Issues

- Check the Box Regulations
- Spousal LLCs
- Basis Rules
- Reconciling Inside and Outside Basis
- Allocation Rules
- Compensation
- Changing Entity Type by Election
- Ownership Changes
- Appendix – Entity Comparison
The limited liability company does not exist as such under federal tax law.
Contrary to a popular myth, it is not a separate entity or tax classification.
It exists only under state law.
The Internal Revenue Code recognizes only two tax entities in operation:
LLCs organized in one state but doing business in others have to register in each state in which the LLC is doing business. Often this requires an annual fee and failure to do so results in penalties and assessments as well as the possibility of negation of liability protection.
1. The partnership form or
2. The corporate form.

➢ Therefore, the classification of one form of entity vs. another is by default depending upon the makeup of the LLC and whether a separate election was made.

➢ Figure 4.1 presents a comparative classification of entities under state law and by federal tax law.
Limited liability companies provide a protection from certain legal actions that would otherwise impair the assets and income of the members of the limited liability companies.

However, it may be wise to form multiple LLCs to fragment the risk.

These are referred to as “serial” LLCs.
Serial LLCs – Not In Book

- A “serial LLC” is any separate unit, company, etc.
- The purpose is to “carve out” liability and isolate it to protect classes of assets.
- For example, an entity that has trucks, real estate, and machinery may want to consider creating separate LLCs to hold each group of assets and protect them from liability triggered by another group of assets such as machinery or trucking.
In Summary – Not In Book

- A limited liability company that has one member is either a sole proprietorship, schedule E, or elects to be treated as a corporation.

- A limited liability company that has more than one member is either a partnership or elects to be a corporation.

- If a multi-member LLC becomes only a single member entity, it reverts back to a sole proprietorship unless it has elected corporate status.
The practitioner should ask for all agreements which include, but are not limited to:

- The articles of incorporation (if any),
- Operating agreements,
- Special agreements, etc.
- Titles to automobiles/trucks
- Names on deeds of real property
Choices for the LLC

- Default is partnership taxation
- May elect corporate taxation
  - Check the box on Form 8832
- If eligible under I.R.C. §1361, may then elect S corporate taxation
  - File Form 2553
- No change in non-tax business form
Which Choice is Best?

- Appendix 1 for key factors
- In depth discussion here on:
  - Flow through loss considerations
  - Basis limitation comparisons
  - I.R.C. §199A and compensation issues
Flexibility – Not In Book

Least Flexible to Most Flexible
1. C corporations – least flexible
2. S corporations
3. Partnerships
4. Sole proprietorships.
An incorporated entity is automatically a C corporation unless it elects to become an S corporation.

Thus, the importance of making a valid election.

The termination of an S corporate election results in a reversion to the C corporation and all of the negative tax consequences of that form of entity.
Issue 2: Spousal LLCs

- Partnership defined:
  - Syndicate, group, pool, joint venture, or other unincorporated organization, that
  - Carries on any business, financial operation, of venture, and is
  - Not a corporation, trust, or estate

- By default, spousal LLC is taxed as a partnership
Elections out of Partnership Taxation

Cross Reference 2017 Workbook
- Formed for investment purposes only, or for the joint production, extraction, or use of property
- Participants must own the property as co-owners.

Qualified Joint Venture
Qualified Joint Venture

- Unincorporated business
- Owned by 2 spouses who
  - File jointly
  - Both materially participate
- May elect out of partnership taxation
- Observation: N/A to LLCs
Qualified Joint Venture

- Each spouse reports his/her *share*:
  - Sch. C, E, or F
  - Sch. SE as appropriate
- No Form 1065 is filed
- Rental R/E income –
  - “QJV” √ box
Qualified Joint Venture

- Election by not filing Form 1065 and reporting income shares on Form 1040
- Okay even if prior Form 1065 filed
- Election is revocable only with IRS consent
Qualified Joint Venture

- EIN required only for *other* reporting
- File SS-4
- Not the EIN of prior partnership; part year ⇒ successor employer
- One spouse may file and pay payroll tax
- Payroll expenses must be split
Ex. 4.1

- Emogene and Charlie are a qualified joint venture
- Split profits 75/25
- Charlie obtains EIN and files Form 941
- Payroll expense must be split 75/25
- Wage matching procedure
LLC owned solely by spouses may choose to be a disregarded entity

Or, be taxed as a partnership

Nine states

Property acquired during marriage

But also, commingled assets, by agreement and certain purchases
For a multimember LLC that is taxed as a partnership, outside basis is the LLC members interest.

The basis of the LLC assets is referred to as the insider basis.

Outside basis determines whether gain or loss is recognized on a distribution, determines the member’s share of LLC losses that he or she can use to offset non-LLC income, and determines the gain or loss on the sale of an LLC interest.
Inside basis is the LLC’s basis in its assets.

Inside basis determines the LLC’s depreciation and its gain or loss on the sale of an asset.

An LLC member’s initial outside basis in an interest acquired by purchase is its cost.

If acquired by gift, it is the donor’s basis.
If the interest is acquired by inheritance, the member’s basis is its fair market value on the date of the decedent’s death or on the alternate valuation date.

