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**Advanced Tax Issues for LLCs**

By Tim Lynn (September, 2007)

I. Check-the-Box

The "Check-the-Box" regulations were adopted by the IRS effective January 1, 1997.<sup>1</sup> Prior to that time, there were complicated rules governing whether a business organization would be taxed as an association (and thus as a corporation), a partnership or another classification. Check-the-Box greatly simplified tax classification, and, because of this simplification, greatly enhanced the usefulness of limited liability companies as a choice of entity.

A. Types of business enterprises. A person (or group of persons) desiring to conduct a business or other activity has a variety of choices regarding the vehicle through which to operate. These include corporations, general partnerships, limited partnerships, limited liability companies, sole proprietorships, specialized entities (e.g., banks and insurance companies), and foreign business entities. The choice of entity will dictate the governing law. In general, the state law of formation will govern the management of the enterprise and the rights and responsibilities of the participants (both owners and managers). The choice will also dictate the tax treatment of the enterprise. For purposes of this article, the focus is upon four tax classifications – C corporation, S corporation, partnership<sup>2</sup>, and disregarded entity.

A corporation is owned by shareholders. Voting rights and distribution rights are determined by the class of stock. A corporation must have at least one class of common stock, and may have one or more classes of preferred stock. A board of directors governs the management of a corporation, generally subject to a one director/one vote rule. A corporation is an entity distinct from its shareholders for legal

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<sup>1</sup> 26 CFR 301.7701-3 (and the other surrounding sections of the regulations under section 7701 of the Code).

<sup>2</sup> All references herein to partnerships and partners are used interchangeably with limited liability company and member. Wherever the terms partnership or partner are used, the reader should assume the reference is to a limited liability company taxed as a partnership and its members.



purposes. A corporation may be a taxpayer separate from its shareholders (a C corporation) or a pass-through entity that is not respected for purposes of income, loss and distribution as an entity separate from its owners for tax purposes (an S corporation).

A C corporation may have one or more owners and multiple classes of stock (subject to any limits imposed under relevant state laws). A C corporation is subject to tax at the federal level (and often at the state level) on its earnings and profits, and may incur additional or different state taxes such as franchise taxes on its share capital, asset base or some other standard. Shareholders of a C corporation are only taxed on money and property distributed by the C corporation to the shareholders. In the case of individual shareholders, such distributions will be taxed as a dividend under section 301 of the Internal Revenue Code (the "Code") unless the distribution qualifies for exchange treatment under section 302 of the Code. Because of the dual tax system (corporate tax on earnings and profits and the shareholder tax on distribution of earnings and profits), a shareholder of a C corporation will incur a double tax upon corporate distributions arising out of earnings and profits accrued after 1913.

With the C corporation, there are no restrictions upon structuring the relative voting rights and relative rights with respect to distributions. However, as a practical matter, it is difficult to make such rights as flexible as with a partnership or LLC (and these rights must be set forth in the certificate of incorporation). For instance, creating a profits interest would be a very difficult task, requiring prior classes of stock to have priority over the new class of stock to the extent of the fair market value of the capital of the corporation on the date of issuance and in parity with the new stock with respect to all distributions in excess of that fair market value. This would be a difficult undertaking with respect to amending the certificate of incorporation to reflect these share values and preferences, as well as time the valuation with the issuance. And the final result would be subject to a double tax, treated as a dividend under most circumstances.

Although an S corporation offers pass-through taxation similar to a partnership, there are some key differences. An S corporation may have no more than 100 shareholders. There is no limit to the number of partners. All shareholders must be individuals or certain types of qualifying trusts (that approximate an individual because all allocated items will appear on the tax return of one individual, such



as a grantor trust). There are no restrictions on the identity of partners. All S corporation shareholders must be U.S. citizens or resident aliens. Foreign persons may be partners. It may have only common stock.<sup>3</sup> Because of the restriction to common stock, no preferences or special allocations can be made. Partnerships have incredible flexibility with respect to preferences and special allocations. An election by a corporation to be taxed as an S corporation must be done with the written consent of all of the shareholders, and the corporation must continue to qualify as an S corporation for the entire tenure of the election. To qualify as a partnership, the enterprise only needs to have more than one member.

