**

**General Rule.** A member of a tiered structure cannot elect under IRC Sec. 444 to have any year other than its required year. A tiered structure exists when an LLC, partnership, S corporation, or personal service corporation owns directly or is owned directly by another LLC, partnership, S corporation, personal service corporation, or trust (other than a grantor trust).

**Exceptions.** There are two major exceptions to the general rule. The upstream *de minimis* rule provides that ownership of an LLC (the owned LLC) by another LLC, partnership, S corporation, personal service corporation, or trust is disregarded if the direct cumulative ownership is 5% or less. The downstream *de minimis* rule disregards an LLC's ownership of other LLCs, partnerships, S corporations, personal service corporations, or trusts if the LLC's cumulative pass-through share is less than 2% of the gross income or less than 5% of the adjusted taxable income (including separately stated items and guaranteed payments) of the LLC.

The downstream *de minimis* rule permits the election of a nonconforming tax year only if the tiered structure consists exclusively of LLCs, partnerships, and S corporations, and if all component members of the tiered structure have the same tax year.

**Example 2-27: Principal members required year rule applied to tiered-structure LLC.**

An LLC has two 24% members. Both are S corporations and have a March 31 year-end. The other members have December 31, June 30, or July 31 year-ends. None of the other members owns more than a 2% interest.

The LLC is part of a tiered structure and is required to have a March 31 year-end under the principal members rule. A nonconforming year-end is not allowed under IRC Sec. 444. Neither *de minimis* rule applies.

**Example 2-28: Majority interest required year rule applied to tiered-structure LLC.**

An LLC has three equal members. One is a corporation with an October 31 year-end, the second is an individual with a December 31 year-end, and the third is a partnership with a December 31 year-end. The LLC is part of a tiered structure. Since neither *de minimis* exception applies, the LLC has a December 31 required year-end (under the majority interest rule) that cannot be changed by making a Section 444 election.

## REQUIRED PAYMENTS WHEN A SECTION 444 ELECTION IS MADE

An LLC electing under IRC Sec. 444 to use a tax year other than its required year must make annual payments submitted with Form 8752. Payments are required even if the Section 444 election was made only to retain an existing year (i.e., when the LLC's required year changed). The required payments constitute a prepaid tax deposit based on the projected cumulative tax deferral created by the use of the nonconforming year for the preceding year. When the deferred tax liability increases, an additional required payment must be made. When the deferred tax liability decreases, the LLC receives a refund of the excess prepaid tax deposit.

An LLC electing a nonconforming year-end under IRC Sec. 444 need not make a required payment if the total deferred tax liability for the current and preceding election years does not exceed $500. However, for any year a Section 444 election is in effect, a Form 8752 must be filed even if there is no payment liability. According to CCA 200411043, to obtain a refund of excess required payments, a partnership, LLC, or S corporation is required to file all delinquent Forms 8752.

### Procedure for Making Required Payment

Form 8752, along with the required payment, must be filed by May 15 following the calendar year in which the current Section 444 election year began. For example, if an LLC's current Section 444 election year began on October 1, 2011, Form 8752 and the required payment are due by May 15, 2012. If the required payment is not made on time, a 10% penalty is imposed on the underpayment. (The penalty for failure to make timely required payments for pass-through entities is not imposed if the taxpayer had reasonable cause.) Willful failure to make the required payment terminates the Section 444 election.

Per Temp. Reg. 1.7519-1T(a)(3), the required payment for the current Section 444 election year is calculated by multiplying the LLC's net income (as defined below) for the preceding tax year (the "base year") by the deferral ratio and then adding back any "applicable payments" to arrive at "base year net income," which is then multiplied by the highest individual tax rate plus 1%. The "deferral ratio" is the deferral period divided by 12 months. The "deferral period" is the number of months from the end of the elected year forward to the end of the required year. For example, an LLC with an elected year-end of September 30 and a required year of December 31 has a three-month deferral period.

**LLC Net Income.** For purposes of the required payment calculation, LLC net income includes all LLC income and expense (including amounts required to be separately stated) except for credits, tax-exempt income, nondeductible expenses, and guaranteed payments. Any potential income or loss recognition limitation at the member level is disregarded in determining LLC net income for required payment purposes. Also, the net income can never be less than zero. LLC net income is multiplied by the deferral ratio to arrive at the first component in the calculation of base year net income.

**Applicable Payments.** Applicable payments are amounts deducted by the LLC and included in the income of LLC members (for example, rent paid by the LLC to a member but not a guaranteed payment). Such amounts, subject to certain limitations, must be added back to LLC net income to calculate base year net income. The amount included in base year net income is limited to the excess of (a) total payments to the member multiplied by the deferral ratio over (b) amounts actually paid during the deferral period included in the preceding year.

**Base Year Net Income.** To arrive at base year net income, the product of LLC net income multiplied by the deferral ratio is added to any applicable payments. Base year net income is then multiplied by the highest individual tax rate plus 1% to arrive at the required payment.

**Example 2-29: Computation of LLC's net income for required payment purposes.**

Bulloney LLC has a Section 444 tax year ending August 31. Its required year is November 30. The following comes from Bulloney's tax return for the year ended August 31, 2011 (the base year):

| | |
|---|---|
| Taxable income for base year | $ 120,000 |
| Add back Interest income | 20,000 |
| Deduct—Capital loss | (10,000) |
| Deduct—Passive loss | (40,000) |
| LLC net income for base year | $ 90,000 |

The capital and passive losses are deducted in full because no potential limitation on a member's ability to deduct a loss or other item is considered in calculating the required payment.

**Example 2-30: Addback of applicable payments to members.**

Assume the same facts as Example 2-29, except $240,000 of rent paid to a member was deducted in arriving at taxable income of $120,000. Included in the $240,000 rent payment is $25,000 paid during the deferral period (September 1–November 30, 2010) included within the base year. How much of the rent payment is added back to net base year income to calculate the required payment for the election year beginning on September 1, 2011?

The addback equals the applicable payments multiplied by the deferral ratio ($240,000 × 3/12 = $60,000) less the amounts paid during the deferral period ($25,000), which equals $35,000 ($60,000 − $25,000). (The deferral ratio is the number of months in the deferral period divided by 12.)

**Example 2-31: Computation of net base year income and required payment.**

Assume the same facts as Example 2-30. Bulloney's required payment for the election year beginning on September 1, 2011 equals:

| | |
|---|---|
| LLC net income for base year | $ 90,000 |
| Deferral ration | × 3/12 |
| Subtotal | $ 22,500 |
| Plus: applicable payment | 35,000 |
| Bulloney's net base year income | $ 57,500 |
| Highest individual tax rate plus 1%[a] | × 36 % |
| Bulloney's required payment | $ 20,700 |

**Note:**

[a] This calculation assumes the highest individual tax rate remains 35% for 2011. It is likely that a higher rate may actually apply.

**Short Period Base Year.** If the tax year preceding the election year is a short year, the net base year income is the excess, if any, of (a) annualized short base year income multiplied by the deferral ratio over (b) applicable payments made during the deferral period of the current election year. Annualized short base year income is calculated first by adding back *all* applicable payments deductible in the short base year to net income for the short period. This total is then annualized by multiplying by 12 and dividing by the number of months in the short year.

### Cumulative Nature of Required Payments

In effect, required payments are a cumulative tax deposit made with the IRS. Accordingly, payments made for prior Section 444 election years are deducted from the current required payment to compute the net payment due for the current Section 444 election year. No interest is earned by the LLC on the required payment. A refund of excess required payments can be requested when the Section 444 election is terminated or when the total required payments made for previous years exceed the required payment computed for the current Section 444 election year.

### Timing of Refund Claim for Excess Required Payments

When an LLC's cumulative required payments made in prior years exceed the required payment for the current year, IRC Sec. 7519(c)(3) specifies the IRS must refund the excess to the LLC by the later of:

a. April 15 of the calendar year following the calendar year in which the election year begins, or

b. 90 days after the claim for refund is filed with the IRS.

The IRS is not required to pay interest on a late refund of required payments under IRC Sec. 7519. The U.S. Court of Federal Claims held in *Semmes, Bowen & Semmes v. U.S.* that IRC Sec. 7519 prohibits the payment of any interest on refunds, irrespective of whether the refund is overdue.

The IRS recently provided interim guidance on the computation of interest on underpayments of Section 7519 required payments (SBSE-20-1209-031). This guidance will be added to the Internal Revenue Manual at IRM 20.2.11.10 during 2010. This provision will require the interest on an underpayment will be calculated from May 15 of Year 1 to May 15 of year 2 based on the applicable rates for that period. Underpayments will be subject to the 10% penalty under IRC Sec. 7519(f)(4).

## SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

18. Hunter's Paradise (HP) LLC, which provides guided hunts during hunting season, wants to apply for a change in tax year based on the natural business year exception. Gross receipts for the current year were $150,000. For HP to use the safe harbor of the "seasonal business test" to support its application, what is the maximum amount of revenue generated outside of hunting season?

    a. $7,500.

    b. $15,000.

    c. $37,500.

    d. $50,000.

19. Which of the following scenarios accurately applies the rules of the gross receipts test under the natural business exception when an LLC is trying to change its tax year?

    a. ABC LLC began operations two years ago and uses the "majority interest" rule to determine its required tax year. ABC will not be able to change its tax year based on the gross receipts test.

    b. JKL LLC is owned by three members, one of which is an S corporation. In applying the gross receipts test, JKL must allocate its distributive share of income from the S corporation ratably over the tax year in question.

    c. RST LLC was converted in the current year from a partnership that had been in existence for five years. It is continuing the business operated by the partnership. RST cannot use the gross receipts test to determine its tax year.

20. Which of the following businesses would most likely qualify under the business purpose exception in an attempt to use a tax year other than the required year?

    a. ABC Investments LLC wants to change to an April 30 year-end because it will assist its members in their financial planning.

    b. JKL Real Estate LLC wants to change to a June 30 year-end because it corresponds to the year end of a recent acquisition.

    c. RST Golf LLC wants to change to a September 30 year-end because the number of rounds played by golfers decreases beginning in October.

    d. XYZ Used Car Sales LLC wants to change to a calendar year-end because it clears out its inventory at the end of the year for tax reduction purposes.

21. Which of the following scenarios is true regarding an LLC's request for a different tax year based on a business purpose?

    a. ABC LLC is making a request to change its tax year under the business purpose exception. Two years ago, a similar request was denied by the IRS. ABC may not make the request in the current year due to the previous denial.

    b. JKL LLC is making a request to change its tax year under the business purpose exception. JKL has three members: John, who is a member-manager; and Katie and Lisa, who are nonmanaging members. John is the only member who is required to sign the form submitted to the IRS.

c. RST LLC is making a request to change its tax year under the business purpose exception. RST's gross income in the current year is $225,000. It must pay a fee of $3,200 with its application in order to change its tax year.

d. XYZ LLC is making a request to change its tax year under the annual business cycle test. To ensure approval, it must include its annual gross receipts and average accounts receivable for the previous four years related to the request.

22. Under which of the following scenarios may the LLC in question make a Section 444 election for a tax year other than its required year?

a. ABC LLC has been in existence for five years. Its required tax year is April 30; however, it adopted a calendar year end under the gross receipts test. It wants to adopt a tax year of March 31 by making a Section 444 election. ABC may make a Section 444 election changing its tax year to March 31.

b. JKL LLC is formed in the current year and its required year end is October 31. It wants to make a Section 444 election in its initial year to change its tax year to April 30. JKL may make a Section 444 election to change its tax year to April 30.

c. RST LLC has been in business for six years. It has a required tax year of June 30. It adopted a tax year of March 31 using the natural business year exception. It wants to make a Section 444 election changing its tax year to a calendar year. RST may make a Section 444 election changing its tax year to the calendar year.

d. XYZ LLC has been in business for three years and has used its required tax year of September 30 since its inception. In the current year, it wants to adopt a tax year of August 31 by making a Section 444 election. XYZ may make a Section 444 election changing its tax year to August 31.

23. What advantage does an LLC and/or its members gain from making a Section 444 election?

a. Electing a different tax year under Section 444 simplifies tax compliance for the LLC.

b. Payments required of the LLC by Section 444 are based on a percentage that is less than the individual members' marginal tax rate, deferring some of the payments to a later time.

c. Payments required as a result of Section 444 are based on the previous year's income, deferring some of the payment due to increasing income to the next year.

d. Electing a different tax year under Section 444 is made on an annual basis, allowing flexibility on the part of the LLC to time payments to maximize cash flow.

24. Which of the following scenarios accurately reflects the rules regarding Section 444 elections to change to a nonconforming tax year?

a. ABC LLC is a new LLC that has been converted from a partnership in the current year. The partnership had previously made an election under Section 444. ABC is required to file a new election under Section 444 to maintain the same nonconforming tax year.

b. JKL LLC is owned by 5 members. Due to individual tax planning issues, each member wants to terminate JKL's previous Section 444 election in the current year. JKL's petition to the IRS to terminate its Section 444 election will be denied since tax planning is not a valid reason for termination.

c. RST LLC is owned by 4 members, two of which are S corporations. The two S corporations each own 8% of RST. Based on the composition of RST's ownership structure, RST will be able to make a Section 444 election to change to a nonconforming tax year.

d. XYZ LLC is attempting to change to a nonconforming tax year under the business purpose exception. XYZ may still avail itself of the Section 444 election to change its tax year if the IRS denies its application under the business purpose exception.

25. Which of the following scenarios correctly applies the rules of making a required payment pursuant to a Section 444 election?

    a. ABC LLC made a Section 444 election in the current year and is preparing Form 8752 to file with the IRS. ABC must file the form and make the required payment by March 15 with its annual tax return.

    b. JKL LLC calculates its deferred tax liability for the current and preceding years to be $450. JKL does not have to make a payment, but it must file Form 8752 in the current year.

    c. RST LLC makes a Section 444 election to change its tax year to June 30. Its required tax year is September 30. For purposes of calculating its required payment, RST's deferral ratio is $^{9}/_{12}$.

    d. XYZ LLC is calculating its required payment under Section 444 for the current year. For purposes of this calculation, the tax-exempt interest XYZ receives from its municipal bonds is included in LLC income.

**SELF-STUDY ANSWERS**

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

18. Hunter's Paradise (HP) LLC, which provides guided hunts during hunting season, wants to apply for a change in tax year based on the natural business year exception. Gross receipts for the current year were $150,000. For HP to use the safe harbor of the "seasonal business test" to support its application, what is the maximum amount of revenue generated outside of hunting season? **(Page 54)**

    a. $7,500. [This answer is incorrect. $7,500 represents 5% of Hunter's gross receipts for the year, which is not the maximum amount allowed. 5% is used in a different manner in the determination of the required year of an LLC taxed as a partnership.]

    **b. $15,000. [This answer is correct. To use the seasonal business test of the natural business exception, revenues in the off season must be "insignificant." A safe harbor rule provides that less than 10% of revenues generated the rest of the year would be deemed to be insignificant. Thus, no more than $15,000, or 10% of $150,000, of Hunter's gross income for the year may be generated outside of hunting season.]**

    c. $37,500. [This answer is incorrect. $37,500 is 25% of the gross receipts of Hunter for the current year. This percentage is used in determining the tax year of an LLC in a different test.]

    d. $50,000. [This answer is incorrect. $50,000 is 33% of the gross receipts of Hunter for the current period. This percentage is too high to be considered "insignificant" and would not fall in the safe harbor rule of the seasonal business test.]