Having a contemporaneous outside valuation is crucial because???
Partnership Basis – Inside and Out

It is crucial because:

- Used to determine gain/loss upon sale of interest
- Limits losses allocable to that member
- Now required on the partners Sch E pg. 2 as an attachment
Initial Basis – Outside

- General rules for purchase, gift, or inheritance
- Contribution of property is likely
  - I.R.C. §721 provides nonrecognition of G/L
  - I.R.C. §722 provides that outside basis = basis of assets contributed, plus any gain recognized
  - I.R.C. §723 provides that inside=outside basis

p. 138
Observation
Depreciated Property

- Nonrecognition rule applies to any subsequent property contributions.
- Potential depreciation recapture under I.R.C. §1245 or 1250 carries over to the company.
Howard contributes assets in exchange for a 50% LLC interest

- $200,000 FMV determines built-in gain of $25,000
- Gain is not recognized (I.R.C. §721)
- Howard has outside basis of $175,000 (I.R.C. §722)
- HN LLC has carryover basis in the assets of $175,000 (I.R.C. §723)
- I.R.C. §1245 recapture potential of $25,000 also carries over to the LLC
Gain on Contribution

- Boot received in excess of basis = gain
- Boot is cash or other consideration in addition to the LLC interest
- Debt relief is considered boot
- I.R.C. §752 allocates a share of partnership debt to the partner
  - Decrease in partner debt share is deemed cash distribution
  - Increase in partner debt share is deemed cash contribution
1. ATB of assets contributed
2. Less: member liabilities assumed by LLC
3. Plus: member share of LLC liabilities under I.R.C. §752
4. Plus: gain recognized (to the extent 1 to 3 total a negative)
Nancy contributes asset with a $250,000 FMV (Recall Howard had contributed $200,000)
Nancy’s assets are subject to a $50,000 debt
Nancy obtains a 50% interest in HN Family LLC

Fig. 4.5 Nancy’s Outside Basis

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>ATB of the assets contributed</td>
<td>$200,000</td>
</tr>
<tr>
<td>Liabilities assumed by LLC</td>
<td>(50,000)</td>
</tr>
<tr>
<td>Nancy’s share of LLC liabilities ($50% × $50,000)</td>
<td>25,000</td>
</tr>
<tr>
<td>Nancy’s basis in the LLC interest</td>
<td>$175,000</td>
</tr>
</tbody>
</table>
Nancy contributes asset with a $250,000 FMV
(Recall Howard had contributed $200,000)
Nancy’s assets are subject to a $50,000 debt
Nancy obtains a 50% interest in HN Family LLC

Fig. 4.5 Nancy’s Outside Basis

<table>
<thead>
<tr>
<th>Description</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>ATB of the assets contributed</td>
<td>$200,000</td>
</tr>
<tr>
<td>Liabilities assumed by LLC</td>
<td>(50,000)</td>
</tr>
<tr>
<td>Nancy’s share of LLC liabilities (50% × $50,000)</td>
<td>25,000</td>
</tr>
<tr>
<td>Nancy’s basis in the LLC interest (no gain)</td>
<td>$175,000</td>
</tr>
</tbody>
</table>
Nancy contributes asset with a $450,000 FMV
Nancy’s assets are subject to a $250,000 debt
Nancy obtains a 50% interest in HN Family LLC

Fig. 4.7 Nancy’s Outside Basis

<table>
<thead>
<tr>
<th>Description</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>ATB of the assets contributed</td>
<td>$110,000</td>
</tr>
<tr>
<td>Liabilities assumed by LLC</td>
<td>(250,000)</td>
</tr>
<tr>
<td>Nancy’s share of LLC liabilities (50% × $250,000)</td>
<td>125,000</td>
</tr>
<tr>
<td>Tentative Basis</td>
<td>(15,000)</td>
</tr>
<tr>
<td>Gain recognized</td>
<td>15,000</td>
</tr>
<tr>
<td>Nancy’s basis in the LLC interest</td>
<td>$ 0</td>
</tr>
</tbody>
</table>
Adjustments to Outside Basis Fig. 4.8

- **Increased by:**
  - ATB of additional contributions
  - Increased member share of LLC liabilities
  - Member share of LLC income

- **Decreased by:**
  - Distributions of money
  - Decreased member share of LLC liabilities
  - ATB of property distributions
  - Member share of LLC losses
  - Member share of nondeductible expenses
Property Distributions

- Reduce outside basis
- ATB of property carries over to member, but
- ATB is limited to member’s outside basis

Negative Capital Accounts are okay

- Negative outside basis is not okay
- IRS can observe this with Sch. K-1 information
- Additional Line 20 reporting if tax basis capital accounts are not being reported in Item L
Adjustments to Outside Basis – Pg. 140 – Not In Book

Decrease to Basis – Pecking Order

- Distributions of cash and property and
- Decreased share of LLC liabilities and
- Share of losses including capital losses and deductions and
- Share of nondeductible expenses.
More

Outside Basis Adjustments

- Outside basis also changes if member acquires additional interest – purchase, gift, inheritance
- Member has unified basis in one interest even if acquired at various times and by various means
Purchase of Partial Interest  
Ex. 4.5

- Fig. 4.9 – straight up, 50% each (ATB and FMV)
- Eddy buys $\frac{1}{2}$ of Ralph’s interest for $115,000$

<table>
<thead>
<tr>
<th></th>
<th>Ralph</th>
<th></th>
<th>Eddy</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>ATB</td>
<td>FMV</td>
<td>ATB</td>
</tr>
<tr>
<td><strong>Before transfer</strong></td>
<td>144,000</td>
<td>230,000</td>
<td>144,000</td>
</tr>
<tr>
<td><strong>Sale</strong></td>
<td>(72,000)</td>
<td>(115,000)</td>
<td>115,000</td>
</tr>
<tr>
<td><strong>After transfer</strong></td>
<td>72,000</td>
<td>115,000</td>
<td>259,000</td>
</tr>
</tbody>
</table>
LLC inside basis still $288,000
Eddy’s 75% share of inside basis is $216,000
But his outside basis is $259,000
I.R.C. §754 election will fix this (stay tuned)
A critical difference between the partnership form of operation and the S corporation form is that any partner’s share of partnership liabilities, or any increase in a partner’s individual liabilities by the partner’s assumption of partnership liabilities is treated as a contribution of money by the partner to the partnership and, accordingly, increases his or her basis for claiming his or her share of proportional losses from the operation of the entity.
The converse applies – any decrease in a partner’s share of liabilities reduces his or her basis for claiming losses incurred in the operation of the partnership.

