Limited Liability Companies and Federal Tax Law – Reference to Pg. 135

• 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:
Limited Liability Companies and Federal Tax Law – Reference to Pg. 135 - Continued

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.
Definition – Not In Book

A Limited Liability Company (LLC) is similar to a Limited Liability Partnership, but, is allowed to operate outside of the professional services industry and may have only one member.
Why a Limited Liability Company?
Not In Book

• 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.
Common Errors in Preparation - Review of LLC Documents – Not In Book

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. These documents should explain…….
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.
Common Errors in Preparation - Review of LLC Documents – Not In Book

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. These documents should explain to the practitioner the relationship of the chosen (or by default) LLC entity.
Review of LLC Documents – Not In Book

Major issues to be considered in the documents are:

1.) Start-up and formation;
2.) Management;
3.) Admissions, exists, terminations;
4.) Income and loss allocations;
5.) Taxation and who does what;
Review of LLC Documents – Not In Book

6.) Dissolution and dissolving of entity and related memberships;

7.) Legalities.

➢ Review in detail the definition section of the entity as to purpose and objective.

➢ Counsel your client in not using the LLC for other objectives.
Comparison of the Entities – Reference to Appendix 1

- Appendix 1 in the chapter provides an overview and a comparison of the differences between the types of entities.
- In choosing an entity form, *ALL* factors must be weighed and not just concentrate on one advantage, etc.
- An example is the nonsense being promoted now about forming or converting to a C corporation because of the 21% tax rate.
- Yet, concentrating on this aspect of a C corporation ignores all of the major negative consequences such as:
Comparison of the Entities – Continued – Not In Book

1. The strict accounting for the owner/shareholder whenever he or she withdraws money from the corporation resulting in the constant presence of a preferential dividend.

2. The “locking in” of net operating losses that can only be used if there are future profits in carryover years.

3. The recognition of capital losses can only occur by offsetting of capital gains.

4. The double taxation that occurs on liquidations of the entity.
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.
Spousal Limited Liability Companies – Pg. 136

- Spouses who operate a business together should form an LLC to protect their assets.
- However, if they do, they are not eligible to elect out of subchapter K and become a joint venture.
- So what? What is this obsession about being a joint venture?
- Partnership requirements are…..
- Spouses who wish to divide the family business into separate schedule Cs as is permitted by the IRS cannot be LLC entities.
Types of Partnerships
Not In Book

- **General Partnership** – all partners have unlimited liability for partnership obligations.

- **Limited Partnership** – general partners remain personally liable for partnership debts; *limited* partners risk only their actual or promised investments.

- Note that only *general* partners have a voice in partnership operations.
Types of Partnerships – Continued – Not In Book

• **Limited Liability Partnership (LLP)** – all partners participate in management; all partners liable for individual behavior/actions but liability limited to capital investment for actions of other partners.

• **Limited Liability Company (LLC)** – similar to LLP, but allowed to operate outside professional services industry and may have only one member.
Partnerships and LLCs Formation Aspects – Reference to Pg. 138

- General partnerships can be formal or informal.
- LLCs and limited liability partnerships must comply with state law.
- Tax free upon transfer (Section 721).
- Lack of control issues on later transfers.
- Basis carryover on assets transferred.
- Excess liabilities issues minimized.
Agreement, Covenants, and Contracts – Not In Book

- As in the case of partnerships that have not elected LLC status, a LLC that elects to be a partnership should have as a minimum a detailed agreement as to all aspects of ownership, operation, and dissolution.

- This is to protect all partners regarding the future of the partnership, especially, in a dissolution in order to guarantee how the dissolution will occur and how any amounts will be paid.

- Remember, a partnership is a “voluntary association” unlike the corporate structure where shareholders are governed by the majority.
Also, LLC that elect to operate as a corporation should also have standard agreements as to all aspects of ownership, operation, and dissolution.