19. Which of the following scenarios accurately applies the rules of the gross receipts test under the natural business exception when an LLC is trying to change its tax year? **(Page 54)**

    **a. ABC LLC began operations two years ago and uses the "majority interest" rule to determine its required tax year. ABC will not be able to change its tax year based on the gross receipts test. [This answer is correct. An LLC desiring to change its tax year using the natural business exception by applying the gross receipts test must have more than two years of gross receipts. Thus, ABC cannot use the gross receipts test given its brief history.]**

    b. JKL LLC is owned by three members, one of which is an S corporation. In applying the gross receipts test, JKL must allocate its distributive share of income from the S corporation ratably over the tax year in question. [This answer is incorrect. If an LLC receives a distributive share from a pass-through entity, the LLC must report the gross receipts in the month of the pass-through entity's tax year end, not evenly over the fiscal year of the LLC.]

    c. RST LLC was converted in the current year from a partnership that had been in existence for five years. It is continuing the business operated by the partnership. RST cannot use the gross receipts test to determine its tax year. [This answer is incorrect. Even though the LLC was just formed, RST is continuing the business of the partnership. In this case, since the partnership was in existence for five years, RST must use the gross receipts history of the partnership in determining whether or not it qualifies to change its tax year under the gross receipts test.]

20. Which of the following businesses would most likely qualify under the business purpose exception in an attempt to use a tax year other than the required year? **(Page 55)**

    a. ABC Investments LLC wants to change to an April 30 year-end because it will assist its members in their financial planning. [This answer is incorrect. The IRS only approves changes to a tax year under the business purpose exception in rare cases. Assisting members with their financial planning is not a business purpose that would pass IRS scrutiny.]

b. JKL Real Estate LLC wants to change to a June 30 year-end because it corresponds to the year end of a recent acquisition. [This answer is incorrect. Changing tax years of an LLC to correspond with a related entity is not considered a valid business purpose by the IRS. JKL's request would be denied.]

**c. RST Golf LLC wants to change to a September 30 year-end because the number of rounds played by golfers decreases beginning in October. [This answer is correct. The IRS looks at all the facts and circumstances in granting permission to change tax years based on the business purpose exception. In this example, the IRS is most likely to grant RST's request as it appears that its business is seasonal in nature and the request is motivated by a reasonable business purpose.]**

d. XYZ Used Car Sales LLC wants to change to a calendar year-end because it clears out its inventory at the end of the year for tax reduction purposes. [This answer is incorrect. The IRS will not approve a tax year change based on a single annual event, such as a year-end clearance sale. To the extent XYZ has no other valid business reason, the IRS will not approve its request.]

21. Which of the following scenarios is true regarding an LLC's request for a different tax year based on a business purpose? **(Page 56)**

a. ABC LLC is making a request to change its tax year under the business purpose exception. Two years ago, a similar request was denied by the IRS. ABC may not make the request in the current year due to the previous denial. [This answer is incorrect. ABC may make a request even if a previous request was denied. ABC must, however, include all the documentation related to the previous denial in its new submission to the IRS.]

**b. JKL LLC is making a request to change its tax year under the business purpose exception. JKL has three members: John, who is a member-manager; and Katie and Lisa, who are nonmanaging members. John is the only member who is required to sign the form submitted to the IRS. [This answer is correct. A properly filed Form 1128 for a tax year change based on the business purpose exception must be signed by a member-manager of the LLC per IRS requirements.]**

c. RST LLC is making a request to change its tax year under the business purpose exception. RST's gross income in the current year is $225,000. It must pay a fee of $3,200 with its application in order to change its tax year. [This answer is incorrect. The IRS now has a tiered structure for LLCs requesting a tax year change through Form 1128. Based on RST's gross income, a fee of $625 would be paid along with the submission of Form 1128.]

d. XYZ LLC is making a request to change its tax year under the annual business cycle test. To ensure approval, it must include its annual gross receipts and average accounts receivable for the previous four years related to the request. [This answer is incorrect. An LLC requesting a tax year change based on the annual business cycle test must provide gross receipts and approximate inventory costs for the required period. XYZ does not have to include information related to accounts receivable.]

22. Under which of the following scenarios may the LLC in question make a Section 444 election for a tax year other than its required year? **(Page 57)**

**a. ABC LLC has been in existence for five years. Its required tax year is April 30; however, it adopted a calendar year end under the gross receipts test. It wants to adopt a tax year of March 31 by making a Section 444 election. ABC may make a Section 444 election changing its tax year to March 31. [This answer is correct. Since the proposed new tax year compared to the required year is only one month (April 30 v. March 31), ABC may make the Section 444 election.]**

b. JKL LLC is formed in the current year and its required year end is October 31. It wants to make a Section 444 election in its initial year to change its tax year to April 30. JKL may make a Section 444 election to change its tax year to April 30. [This answer is incorrect. JKL may not make a Section 444 election changing its tax year to April 30 because the deferral period between the required tax year (October 31) and the proposed tax year (April 30), six months, exceeds that allowed for a new LLC.]

c. RST LLC has been in business for six years. It has a required tax year of June 30. It adopted a tax year of March 31 using the natural business year exception. It wants to make a Section 444 election changing its tax year to a calendar year. RST may make a Section 444 election changing its tax year to the calendar year. [This answer is incorrect. RST may not make a Section 444 election because the new deferral period between the required period (June 30) and proposed period (December 31), six months, is longer than the allowed deferral period.]

d. XYZ LLC has been in business for three years and has used its required tax year of September 30 since its inception. In the current year, it wants to adopt a tax year of August 31 by making a Section 444 election. XYZ may make a Section 444 election changing its tax year to August 31. [This answer is incorrect. XYZ may not make a Section 444 election because it failed to make the election in its initial year. In this case, any change in its tax year will result in an increased deferral period, since the deferral period currently is zero months. Since the deferral period will increase no matter which month is proposed, XYZ is cannot avail itself of the Section 444 election.]

23. What advantage does an LLC and/or its members gain from making a Section 444 election? **(Page 58)**

a. Electing a different tax year under Section 444 simplifies tax compliance for the LLC. [This answer is incorrect. An election under Section 444 adds complexity, including the determination of the required payment.]

b. Payments required of the LLC by Section 444 are based on a percentage that is less than the individual members' marginal tax rate, deferring some of the payments to a later time. [This answer is incorrect. The required payment rate is calculated by taking the highest individual tax rate and adding 1%. Members may have significantly lower marginal tax rates.]

**c. Payments required as a result of Section 444 are based on the previous year's income, deferring some of the payment due to increasing income to the next year. [This answer is correct. The Section 444 is beneficial in periods of rising income because the required payment is based on the previous year's income. Thus, tax deferral continues each year. LLCs that expect continued increases in income should consider making the election.]**

d. Electing a different tax year under Section 444 is made on an annual basis, allowing flexibility on the part of the LLC to time payments to maximize cash flow. [This answer is incorrect. Form 8752 must be filed each year a Section 444 election remains in effect, but the actual election is effective until terminated.]

24. Which of the following scenarios accurately reflects the rules regarding Section 444 elections to change to a nonconforming tax year? **(Page 59)**

a. ABC LLC is a new LLC that has been converted from a partnership in the current year. The partnership had previously made an election under Section 444. ABC is required to file a new election under Section 444 to maintain the same nonconforming tax year. [This answer is incorrect. Depending on the form of the conversion, ABC may or may not be required to make a new election. If the partnership is not terminated upon the conversion, the LLC maintains the partnership's EIN, and the partnership's tax year stays the same, a new election by the LLC is not required.]

b. JKL LLC is owned by 5 members. Due to individual tax planning issues, each member wants to terminate JKL's previous Section 444 election in the current year. JKL's petition to the IRS to terminate its Section 444 election will be denied since tax planning is not a valid reason for termination. [This answer is incorrect. An LLC may terminate its Section 444 election for tax planning reasons; however, a decision to terminate the election should not be made lightly as the LLC may not make the election in future years.]

c. RST LLC is owned by 4 members, two of which are S corporations. The two S corporations each own 8% of RST. Based on the composition of RST's ownership structure, RST will be able to make a Section 444 election to change to a nonconforming tax year. [This answer is incorrect. Because RST is an LLC that is owned directly by S corporations, it is considered a tiered LLC. Tiered LLCs are generally prohibited from making a Section 444 election. Based on the percentage ownership of the S corporations, RST would not qualify for either of the *de minimis* exceptions.]

**d. XYZ LLC is attempting to change to a nonconforming tax year under the business purpose exception. XYZ may still avail itself of the Section 444 election to change its tax year if the IRS denies its application under the business purpose exception. [This answer is correct. Even though the IRS may deny an LLC's application under a business purpose or other exception, the LLC may file for a backup election. The backup election must be filed properly and in a timely manner to be approved by the IRS.]**

25. Which of the following scenarios correctly applies the rules of making a required payment pursuant to a Section 444 election? **(Page 61)**

a. ABC LLC made a Section 444 election in the current year and is preparing Form 8752 to file with the IRS. ABC must file the form and make the required payment by March 15 with its annual tax return. [This answer is incorrect. Form 8752 must be filed by May 15 of the year following the calendar year in which the election was effective.]

**b. JKL LLC calculates its deferred tax liability for the current and preceding years to be $450. JKL does not have to make a payment, but it must file Form 8752 in the current year. [This answer is correct. If the required payment of an LLC is less than $500, the LLC does not have to make a payment. Form 8752 must be filed, however, each year the election remains in effect.]**

c. RST LLC makes a Section 444 election to change its tax year to June 30. Its required tax year is September 30. For purposes of calculating its required payment, RST's deferral ratio is $^{9}/_{12}$. [This answer is incorrect. The deferral ratio represents the number of months from the requested year until the required year divided by 12 months. In this example, RST's requested year is June 30 and its required year is September 30. Thus, the deferral period is three months, making the deferral ratio $^{3}/_{12}$.]

d. XYZ LLC is calculating its required payment under Section 444 for the current year. For purposes of this calculation, the tax-exempt interest XYZ receives from its municipal bonds is included in LLC income. [This answer is incorrect. Although the calculation includes certain separately-stated items of income and loss, the required payment calculation *excludes* tax-exempt interest income and guaranteed payments to members.]

## EXAMINATION FOR CPE CREDIT

### Lesson 2 (LLCTG101)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

16. XYZ is an LLC that is taxed as a partnership and is comprised of four members. John, the managing member, is trying to determine the "required year" for XYZ. To determine the required year for XYZ, which rule must be applied first?

    a. "Least aggregate deferral" rule.

    b. "Principal members" rule.

    c. "Profits and capital" rule.

    d. "Majority interest" rule.

17. ABC is an LLC with 15 members. 9 members own 4% each and have a calendar year-end. 4 members own 10% each and have a September 30 year-end. 1 member is a tax-exempt organization that owns 14% and has a June 30 year-end. 1 member is a C corporation that owns 10% and has a March 31 year-end. Using the "principal members" rule, what is the required year of ABC?

    a. March 31.

    b. June 30.

    c. September 30.

    d. December 31.

18. Jack Co. and Jill Co. start a new LLC in the current year and will each own 50% of the company. Jack Co.'s fiscal year-end is March 31. Jill Co.'s fiscal year-end is July 31. Assuming the new LLC uses the March 31 year-end, what is the amount of aggregate deferral of income?

    a. 1.5.

    b. 2.0.

    c. 2.5.

    d. 4.0.

19. When ownership in an LLC changes, the least aggregate deferral must be calculated based on the new members' tax years. Pursuant to the special *de minimis* rule, the LLC may continue using its current tax year if the difference between the previous aggregate deferral and the new aggregate deferral is less than which of the following?

    a. .5.

    b. .10.

    c. .15.

    d. .20.

20. ABC LLC has a September 30 year-end pursuant to the "majority interest" rule. Based on an ownership change, ABC must change its year-end to November 30. How many years may ABC maintain a November 30 year-end subsequent to this change?

    a. One year after the year of change.

    b. Two years after the year of change.

    c. Three years after the year of change.

    d. Four years after the year of change.

21. To change to a new tax year pursuant to the procedures of Rev. Proc. 2006-46, an LLC must not have made a change to its tax year within a _____ month period ending with the last month of the requested tax year.

    a. 24.

    b. 36.

    c. 48.

    d. 60.

22. XYZ LLC wants to change its tax year pursuant to Rev. Proc. 2002-39, using the annual business cycle test to show that it qualifies under the natural business year exception. Generally speaking, XYZ must show that its gross receipts for the current short period and the preceding _____ years are evidence that XYZ meets the annual business cycle test.

    a. 2.

    b. 3.

    c. 5.

    d. 7.

23. ABC LLC wants to change its tax year to August 31 under the natural business year exception by using the gross receipts test. Its annual gross receipts for *each* year related to the requisite measurement period are $500,000. *At a minimum*, what must ABC's gross receipts total in July and August each year to qualify for the natural business year using the gross receipts test?

    a. $50,000.

    b. $100,000.

    c. $125,000.

    d. $250,000.

24. ABC LLC wishes to file a Form 1128 requesting a new tax year ending April 30. ABC's previously reported on a calendar-year basis. According to the provisions of Rev. Proc. 2002-39, what is the *earliest* day on which ABC may file Form 1128?

    a. January 1.

    b. March 15.

    c. May 1.

    d. September 15.

25. Brown & Briddle filed to become a LLC on August 1, 2008. They filed their 2008 tax return as a LLC and discovered in May 2009 the company overpaid their required fees and by December 2009, they decided that their overpayment for 2008 exceeds their fees required for 2009. They file for a refund from the IRS on December 15, 2009. Which of the following is correct regarding their refund?

    a. The IRS does not owe them a refund until April 15, 2010.

    b. The IRS will owe Brown & Briddle interest on the excess amount paid.

    c. Brown & Briddle is due their refund by March 15, 2010.

    d. Brown & Briddle waited too long to request their refund. They will not be able to obtain one from the IRS.

# Lesson 3: Converting to an LLC

## INTRODUCTION

Operating a business as an LLC has many advantages. (See the discussion in the previous lesson.) Consequently, businesses already established as other types of entities may wish to operate as an LLC. Depending on the type of entity in which the business is conducted (i.e., general or limited partnership, C corporation, S corporation, or sole proprietorship), conversion to an LLC can be a relatively simple and inexpensive process or a costly undertaking. This lesson focuses on the issues the practitioner needs to address to determine if the conversion of an existing entity to an LLC is viable. Information is also provided to help determine how the conversion can best be accomplished.

**Learning Objectives:**

Completion of this lesson will enable you to:

- Identify and determine the relative importance of issues that may arise when converting another type of business entity into an LLC.
- Identify and analyze the tax effects of converting a sole proprietorship or a partnership into an LLC.
- Determine whether converting from a C corporation or an S Corporation into an LLC is beneficial from a tax standpoint.