This is radically different than from the basis necessary to claim losses from a shareholder’s proportionate share (based upon his or her actual stockholding percentage) of the corporation’s net losses.

In the case of an S corporate shareholder, only his or her *ACTUAL ECONOMIC* outlay and not “guarantees” is allowed to increase basis.
Allocation of Liabilities

Background Info

- Member share of LLC liabilities creates basis
- Not so for S corporation shareholders who must make a cash outlay to obtain basis
- Definition of liability (examples in text):
  - Results in an increase is asset basis
  - Gives rise to an immediate deduction
  - Gives rise to a nondeductible expense
- May be either recourse or nonrecourse
- Nonrecourse – only the entity bears risk
Allocation of Recourse Liabilities
Constructive Liquidation

➢ Allocation is based on economic risk of loss
1. All liabilities are due and payable in full
2. All assets have zero value
3. All assets are sold
4. Allocate losses from Step #3
5. Liquidate company

➢ Whoever would be liable for the debt is allocated the debt
Allocation of Recourse Liabilities
Obligation of Member

Liability of a member may come from

1. Contractual obligations – guarantees, etc.
2. Operating agreement – capital contribution and deficit restoration obligations
3. State law
Dhru (60%) and Farhan (40%) operate Fashion Pants, LLC.

Farhan concerned about basis.

Need to know debt share.
### FIGURE 4.11 Fashion Pants, LLC’s Balance Sheet

<table>
<thead>
<tr>
<th></th>
<th>ATB</th>
<th>Book Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$79,000</td>
<td>$79,000</td>
</tr>
<tr>
<td>Accounts receivable</td>
<td>0</td>
<td>101,000</td>
</tr>
<tr>
<td>Inventory</td>
<td>0</td>
<td>200,000</td>
</tr>
<tr>
<td>Equipment</td>
<td>622,000</td>
<td>424,000</td>
</tr>
<tr>
<td>Building</td>
<td>421,000</td>
<td>400,000</td>
</tr>
<tr>
<td>Land</td>
<td>626,000</td>
<td>626,000</td>
</tr>
<tr>
<td><strong>Total assets</strong></td>
<td><strong>$1,748,000</strong></td>
<td><strong>$1,830,000</strong></td>
</tr>
<tr>
<td>Bank debts</td>
<td>$1,550,000</td>
<td>$1,550,000</td>
</tr>
<tr>
<td>Capital—Dhru</td>
<td>188,000</td>
<td>190,400</td>
</tr>
<tr>
<td>Capital—Farhan</td>
<td>10,000</td>
<td>89,600</td>
</tr>
<tr>
<td><strong>Total liabilities and capital</strong></td>
<td><strong>$1,748,000</strong></td>
<td><strong>$1,830,000</strong></td>
</tr>
</tbody>
</table>
Nonrecourse Liabilities

- Only LLC bears economic risk
- Generally allocated based on profit shares
- See Treas. Reg. §1.752-3(a)
  - Minimum gain chargeback
  - Built-in gains under I.R.C. §704(c)
Guarantees by members make that debt *recourse to them*

- Loan from member or related party makes it recourse to them
- Allocation to SMLLC is limited to “net value” of the SMLLC unless owner is obligated
Generally, cash distributions do not trigger gain (I.R.C. §731)
Simply reduces outside basis
Excess distributions create gain
Reduction in member share of liabilities can likewise create gain
Excess Cash Distributions
Ex. 4.7

- Ottavio has outside basis of $40,000
- Receives cash of $5,000 per month
- No requirement to repay if profits are less
- Allocated profits are $100,000
• Distributions through August are tax-free
• Distributions for remaining 4 months are taxable
• Ending basis is $100,000 (Fig. 4.13)
Excess Losses

- Loss deductions are limited to basis
- Excess losses carry over until basis is restored
Sale of Partnership Interest
“Short Version”

- Outside basis is subtracted from the amount realized to determine gain or loss.
- I.R.C. §741 – partnership interest is a capital asset
- I.R.C. §751 – gain is ordinary to the extent of inventory/unrealized receivables
The inside and outside basis of a member’s interest may not equal. This imbalance can be caused by different facts including the exist and admission of a new member/partner. In such cases, the Internal Revenue Code provides for a Section 754 election which will allow for the inside basis to be stepped up to equal the outside basis. The election has strict requirement but is of great value and increases depreciation (as an example) and basis for the calculation of later gain or loss on disposal of assets.
Reconciling Inside and Outside Basis

Outside basis may differ from inside basis if:

- Member recognizes gain on the contribution of an asset
- A member recognizes gain on a cash distribution
- A member receives any LLC interest by purchase or inheritance
- Basis of a distributed asset exceeds member’s outside basis
Reconciling Inside and Outside Basis

- LLC may elect to adjust inside basis
- I.R.C. §734 for distributions
- I.R.C. §743 for transfers of interests
- I.R.C. §743 is mandatory for transfers with substantial built-in losses
I.R.C. §754 Election

- Made by the LLC by the extended due date
- Applies to all subsequent years
- Basis adjustments allocated only to members involved in transaction
- Sch. B answer *plus* attached stmt. showing calculations of adjustment
754 Election– Not In Book

- summary points are:
  1. The Section 754 election has a special six year statute of limitations on the gain or loss on the sale, exchange, or disposal of the assets subjected to the election.
2. The assets subjected to the Section 754 election “stepped up” basis should be separately segregated and depreciated in the depreciation schedule.