Please note that an LLC is a separate entity under state law.
Agreements – Continued – Not In Book

The “bottom line” is that just because the LLC form is chosen, the need for the traditional and very important agreements is not in any manner altered!
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.
Basis Rules – Page 138 - Continued

• 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.
Basis Rules – Page 138 - Continued

• 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 vs. Limited Liability Company Status – Not In Book

- IRS examiners are raising a contentious issues of not allowing the depreciation in the partnership as well as not allowing the contribution of the property to the partnership that is an LLC.
- Thus, the partner’s basis is reduced accordingly.
- This is even happening in husband-wife partnerships that are file a joint return to reflect the partnership results.
Partnership vs. Limited Liability Company Status – Continued – Not In Book

- Related to the contribution of property to the partnership, the IRS is focusing on the partner’s contribution of property to a partnership.
- If property is contributed and recorded on the books at fair market value, then the IRS is demanding to see its cost.
- If the taxpayer insists on the recordation at fair market value, then the IRS is forcing the contributing partner to recognize gain under the applicable code section.
Partnership vs. Limited Liability Company Status – Continued – Not In Book

• The issue represents a more than decade long love-hate that the IRS has with the limited liability company format and IRS confusion in what an LLC is.

• In representing the client if this issue is raised, please do the following……..
A contributing member will recognize gain on a contribution to an LLC in exchange for an interest in the LLC if the contributor receives "boot" that exceeds the contributor's basis in the LLC interest.

- Boot is cash or other consideration in the LLC.
- A member that is relieved of debt on the contribution of an asset experiences taxable gain.
- This is often an ignored issue.
Adjustments to Outside Basis – Pg. 140

Figure 4.8
Increase to Basis +

- Additional contributions including cash and
- Purchase, gift, or inheritance of additional membership interest and
- Increased share of LLC liabilities and
- Share of LLC income or gain including tax-exempt income.
Adjustments to Outside Basis – Pg. 140 – Not In Book

Decrease to Basis –

- 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.
Negative Capital Account – Practitioner Note – Pg. 140

• Basis cannot be negative.

• However! A member may have a negative tax capital account.

• See practitioner note for special reporting requirements if a partnership LLC reports other than tax capital amounts to its members on schedule K-1.
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.
Basis – Claiming a Loss – Pg. 141 - Continued

- 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.
Proof of Basis and the IRS – Not In Book

• In recent years, the IRS has won two critical court cases regarding the requirement of a shareholder or partner to prove his or her basis in the entity for purposes of showing that he or she had sufficient basis to claim his or her allocated losses in the operation of that entity.

• In each case, the Court has ruled that the IRS can require a total reconstruction/proof of the shareholder or partner’s basis and that such basis is a separate, ongoing computation that is not affected by the statute of limitations of the related returns.
Proof of Basis and the IRS – Not In Book - Continued

• What this means is....

• An example of the IRS audit requirement is....
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 – Not In Book

• I will not cover the very technical requirements here as this is a separate four hour course and requires a step by step technical analysis by the practitioner.

• However, several 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.
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.

• An example is ……

• Tax planning opportunity here is…. 
Draft of Form K-1 - NIB

• The draft of the 2019 form K-1 for form 1065 has been released.
• It contains five new areas:
  1. The partner’s basis must be reported on the tax basis.
The purpose of requiring the tax basis is to allow the IRS to earlier identify taxpayers that have claimed a loss in excess of basis.
2. Separate lines have been added for guaranteed payments for services and guaranteed payments for capital.

3. The form has added lines 21 and 22 to Part III to report “more than one activity for at-risk purposes” and “more than one activity for passive activity purposes.”
4. The partner’s beginning and ending Section 704(c) gain or loss must be entered in Part II.

• If the basis of contributed property differs from its FMV at contribution, Section 704(c) requires gain or loss with respect to such property to be allocated to the contributing partner.
• The purpose of this section of the code is to prevent gain or loss from being shifted to another partner.
• Section 199A information will now be reported on a subsequent schedule.
• Part III, line 20, code Z will direct the partner to the attachment.
• Partnerships can provide compensation in the form of what is termed as guaranteed payments.
• Such payments have to be detailed in the partnership agreement or updated side agreements.
• Guaranteed payments are subject to self-employment tax and do not qualify for the QBID.
An increasingly common issue is where some partnerships are paying partners a wage, reporting the wages on the forms 940 and 941, and furnishing the partner with a form W-2.

You cannot do this!! This is not permitted.....