**Issues Affecting the Decision to Convert to LLC Status**

Many issues affect the decision of an existing business to convert to LLC status. These issues generally fall into the following categories:

a. *General Tax Considerations.* One of the major hurdles to any conversion is the tax costs a conversion may trigger. In some cases these costs may outweigh the advantages gained from operating as an LLC. The tax cost of converting an existing entity into an LLC not only includes the federal income tax cost of the conversion, but also may include a considerable state tax cost. [Beginning in 2011, the top individual income tax rate is scheduled to increase to 39.6%. The maximum rate on adjusted net capital gain of an individual is scheduled to be 20% (18% for property purchased after 2000 and held more than five years). In addition, any adjusted net capital gain otherwise taxed at a 15% rate is scheduled to be taxed at a 10% rate (8% for property held more than five years). The tax on qualified dividend income will rise from its current 15% to ordinary income rates (and so up to 39.6%). When the 3.8% health care surtax on individuals earning more than $200,000 per year ($250,000 for married couples) goes into effect in 2013, the dividend tax will become the highest income tax in the country. It is uncertain if Congress will enact legislation to lower the scheduled rate increases. Practitioners should monitor activity in this area.]

b. *Tax Classification Considerations.* Typically, an entity converting to LLC status wants to be classified as a partnership for federal income tax purposes. New LLCs with more than one member are classified as partnerships by default. Consequently, any entity (such as a corporation) with more than one owner that converts to LLC status by liquidating and forming a new entity automatically is taxed as a partnership. New LLCs with a single member are disregarded under the default rules or can elect to be taxed as a corporation. Disregarded entities are treated as entities not separate from their owners. An entity may elect to change its classification by filing Form 8832 (Entity Classification Election). If an entity changes its classification, it generally cannot again elect to change its classification during the 60 months following the effective date of the election.

c. *State Law Considerations.* Some states have limitations on the purposes for which an LLC can be formed. Specific prohibitions on engaging in banking or insurance exist in certain states. An entity engaging in one of these prohibited businesses would not want to convert to LLC status. In addition, since an LLC is a creature of state law, the converting business must adopt articles of organization and an operating agreement that conform to the requirements of the LLC statute in the state of organization. Although most state LLC statutes provide a high degree of flexibility in how LLCs are organized and operated, there may be statutory constraints that make operation as an LLC unattractive.

d. *Structuring Considerations.* There are many ways to structure the conversion of an existing business into an LLC. These include (1) the merger of the existing business and a newly formed LLC, (2) a distribution of interests in the existing business or the existing business's assets to its owners followed by a contribution of the assets to an LLC, and (3) conversion of the existing business into an LLC by certificate. The choice of the conversion structure may affect not only the tax cost of the conversion, but also the tax attributes of the converted business and its owners.

e. *Miscellaneous Considerations.* There are several significant nontax considerations in planning for the conversion of an existing entity into an LLC. The cost of these nontax considerations may be so prohibitive in some situations that the business contemplating conversion decides against it. For example, in some states a conversion may result in a reassessment of the business entity's property for property tax purposes. Additionally, some states charge a fee for recording the property transfer. Further, many lenders charge a fee (plus recording costs) for refiling liens and other legal documents in the new LLC name.

This lesson discusses the conversion to LLC status of general and limited partnerships, C corporations, S corporations, and sole proprietorships. Practitioners should carefully review the following paragraphs for general provisions that apply to all conversions and then review the appropriate paragraphs for more detailed information on the conversion of the specific entity type involved. This lesson also discusses the conversion of a partnership into a limited liability partnership (LLP).

## CONVERTING ANY ENTITY INTO AN LLC

Although each conversion of an existing entity will have some unique aspects, certain issues must be considered when converting any type of entity into an LLC.

### Choosing a Governing State LLC Statute

A business entity considering conversion into an LLC must choose the state in which the LLC will be organized. This choice will be based on several factors, including:

a. The provisions of the state LLC act, including any prohibitions on the type of business that can be conducted by LLCs. The provisions of the state LLC act that control the merger of an LLC with another entity or the conversion of a partnership into an LLC also have a bearing.

b. The taxes and other costs that will be imposed by the state of organization on an LLC, as opposed to the existing form of entity. These include not only income tax, but in some cases, annual filing fees, franchise tax, and other state taxes, and fees.

c. The cost of forming an LLC in the state. The cost of organizing an LLC is minimal in almost every state, but does vary from state to state. Special attention should be given to how the conversion will affect the converting entity's property tax liability.

d. The cost of transferring property in certain types of conversions. State transfer tax rules will vary from state to state.

e. The owners' exposure to liability. In some conversion structures, the owners of the converting entity will be exposed to liability for the debts of the entity at some point during the conversion process because of the deemed chain of events. (In most partnership conversions, the general partners of the converting partnership remain liable for the converting partnership's preconversion debts.)

f. The impact of the state statute on the ability of members to use valuation discounts for estate planning purposes. For example, LLCs formed in states where members have no right of withdrawal generally result in a higher discount for lack of marketability than LLCs formed in states without such a provision.

g. The availability of series LLCs. Delaware, Illinois, Iowa, Nevada, Oklahoma, Tennessee, and Utah now permit LLCs to designate separate series (or divisions) within the entity into which assets and ownership interests can be segregated. See the previous lesson for a discussion of series LLCs.

**Merger of Entities Formed in Different States.** Some states, such as New York and California, allow domestic LLCs to merge or consolidate with other types of business entities (including corporations and partnerships) with no requirement that the other business entity be formed in the same state as the domestic LLC. Accordingly, a corporation formed in Oregon could merge into a California LLC under the California statute. Other states permit domestic LLCs to merge only with other domestic or foreign LLCs, or put other restrictions on the ability of a domestic LLC to merge. Depending on how the conversion is structured, the LLC may have to be formed in a state whose LLC statute permits the desired merger. (Although a corporation is frequently authorized by state law to merge with an LLC, such a merger is not a tax-free Type A reorganization, because two corporations are not involved.) However, Reg. 1.368-2(b)(1)(ii) allows a Type A merger of a corporation into a single-member disregarded entity (including a single-member LLC that does not elect corporate status) where the merger is the result of the operation of state law and the following events occur simultaneously at the effective time of the transaction:

a. All of the assets (other than those distributed in the transaction) and liabilities (except to the extent liabilities are satisfied or discharged in the transaction or are nonrecourse liabilities to which assets distributed in the transaction are subject) of the corporation are transferred to the disregarded entity; and

b. The separate legal existence of the merged corporation ceases for all purposes.

### Notification of Creditors and Franchisors

If the entity considering conversion to LLC status has secured creditors who can object to the transfer of assets, those creditors must be notified of the intended conversion and agree to it. Some authorities believe the consent of secured creditors is not necessary when the converting entity is a partnership and there is no legal change in the owner of the property securing the debt under applicable state law (a "formless" conversion). In this scenario, by operation of law, the LLC is considered to be the same entity as the converting partnership, and all property owned by the converting partnership is deemed to be property of the LLC. Additionally, there is usually no change in the liability of the general partners of a partnership for existing partnership liabilities because of a conversion to LLC status. General partners who become members of an LLC as a result of a conversion remain liable under state law for any debt, obligation, or liability incurred by the partnership before the conversion.

Notification of creditors can, however, avoid certain problems. For example, all bank loan documents should be amended to reflect the new LLC as the borrower. This prevents the bank from using the conversion as a reason to default a loan with favorable terms. In addition, failure to amend the bank loan documents may result in liability for the prior entity since the bank could argue that a fraudulent transfer has occurred. In addition to notifying creditors of the conversion, franchisers or others with a similar relationship sometimes must be notified. Many intangible assets or agreements have transfer restrictions that must be observed. All such agreements (such as franchise agreements) should be reviewed to determine whether consent is needed to transfer the asset to the new LLC.

### Notification of Customers, Clients, and Others

Generally, a business is not required to notify its customers or clients if it converts into an LLC. However, a partnership that performs professional services probably should notify its clients of the change in the structure of the business, since the legal relationship between the client and the entity performing the services is altered because of the conversion. That is, before the conversion, a client filing a malpractice claim against the service entity could attempt to attach the assets of the entity itself and all of its owners—after the conversion a client with a malpractice claim can only attach the assets of the LLC and the owner who provided the services. (No state allows an alteration of the legal relationship between the client and the individual performing the services.) Professional service entities converting to LLC status generally must also register with the state licensing authority and notify their malpractice insurance carrier. Professional entities also must investigate whether they can use their existing name in the states in which they do business.

### Transfer Taxes

Some LLC statutes contain provisions that preclude transfer taxes from being imposed on transfers of property effected by certain conversions. For example, the New York statute provides that a partnership converting into an LLC is for all purposes the same entity that existed before the conversion. Consequently, all real, personal, tangible, and intangible property of the converting partnership is vested in the LLC and no transfer is deemed to occur. No deed of transfer or other transfer of title to partnership property is required.

Notwithstanding these types of provisions, state and local tax authorities may still attempt to impose a transfer tax on LLC conversions when a deed is filed to acknowledge title in the LLC. The conversion of a C corporation is even more likely to result in the assessment of transfer taxes, because the LLC is not considered to be the same entity as the converted C corporation. However, most states have special transfer provisions that limit transfer taxes or assess only a nominal administrative charge when the form of the entity changes but the owners remain the same. If transfer taxes apply, however, some forms of conversion may prove more costly than others because the deemed series of events in some types of conversions result in more than one change in ownership on which transfer taxes may be imposed.

It appears unlikely the liability for transfer taxes will outweigh the overall benefits of converting an existing entity into an LLC. However, awareness of the adverse effects could avoid potential problems with the client.

**Reassessment of Real Property Values**

Depending on state law, certain types of conversions could trigger reassessment of the real property held by the converting entity. Despite any provisions in the state LLC statute, local taxing authorities may find conversions to be an opportunity to generate additional revenue by reassessment, especially if the local taxing authority has not done a recent revaluation. The reassessment of a business's real property could be very costly if the business holds significant amounts of appreciated real property—such as a real property development business. However, the reassessment issue generally is a problem only to the extent that the property is reassessed before the time otherwise scheduled for reassessment (since most property is assessed periodically).

**Application of Securities Laws**

Federal and state securities laws may apply to certain types of conversions, particularly the conversion of a limited partnership into an LLC. These laws generally require a "sale" of "securities" to be registered or exempt. Most state "blue sky" laws provide that exchanges in connection with a merger, purchase, or other reorganization in consideration for securities must be qualified unless otherwise exempt. However, since entities converting to LLC status are usually closely held, compliance with these laws may not be required. In states where LLC interests are considered securities, and in all conversions of limited partnerships to LLCs, an attorney well versed in securities law should be consulted to ensure compliance with all federal and state securities laws.

**Short Tax Years**

The conversion of any business entity other than a partnership or sole proprietorship into an LLC requires the converting entity to file a short year tax return for the year of conversion (unless the conversion takes place on the last day of the entity's tax year).

**Administrative Items**

In addition to the issues discussed previously, numerous administrative tasks must be completed by the managers of an LLC converted from another entity. These tasks include the following:

a. The name of the converted entity must be registered with the state. Professional entities may be limited in various states as to the names they can use.

b. The new entity must open a new checking account (or restyle any existing accounts).

c. Any securities held by the LLC should be re-registered in the LLC's name.

d. Financing statements should be re-recorded (which will probably be required by secured creditors). There normally is a nominal charge for re-recording.

e. The managers should amend any franchise agreements or other contracts to reflect the new entity's name and status. The managers may be required to certify that the business's ownership remains the same.

f. The new entity may need to be substituted for the converted entity in any outstanding lease. For example, if the converting entity leases office space, the LLC must be substituted as the lessee with the consent of the lessor.

g. Deeds of trust may need to be amended, if required by state statute.

h. LLC letterhead, envelopes, business cards, etc., should be used from the date of conversion.

i. Titles to recordable property (such as company cars) should be transferred to the new LLC.

j. If the LLC is going to operate under a fictitious name (or if the converted entity used a fictitious name), the name may need to be re-registered with the state.

k. Insurance coverages should be updated and the insured changed to the LLC.

l. Payroll tax registration, state tax registration, and similar items should be changed.

m. Business licenses, peddler licenses, and other similar licenses should be re-registered.

n. State unemployment rates should be checked to ensure the LLC can continue to use the old (hopefully low) rate.

o. Refunds may be available for business licenses and taxes when an entity is converted to an LLC.

While changing the legal form of the entity to an LLC does not constitute a change in reporting entity, conversion to an LLC may in some cases result in a change in the reporting entity. For example, if commonly-owned companies for which combined financial statements were not previously presented are combined into a single LLC, a change in the reporting entity would occur. The disclosures required by FASB ASC 250-10-05 (formerly SFAS No. 154) should be made and financial statements for prior periods presented should be restated.

## SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

26. What is the default classification for federal income tax purposes of a business entity with more than one member that converts to an LLC?

    a. Corporation.

    b. Disregarded entity.

    c. Partnership.

27. ABC Company is converting to an LLC. Which of the following statements relating to state law considerations that must be taken into account is the most accurate?

    a. The new LLC must immediately pay an annual tax for the privilege of conducting business in the state of organization.

    b. The new LLC must adopt articles of organization and an operating agreement that conform to the LLC requirements in the state of organization.

    c. The new LLC cannot merge or consolidate with foreign business entities not organized in the same state.

    d. The new LLC must promptly notify all creditors, franchisors, customers, and insurance carriers.

28. Joe and Allen are members of a business entity organized in California. They want to merge with an Oregon LLC in a tax-free reorganization. Which of the following mergers would be most likely to be tax-free?

    a. Joe and Allen are shareholders in a corporation and the entity they intend to merge with is a multi-member LLC.

    b. Joe and Allen are shareholders in a corporation and wish to merge with an LLC treated as a single-member disregarded entity.

    c. Joe and Allen are shareholders in a corporation and wish to merge with a single member LLC that elects corporate status.

29. When converting to an LLC, some states impose transfer taxes on property, real, personal, tangible and intangible. Which of the following scenarios would **not** trigger transfer taxes on the conversion?

    a. A C corporation converts to an LLC.

    b. A partnership converts to an LLC.

    c. A sole proprietor converts to a single member LLC, taxed as a disregarded entity, and files with the court a deed to acknowledge title to the property in the LLC.

    d. An S corporation with four shareholders converts to an LLC with two members.

30. Martin and Melvin operate their retail sales business as a partnership and they are considering converting the business into an LLC. Which of the following individuals or entities must the partnership notify?

    a. Customers and clients.

    b. Creditors.

    c. Banks.

    d. A customer who filed a lawsuit against the original partnership.

31. Under which of the following scenarios will a business entity converting to an LLC during the tax year be required to file a tax return for the original entity?

    a. The original entity is an S corporation.

    b. The original entity is a partnership.

    c. The original entity is a sole proprietorship.

## SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

26. What is the default classification for federal income tax purposes of a business entity with more than one member that converts to an LLC? **(Page 77)**

    a. Corporation. [This answer is incorrect. To become a corporation after converting to an LLC, the LLC must also "check the box" on Form 8832, Entity Classification Election.]

    b. Disregarded entity. [This answer is incorrect. A disregarded entity is an LLC with a single member. When a single member business converts to an LLC, it is "disregarded" at the federal level and the member reports the LLC's operations on Form 1040, Schedule C.]

    **c. Partnership. [This answer is correct. A business entity with more than one member is automatically classified as a partnership for federal income tax purposes by the IRS, without having to take any extra steps.]**

27. ABC Company is converting to an LLC. Which of the following statements relating to state law considerations that must be taken into account is the most accurate? **(Page 77)**

    a. The new LLC must immediately pay an annual tax for the privilege of conducting business in the state of organization. [This answer is incorrect. Although some states require the payment of an annual tax in the year of organization, other states require, for example, income tax or franchise tax.]

    **b. The new LLC must adopt articles of organization and an operating agreement that conform to the LLC requirements in the state of organization. [This answer is correct. Since an LLC is organized at the state level, it must confirm to the requirements of the LLC statute in the state of organization.]**

    c. The new LLC cannot merge or consolidate with foreign business entities not organized in the same state. [This answer is incorrect. Some states allow domestic LLCs to merge with foreign or domestic business entities.]

    d. The new LLC must promptly notify all creditors, franchisors, customers, and insurance carriers. [This answer is incorrect. Although some notification must take place, it is not a state law consideration.]

28. Joe and Allen are members of a business entity organized in California. They want to merge with an Oregon LLC in a tax-free reorganization. Which of the following mergers would be most likely to be tax-free? **(Page 79)**

    a. Joe and Allen are shareholders in a corporation and the entity they intend to merge with is a multi-member LLC. [This answer is incorrect. Although the merger is allowed, it may not be tax-free because two corporations are not involved.]