3. Assets subjected to the Section 754 election as to the stepped up basis do not qualify for the bonus depreciation.

4. Prior tax workbooks have given step by step instructions on this critical election.
ATB of distributed asset limited by outside basis

- Ex. 4.8 No problem with Parcel C
- Ex. 4.9 Parcel A ATB of $10,000 is greater than outside basis of $8,000
- Fig. 4.16 – out of balance by $2,000
I.R.C. §755
Allocation of Adjustments

- Adjustment is allocated to remaining assets
- Separate capital gains property from ordinary income property
- Adjustment for excess cash distribution allocated to cap. gains property
- Adjustments for property distributions allocated to same class *only*
Increase in basis is allocated

- Proportionately within the class based on relative unrealized appreciation to the extent of such appreciation
- Any remaining adjustment, proportionately based on relative FMVs

Decrease in basis is allocated

- Proportionately within the class based on relative unrealized depreciation to the extent of such depreciation
- Any remaining adjustment, proportionately based on relative ATBs
### Allocation of Adjustments

**FIGURE 4.18 FMV and Built-In Gains after Distribution**

<table>
<thead>
<tr>
<th></th>
<th>ATB</th>
<th>FMV</th>
<th>Built-In Gain</th>
</tr>
</thead>
<tbody>
<tr>
<td>Parcel B</td>
<td>$8,000</td>
<td>$30,000</td>
<td>$22,000</td>
</tr>
<tr>
<td>Parcel C</td>
<td>3,000</td>
<td>30,000</td>
<td>27,000</td>
</tr>
<tr>
<td>Parcel D</td>
<td>6,000</td>
<td>30,000</td>
<td>24,000</td>
</tr>
<tr>
<td>Total assets</td>
<td>$17,000</td>
<td>$90,000</td>
<td>$73,000</td>
</tr>
<tr>
<td>Lost basis</td>
<td>2,000</td>
<td>0</td>
<td>(2,000)</td>
</tr>
<tr>
<td>Total</td>
<td>$19,000</td>
<td>$90,000</td>
<td>$71,000</td>
</tr>
</tbody>
</table>

**Capital—Mackenzie**

<table>
<thead>
<tr>
<th></th>
<th>ATB</th>
<th>FMV</th>
<th>Built-In Gain</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital—Mackenzie</td>
<td>$17,000</td>
<td>$40,000</td>
<td>$23,000</td>
</tr>
<tr>
<td>Capital—Megan</td>
<td>0</td>
<td>10,000</td>
<td>10,000</td>
</tr>
<tr>
<td>Capital—Crystal</td>
<td>2,000</td>
<td>40,000</td>
<td>38,000</td>
</tr>
<tr>
<td>Total liabilities and capital</td>
<td>$19,000</td>
<td>$90,000</td>
<td>$71,000</td>
</tr>
</tbody>
</table>
**FIGURE 4.19 Allocation of Basis Adjustment**

<table>
<thead>
<tr>
<th>Parcel</th>
<th>Built-In Gain</th>
<th>Basis Adjustment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Parcel B</td>
<td>$22,000</td>
<td>$2,000 × ($22,000 ÷ $73,000) = $602.74</td>
</tr>
<tr>
<td>Parcel C</td>
<td>27,000</td>
<td>$2,000 × ($27,000 ÷ $73,000) = 739.73</td>
</tr>
<tr>
<td>Parcel D</td>
<td>24,000</td>
<td>$2,000 × ($24,000 ÷ $73,000) = 657.53</td>
</tr>
<tr>
<td>Total</td>
<td>$73,000</td>
<td>$2,000.00</td>
</tr>
</tbody>
</table>
I.R.C. §743 Adjustments
Transfers of Interest

- Adjustment is difference between outside basis and transferee’s share of inside basis
- Adjustment may be an increase or a decrease to ATB of LLC assets
- Inside basis equals transferee’s share of debts plus previously taxed capital
Previously Taxed Capital

Deemed liquidation at FMV
- Cash received by transferee
- Plus: Any tax loss allocated
- Less: Any tax gain allocated
- Generally equals tax basis capital account
FIGURE 4.21 SMO, LLC Balance Sheet

<table>
<thead>
<tr>
<th></th>
<th>ATB</th>
<th>FMV</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total assets</td>
<td>$150,000</td>
<td>$900,000</td>
</tr>
<tr>
<td>Liabilities</td>
<td>$</td>
<td>0</td>
</tr>
<tr>
<td>Capital—Sally</td>
<td>50,000</td>
<td>300,000</td>
</tr>
<tr>
<td>Capital—Miguel</td>
<td>50,000</td>
<td>300,000</td>
</tr>
<tr>
<td>Capital—Omar</td>
<td>50,000</td>
<td>300,000</td>
</tr>
<tr>
<td>Total liabilities and capital</td>
<td>$150,000</td>
<td>$900,000</td>
</tr>
</tbody>
</table>
Sale of SMO LLC Assets