The issue involving the payment of compensation in an S corporation is two fold:

1. Requirement to pay “reasonable compensation”.

Compensation – LLCs – Pgs. 160 – 164 – Not In Book
Compensation – LLCs – Pgs. 160 – 164 – Not In Book

- This requirement has as a pro and con as to enforcement by the IRS…

2. The ability of the IRS to “determine” “reasonable compensation” in an S corporation in order to computationally adjust downward net earnings of the S corporation by what the IRS determines is reasonable to reduce the QBID.

- It is still very uncertain as to what this means or what is the ultimate ability of the IRS to do this…
Entity Election – Choice – Reference to Pgs. 169 – 172 – Not In Book

• The text has covered lightly the election to be an S corporation and, instead, has focused on the LLC partnership form of operation.

• The choice requires subjective thought, knowledge of the client’s business, and forecasting current and future results.

• This requires the practitioner to have an intimate knowledge of the client’s business, abilities, and to obtain information from him or her.
Entity Election – Choice – Not In Book

- The LLC partnership format is more flexible than the S corporation form and the C corporation should not even be considered for the following reasons....
- For a number of years, the S corporate form has been showing an increased rigidity resulting in unforeseen tax hurdles.
- Both the partnership format and the S corporation model offer equal liability protection if they are limited liability companies.
Entity Election – Choice – Not In Book
Not In Book

• The LLC partnership format, because any partner can elect that he or she wants to exist at any time (a partnership is considered a “voluntary association”), requires a well thought-out agreement that addresses such issues as to the value and under what terms to compensate a departing partner.

• The absence of a partnership agreement can be and often is a fatal flaw to the existence of the business and the relationship among partners.

• Here is an example....
Entity Election – Choice – Not In Book

Not In Book

- While the absence of an agreement as to valuation and payment of existing shareholders is not as fatal in the S corporation format, it is still very critical to the continued existence of the entity and, thus, guides overall succession planning.

- It is vital to avoid in any agreement between shareholders in an S corporation any type of preference of one shareholder over another in any form.

- Such preferences are deemed a “second class of stock”.
Entity Election – Choice – Not In Book
Reference to Pgs. 171, 172, & 173

• The existence of a deemed “second class” (an actual, formal second class does not have to exist) will result in an immediate termination of the S election and, as the chapter, discusses a reversion to a C corporation with all of many, negative, tax ramifications of that type of entity.

• It is also important that when a partnership LLC elects to become an S corporation as discussed on pages 171 and 172 even when such a change is triggered by planned or unplanned ownership changes as discussed on page 173, that the partnership agreement is reviewed and modified regarding any preferential terms that applied to a partner and now apply to a shareholder.

• This will prevent a termination of the S election.
Entity Election – Choice – Not In Book

Not In Book

- S corporations have two basic requirements that are very restrictive:
  - The basis of the individual shareholder for purposes of determining the ability to deduct losses and the amount of taxable gains on distributions in excess of basis is restricted to his or her’s ACTUAL capital investment or a very, rigid loan structure requiring the shareholder to DIRECTLY loan the money to the corporation and have the corporation directly pay back the loan to the shareholder.
S Corporation Enforcement – Not In Book

- As part of the LMSB “campaigns”, the IRS has announced a vigorous enforcement program regarding S corporations.
- This could have been predicted and is long overdue.
- The IRS has announced three areas of new audit enforcement:
  1. Distributions by an S corporation:
     - Focus is on the failure of to report the gain on distributions of appreciated property to shareholders.
     - Failure to report dividends from accumulated earnings and profits that resulted from a C corporation that had converted to an S corporation.
S Corporation Enforcement – Continued – Not In Book

- Cash or property distributions that exceed the shareholder’s basis in the corporation:
- My thoughts are....

2. The existence of the applicability of the Built-In Gains Tax (BIG):

   ➢ This is no surprise concerning the over emphasis on the existence of the qualified business income deduction for S corporation qualified income and the many pressures to for clients to convert from a C format to an S one.

   ➢ The tax is 21% (new corporate rate) on the net profit from sales of assets owned before the conversion and five years after.
S Corporation Enforcement – Continued – Not In Book

I would especially be careful with this computation because of the severity of the tax consequences and when consulting with a client have them sign a representation letter that they were advised on the consequences.