    **b. Joe and Allen are shareholders in a corporation and wish to merge with an LLC treated as a single-member disregarded entity. [This answer is correct. A tax-free reorganization (merger) of a corporation into a single-member disregarded entity is allowed under Reg. 1.368-2(b)(ii) under certain conditions.]**

    c. Joe and Allen are shareholders in a corporation and wish to merge with a single member LLC that elects corporate status. [This answer is incorrect. A Type A tax-free merger of a corporation into a single-member disregarded entity is allowed, if the LLC does not elect corporate status.]

29. When converting to an LLC, some states impose transfer taxes on property, real, personal, tangible and intangible. Which of the following scenarios would **not** trigger transfer taxes on the conversion? **(Page 79)**

    a. A C corporation converts to an LLC. [This answer is incorrect. A C corporation that converts to an LLC is not considered to be the same entity as the converted C corporation and, thus, a transfer is deemed to have taken place.]

**b. A partnership converts to an LLC. [This answer is correct. A partnership is considered to be the same entity that existed before the conversion so no transfer is deemed to have occurred.]**

c. A sole proprietor converts to a single member LLC, taxed as a disregarded entity, and files with the court a deed to acknowledge title to the property in the LLC. [This answer is incorrect. Some taxing authorities will try to tax property when a deed is filed to change title in the property.]

d. An S corporation with four shareholders converts to an LLC with two members. [This answer is incorrect. When the owners in a conversion do not remain the same, the entity is considered to be a different entity.]

30. Martin and Melvin operate their retail sales business as a partnership and they are considering converting the business into an LLC. Which of the following individuals or entities must the partnership notify: **(Page 79)**

a. Customers and clients. [This answer is incorrect. Generally, a business is not required to notify its customers and clients if it converts to an LLC unless the legal relationship between the entity and its customers or clients changes. A professional services partnership may need to notify clients because the relationship is altered.]

b. Creditors. [This answer is incorrect. Since there is no legal change in the liability of general partners, creditors need not be notified. General partners who become members of an LLC remain liable for debts incurred by the partnership before the conversion to an LLC. The partnership may want to notify creditors, however, to avoid certain problems.]

**c. Banks. [This answer is correct. All bank loan documentation should be amended to reflect the new LLC as the borrower, so the bank cannot use the conversion as a reason to change the terms of a favorable loan.]**

d. A customer who filed a lawsuit against the original partnership. [This answer is incorrect. Since there is no alteration of the legal relationship between the parties and the converting entity is not a services entity, the irate customer need not be notified of the conversion.]

31. Under which of the following scenarios will a business entity converting to an LLC during the tax year be required to file a tax return for the original entity? **(Page 80)**

**a. The original entity is an S corporation. [This answer is correct. The conversion to an LLC requires a short period return, Form 1120S, to be filed.]**

b. The original entity is a partnership. [This answer is incorrect. A partnership converting to an LLC taxed as a partnership is not considered a change in the type of entity and the partnership is not required to file a short period return.]

c. The original entity is a sole proprietorship. [This answer is incorrect. Both a sole proprietor and a one-member LLC are disregarded entities at the federal level and so only a normal Form 1040 for the year of conversion need be filed.]

# CONVERSION OF A SOLE PROPRIETORSHIP

The conversion of a sole proprietorship into an LLC is accomplished by filing for a certificate of formation (or other required document), paying the appropriate fee, and executing articles of organization and an operating agreement (if required).

A sole proprietor considering adding another member to his newly formed LLC should analyze the impact of the conversion on any transferred liabilities. Liabilities of a LLC classified as a partnership are shared between the proprietor and the new member for basis purposes. If the proprietor's interest in the business is substantially reduced, the proprietor may have less basis available for deducting LLC losses or may recognize a gain on the contribution of assets and liabilities to the LLC.

### Possible Loss Recapture Due to Application of the At-risk Rules

The conversion of a sole proprietorship into an LLC may result in the former proprietor recognizing income due to required loss recapture under the at-risk rules. Recapture may be required if the business activity and the proprietor are subject to the at-risk rules under IRC Sec. 465 and if losses have been recognized in prior years.

A conversion may, but is not likely to, cause a proprietor to suffer a reduction of his amount at risk. The reason a reduction seldom occurs is because the proprietor generally remains liable for debts incurred prior to the conversion. Any reduction that does occur is a result of the rules providing that members get at-risk basis for recourse debts, but not for nonrecourse debts (except for qualified nonrecourse financing. Since LLC debts typically are all treated as nonrecourse debts, the proprietor's at-risk basis may be reduced if he has no liability with regard to the business's debts after conversion. This reduction in at-risk basis can result in a former proprietor recognizing gain to the extent losses previously deducted must be recaptured. Gain recognition can only occur if the reduction in the amount at-risk causes the previously deducted losses to exceed the member's at-risk basis.

**Example 3-1: Sole proprietor recognizes gain because of at-risk rules.**

Joe owns a sole proprietorship that operates a retail shop. On the advice of his lawyer, Joe decides to convert the sole proprietorship to an LLC. The only debt of the proprietorship is a $100,000 loan from a local bank for which Joe has personal liability. At the time of the conversion, the bank agrees to substitute the LLC as the borrower and release Joe from personal liability on the note. Instead, the note is secured by the assets of the LLC.

Prior to the conversion, Joe had contributed $75,000 of cash to the operation of the retail shop and deducted $150,000 of loss from the operation of the shop. Because the $100,000 loan was recourse, it provided him with at-risk basis. Consequently, Joe's at-risk basis in the activity prior to the conversion was $25,000 ($175,000 basis − $150,000 losses).

After the conversion, Joe is no longer at-risk for the $100,000 note, which is now exculpatory debt for which no member is liable. Consequently, Joe must recapture his previously deducted losses to the extent his at-risk basis has fallen below zero. The amount reported as income is $75,000, Joe's $25,000 at-risk basis reduced by the $100,000 of debt assumed by the LLC.

### Contribution of Assets

If the sole proprietor contributes assets to a single-member LLC taxed as a disregarded entity, no transaction occurs for tax purposes, since he is deemed to continue holding the assets as a sole proprietor. (However, for state law purposes, the LLC holds title to the assets of the business after the conversion.) If the sole proprietor contributes the assets to a new LLC that has an additional member (and is taxed as a partnership), the owner is deemed to contribute the assets of the business, subject to any liabilities, to the newly formed LLC under the general nonrecognition rules of IRC Sec. 721. This transaction is now subject to the rules of Rev. Rul. 99-5. Under IRC Sec. 721, no gain or loss generally is recognized.

### Available Accounting Methods

A single-member LLC taxed as a disregarded entity must use the accounting methods of the owner. A partnership or an LLC taxed as a partnership generally can use any method of accounting as long as it clearly reflects income. However, an LLC taxed as a partnership generally cannot use the cash method if it has a C corporation member or is a "tax shelter." Since most sole proprietorships use the cash method, a sole proprietor considering conversion to an LLC taxed as a partnership (because there will be one or more new members) needs to determine if the cash method will still be available. In most cases, the new LLC can continue using the cash method.

### Self-employment Tax

Prop. Reg. 1.1402(a)-2 generally provides that LLC members are not subject to SE tax on their share of LLC income (i.e., they are treated as limited partners) unless one of the following applies:

a. They have personal liability for the debts of or claims against the LLC by reason of being a member.

b. They have the authority under state law to contract on behalf of the LLC.

c. They participate in the LLC's trade or business more than 500 hours during the LLC's tax year.

d. They are a member in an LLC providing professional services.

The Taxpayer Relief Act of 1997 (TRA '97) placed a moratorium on the issuance of final or temporary regulations defining a limited partner for self-employment purposes until July 1, 1998. No new regulations have been issued as of the publication date of this book. While the authors believe that the general reasoning of the proposed regulations discussed in the preceding paragraphs will ultimately be adopted, the proposed regulations are not currently effective. (However, an IRS spokeswoman indicated in June 2003 that taxpayers following the proposed regulations will not be challenged.) The authors believe that, given the intense criticism the IRS and Treasury received after issuing the proposed regulations, no new regulations will be issued until Congress addresses the issue.

## CONVERSION OF A GENERAL OR LIMITED PARTNERSHIP

A partnership conversion into an LLC can be structured in five ways. Most of these methods provide a relative degree of certainty regarding the tax treatment of the partners in the converting partnership and can be used with confidence. The five methods of conversion include the following:

a. Conversion by certificate.

b. Statutory merger.

c. Contribution of the partners' partnership interests to the LLC in exchange for LLC interests.

d. Contribution of assets by the partnership to the LLC, followed by distribution of the LLC interests to the partners. [This mirrors what occurs when a partnership undergoes a technical termination under the Section 708(b)(1)(B) regulations.]

e. Liquidation of the partnership followed by a contribution of assets by the partners to a new LLC.

### Conversion by Certificate

Under the Revised Uniform Limited Partnerships Act (RULPA), the conversion of a general partnership into a limited partnership, or vice versa, is provided for by the filing of a certificate. Several states have the same provisions for partnerships to convert to LLCs. In states where conversion by certificate is allowed, a partnership can become an LLC by filing a certificate of conversion, which is generally accompanied by a copy of the new LLC's articles of organization. A partnership that converts into an LLC by certificate is, under state law, the same legal entity as before the conversion. Presumably, the IRS addressed the conversion of a partnership into an LLC by certificate in

Ltr. Rul. 9525058. Although the ruling does not specifically provide that the conversion is by certificate, it does provide that "pursuant to the Act, all property owned by the converting partnership is vested in the LLC, all obligations of the converting partnership become obligations of the LLC, and any action or proceeding pending against the converting partnership may be continued as if the conversion had not occurred." This language mirrors the effects of a conversion by certificate in the New York Act. In this letter ruling, the IRS found the conversion was "analogous" to the situation in Rev. Rul. 84-52—in this ruling the partners in the converting partnership contributed their interests in the partnership to the LLC in exchange for membership interests in the LLC. The revenue ruling holds that in such situations the converting partnership does not terminate, and the partners recognize no gain or loss except in certain situations when a partner's share of liabilities decreases as a result of the conversion.

### Conversion by Merger

Most state LLC acts have specific provisions that apply to the merger of a domestic LLC with other types of business entities. States generally allow a domestic LLC to merge with or into any other domestic or foreign business entity. However, some states provide only a limited ability to merge—sometimes only with other domestic or foreign LLCs. If a partnership is contemplating a conversion by merger, the practitioner needs to make sure the state in which the LLC is organized allows the LLC and the partnership to merge. A merger is usually accomplished by entering into a written plan of merger and filing articles of merger with the Secretary of State. A minimal filing fee normally is required to be paid with the articles. In addition, some states have notification requirements at the time of a merger. Practitioners need to review the state LLC statute carefully to determine all of the steps that must be taken to comply with the state merger rules.

The merger of two partnerships (or a partnership and an LLC classified as a partnership) is generally governed by the provisions of IRC Sec. 708(b)(2)(A). Under this rule, if two or more partnerships merge or consolidate, the resulting partnership or LLC is considered the continuation of the merging partnership whose members own an interest of more than 50% in the capital and profits of the resulting partnership. In a conversion situation, the partners and members usually will be identical in both entities, causing the partnership credited with contributing the greatest dollar value of assets to the post-merger partnership or LLC to be deemed to continue. The post-merger LLC retains the continuing partnership's federal tax identification number, accounting methods, and elections.

The IRS has issued several letter rulings that deal with the tax effects of merging a partnership into an LLC. Ltr. Rul. 9210019 addressed the merger of a Texas limited partnership into a Texas LLC. Ltr. Rul. 9452024 addressed the merger of a general partnership in an unspecified state into an LLC formed in the same state. In Ltr. Ruls. 9738013, 9741018, and 9741021, the IRS addressed the merger of two Michigan limited partnerships. In all cases, the IRS held that the merger was analogous to the situation in Rev. Rul. 84-52 in which the partners in the preconversion partnership transferred their interests to the newly formed LLC in return for membership interests in the LLC. Accordingly, the rulings found the merger was not taxable under the general nonrecognition rules of IRC Sec. 721 (unless there was a decrease in a member's share of liabilities as a result of the conversion). The LLC resulting from the statutory merger was deemed to be a continuation of the preconversion partnership, and the partner/members' bases and holding periods in their membership interests were deemed to be the same as the bases and holding periods of their interests in the preconversion partnership. See a more detailed discussion of Rev. Rul. 84-52 beginning in the following paragraph.

### Transfer of Partnership Interests to LLC in Exchange for Membership Interests

Probably the most common method of converting a partnership into an LLC is the transfer of the partners' interests in the preconversion partnership to a newly formed LLC in exchange for membership interests in the LLC. The partnership is then liquidated and its assets are distributed to the LLC. When this method is used, the new LLC can be formed under the laws of any state and, if allowed by the state statute, can be formed by organizers who are not and will not be members.

Rev. Rul. 95-37 addresses this type of conversion and provides that the conversion of a partnership into an LLC classified as a partnership has the same federal tax consequences as the conversion of a general partnership into a limited partnership (or vice versa). The effects of this type of partnership conversion were established in Rev. Rul. 84-52. This ruling addressed the conversion of a general partnership into a limited partnership when each partner's interest in profits, losses, and capital remained the same after the conversion and the business of the general partnership continued to be carried on after the conversion. In this ruling, the IRS held that the conversion constituted a contribution of the partnership interests in the preconversion partnership to the converted partnership that is tax-free under the general nonrecognition rule of IRC Sec. 721. Because the business of the preconversion partnership was carried on by the converted partnership and there was not a transfer of more than 50% of the capital and profits interests in the partnership (a contribution to a partnership is not a sale or exchange when determining if a termination has occurred), no termination occurred under the Section 708 rules. Accordingly, the converted partnership was deemed to be a continuation of the preconversion partnership. Each partner had the same basis and holding period in his postconversion partnership interest as in his preconversion partnership interest. (In the Preamble to TD 8902, the IRS confirmed that Reg. 1.1223-3, relating to the holding period of partnership interests, does not apply to the conversion of a partnership—but that Rev. Rul. 84-52 continues to apply.) Although there is no termination of the converting partnership, the LLC should include a disclosure statement in its return for the year of the conversion.

Several other issues that arise in connection with this method of converting a partnership into an LLC are discussed in Rev. Rul. 95-37 and Rev. Rul. 84-52, including the following:

a. If, as a result of a conversion, the partner/member's share of liabilities increases, the contribution of money deemed to occur increases the basis of the contributing partner/member in the postconversion entity.

b. If, as a result of a conversion, the partner/member's share of liabilities decreases, the distribution of money deemed to occur reduces the basis of the distributee partner/member in the postconversion entity (but not below zero). If gain is recognized by the distributee because the deemed distribution exceeds the basis of his interest, the gain recognized increases the distributee's basis in the postconversion entity.

c. The converting partnership's tax year does not close with respect to all partners or any partners because the conversion is not a sale, exchange, or liquidation of the partners' interests under IRC Sec. 706(c)(2)(A).

d. Because there is no termination of the converting partnership, the LLC that results from the conversion need not obtain a new taxpayer identification number.

e. The federal tax consequences of converting a partnership into an LLC are the same whether the resulting LLC is formed in the same state or in a different state from the converting partnership.

Similar conclusions regarding this method of converting a partnership into an LLC were also reached in Ltr. Ruls. 9226035, 9407030, 9432018, 9443024, 9511033, and 9623016.