- $750,000 gain recognized ($900,000 – 150,000)
- Daphne allocated $250,000 taxable gain
- Daphne has no economic gain
- Her outside basis will exceed FMV of her interest

**FIGURE 4.24 Outside Basis after the Sale**

<table>
<thead>
<tr>
<th></th>
<th>Daphne</th>
<th>Miguel</th>
<th>Omar</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Initial outside basis</strong></td>
<td>$300,000</td>
<td>$ 50,000</td>
<td>$ 50,000</td>
</tr>
<tr>
<td><strong>Gain from asset sale</strong></td>
<td>250,000</td>
<td>250,000</td>
<td>250,000</td>
</tr>
<tr>
<td><strong>Ending outside basis</strong></td>
<td>$550,000</td>
<td>$300,000</td>
<td>$300,000</td>
</tr>
</tbody>
</table>
FIGURE 4.25 Daphne’s Optional Basis Adjustment

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Daphne’s outside basis</td>
<td>$300,000</td>
</tr>
<tr>
<td>Less: Share of inside basis</td>
<td>(50,000)</td>
</tr>
<tr>
<td>Section 743 basis adjustment</td>
<td>$250,000</td>
</tr>
</tbody>
</table>
Transfer of Interest – Ex. 4.12
With Inside Basis Adj

FIGURE 4.26 SMO Balance Sheet—with a Section 743 Basis Adj.

<table>
<thead>
<tr>
<th></th>
<th>ATB</th>
<th>FMV</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Assets</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>I.R.C. § 743 basis (Daphne only)</td>
<td>250,000</td>
<td>0</td>
</tr>
<tr>
<td>Total assets</td>
<td>$400,000</td>
<td>$900,000</td>
</tr>
<tr>
<td><strong>Liabilities</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Capital—Daphne</td>
<td>300,000</td>
<td>300,000</td>
</tr>
<tr>
<td>Capital—Miguel</td>
<td>50,000</td>
<td>300,000</td>
</tr>
<tr>
<td>Capital—Omar</td>
<td>50,000</td>
<td>300,000</td>
</tr>
<tr>
<td>Total liabilities and capital</td>
<td>$400,000</td>
<td>$900,000</td>
</tr>
</tbody>
</table>
Allocation of Basis Adj. Under I.R.C. §743

- First allocate between capital gain and ordinary income property
- Then allocate based on proportion of appreciation within each class
## FIGURE 4.28 Proportionate Share of Appreciation

<table>
<thead>
<tr>
<th></th>
<th>ATB</th>
<th>FMV</th>
<th>Difference</th>
<th>% of Class</th>
<th>% of Total</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Ordinary income property:</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>A/R</td>
<td>$0</td>
<td>$180,000</td>
<td>$180,000</td>
<td>27.07%</td>
<td></td>
</tr>
<tr>
<td>Inventory</td>
<td>0</td>
<td>280,000</td>
<td>280,000</td>
<td>42.10%</td>
<td></td>
</tr>
<tr>
<td>Equipment*</td>
<td>295,000</td>
<td>500,000</td>
<td>205,000</td>
<td>30.83%</td>
<td></td>
</tr>
<tr>
<td><strong>Total ordinary income property</strong></td>
<td>$295,000</td>
<td>$960,000</td>
<td>$665,000</td>
<td>100.00%</td>
<td>81.10%</td>
</tr>
<tr>
<td><strong>Capital gain property:</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Building</td>
<td>$475,000</td>
<td>400,000</td>
<td>($75,000)</td>
<td>(48.39%)</td>
<td></td>
</tr>
<tr>
<td>Land</td>
<td>570,000</td>
<td>800,000</td>
<td>230,000</td>
<td>148.39%</td>
<td></td>
</tr>
<tr>
<td><strong>Total capital gain property</strong></td>
<td>$1,045,000</td>
<td>1,200,000</td>
<td>$155,000</td>
<td>100.00%</td>
<td>18.90%</td>
</tr>
<tr>
<td><strong>Total assets (excluding cash)</strong></td>
<td>$1,340,000</td>
<td>$2,160,000</td>
<td>$820,000</td>
<td>100.00%</td>
<td></td>
</tr>
</tbody>
</table>
### FIGURE 4.29 Proportionate Allocation

<table>
<thead>
<tr>
<th></th>
<th>% of Class*</th>
<th>Allocation of Basis Adjustment</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Ordinary income property:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>A/R</td>
<td>27.07%</td>
<td>$54,884</td>
</tr>
<tr>
<td>Inventory</td>
<td>42.10%</td>
<td>85,358</td>
</tr>
<tr>
<td>Equipment</td>
<td>30.83%</td>
<td>62,508</td>
</tr>
<tr>
<td><strong>Total ordinary income property</strong></td>
<td>100.00%</td>
<td>$202,750</td>
</tr>
<tr>
<td><strong>Capital gain property:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Building</td>
<td>(48.39%)</td>
<td>($22,864)</td>
</tr>
<tr>
<td>Land</td>
<td>148.39%</td>
<td>70,114</td>
</tr>
<tr>
<td><strong>Total capital gain property</strong></td>
<td>100.00%</td>
<td>$47,250</td>
</tr>
<tr>
<td><strong>Total assets (excluding cash)</strong></td>
<td></td>
<td>$250,000</td>
</tr>
</tbody>
</table>
Inherited Interest

- Outside basis becomes FMV date of death (or alternate)
- Eligible for basis adjustment election under I.R.C. § 754
- NOTE: adjustment does not apply to items of IRD
  
  Election binding – may reduce basis
Inherited Interest
Ex. 4.14

- Aleksandra receives interest at father’s death
- Outside basis will not include A/R
- Inventory is not IRD and is therefore eligible for basis adjustment
- Otherwise, process is the same as in Ex. 4.13
The partnership agreement is controlling and, thus, is extremely important.