3. Basis in the S corporation – whether the client has sufficient basis in the S corporation

Beginning in 2018, we were supposed to attach to the client’s tax return a computation of the basis to those who are in the following situations:

A. Reported a loss.
S Corporation Enforcement – Continued – Not In Book

B. Dispositions of stock.
C. Received a distribution.
D. Received a loan repayment from the company.

➢ The audits in this new enforcement campaign are supposed to happen at the shareholder level with each individual shareholder’s returns being subject to examination.

➢ How this is supposed to happen without auditing the related S corporation is a....
2. Numerous, discriminatory restrictions on what is allowed to a 2% or more shareholder regarding benefits, certain deductions, etc.

➢ There is an entire chapter in a previous years workbook on this topic.

➢ The advantages of an S corporation are:

1. The more formal control of a majority shareholder by the sheer percentage of his or her ownership percentage and consistency in future succession.

2. The ability to regulate the amount of compensation to reduce the amount of FICA/Medicare taxes, although, as we had previously discussed the increased ability of the IRS to determine reasonable compensation is ever present.
The LLC partnership form has the advantage of allowing all losses generated by the entity with the increased basis rules that allow for the indirect liability of the partner for such economic losses rather than the rigid basis rules of the S corporation as well as less negative tax treatment regarding the benefits received by the partners through the partnership.

However, the major drawback is that the partner’s distributive share of net earnings is subject to the full limits of self-employment taxes, the ability of any partner to “quit” at any time, and problems involving long-term succession planning.
Entity Election – Choice – Not In Book
Not In Book

- Both entity forms have the same degree of liability protection if they have elected to be a limited liability company (most attorneys agree that the S corporate form is a redundancy for liability protection if that entity is an LLC).
- Both require a balance sheet and the issuance of schedules K-1.
- Partners and shareholders are equally liable for the treatment of distributions in excess of basis as a taxable event.
LLC Multimember Entities – Partnership or S Corporation? 
Not In Book

• The choice of a partnership LLC would be preferable in the case of a new or startup business that can reasonably expect losses in its opening years in order to prevent those losses from not being deductible due to a lack of basis in the restrictive S corporation entity form.

• The election to be an S corporation can be made if and when the partnership is profitable for purposes of FICA/Medicare tax planning.
Regarding the payment of FICA/Medicare, what is wrong with that?

- Does the partner/shareholder invest in his or her retirement any amounts that were saved?

- The S corporation requires the filing of form 2553 by the 75th day of the tax year in which it is desired to take effect.

- The application must be timely and detailed.
Ownership Changes – Pg. 173

• Events changing single member limited liability company to a multimember limited liability company.
• Once again, the underlying tax law is a default one.
• That is a single member is a disregarded entity that can file a schedule C, schedule F, or a schedule E. Whereas, a multi-member LLC is a partnership unless it elects to become a corporation.
• Whenever a multiple member limited liability company that is classified as a partnership is reduced to only one member then it becomes a disregarded entity (i.e., sole proprietorship, schedule E).

• Upon termination of the partnership, the partnership is deemed to have made a liquidating distribution of assets to its partners.

• The partner recognizes gain only to the extent that any money distributed exceeds the adjusted basis of the partner’s interest immediately before the distribution.
Multimember Limited Liability Company to Single Member Limited Liability Company – Pg. 174 - Continued

• If the partnership distributes only cash and or unrealized receivables and inventory in liquidation of a partner’s interest in a partnership, the partner recognizes loss to the extent of the excess of the adjusted basis of the partner’s interest in the partnership over the sum of money distributed and the basis to the distribute of any unrealized receivables and inventory.
Multimember Limited Liability Company to Single Member Limited Liability Company – Pg. 177

• Remember: Under the TCJA, a change in the ownership of a partnership by a greater than 50% partner no longer automatically terminates it.

• Now, the partnership is only terminated upon the cessation of business or reduction of ownership to one member.
Conversion of an LLC to a Partnership
Practitioner Note – Pg. 176

• The conversion/election of a partnership to limited liability status under state law does not result in any gain or loss to the partnership or members.
• The election of LLC status does not require it to obtain a new employer identification number.
• It does not close the partnership year.
• In conclusion, nothing changes.
Final Events

- Disproportionate distributions – excellent, detailed calculation regarding a member’s basis – Pg. 177.
- Sale of LLC interest – general rules – Pg. 177.
- Retirement or death of a member – Pg. 178, 179, & 180.