**Impact on Converting Limited Partnerships.** The general partners of a *limited partnership* are liable for all recourse debts of the partnership. Accordingly, general partners include the partnership's recourse debts in the basis of their partnership interests because they share the economic risk of loss for the debt. Limited partners are generally not allocated any of a limited partnership's recourse debts. If debt changes from recourse to nonrecourse upon conversion of the partnership to an LLC, it is allocated to all the LLC members (both former general partners and former limited partners). This causes a reduction in the share of LLC liabilities allocated to the general partners in a limited partnership and an increase in the share of LLC liabilities allocated to the limited partners. Since a decrease in a member's or partner's share of liabilities is treated as a distribution of cash under the Section 752 rules, general partners are deemed to receive a cash distribution upon the conversion, which may result in gain recognition if the deemed distribution exceeds the basis of their LLC interests. Even if there is no gain recognition, the general partners have a reduced basis against which to deduct future losses. This is not as serious a problem as it may seem, however, because general partners of a converting partnership usually remain liable for any debts or obligations of the converting partnership incurred prior to conversion. (Alternatively, the general partners could agree to guarantee the previously recourse debts of the LLC.) If this is the case, the debts are still recourse to the general partners and there is no reduction in the amount of basis from debt they are allocated. However, reduction in basis may occur gradually as preconversion debts are replaced with postconversion debts. (In all likelihood, some or all of the members of an LLC may be required to guarantee LLC debt in order to facilitate borrowing.)

**Example 3-2: Gain on conversion due to decrease in general partner's share of debt.**

Bryant Imports Limited Partnership is a calendar year, accrual basis partnership considering conversion to LLC status. The partners of Bryant have never contributed property other than cash to the partnership. The partnership agreement provides that Elliott, the general partner, will be allocated the first $100,000 of partnership losses. When the partnership begins to recognize profits, or after $100,000 of loss has been allocated to Elliott, the limited partners, Wes and Andy, will each be allocated 45% of the partnership's income, gain, or loss, with the remaining 10% allocated to Elliott. On the projected date of conversion, it is anticipated the partnership's balance sheet will be as follows:

| | Tax Basis | FMV |
|---|---|---|
| Assets: | | |
| Cash | $ 10,000 | $ 10,000 |
| Inventory | 60,000 | 70,000 |
| Other assets | 30,000 | 40,000 |
| Total assets | $ 100,000 | $ 120,000 |
| Liabilities and capital: | | |
| Notes payable | $ 120,000 | $ 120,000 |
| Capital— | | |
| Elliott (10% GP) | (20,000) | — |
| Andy (45% LP) | — | — |
| Wes (45% LP) | — | — |
| Total liabilities and capital | $ 100,000 | $ 120,000 |

After the conversion, the preconversion debt is replaced by new debt that is not secured by specific LLC property and on which the LLC is the only named debtor. The notes payable, which were recourse debts in the partnership, will be allocated as nonrecourse debts in the new LLC. (They are exculpatory liabilities for which no member has personal liability, but which are not secured by specific LLC property.) In the partnership, Elliott was allocated 100% of the basis from the recourse notes payable, because he had the economic risk of loss for the debt. Consequently, he had $120,000 of basis from debt—more than enough to deduct the $20,000 of losses that he was previously allocated.

After the conversion, however, the notes payable are allocated as nonrecourse debt to all partners. Assuming the LLC's minimum gain is $20,000, the first $20,000 of the LLC's notes payable are allocated to Elliot, with the remaining $100,000 based on the members' profits interests. Accordingly, the notes payable will be allocated $12,000 to Elliott, and $54,000 each to Wes and Andy. Because Elliott has not deducted losses in excess of his basis in the LLC, he will not be required to report income.

However, Elliott will be required to recognize his negative capital account as a recapture of previous losses under the at-risk rules. Since no member will receive at-risk basis from the LLC's nonrecourse debt, any loss allocations to the members in future years will be limited by the at-risk rules.

Variation: A much more likely scenario is that Elliott will continue to be liable for the preconversion debts of the partnership. In that case, Elliott will continue to receive basis from debt from the $120,000 of partnership/LLC debt and will recognize no gain on the conversion. However, as the preconversion debt is paid off or replaced by new debt, Elliott's basis will be reduced and gain may be recognized.

### Organization and Start-up Costs of New LLC

Organization costs are otherwise capitalizable costs incurred in the formation of a partnership or an LLC classified as a partnership (including legal fees, filing fees, and related costs). Organization expenses eligible for deduction or amortization include only those expenses incurred prior to the original due date (not including extensions) of the tax return for the year in which the partnership or LLC begins business operations. Expenses incurred after the date the LLC begins business must be capitalized as nondeductible and nonamortizable expenses—regardless of whether the partnership or LLC makes an otherwise valid amortization election. An LLC can deduct organization costs for the tax year in which it begins business in an amount equal to the lesser of (a) the amount of organization costs incurred, or (b) $5,000, reduced (but not below zero) by the amount by which the organization costs exceed

$50,000. Any organization expenses in excess of the deductible amount are amortized ratably over 15 years (180 months) beginning with the month in which the LLC begins business.

Because an LLC that is a converted partnership is considered a continuation of the preconversion partnership, it is not clear if the costs of forming the LLC are deductible or amortizable. It appears that the amortizable portion of the converted partnership's organization costs will be subject to the general rules that apply to amortizable intangibles, including the anti-churning rules. Under these rules, since the user of the partnership's property has not changed, the post-conversion LLC will continue to amortize the partnership's organization costs over the remaining life of the asset.

The treatment of the start-up costs of a new partnership or LLC classified as a partnership are governed by IRC Sec. 195. An LLC can deduct in the year in which its active trade or business begins an amount of start-up costs equal to the lesser of (a) the amount of start-up costs incurred with respect to the active trade or business, or (b) $5,000 ($10,000 for tax years beginning in 2010), reduced (but not below zero) by the amount by which start-up costs exceed $50,000 ($60,000 for tax years beginning in 2010). Any remaining start-up costs are amortized ratably over a 15-year (180 month) period. The amortizable portion of a converted partnership's start-up costs appears to be subject to the general rules that apply to amortizable intangibles, including the anti-churning rules. Under these rules, since the user of the partnership's property has not changed, the post-conversion LLC will continue to amortize the partnership's start-up costs over the remaining life of the asset.

The $5,000 ($10,000 for start-up costs for years beginning in 2010) limit on deductible organization expenses and start-up costs applies at the partnership or LLC level, not the partner or member level.

Pending legislation would temporarily raise the deduction for start-up expenditures to $10,000 subject to a phase-out after $60,000 if enacted.

**Conversion to Single-member LLC**

A multi-member LLC can become a single-member LLC either by design or because of the death, retirement, or resignation of one or more members. If the multi-member LLC is taxed as a partnership, the partnership's tax year will end on the date that the LLC fails to have more than one member. From that date forward, the LLC is taxed as a disregarded entity under the default rules (or may elect under the classification regulations to be taxed as a corporation. If the multi-member LLC is taxed as a corporation, a change in the number of members has no effect on its classification.

A change in the number of members in an entity does not result in the creation of a new entity under the 60-month limitation on classification elections .

Rev. Rul. 99-6 clarifies the tax treatment of a multi-member LLC classified as a partnership that becomes a single-member LLC because of a sale of all LLC interests to one member. This ruling holds that the selling members must report gain or loss on the sale of their LLC interests, but that for purposes of determining the tax treatment of the purchasing member, the existing LLC is deemed to terminate under the Section 708 rules. Under the rules of the *McCauslen* case and Rev. Rul. 67-65, the assets of the terminating partnership are deemed distributed to the pre-sale members who then are deemed to sell all or part (if the purchasing member is already a member of the LLC) of the LLC's assets to the purchasing member. The purchasing member's basis in the assets deemed contributed to the "new" LLC is the price of the interest in LLC assets he purchased, plus a carryover basis in any assets he was deemed to own prior to the sale transaction (because he was already a member in the LLC). The purchasing member's holding period for the assets deemed purchased begins on the day immediately following the date of sale. His holding period for the assets with a carryover basis included the LLC's holding period for those assets. The purchasing member recognizes gain and assigns basis under the general rules that apply to terminations.

Rev. Rul. 2001-61 provides that when an entity classified as a partnership becomes a disregarded entity, the resulting disregarded entity uses the partnership's EIN.

### Conversion to Multi-member LLC

A single-member LLC can become a multi-member LLC when the single member sells an interest in the LLC to another member, or when another member is admitted by making a contribution to the LLC. Under Reg. 301.7701-3(f), an LLC that is a disregarded entity is classified as a partnership on the date it has more than one member. Rev. Rul. 99-5 clarifies the tax treatment of a single-member LLC classified as a disregarded entity when an additional member is added. If the new member acquires his interest in the LLC by purchase from the existing member, he is deemed to purchase an interest in each of the LLC's assets and contribute that interest to a new LLC. The selling member recognizes gain or loss from the deemed sale of the interest in LLC assets and his basis in the new LLC is the basis of the assets he retained. His holding period for the LLC interest received includes his holding period in the capital assets and Section 1231 property held by the converted LLC. The new member has a basis in the assets contributed to the new LLC equal to his cost. His holding period in his interest in the new LLC begins the day after the day of sale. If a single-member LLC gains an additional member by contribution from the new member, the original owner is treated as having contributed all of the LLC's assets to a new LLC, to which the new member is also deemed to have made a contribution. The general rules applicable to contributed property apply to determine the basis and holding period of the contributed property and the members' ownership interests.

Rev. Rul. 2001-61 provides that when a disregarded entity using its own EIN becomes a partnership, the partnership uses the EIN of the disregarded entity.

### Converting to an LLP

**Conversion of Partnership.** General or limited partnerships are frequently converted into limited liability partnerships by filing a registration with the state government. Rev. Rul. 95-55 addressed registration of a New York general partnership under the New York State LLC Act as a New York registered limited liability partnership (RLLP). The IRS ruled that this registration as an RLLP is treated as a partnership-to-partnership conversion subject to the principles of Rev. Rul. 84-52. Accordingly, a general partnership will not terminate under IRC Sec. 708(b)(1)(B) as a result of its registration as an RLLP and must continue to use the same methods of accounting used before its registration as an RLLP.

Under most LLP statutes, conversion of a partnership to an LLP can be legally effected simply by registering the existing partnership as an LLP and paying the required fee. The partners in the new LLP are the same as the preconversion partners, and the state's partnership statutes continue to apply, subject to the modifications contained in the state's LLP law. Therefore, there is no need to transfer title to firm assets, pay property transfer taxes, or give any other legal significance to the conversion process. The assets and liabilities of the "old" partnership become those of the "new" LLP by operation of law. LLP partners who had personal liability for debts of the "old" general partnership remain personally liable for those debts after the conversion. Typically, no approval is required from state professional bodies (such as legal licensing agencies and boards of accountancy) to convert an existing general partnership into an LLP because the LLP is viewed as a continuation of the same entity.

In contrast, a change in the legal ownership of a partnership's assets—as would usually occur when converting a general partnership into an LLC or a corporation—can potentially result in lease terminations, loss of licenses and rights to use intangible assets, acceleration of loan repayment dates, and requirements for approval from professional bodies—in addition to the expense and trouble of transferring title. All of these issues are avoided with conversions of a general partnership into an LLP via registration.

Another approach to conversion from a general or limited partnership to an LLP is to cause the "old" general partnership to contribute its assets and liabilities to the newly formed LLP in exchange for LLP ownership interests (generally tax-free under IRC Sec. 721). The LLP interests are then distributed to the partners in liquidation of their interests in the "old" partnership (generally tax-free under IRC Sec. 731). Alternatively, the partners can contribute their interests in the "old" general partnership to the newly formed LLP in exchange for LLP interests (again, generally tax-free under IRC Sec. 721). The "old" partnership then distributes all its assets and liabilities to the LLP in liquidation (again, generally tax-free under IRC Sec. 731). Both liquidation approaches are relatively unattractive for legal reasons because state law may require the "old" partnership to transfer title of firm assets to the "new" LLP.

Finally, state law may permit the "old" general partnership to merge with the newly formed LLP, with the LLP being the surviving entity. In terms of legalities, a conversion using a merger transaction is much "cleaner" than one using a liquidation of the "old" partnership. With a merger, the surviving LLP generally assumes all rights and obligations of the "old" partnership by operation of law without any need to transfer title.

**Conversion of Corporation.** If a professional practice is currently operating as an S corporation, the owners may want to consider converting into an LLP to avoid limitations imposed by the S corporation eligibility rules. When a professional practice is currently operating as a C corporation, the owners may want to consider conversion to "stop the bleeding" with respect to the double taxation problem. Mechanically, corporate conversions can be effected in several different ways. The corporation could distribute its assets and liabilities to its shareholders in complete liquidation, with the shareholders then contributing them to a newly formed LLP in exchange for LLP interests. Or the assets and liabilities of the corporation could be contributed to a newly formed LLP in exchange for LLP ownership interests which are then distributed to shareholders in complete liquidation. Finally, state law may permit the corporation to merge with a newly formed LLP, with the LLP being the surviving entity. Mechanically, the merger transaction is accomplished by having the corporation contribute all its assets and liabilities to the LLP in exchange for LLP interests. The corporation then distributes the LLP interests in complete liquidation.

Regardless of which of the previous mechanical methods is used to effect a corporate conversion, there will be a taxable liquidation of the corporation for federal income tax purposes. This will result in corporate-level gain or loss recognition. The liquidation transaction is treated as a fully taxable disposition of the corporation's assets for FMV pursuant to IRC Sec. 336(a). This treatment applies equally to both S and C corporations. In other words, a converting corporation with appreciated assets will recognize taxable income or gain as a result of the conversion. At the shareholder level, the liquidating distribution from the corporation is treated as sales proceeds received in exchange for the stock surrendered by the shareholder. The amount of the deemed sales proceeds is the FMV of property distributed. The shareholder then compares the sales proceeds to the basis in the surrendered shares and recognizes taxable gain or loss on the exchange. The basis of an S corporation shareholder's stock will be increased by his share of the gain recognized by the corporation on the liquidation.

## SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

32. Robert is a sole proprietor of a retail jewelry store. He decides to convert to an LLC taxed as a disregarded entity. The only debt the proprietorship had was a $3,000 bank loan for which Robert had personal liability. Under which of the following scenarios must Robert recognize gain because of the at-risk rules?

    a. At the time of the conversion, the bank agreed to substitute the LLC as borrower and released Robert from personal liability. Prior to the conversion, Robert contributed $5,000 to the business and deducted a business loss of $3,500.

    b. Prior to the conversion, Robert contributed $5,000 to the business and deducted a business loss of $7,500.

    c. At the time of the conversion, the bank agreed to substitute the LLC as borrower and released Robert from personal liability. Before the conversion, Robert deducted a business loss of $2,500.

33. Which of the following is the most common method of converting a partnership into an LLC?

    a. Conversion by certificate.

    b. Conversion by merger.

    c. Conversion by exchanging partnership interests in the preconversion partnership for membership interests in the new LLC.

    d. Conversion by liquidation of preconversion partnership followed by contribution of those assets to the new LLC.

34. Brad and Ken are general partners in a limited partnership, BK Automotive, which also has three limited partners. Brad and Ken each have a 35% profits interest and the other partners each have a 10% profits interest. BK Automotive converted to LLC status taxed as a partnership. Prior to the conversion, the local bank loaned BK Automotive $50,000 for which Brad and Ken had personal liability. Before the conversion, Brad and Ken had each claimed a prior year $5,000 loss. After the conversion, the local bank agreed to release Brad and Ken as guarantors of the loan and substituted the new LLC as the debtor. Which of the statements regarding the loan is correct?

    a. Brad and Ken are each allocated recourse debt of $25,000. because they were general partners who took out the original loan.

    b. The loan becomes nonrecourse, so Brad and Ken become subject to the at-risk rules relating to the loan when it releases them as guarantors.

    c. Brad and Ken are allocated debt of $10,000 because debt is allocated equally to all members.

    d. Brad and Ken can deduct losses from the LLC up to their $20,000 remaining share of nonrecourse debt each because they used up $5,000 each in a prior year.