The partner’s share of net income or losses from the operation of the partnership entity is not necessarily that of his or her percentage of ownership interest in the entity (as is the common treatment) but can be allocated in any manner the agreement so stipulates and can change from period to period.
Allocation of Gains and Losses – Not In Book

- The allocation must be clearly detailed in the agreement and the more language the better.
- It must have what is termed “economic effect” which has been defined by the courts to be quite liberal in favor of the partners.
- The new audit rules are quite clear.
Allocation Issues

• S corporations – all items - per share, per day
• LLCs taxed as partnerships – more flexible – but with land mines
  • Allocations need not correspond to capital ownership
  • I.R.C. §704(b) allows great flexibility as an option
  • I.R.C. §704(c) however requires allocations on contributed property
Special Allocations
I.R.C. §704(b)

• Economic effect required
• Tax allocation must correspond to underlying economic agreement
• 3 requirements for operating agreement
  1. Properly maintained capital accounts
  2. Liquidation tied to these capital accounts
  3. Required restoration of deficit capital account
• Allocation of Sec. 179 to one member
  ➡ OK – all requirements met in agreement

• Planning Pointer
  ➡ All other tax attributes of asset allocated same
  ➡ Future depreciation, gain, or loss
Special Allocations
Alternate Econ. Eff. Test

• Alternative for deficit restoration to reduce risk to member

• Qualified income offset provision instead
  • Member *unexpectedly* receives an allocation or distribution resulting in a deficit capital account
  • Allocate income and gain to that member to eliminate the deficit as quickly as possible

• Ex. 4.17 Unexpected lawsuit
• Substantially affect amount ultimately received by member independent of tax consequences

• Not substantial if after-tax consequences of
  • at least one member are better, and
  • those of no other member are worse

• Presumed not substantial if net increases and decreases to capital account are about the same as w/o special allocation (Ex. 4.18)
Tax practitioner should:

- review operating agreement for required terms before making special allocations

- Verify that LLC actually complies with these provisions

- You probably can’t do this – IF IT ISN’T IN WRITING!!!
Attempts to prevent shifting of precontribution gain or loss among members

- Must allocate income, gain, loss, and deductions on contributed property
- To equalize the difference between the ATB and FMV of contributions
- Among the members
Ex. 4.19 Built-in Gain

**FIGURE 4.33 Initial Capital Contributions to S&S, LLC**

<table>
<thead>
<tr>
<th></th>
<th>ATB</th>
<th>FMV</th>
<th>Built-In Gain</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sadie—cash</td>
<td>$50,000</td>
<td>$50,000</td>
<td>$0</td>
</tr>
<tr>
<td>Sam—land (Parcel A)</td>
<td>$20,000</td>
<td>$50,000</td>
<td>$30,000</td>
</tr>
</tbody>
</table>

- Subsequent sale of land with $70,000 gain
- First $30,000 allocated to Sam
- Remaining $40,000 can be split as members agree
- Note: Economic Gain is split 50/50
• Three methods in Regs
  • Traditional Method with Ceiling Rule
  • Traditional Method with Curative Allocation
  • Traditional Method with Remedial Allocations
• Other reasonable methods
Ceiling Rule
Under I.R.C. §704(c)

Required allocation cannot exceed company amount

- Ex. 4.20
  - Sale now generates a **book loss of $5,000** but a **taxable gain of $25,000**
  - Economic (book) loss is split 50/50
  - Sam (contributor)
    - allocated full $25,000 of gain
    - will continue to have $5,000 of built-in gain
  - Sadie – economic loss but no tax deduction
Ceiling Rule
Under I.R.C. §704(c)

Required allocation cannot exceed company amount

Ex. 4.20

- Sale now generates a **book loss of $5,000** but a **taxable gain of $25,000**
- Economic (book) loss is split 50/50
- Sam (contributor)
  - allocated full $25,000 of gain
  - will continue to have $2,500 of built-in gain
- Sadie – economic loss but no tax deduction
Allocate other company items to reduce differences between book and tax on contributions

- Ex. 4.21 Company buys parcel B with its cash and sells it for a $30,000 gain (book and tax)
  - Company can now allocate $25,000 gain from Parcel A and $5,000 gain from Parcel B to Sam
  - Sam’s book to tax difference is eliminated
  - Sadie is allocated $12,500 tax gain on Parcel B
  - Her book allocation matches tax allocation
### FIGURE 4.35 S&S, LLC’s Capital Accounts with Curative Allocations