35. Evan is the only member of an LLC that is treated as a disregarded entity. The LLC has its own employer identification number (EIN). On September 1, Evan sells a 45% interest in the company to Eric. Which of the following statements is the most accurate?

    a. The company's LLC status will terminate on the date that Eric becomes a member.

    b. Evan recognizes no gain or loss on the sale, but does adjust his basis in the LLC so that the gain or loss is deferred until he disposes of his interest in the LLC.

    c. Eric is considered to purchase an interest in each of the LLC's assets, then to contribute that interest to a new LLC.

    d. The company must obtain a new EIN as of the date Eric purchases his interest on the LLC.

## SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

32. Robert is a sole proprietor of a retail jewelry store. He decides to convert to an LLC taxed as a disregarded entity. The only debt the proprietorship had was a $3,000 bank loan for which Robert had personal liability. Under which of the following scenarios must Robert recognize gain because of the at-risk rules? **(Page 87)**

    a. At the time of the conversion, the bank agreed to substitute the LLC as borrower and released Robert from personal liability. Prior to the conversion, Robert contributed $5,000 to the business and deducted a business loss of $3,500. [This answer is incorrect. No gain is recognized because of at-risk rules because Robert had basis in his capital contribution.]

    b. Prior to the conversion, Robert contributed $5,000 to the business and deducted a business loss of $7,500. [This answer is incorrect. No gain is recognized under the at-risk rules because Robert still has personal liability for the loan after the conversion in addition to the $5,000 basis for contributed capital.]

    **c. At the time of the conversion, the bank agreed to substitute the LLC as borrower and released Robert from personal liability. Before the conversion, Robert deducted a business loss of $2,500. [This answer is correct. Robert must now recognize a gain of $2,500 because he no longer has any debt basis in the loan against which he took the loss.]**

33. Which of the following is the most common method of converting a partnership into an LLC? **(Page 89)**

    a. Conversion by certificate. [This answer is incorrect. Some states do not allow conversion by certificate.]

    b. Conversion by merger. [This answer is incorrect. Some states provide only a limited ability to convert by merging.]

    **c. Conversion by exchanging partnership interests in the preconversion partnership for membership interests in the new LLC. [This answer is correct. Under this method, the new LLC can be formed under the laws of any state and, if allowed, can be formed by organizers who are not and will not be members. The ease of transition makes it the most common.]**

    d. Conversion by liquidation of preconversion partnership followed by contribution of those assets to the new LLC. [This answer is incorrect. This conversion method is sometimes accorded unfavorable treatment by the IRS.]

34. Brad and Ken are general partners in a limited partnership, BK Automotive, which also has three limited partners. Brad and Ken each have a 35% profits interest and the other partners each have a 10% profits interest. BK Automotive converted to LLC status taxed as a partnership. Prior to the conversion, the local bank loaned BK Automotive $50,000 for which Brad and Ken had personal liability. Before the conversion, Brad and Ken had each claimed a prior year $5,000 loss. After the conversion, the local bank agreed to release Brad and Ken as guarantors of the loan and substituted the new LLC as the debtor. Which of the statements regarding the loan is correct? **(Page 90)**

    a. Brad and Ken are each allocated recourse debt of $25,000 because they were general partners who took out the original loan. [This answer is incorrect. Individual members of the LLC are not personally responsible for an LLC's liabilities unless they agree to accept such responsibility. The bank released Brad and Ken from their loan guaranty.]

    **b. The loan becomes nonrecourse, so Brad and Ken become subject to the at-risk rules relating to the loan when it releases them as guarantors. [This answer is correct. LLC members are not personally liable for the LLC's debts, unless they personally guarantee them. Because Brad and Ken no longer have responsibility to repay the debt, it becomes nonrecourse and Brad and Ken have no at-risk basis in it. This means that their share of the LLC's losses cannot be deducted against the loans unless Brad and Ken increase their at-risk basis.]**

c. Brad and Ken are allocated debt of $10,000 because debt is allocated equally to all members. [This answer is incorrect. Debt is allocated to members in accordance with their profits interest. Therefore, Brad and Ken are allocated $17,500 each ($50,000 35%). However, because the debt is nonrecourse, the at-risk rules provide that it cannot be used to offset the members' shares of LLC's losses.]

d. Brad and Ken can deduct losses from the LLC up to their $20,000 remaining share of nonrecourse debt each because they used up $5,000 each in a prior year. [This answer is incorrect. Brad and Ken have no responsibility to repay the loan, which makes them subject to the at-risk rules limiting the deduction for their share of the LLC's losses. Brad and Ken cannot deduct such losses until they increase their at-risk basis. The fact that they previously deducted losses does not mean that they can continue to do so.]

35. Evan is the only member of an LLC that is treated as a disregarded entity. The LLC has its own employer identification number (EIN). On September 1, Evan sells a 45% interest in the company to Eric. Which of the following statements is the most accurate? **(Page 93)**

a. The company's LLC status will terminate on the date that Eric becomes a member. [This answer is incorrect. On the date it has more than one member, an LLC is treated as a partnership.]

b. Evan recognizes no gain or loss on the sale, but does adjust his basis in the LLC so that the gain or loss is deferred until he disposes of his interest in the LLC. [This answer is incorrect. Evan recognizes gain or loss from the deemed sale of LLC assets and his basis in the new LLC is the basis of the assets he retained.]

**c. Eric is considered to purchase an interest in each of the LLC's assets, then to contribute that interest to a new LLC. [This answer is correct. The deemed purchase and contribution are covered in Rev. Rul. 99-5, which covers the tax treatment of a single-member LLC treated as a disregarded entity when an additional member is added.]**

d. The company must obtain a new EIN as of the date Eric purchases his interest in the LLC. [This answer is incorrect. According to Rev. Rul. 2001-61, when a disregarded entity using its own EIN to report payroll taxes becomes a partnership, the partnership continues to use the disregarded entity's EIN.]

# CONVERSION OF A C CORPORATION

Only infrequently will it be beneficial for a C corporation to convert into an LLC. Although conversion allows the C corporation shareholders to continue to have limited liability while acquiring the advantages of pass-through taxation, the heavy tax cost of the conversion normally will be prohibitive. However, in certain situations where the corporation has depreciated assets or significant NOL carryovers, conversion to LLC status may be beneficial.

Conversion of a C corporation into an LLC always involves the liquidation of the corporation. Liquidation of a C corporation can potentially result in a double tax—one on the corporation's distribution of assets (IRC Sec. 336) and one on the distribution to the shareholders. The following is a brief general discussion of the tax treatment of a C corporation liquidation.

### Taxation of C Corporation Liquidation

**Tax on Corporation.** Under IRC Sec. 336, a liquidating C corporation must recognize gain or loss on distributions of property to the shareholders as if the property had been sold to them for its fair market value (FMV). The character of the gain recognized (capital versus ordinary) depends on the character of the property being distributed. (Depreciation recapture and similar rules may also affect the character of the gain recognized.) Generally, corporations are allowed to recognize losses when property is distributed to shareholders in complete liquidation of the corporation. However, a corporation making a liquidating distribution to a related person (under the rules of IRC Sec. 267) cannot recognize the loss if the distribution is not pro rata or disqualified property is distributed. Disqualified property is any property acquired by the corporation in a Section 351 transfer or as a contribution to capital during the five-year period ending on the distribution date; or any property whose adjusted basis is determined by reference to the adjusted basis of such property.

Chief Counsel Advice 200924043 clarifies that when a parent corporation is liquidated as a result of its conversion to an LLC, deferred losses on intercompany sales between the parent and its wholly owned subsidiary can be recognized.

In Ltr. Rul. 200613027, the IRS ruled that the conversion of an LLC to a corporation followed by a rescission of the incorporation did not result in a taxable liquidation of the corporation. Instead, the entity was treated as an LLC for the entire tax year and the incorporation transaction was ignored.

**Tax on Shareholder.** IRC Sec. 331 governs the tax treatment of liquidating distributions at the shareholder level. The Section 331 rules require the liquidating distribution to be treated as full payment in exchange for the shareholder's stock. The shareholders must recognize gain (or loss) equal to the difference between the FMV of the assets received and the adjusted basis of the stock surrendered. If the stock surrendered is a capital asset, the transaction results in the recognition of capital gain or loss. The shareholder's basis in the property received in the liquidating distribution is its FMV at the time of distribution if gain or loss is recognized on the receipt of the property.

The top individual tax rate is scheduled to increase to 39.6% in 2011.

See *PPC's 1120 Deskbook* for a detailed discussion of C corporation liquidations.

### Determining If Conversion Is Desirable

Because there may be a high tax cost to convert a C corporation with significantly appreciated assets, practitioners probably will only want to consider conversion if circumstances limit the gain that will be recognized by the corporation on the distribution of its assets and/or the gain that will be recognized by the shareholders on the receipt of the liquidating distribution. In general a corporate conversion may be desirable if:

a. *The Corporation Holds Assets That Have Not Appreciated or That Have Depreciated.* In such situations, the FMV of the property distributed does not exceed the basis of the transferred assets and the corporation does not recognize gain. Additionally, the FMV of the assets distributed to the shareholders most likely will not exceed the basis of their stock, and gain recognition will not be required at the shareholder level. Since the current economy has resulted in many LLCs holding depreciated assets, now may be a particularly good climate for corporations desiring to convert to LLC status.

b. *The Corporation and/or its Shareholders have NOLs or Capital Loss Carryforwards That Absorb Any Gain Recognized on the Liquidating Distribution.* Shareholders may have capital loss carryforwards from other activities or investments that can be used to offset the gain. The corporation may have NOL or capital loss carryforwards that can offset some or all of the corporations gain on the deemed sale of assets associated with its liquidating distribution.

c. *The Corporation Holds Assets That Will Appreciate Rapidly in the Future (Such As a Potential Patent, Intellectual Property, or Real Estate).* If rapid appreciation is expected in the future, it may be preferable to "bite the bullet" and recognize the gain on liquidation of the corporation now, rather than continuing to operate as a corporation.

**Ways to Structure C Corporation Conversion**

There are three basic ways to structure the conversion of a C corporation into an LLC. All three ways result in the liquidation of the corporation and a substantial tax cost. However, the choice of method may affect the shareholder/members' bases in their interests in the LLC or the LLC's basis in its assets. The three methods are:

a. *The Shareholders of the C Corporation Form the LLC by Transferring Their Stock to the LLC in Exchange for Membership Interests.* At that point, the shareholders own interests in the LLC and the LLC owns all the stock of the C corporation. The corporation then liquidates, which results in the LLC (as the sole shareholder) receiving the liquidating distribution. Generally, no gain or loss is recognized by the shareholders on the contribution of their C corporation stock to the LLC. When the corporation liquidates into the LLC, it pays a tax on the difference between the FMV and tax basis of the distributed assets. The LLC recognizes gain on receipt of the liquidating distribution, which is passed through to its members. The shareholder/members have a carryover basis in their LLC interests equal to the basis they had in the C corporation's stock increased by the gain passed through from the LLC. [IRC Sec. 704(c) requires each member of the LLC to be taxed subsequently on the gain or loss inherent in their stock at the time of its transfer to the LLC.] The LLC will have a basis in the corporation's assets equal to the FMV of the assets on the date of liquidation.

b. *The C Corporation and Its Shareholders Transfer Assets to Form an LLC.* The C corporation transfers its assets (subject to liabilities) to the LLC, and the shareholders transfer cash or other assets. The C corporation then liquidates and distributes its membership interest in the LLC to the shareholders. Again, no gain or loss is recognized on the contribution of assets to the LLC by the corporation or shareholders under IRC Sec. 721. The corporation recognizes a gain on the liquidating distribution of the LLC interests to the shareholders equal to the difference between the FMV and tax basis of the distributed interests. The shareholders recognize gain on receipt of the liquidating distribution equal to the difference between the FMV of the distributed LLC interests and the basis in their stock. The LLC has a carryover basis in the corporation's assets equal to the basis of the assets in the hands of the corporation prior to contribution. (However, the distribution of ownership interests in the LLC constitutes a transfer within the meaning of IRC Sec. 743 and the LLC can adjust the basis of its assets if a Section 754 election is in effect.) The shareholders have a basis in the LLC interests distributed by the corporation equal to FMV on the date of liquidation. (The basis of the shareholders in their LLC interests acquired by contribution is the amount of cash and tax basis of property contributed for the interests.) One advantage of this type of transaction is that significant discounts may be applied to the LLC interests distributed to the former shareholders, since the Section 2701–2704 limitations apply only for gift and estate tax purposes. Practitioners might consider adding restrictions to significantly increase the discount available. Another advantage of this liquidation structure is that transfer taxes imposed by some states on the transfer of real property normally will not be assessed on a contribution of real property rather than a distribution of real property.

c. *The Corporation Liquidates and Distributes Its Assets to the Shareholders.* The shareholders then contribute the distributed assets to the LLC in return for membership interests. The corporation recognizes income equal to the difference between the FMV and tax basis of the distributed assets. The shareholders recognize income equal to the difference between the FMV of the distributed property and their stock basis. No gain or loss is recognized on the contribution of assets by the shareholders to the LLC under IRC Sec. 721. The results of this conversion structure are the same as the structure discussed in item a. However, a disadvantage of this type of conversion is that the shareholders have liability for the corporation's debts at the point in time they are considered to hold the corporation's assets and liabilities.

## CONVERSION OF AN S CORPORATION

The conversion of an S corporation into an LLC usually carries a less onerous tax burden than the conversion of a C corporation. Like the conversion of a C corporation, the conversion of an S corporation requires the liquidation of the S corporation. However, the increase in an S corporation shareholder's basis resulting from passed-through income and gains triggered by the liquidating distribution will usually eliminate the threat of double taxation. Following is a brief general discussion of the tax treatment of an S corporation liquidation.

### Taxation of S Corporation Liquidation

**Tax on Corporation.** Under IRC Sec. 336, a liquidating S corporation must recognize gain or loss on distributions of property to the shareholders as if the property had been sold to them for its FMV. The character of the gain recognized (capital versus ordinary) depends on the character of the property being distributed. (Depreciation recapture and similar rules may also affect the character of the gain recognized.) Generally, corporations are allowed to recognize losses when property is distributed to shareholders in complete liquidation of the corporation. However, a corporation making a liquidating distribution to a related person (under the rules of IRC Sec. 267) cannot recognize the loss if the distribution is not pro rata or disqualified property is distributed. Disqualified property is any property acquired by the corporation in a Section 351 transfer or as a contribution to capital during the five-year period ending on the distribution date; or any property whose adjusted basis is determined by reference to the adjusted basis of such property.

The gain recognized by the S corporation on the liquidating distribution is passed through to the S corporation shareholders and increases the basis of their S corporation stock.

**Tax on Shareholder.** IRC Sec. 331 governs the tax treatment of liquidating distributions at the shareholder level. The Section 331 rules require the liquidating distribution to be treated as full payment in exchange for the shareholder's stock. The shareholders must recognize gain (or loss) equal to the difference between the FMV of the assets received and the adjusted basis of the stock surrendered. Since the S corporation shareholders increase the basis of their stock for the gain recognized by the S corporation on the liquidating distribution, there may be no difference in the basis of the assets received and the shareholders' stock basis. However, a significant shareholder-level tax liability may result if the liquidating distribution triggers ordinary income that is passed through by the S corporation to its shareholders. (If the shareholders have capital losses, they will be unable to use them to shelter more than modest amounts of ordinary income.) The shareholder's basis in the property received in the liquidating distribution is its FMV at the time of distribution.

**S Corporation Holding Built-in Gains Property.** Liquidation of an S corporation may cause the corporation to recognize built-in gains tax. The built-in gains tax applies only to S corporations that were formerly C corporations. IRC Sec. 1374 imposes a 10-year recognition period with respect to property held on the date of the S election that had a FMV different from its tax basis on that date. (For tax years beginning in 2009 and 2010, no tax is imposed on the net recognized built-in gain of an S corporation if the seventh tax year in the recognition period preceded the 2009 and 2010 tax years. This effectively shortens the built-in gains period to seven years for gains recognized in 2009 and 2010. For tax years beginning in 2011, the holding period of assets subject to the built-in gains tax is shortened to five years if the fifth tax year in the recognition period precedes the tax year beginning in 2011.) During the 10-year (or 7-year) recognition period, the built-in gains tax is imposed at the highest regular corporate tax rate (currently 35%) on any gain resulting from the disposition of assets held at the time of conversion to S status. The built-in gains tax is subject to several limitations.

### Determining If Conversion Is Desirable

As with the conversion of a C corporation, practitioners probably want to consider conversion of an S corporation only if circumstances limit the gain that will be recognized by the corporation on the distribution of its assets. However, the liquidation of an S corporation is usually subject to only one level of tax because of the increase in basis resulting from the pass-through of income to S corporation shareholders. (However, if an S corporation recognizes ordinary income from the deemed sale of its assets because of depreciation recapture or some other recharacterization rule, shareholder capital losses will not shelter more than modest amounts of the ordinary income.) An S corporation conversion may be particularly desirable when the corporation holds unappreciated or depreciated assets and has no built-in gains property.

**Ways to Structure S Corporation Conversion**

The same three conversion structures that apply to C corporations also apply to S corporations. The following is a discussion of these three methods in light of the special rules that apply to S corporations:

a. *The Shareholders of the S Corporation Form an LLC by Transferring Their Stock to the LLC in Exchange for Membership Interests.* At that point, the shareholders own interests in the LLC and the LLC owns all the stock of the S corporation. The corporation then liquidates, which results in the LLC as the sole shareholder receiving the liquidating distribution. Generally no gain or loss is recognized by the shareholders on the contribution of their S corporation stock to the LLC. When the corporation liquidates into the LLC, it recognizes gain equal to the difference between the FMV and tax basis of the distributed assets. This gain is passed through to the LLC, which in turn passes the gain through to its members. The shareholder/members have a carryover basis in their LLC interests equal to the basis they had in the S corporation's stock, increased by gain on the liquidating distribution passed through from the LLC. [IRC Sec. 704(c) will require each member of the LLC to subsequently be taxed on the gain or loss inherent in their stock at the time of its transfer to the LLC.] The LLC has a basis in the S corporation's assets equal to the FMV of the assets on the date of liquidation.

   Because an LLC taxed as a partnership is not an eligible S corporation shareholder, the transfer of stock to the LLC causes termination of the corporation's S election. (However, if the LLC elects to be classified as a corporation, the transferor S corporation's S election remains in effect—see Ltr. Rul. 9636007. Also, if the LLC is a single-member LLC owned by an eligible shareholder, the corporation's S election remains in effect.)

b. *The S Corporation and Its Shareholders Transfer Assets to Form an LLC.* The S corporation transfers its assets (subject to liabilities) to the LLC, and the shareholders transfer cash or other assets. The S corporation then liquidates and distributes its membership interest in the LLC to the shareholders. Again, no gain or loss is recognized on the contribution of assets to the LLC by the S corporation or shareholders under IRC Sec. 721. The S corporation recognizes a gain on the liquidating distribution of the LLC interests to the shareholders equal to the difference between the FMV and basis of the distributed interests. The gain is passed through to the shareholders and increases the basis in their S corporation stock. The shareholders recognize gain on receipt of the liquidating distribution equal to the difference between the FMV of the distributed LLC interests and the basis in their stock, which should be minimal. The LLC has a carryover basis in the corporation's assets equal to the basis of the assets in the hands of the corporation prior to contribution. (However, the distribution of ownership interests in the LLC constitutes a transfer within the meaning of IRC Sec. 743 and the LLC can adjust the basis of its assets if a Section 754 election is in effect.) The shareholders have a basis in the LLC interests distributed by the corporation equal to FMV on the date of liquidation. (The basis of the shareholders in their LLC interests acquired by contribution is the amount of cash and tax basis of property contributed for the interests.

c. *The S Corporation Liquidates and Distributes Its Assets to the Shareholders.* The shareholders then contribute the distributed assets to the LLC in return for membership interests. The S corporation recognizes income equal to the difference between the FMV and tax basis of the distributed assets. The gain recognized by the S corporation increases the basis of the shareholders in their stock. The shareholders recognize income equal to the difference between the FMV of the distributed property and their stock basis, which should be minimal. No gain or loss is recognized on the contribution of assets by the shareholders to the LLC under IRC Sec. 721. The results of this conversion structure are the same as the structure discussed in item a. As with the parallel C corporation conversion, a disadvantage of this type of conversion is that the shareholders have liability for the S corporation's debts at the point in time they are considered to hold the S corporation's assets and liabilities.

In Ltr. Rul. 200628008, the IRS addressed the merger of two S corporations into a disregarded LLC (owned by an LLC taxed as a partnership) followed by a distribution of cash to the sole shareholder of the two target S corporations. The IRS held that the merger is treated as a deemed sale of the S corporations' assets to the shareholder LLC, followed by the liquidation of the S corporations resulting in gain or loss to the S corporation shareholder.

## CONVERSION OF LLC TO CORPORATION

Reg. 301.7701-3(g)(1) provides that at the time of an election by a partnership (or LLC taxed as a partnership) or disregarded entity to be classified as a corporation, the converting entity is deemed to contribute all of its assets and liabilities to the corporation in exchange for stock of the corporation. If the converting entity is a partnership or LLC taxed as a partnership, the stock in the corporation is then deemed to be distributed to the partners or members in the electing entity. (This is the same method as that outlined for converting a corporation to an LLC in item b. above.) An election to be taxed as a corporation is treated as occurring at the start of the day for which the election is effective. (Note that when an eligible entity files an S election, it is deemed to have made the election to be taxed as a corporation.) However, any transactions that are deemed to occur as a result of the election, such as the transfer of assets and stock discussed in this paragraph, are treated as occurring immediately before the close of the day before the election is effective. Members in the converting LLC may recognize gain on the deemed liquidation of the LLC if losses were taken using LLC debts for basis and the corporation assumes those debts. If a partnership, LLC, or disregarded entity elects corporate classification, the parties are not actually required to form a corporation or to transfer assets under state law. However, a conversion under the check-the-box regulations may preclude the shareholders from receiving Section 1244 stock because no stock is actually issued.

A partnership, LLC, or disregarded entity can convert to corporate status under one of the methods outlined in Rev. Rul. 84-111, rather than under the election provided by the check-the-box regulations. However, in such cases it is necessary to actually form a corporation under state law and transfer assets, liabilities, and stock consistent with the form of transaction chosen. This may result in lease terminations, reappraisals of property, or the need to obtain creditor consent. In Rev. Rul. 2004-59, the IRS looked at the tax consequences of an LLC (taxed as a partnership) converting to a state law corporation under a state statute that does not require an actual transfer of the unincorporated entity's assets or interests (i.e., a state law formless conversion statute). After noting that Rev. Rul. 84-111 does not apply when a partnership converts into a corporation in accordance with a state law formless conversion statute, the IRS ruled that the LLC is deemed to have contributed all of its assets and liabilities to the corporation in exchange for stock. The LLC is then deemed to liquidate and distribute the corporate stock to its members.

Rev. Rul. 2009-15 clarifies that when an LLC taxed as a partnership becomes a corporation (either by a state law formless conversion or under the check-the-box regulations) it is eligible to make an S election for its first taxable year, and the conversion results in no short C corporation tax year.

**SELF-STUDY QUIZ**

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

36. Bell, Inc., a C corporation liquidates and distributes its only asset to Bill the sole shareholder. The asset has a fair market value (FMV) of $115,000 and basis of $75,000. Bill has basis of $35,000 in his stock. What is Bill's gain on the liquidation?

    a. -0-.

    b. $5,000.

    c. $40,000.

    d. $80,000.

37. JP Inc., an S corporation, liquidates and distributes its assets to Jack, the sole shareholder. The assets have a fair market value of $100,000 and the corporation's basis in the assets is $35,000. Jack has basis in his stock of $53,000 before considering the liquidation. The fair market value of the stock is $25,000. What is the amount of gain that the corporation reports on its tax return, Form 1120S?

    a. $47,000.

    b. $65,000.

    c. $75,000.

    d. $100,000.

38. Assume the same facts as in the preceding question. What is Jack's basis in the stock after the liquidation?

    a. $53,000.

    b. $78,000.

    c. $118,000.

    d. $153,000.

39. An S election will terminate under which of the following circumstances?

    a. The S corporation transfers its stock to an LLC taxed as an S corporation.

    b. The S corporation transfers its stock to an LLC taxed as a partnership.

    c. The S corporation transfers it stock to a single-member LLC owned by an eligible shareholder.

40. JJ Company, an LLC, intends to elect to be treated as a corporation. The LLC is which of the following?

    a. Required to form a corporation.

    b. Required to transfer assets to the corporation.

    c. Taxed as a corporation at the start of the day for which the election is effective.

    d. Required to treat the deemed transfers of assets and stock as occurring at the start of the day for which the election is effective.

## SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

36. Bell, Inc., a C corporation liquidates and distributes its only asset to Bill the sole shareholder. The asset has a fair market value (FMV) of $115,000 and basis of $75,000. Bill has basis of $35,000 in his stock. What is Bill's gain on the liquidation? **(Page 99)**

    a. -0-. [This answer is incorrect. Gain or loss is recognized at the shareholder level when a corporation liquidates.]

    b. $5,000. [This answer is incorrect. The shareholder's gain on liquidation is not affected by the gain at the corporate level. The fact that the corporation recognized a $40,000 gain ($115,000 – $75,000) has no bearing on the calculation of Bill's gain or loss on the liquidation.]

    c. $40,000. [This answer is incorrect. The fact that the corporation has $75,000 of basis in the asset has no bearing on the calculation of the shareholder's gain or loss on the liquidation.]

    **d. $80,000. [This answer is correct. Bill recognizes gain or loss equal to the difference between the FMV of the asset received ($115,000) and his stock basis ($35,000).]**

37. JP Inc., an S corporation, liquidates and distributes its assets to Jack, the sole shareholder. The assets have a fair market value of $100,000 and the corporation's basis in the assets is $35,000. Jack has basis in his stock of $53,000 before considering the liquidation. The fair market value of the stock is $25,000. What is the amount of gain that the corporation reports on its tax return, Form 1120S? **(Page 101)**

    a. $47,000. [This answer is incorrect. Jack's basis is not considered in the calculation of the gain at the corporate level.]

    **b. $65,000. [This answer is correct. Per IRC Sec. 336, the corporation reports gain as if it sold the assets for their fair market value. Thus, the gain is the fair market value of the assets minus the assets' adjusted basis.]**

    c. $75,000. [This answer is incorrect. The fair market value of the stock is not used in the calculation of the corporate gain.]

    d. $100,000. [This answer is incorrect. The corporation is not required to report the assets' fair market value as gain.]

38. Assume the same facts as in the preceding question. What is Jack's basis in the stock after the liquidation? **(Page 101)**

    a. $53,000. [This answer is incorrect. Jack's basis will change because appreciated property was distributed to him.]

    b. $78,000. [This answer is incorrect. The fair market value of the stock is not a factor in calculating Jack's stock basis.]

    **c. $118,000. [This answer is correct. Jack's beginning basis of $53,000 is increased by the $65,000 gain passed through by the S corporation to Jack.]**

    d. $153,000. [This answer is incorrect. Jack's basis is not increased by the fair market value of the distributed assets.]

39. An S election will terminate under which of the following circumstances? **(Page 102)**

    a. The S corporation transfers its stock to an LLC taxed as an S corporation. [This answer is incorrect. The S election can terminate when an S corporation transfers its stock to an LLC, but not if the LLC is taxed as an S corporation.]

    **b. The S corporation transfers its stock to an LLC taxed as a partnership. [This answer is correct. A partnership is not allowed to hold S corporation stock, so the election terminates when the stock is transferred to the LLC.]**

    c. The S corporation transfers it stock to a single-member LLC owned by an eligible shareholder. [This answer is incorrect. An S corporation can terminate when stock is transferred to an LLC, but does not terminate if the LLC is single-member and owned by an individual eligible to hold S corporation stock.]

40. JJ Company, an LLC, intends to elect to be treated as a corporation. The LLC is which of the following? **(Page 103)**

    a. Required to form a corporation. [This answer is incorrect. An LLC treated as a corporation remains an LLC.]

    b. Required to transfer assets to the corporation. [This answer is incorrect. An LLC treated as a corporation is still an LLC and is no transfer of assets is necessary.]

    **c. Taxed as a corporation at the start of the day for which the election is effective. [This answer is correct. The LLC is classified as an association taxable as a corporation on that day.]**

    d. Required to treat the deemed transfers of assets and stock as occurring at the start of the day for which the election is effective. [This answer is incorrect. The LLC is required to treat the deemed transfers as occurring immediately before the close of the day before the election is effective.]

## EXAMINATION FOR CPE CREDIT

### Lesson 3 (LLCTG101)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

26. Carol and Ann are considering converting their business into an LLC. Their current business entity has secured creditors. Under which of the following scenarios must Carol and Ann notify their creditors of their conversion to an LLC?

    a. Carol and Ann convert from a C corporation to an LLC.

    b. Carol and Ann are each sole proprietors who want to form an LLC together.

    c. Carol and Ann convert from a limited partnership into an LLC.

    d. Carol and Ann are general partners in a partnership converting to an LLC taxed as a partnership.

27. Conversion to an LLC may result in a change in the reporting entity.

    a. True.

    b. False.

    c. Do not select this answer choice.

    d. Do not select this answer choice.

28. Which of the following accounting methods is permitted for a newly organized LLC?

    a. A sole proprietor using the accrual method converts to a single member LLC, taxed as a disregarded entity. The new LLC wants to use the cash method of accounting.

    b. A C corporation, using the accrual method of accounting, converts to an LLC taxed as a partnership. The new LLC has a C corporation as a member. The new LLC wants to use the cash method of accounting.

    c. A sole proprietor uses the cash method of accounting and converts to a single member LLC, taxed as a disregarded entity. The new LLC wants to continue to use the cash method of accounting.

    d. Two sole proprietors each using the cash method of accounting convert to an LLC taxed as a partnership. The new LLC is a tax shelter and wants to use the same method of accounting it used prior to the conversion.

29. Mary is a member of an LLC. Mary is **not** subject to self-employment tax under which of the following scenarios?

    a. Mary has authority under the laws of the state of organization to contract on behalf of the LLC.

    b. Mary participates in the LLC's business for more than 500 hours during the tax year.

    c. Mary has no personal liability for the debts of or claims against the LLC.

    d. Mary is a member of an LLC providing professional services.

30. Which of the following is **not** a method of converting from a general or limited partnership to an LLC?

    a. Transfer of partners' interests in the preconversion partnership for interests in the new LLC, followed by liquidation of the preconversion partnership and distribution of assets.

    b. Contribution of assets from the liquidation of the partnership by the partners to the new LLC.

    c. Amending the partnership agreement by the required number of general partners voting to convert to an LLC followed by notification to the limited partners.

    d. Do not select this answer choice.

31. Hydraulics Company is a calendar year accrual basis limited partnership which converts to an LLC taxed as a partnership. Prior to the conversion, the partnership borrowed $100,000 from the bank. After the conversion, the preconversion debt is replaced by nonrecourse debt in the new LLC. Stan had a 100% interest in the loan and had taken losses in the amount of $40,000, which reduced his debt basis. Post-conversion, Tom and Dan, who are limited partners, are each allocated 40% of the LLCs income or loss and Stan is allocated 20% of income or loss. How much of the note is allocated to Stan after the conversion?

    a. $60,000.

    b. $33,333.

    c. $20,000.

    d. $100,000.