<table>
<thead>
<tr>
<th></th>
<th>Sadie</th>
<th>Sam</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Initial capital</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Tax Capital</td>
<td>$50,000</td>
<td>$20,000</td>
</tr>
<tr>
<td>Book Capital</td>
<td>$50,000</td>
<td>$50,000</td>
</tr>
<tr>
<td><strong>Sale of Parcel A</strong></td>
<td>0</td>
<td>25,000</td>
</tr>
<tr>
<td>Tax Capital</td>
<td>0</td>
<td>25,000</td>
</tr>
<tr>
<td>Book Capital</td>
<td>(2,500)</td>
<td>(2,500)</td>
</tr>
<tr>
<td><strong>Curative gain allocation</strong></td>
<td>0</td>
<td>5,000</td>
</tr>
<tr>
<td>Tax Capital</td>
<td>0</td>
<td>5,000</td>
</tr>
<tr>
<td>Book Capital</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td><strong>Sale of Parcel B</strong></td>
<td>12,500</td>
<td>12,500</td>
</tr>
<tr>
<td>Tax Capital</td>
<td>12,500</td>
<td>12,500</td>
</tr>
<tr>
<td>Book Capital</td>
<td>15,000</td>
<td>15,000</td>
</tr>
<tr>
<td><strong>Ending capital</strong></td>
<td>$62,500</td>
<td>$62,500</td>
</tr>
<tr>
<td>Tax Capital</td>
<td>$62,500</td>
<td>$62,500</td>
</tr>
<tr>
<td>Book Capital</td>
<td>$62,500</td>
<td>$62,500</td>
</tr>
</tbody>
</table>
Remedial Method
Under I.R.C. §704(c)

- Company has no gain from Parcel B and so ceiling rule applies
- Make up fictitious gain, loss, income, expense
- Make offsetting allocations of fictitious amounts to eliminate remaining book/tax from that contributed asset
Cost recovery deductions allocated to match economic (book) allocations to *noncontributor* of depreciable property

- Ex. 4.22
  - Tax depreciation $12,000
  - Book depreciation $20,000
  - Cash contributor allocated $10,000 tax dprn.
  - Property contributor allocated $2,000 balance
  - Fig. 4.36 goal accomplished!
Compensation of Members

- S corp S/H employees – “reasonable comp”
- Partners cannot receive wages
- Partners may receive guaranteed payments and/or special allocations
- Guaranteed payments impact:
  - QBI deduction
  - Sec. 179 deduction
  - SE tax
Guaranteed Payments

For services, or use of capital
Without regard to company income
Payable in all events
May need to be capitalized by company
Always current, ordinary income to member
Ex. 4.23 – guaranteed payment plus profits
Ex. 4.24 - guaranteed payment creates loss share
Guaranteed Payments and QBI

- Wages paid to shareholders reduce QBI
- Guaranteed payments to members reduce QBI unless paid for use of capital and if allocable to the recipient’s trade or business
- See QBI chapters
  - Wages paid to S/H count for wage limit
  - Gtd. pymts. to members do not count
Guaranteed Payments and §179

• §179 deduction of LLC limited to the taxable business income of the LLC

• Gtd. pymts. do not reduce company income for the §179 limit

• §179 deduction is allocated as a separately stated item

• Member not receiving gtd. pymt. could face taxable business income limit (Ex. 4.25)
Guaranteed Payments and SE Tax

- Gtd. pymts. from trade or business LLC are SE income
- Prop. regs. allow for LLC members to treat distributive share the same as a limited partner
  - Restricted activity
  - Multiple classes of interest possible
  - Special rules for bifurcation of an interest
Disregarded entity, C corp, or S Corp?
QBI deduction, SE tax, income tax
Thorough analytical approach is critical
C corp. is worst even without tax on dividend distributions
Increased QBI deduction with disregarded does not offset increased SE tax compared to S corp.
C Corp –
• FICA on reasonable comp (based on effort),
• 21% corporate level tax,
• dividends as return on capital taxed at capital gains rates,
• more tax when R/E are distributed
• No QBI deduction
Some practitioners speculate that C corporations are a better alternative for specified service trade or businesses (SSTBs) if owners are over the threshold. This is not necessarily true. If a taxpayer is in the top tax bracket, the tax rate on SSTB income is 37%. The effective tax rate for C corporation income, if all is distributed, is 36.8%, not including NIIT or state and local tax. This is calculated by adding the 21% flat tax rate to the effective dividend rate of 20% X .79 = 36.8%. This is because the 20% dividend rate is multiplied by what is left over after paying the corporate tax, or 79% of profits.
Positive Factors of C Corp - NIB

- State and local income tax, which would be fully deductible for a C corporation, but limited to $10,000 on an individual tax return.
- Plans to sell the corporation at a future date.
- §1202 exclusion potential.
- §105 plans to pay for shareholder health costs, if otherwise qualifying.
Positive Factors of C Corp cont. - NIB

- Plans to reinvest the profits and not distribute dividend income, where individuals may not wish to pay tax on income they will not receive.
- Multiple classes of stock are desired, which cannot be done with an S corporation.
- The company has foreign investors.
S Corp –
- FICA on reasonable comp (based on effort),
- No corporate level tax,
- All retained income taxed at owner ordinary rates
- QBI deduction to S/H based on net S corp. income
Partnership with gtd. pymts.