32. Hydraulics Company is a calendar year accrual basis limited partnership which converts to an LLC taxed as a partnership. Prior to the conversion, the partnership borrowed $100,000 from the bank. After the conversion, the preconversion debt is replaced by nonrecourse debt in the new LLC. Stan had a 100% interest in the loan and had taken losses in the amount of $40,000, which reduced his debt basis. Post-conversion, Tom and Dan, who are limited partners, are each allocated 40% of the LLCs income or loss and Stan is allocated 20% of income or loss. How much interest in the debt do Tom and Dan each have in the post-conversion company?

    a. $0.

    b. $33,333.

    c. $40,000.

    d. $24,000.

33. Hydraulics Company is a calendar year accrual basis limited partnership which converts to an LLC taxed as a partnership. Prior to the conversion, the partnership borrowed $100,000 from the bank. After the conversion, the preconversion debt is replaced by nonrecourse debt in the new LLC. Stan had a 100% interest in the loan and had taken losses in the amount of $40,000, which reduced his debt basis. Post-conversion, Tom and Dan, who are limited partners, are each allocated 40% of the LLCs income or loss and Stan is allocated 20% of income or loss. How much income, if any, will Stan be required to report as a result of claiming prior year losses?

    a. $40,000.

    b. $20,000.

    c. $6,667.

    d. $0.

34. Organizational expenses of a new partnership or LLC are eligible for deduction or amortization if they are incurred under which of the following circumstances?

    a. The expenses are incurred during the LLC's first two tax years.

    b. The organizational expenses do not exceed $10,000.

    c. The expenses are incurred prior to the original due date of the tax return of the year the LLC begins doing business.

    d. If the expense is incurred after beginning business operations, the partnership or LLC makes a valid amortization election.

35. A multi-member LLC taxed as a partnership can become a disregarded entity if which of the following occurs?

    a. Only one of the members makes a contribution to the LLC.

    b. One purchases all of the LLC's assets.

    c. Each member agrees to file Schedule C.

    d. The LLC makes a check-the-box election to be treated as a disregarded entity.

36. Conversion of a partnership to an LLP can be accomplished by which of the following?

    a. Registering the existing partnership with the state and paying the required fees.

    b. The converted partnership recognize the state's partnership statutes in its articles of organization.

    c. Transferring legal title to firm assets to the LLP and paying any required transfer taxes or fees.

    d. The general partners agree to remain liable for the partnership's liabilities.

37. Shareholders of a C corporation can form an LLC by transferring their stock in exchange for membership interests. Which statement is the most accurate?

    a. Gain or loss is recognized by the shareholders upon contribution of their stock to the LLC.

    b. No gain or loss is recognized at the C corporation level.

    c. The LLC becomes the sole shareholder upon liquidation of the C corporation.

    d. The shareholders have basis in the LLC equal to FMV of their stock on the date of liquidation.

38. A disadvantage of the method of converting to an LLC whereby the corporation liquidates and distributes its assets to the shareholders is which one of the following?

    a. Some states will assess transfer taxes on the transfer of real property to the individual.

    b. The shareholders have liability for the corporation's debts at the time they are considered to hold the assets and liabilities of the corporation.

    c. Each shareholder must pay a tax on the difference between FMV and tax basis of the distributed assets.

    d. Although gain must be recognized by the shareholder upon distribution of the corporation's assets, losses are disallowed.

39. KL, Inc., an S corporation with one shareholder, liquidates and recognizes gain on the liquidation. How does the gain affect the shareholder?

    a. The shareholder's basis is increased by the amount of the gain.

    b. The shareholder recognizes gain to the extent there is a difference between FMV and tax basis of the property received.

    c. Any gain passed through to the shareholders by the S corporation on the liquidating distribution is deemed to be capital in nature.

    d. The built-in gains tax will apply at the corporate level to the extent of gain recognized on the liquidation.

40. An S corporation is subject to the built-in gains tax under which of the following circumstances?

    a. It was a partnership with appreciated assets that incorporated and elected S status.

    b. It holds shares in a C corporation.

    c. It was a C corporation before electing S status.

    d. Its S election is declared invalid and it reverts to C corporation status.

# GLOSSARY

**Accrual method:** A partnership holding inventories must also use the accrual method. (Rev. Proc. 2001-10 provides that the Commissioner may exercise his discretion to except a qualifying taxpayer with average annual gross receipts of $1 million or less from the requirements to account for inventories and to use an accrual method of accounting for purchases and sales of merchandise. In addition, partnerships with average annual gross receipts of $10 million or less may qualify to use the cash method under the provisions of Rev. Proc. 2002-28.

**Allocations:** Profits and losses of an LLC taxed as a partnership are allocated among its members in accordance with its operating agreement.

**Basis:** An election unique to LLCs and partnerships allows a taxpayer acquiring an interest in an LLC taxed as a partnership to step up the tax basis of the LLC's assets to reflect the purchase price.

**Capital interest:** As a general rule IRC Sec. 721 provides that no gain or loss is recognized by an LLC taxed as a partnership or its members upon the contribution of property to the LLC in exchange for a membership interest. This general nonrecognition rule is subject to several exceptions. It does not apply to contributions that do not consist solely of property or that are made to investment companies. In addition, the nonrecognition rule may not apply when the contributed property is subject to liabilities, or the LLC otherwise assumes member liabilities in connection with the transaction. The nonrecognition rule also does not apply to the receipt of a capital interest in exchange for the performance of services.

**Cash method:** According to IRC Sec. 446, an LLC can use any method of accounting provided it clearly reflects income. (Rev. Proc. 2001-10 provides that the Commissioner may exercise his discretion to except a qualifying taxpayer with average annual gross receipts of $1 million or less from the requirements to account for inventories and to use an accrual method of accounting for purchases and sales of merchandise. In addition, Rev. Proc. 2002-28 allows qualifying small businesses with average annual gross receipts between $1 million and $10 million, to use the cash method with respect to eligible trades or businesses.) However, like a partnership, an LLC is not allowed to use the cash method if it has a C corporation as one of its members (unless the LLC's annual gross receipts are less then $5 million) or meets the definition of a tax shelter.

**Common law:** In common law states, property is treated as it is titled, except when dividing marital property in a divorce proceeding. Property held concurrently (e.g., jointly) by spouses in common law states is under the control of each spouse, and either spouse can dispose of the entire amount of concurrent property, except in the case of tenancy by the entirety property, which requires the consent of both spouses. In common law states, property acquired in the name of one spouse (separate property) is under the exclusive control of the owner/spouse, and the other spouse has no rights in the separate property of the owner/spouse until a divorce occurs. Therefore, unless a divorce is imminent, the separate property of one spouse is not subject to the liabilities of the other spouse.

**Community property:** Generally, in community property states, married persons have two types of property: separate property and community property. Unlike common law states, community property states look to the source of the property (not the name in which it is titled) to determine the character of the property. In most community property states, the property statutes specifically describe the types of property that are separate property and define community property as all property other than separate property. Generally, each spouse has sole control over his or her separate property and the separate property is liable for the debts of the spouse who owns it but not the debts of the other spouse. In community property states, a spouse's separate property generally includes (a) property acquired prior to the marriage; (b) property acquired during the marriage by gift, inheritance, or personal injury damages award; and (c) property converted from community property to separate property by a written marital property agreement signed by both spouses. Earnings (e.g., rent, interest, and dividends) from separate property are generally considered community property unless otherwise provided in a written marital property agreement signed by both spouses.

**Community property state:** Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin.

**Disregarded entity:** Disregarded entities are treated as entities not separate from their owners.

**Guaranteed payments:** If services are provided in a member's capacity as an owner, the member can be compensated through special allocations of income or guaranteed payments.

**LLC:** Limited Liability Company.

**LLP:** Limited Liability Partnership.

**Multi-member LLC:** A single-member LLC can become a multi-member LLC when the single member sells an interest in the LLC to another member, or when another member is admitted by making a contribution to the LLC.

**Nonconforming tax year:** An LLC taxed as a partnership generally must use the year of its principal members. Exceptions to this general rule allow an LLC to use a nonconforming year under the natural business year or business purpose exception. An LLC can also elect, in certain cases, to use a nonconforming tax year under IRC Sec. 444. This election may require the LLC to make prepaid tax deposits.

**Nonrecognition Rule:** As a general rule IRC Sec. 721 provides that no gain or loss is recognized by an LLC taxed as a partnership or its members upon the contribution of property to the LLC in exchange for a membership interest. This general nonrecognition rule is subject to several exceptions. It does not apply to contributions that do not consist solely of property or that are made to investment companies. In addition, the nonrecognition rule may not apply when the contributed property is subject to liabilities, or the LLC otherwise assumes member liabilities in connection with the transaction. The nonrecognition rule also does not apply to the receipt of a capital interest in exchange for the performance of services.

**Organizational expenses:** If the organizers incur substantial costs in organizing the LLC, the articles or operating agreement should provide for the reimbursement of those costs. IRC Sec. 195 allows up to $5,000 of startup or organizational expenses to be expensed. The deduction is reduced dollar-for-dollar for expenses in excess of $50,000. Any expenses not deductible under this provision can be amortized over 15 years.

**Required Year:** S corporations generally are required to use a calendar year for tax purposes unless the corporation qualifies for a business purpose fiscal year or elects to have a tax year other than the required year under IRC Sec. 444.

**Schedule K-1:** Electing large partnerships file Form 1065B and are required to furnish Schedules K-1 to partners on or before the first March 15 following the close of the partnership's tax year.

**Self Employment Tax:** Payments for services characterized as guaranteed payments are subject to self-employment tax. If a payment for member services is a special allocation of income, Prop. Reg. 1.1402(a)-2 provides that the allocated income is subject to SE tax if the member (a) has personal liability for debts, (b) has authority to contract on behalf of the LLC, or (c) participates in the LLC's trade or business for more than 500 hours during the tax year.

**Separate property:** In common law states, property acquired in the name of one spouse (separate property) is under the exclusive control of the owner/spouse, and the other spouse has no rights in the separate property of the owner/spouse until a divorce occurs. Therefore, unless a divorce is imminent, the separate property of one spouse is not subject to the liabilities of the other spouse.

**Series LLC:** A number of states (including Delaware, Illinois, Iowa, Minnesota, Wisconsin, North Dakota, Oklahoma, Nevada, and Tennessee) have enacted provisions allowing for the creation of series LLCs or partnerships. The statutes allow this type of LLC to designate separate series (or divisions) within the entity into which assets and ownership interests can be segregated. The series LLC can be structured to take advantage of the segregation possibilities under the statute, allowing each series to stand alone. Each series can have its own business or investment purpose, classes of ownership interest, and liability limitations.

**Single-member LLC:** An LLC with a single member is treated as the same tax entity as its owner (disregarded entity) or can elect to be taxed as a corporation.

**Technical Termination:** There is a sale or exchange of 50% or more of the total interest in LLC capital and profits within a 12-month period.

**Unreasonable compensation:** In the context of partnerships, LLCs taxed as partnerships or sole proprietorships, and sole proprietorships, the issue of unreasonable compensation does not arise because all taxable income, regardless of whether it is distributed, is taxed at the employee/owner level. Consequently, the unreasonable compensation issue is another disadvantage of operating as a C corporation. [Although the income of an S corporation is also taxed at the owner level, the IRS has sometimes argued that S corporations undercompensate employee/shareholders and must recharacterize a portion of the dividends paid to those employee/shareholders as salary (which is subject to payroll taxes).]

# INDEX

# TESTING INSTRUCTIONS FOR EXAMINATION FOR CPE CREDIT

## Companion to to PPC's Guide to Limited Liability Companies—Choosing or Converting to an LLC (LLCTG101)

1. Following these instructions is information regarding the location of the **CPE CREDIT EXAMINATION QUESTIONS** and an **EXAMINATION FOR CPE CREDIT ANSWER SHEET**. You may use the answer sheet to complete the examination consisting of multiple choice questions.

   **ONLINE GRADING.** Log onto our Online Grading Center at **cl.thomsonreuters.com** to receive instant CPE credit. Click the purchase link and a list of exams will appear. Search for an exam using wildcards. Payment for the exam is accepted over a secure site using your credit card. Once you purchase an exam, you may take the exam three times. On the third unsuccessful attempt, the system will request another payment. Once you successfully score 70% on an exam, you may print your completion certificate from the site. The site will retain your exam completion history. If you lose your certificate, you may return to the site and reprint your certificate.

   **PRINT GRADING.** If you prefer, you may mail or fax your completed answer sheet to the address or number below. In the print product, the answer sheets are bound with the course materials. Answer sheets may be printed from electronic products. The answer sheets are identified with the course acronym. Please ensure you use the correct answer sheet. Indicate the best answer to the exam questions by completely filling in the circle for the correct answer. The bubbled answer should correspond with the correct answer letter at the top of the circle's column and with the question number.

   Send your completed **Examination for CPE Credit Answer Sheet, Course Evaluation,** and payment to:

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2. If you change your answer, remove your previous mark completely. Any stray marks on the answer sheet may be misinterpreted.

3. Copies of the answer sheet are acceptable. However, each answer sheet must be accompanied by a payment of $79. Discounts apply for 3 or more courses submitted for grading at the same time by a single participant. If you complete three courses, the price for grading all three is $225 (a 5% discount on all three courses). If you complete four courses, the price for grading all four is $284 (a 10% discount on all four courses). Finally, if you complete five courses, the price for grading all five is $336 (a 15% discount on all five courses or more).

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## EXAMINATION FOR CPE CREDIT

To enhance your learning experience, examination questions are located immediately following each lesson. Each set of examination questions can be located on the page numbers listed below. The course is designed so the participant reads the course materials, answers a series of self-study questions, and evaluates progress by comparing answers to both the correct and incorrect answers and the reasons for each. At the end of each lesson, the participant then answers the examination questions and records answers to the examination questions on either the printed **EXAMINATION FOR CPE CREDIT ANSWER SHEET** or by logging onto the Online Grading System. The **EXAMINATION FOR CPE CREDIT ANSWER SHEET** and **SELF-STUDY COURSE EVALUATION FORM** for each course are located at the end of all course materials.

## EXAMINATION FOR CPE CREDIT ANSWER SHEET

**Companion to to PPC's Guide to Limited Liability Companies—**
**Choosing or Converting to an LLC (LLCT101)**

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**Expiration Date: November 30, 2011**

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**Please Print Legibly**—Thank you for your feedback!

Course Title: Companion to to PPC's Guide to Limited Liability Companies—Choosing or Converting to an LLC

Course Acronym: LLCTG101

Your Name (optional): ____________________ Date: ____________

Email: ____________________

**Please indicate your answers by filling in the appropriate circle as shown:**
**Fill in like this ● not like this ⊘ ⊗ ✓.**

| **Satisfaction Level:** | **1** | **2** | **3** | **4** | **5** | **6** | **7** | **8** | **9** | **10** |
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| 4. Were the stated learning objectives met? | ○ | ○ | ○ | ○ | ○ | ○ | ○ | ○ | ○ | ○ |
| 5. Were the course materials accurate and useful? | ○ | ○ | ○ | ○ | ○ | ○ | ○ | ○ | ○ | ○ |
| 6. Were the course materials relevant and did they contribute to the achievement of the learning objectives? | ○ | ○ | ○ | ○ | ○ | ○ | ○ | ○ | ○ | ○ |
| 7. Was the time allotted to the learning activity appropriate? | ○ | ○ | ○ | ○ | ○ | ○ | ○ | ○ | ○ | ○ |
| 8. If applicable, was the technological equipment appropriate? | ○ | ○ | ○ | ○ | ○ | ○ | ○ | ○ | ○ | ○ |
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