- SE tax on all except allocation to Viktor (limited)
- Gtd. pymts. reduce QBI
- See Fig. 4.44 footnote regarding reduction of QBI by deduction for $\frac{1}{2}$ SE tax attributable to QBI
- Special allocation of profits rather than gtd. pymts. increases QBI and reduces tax (Fig. 4.45)
### FIGURE 4.46
Comparison of C Corporation, S Corporation, and Partnership

<table>
<thead>
<tr>
<th>Entity Type</th>
<th>C Corporation</th>
<th>S Corporation</th>
<th>Partnership with Guaranteed Payment</th>
<th>Partnership without Guaranteed Payment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Entity level tax</td>
<td>$27,965</td>
<td>$11,475</td>
<td>N/A</td>
<td>N/A</td>
</tr>
<tr>
<td>Owner level FICA/SE tax</td>
<td>$11,475</td>
<td>$11,475</td>
<td>$27,553</td>
<td>$27,553</td>
</tr>
<tr>
<td>Owner level income tax</td>
<td>$39,000*</td>
<td>$51,076</td>
<td>$50,126</td>
<td>$43,434</td>
</tr>
<tr>
<td>Total tax</td>
<td>$78,440</td>
<td>$74,026</td>
<td>$77,679</td>
<td>$70,987</td>
</tr>
</tbody>
</table>

Caveat (page 169): Depends on specific facts
No Cookie Cutter Formula

- Gather enough information
- KNOW YOUR CLIENT!!!
- Analyze the facts
- Know the tax laws associated with each entity type
Changing Entity Type By Election

- May be mechanically easy with “check the box” (Form 8832)
- May be income tax costly
Changing Entity Type
SMLLC to Corp

• I.R.C. §351 applies whether C or S corporation
• Ex. 4.28 – tax free except for cash received
• Ex. 4.29 – debts transferred in excess of ATB creates taxable gain (Fig. 4.48 for stock basis)
Changing Entity Type
C Corp back to SMLLC

- Limit on elections – must generally wait 60 months
  - Deemed distribution of assets and liabilities
  - Taxable gain taxed at corporate level (FMV-ATB)
  - Taxable distribution to S/H
  - Ex. 4.30
Changing Entity Type
S Corp back to SMLLC

• Same deemed distribution of assets and liabilities and taxable gain at corporate level (FMV-ATB)
• Gain is allocated and taxed to S/H
• S/H stock basis is increased
• No additional gain to S/H from liquidation

 Loss of S status makes entity a C corporation
Changing Entity Type
Multimember LLC to Corp

- LLC deemed to acquire stock and distribute to members in exchange for LLC interests
- Generally tax-free
  - Contributing taxpayers control 80% or more
  - Debt contributed is less than ATB of assets
  - No property with precontribution gain within 7 years, disguised sale, disproportionate
- Ex. 4.31 – okay, Ex. 4.32 – too much debt
Changing Entity Type
Corp to Multimember LLC

- Same deemed taxable liquidation as with SMLLC
- Contribution of assets and liabilities to LLC
  ➤ generally tax-free *unless* net debt relief to member exceeds ATB of assets contributed
Ownership Changes Resulting in Entity Change

SMLLC to Multimember

- Sale of an interest
- Gift of an interest
- Death and distribution to heirs
- Divorce or relocation (community property state issue)
Ownership Changes
Multimember to SMLLC

- Sale or gift to one member
- Redemption of all but one member
- Death of all but one member
- Relocation of spouses to community property state
- Divorce settlement
- Merger of members
Ownership Changes
Sale to One Remaining Member

- Ex. 4.33

- Seller reports sale of interest under I.R.C. §§741 and 751

- Continuing owner has:
  - Cost basis and holding period from deemed asset purchase
  - Generally, carryover basis and tack-on holding period for deemed asset distribution
Ownership Changes
Sale of All Interests to New Member

- Ex. 4.34

- Partnership *terminates* by distribution of assets to original owners

- Original owners deemed asset sale

- New owner has cost basis and new date acquired in all assets
Ownership Changes

Sale of SMLLC Interest to New Member

- Ex. 4.35
- Treated as sale and purchase of assets outside the entity
- Assets subsequently contributed
- Each asset will have *split basis* and *holding period*
Ex. 4.36

Treated as asset contribution by both parties

Assets will have *carryover basis* and *tack-on holding period*

Holding period of interests include that of contributed capital/1231 assets
Ownership Changes
Complete Termination

- Business ceases by all members
- Assets distributed
- Gain recognized only if:
  - Cash distributed exceeds basis (watch debt)
  - Sec.751 assets are not distributed proportionately (see 2016 Tax Workbook)
- 5-step process for allocating outside basis to distributed assets
Ownership Changes
Liquidating a Membership Interest (I.R.C. §736)

- I.R.C. §751 which “looks through” to ordinary income assets still applies
- Contrast with installment sale – no interest, can recover basis first rather than prorata
- Ex. 4.38 – proportionate distribution of assets
  - 4-steps to allocate outside basis to assets
  - Potential §1245 recapture carries over
- Continues as member until final dollar is paid
Ownership Changes

Liquidating a Membership Interest (I.R.C. §736)

- Allocation of Cash Payments
  - I.R.C. §736(a) versus I.R.C. §736(b)
  - I.R.C. §751(b) provisions
  - I.R.C. §1245 recapture
- Ex. 4.39 – no I.R.C. §1245 recapture
  - 20% I.R.C. §736(a) payment
  - 80% I.R.C. §736(b) payment
    - 40% I.R.C. §751(b) payment
    - 60% non I.R.C. §751(b) payment
Ownership Changes
Liquidating a Membership Interest (I.R.C. §736)

Death of a member
- Outside basis becomes FMV used in estate
- Does not include IRD

Ex. 4.40
- No basis in payment attributable to IRD
  - Accounts receivable
  - Goodwill
- Payments allocable to IRD will be ordinary
- Remainder of payment will be recovery of basis
• 21 factors to consider
• Partnership, S corp., C corp., disregarded entity
That’s all folks!!

My brain is full, may I please be excused?