Because it is a pass-through entity, profits and losses are allocated to shareholders rather than being recognized by the corporation. However, except as specifically modified by Section 1361, et seq., of the Code, an S corporation is otherwise treated as corporation for all other purposes under the Code. The S corporation is not a pure pass-through – an S corporation is subject to all laws applicable to C corporations, except as specifically modified under section 1361, et seq. For example, if an S corporation distributes property (other than money), the S corporation recognizes any gain at the fair market value of the distributed property.

Taxation of a partnership is similar to that of an S corporation. Profits and losses pass-through to the shareholders, who recognize income or loss. The partnership is not a taxpayer distinct from its owners. Because it is a more pure pass-through, there are significant differences between partnerships and S corporations:

1. In general, property may be contributed to a partnership by a partner without any recognition of gain (or loss) by either partner or partnership. A contribution of property by a shareholder to an S corporation must qualify for non-recognition treatment under section 351 of the Code.
2. In general, property (including money) may be distributed by a partnership to a partner without any recognition of gain (or loss) by either partner or partnership, provided the partner has

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<sup>3</sup> The common stock of an S corporation may be divided into voting and non-voting stock without violating the one class of stock rule.



an outside basis in his partnership interest at least equal to fair market value of the distributed property.<sup>4</sup> As in the case of the partnership, an S corporation shareholder will not recognize gain to the extent of the shareholder's basis in the shareholder's stock. However, as noted above, the S corporation may recognize gain upon the distribution of property other than money.

3. A partner has a unified basis consisting of the partner's basis in any loans to the partnership and the partner's basis in his or her partnership interest. An S corporation shareholder has a separate basis in debt and stock. If the shareholder utilizes debt basis to recognize allocated losses, the shareholder will be in a trap where any payment of principle on the debt will be effectively double-taxed (income at corporate level to generate cash, capital gain at shareholder level on payment of principal without basis). Effectively, the shareholder will never be repaid until a terminating event such as a sale of the business. If the S corporation shareholder in this situation does not own 100% of the stock of the S corporation, all distributions will be made in the form of distributions shared in by all other shareholders (otherwise the shareholder will have to incur the double tax on repayment of principal).

4. A partner receives outside basis for his or her share of partnership liabilities (recourse and non-recourse). An S corporation shareholder receives no basis by reason of corporate debt. This creates an opportunity to distribute cash from the partnership tax-free, from the proceeds of a loan or otherwise.

5. A partnership, in general terms, is any business enterprise that has more than one owner and that is not taxed as an association. There is no election to be taxed as a partnership. Provided it continues to have more than one owner, the classification as a partnership will not change by reason of transactions involving its partners. Treatment as an S corporation is an election. Such election may be revoked at any time by a majority in interest of the shareholders. The election may be terminated because

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<sup>4</sup> Exceptions to keep in mind are where appreciated property is contributed by a partner to a partner and is subsequently distributed to another partner or sold by the partnership and where losses have been previously recognized by a partner (the prior losses will be recognized as income upon the subsequent distribution – with the tax benefit of the prior loss being deferred to the tax year following the year of the distribution).



the restrictions on S corporations are violated – types of shareholders, number of shareholders, classes of stock. An S election termination can have disastrous effects: (1) the corporation becomes a taxpayer and earnings and profits become subject to double-taxation, (2) re-election as an S corporation is unavailable for 5 years; (3) re-election as an S corporation imposes built-in gain treatment upon appreciation (including appreciation during the prior S period); and (4) the benefits of AAA may be lost, resulting in some distributions that could have been made tax-free becoming subject to tax as a dividend.

6. A partner will be subject to the Medicaid tax on all of the income of the partnership allocated to the partner. An S corporation shareholder will be subject to FICA only on wages paid by the corporation (and not on dividends or other distributions).

7. Upon a sale of a partnership interest, a partner will recognize as ordinary income items in his or her capital account that would be ordinary income when recognized by the partnership (such as accounts receivable and inventory). Upon a sale of stock, the S corporation shareholder will almost certainly obtain capital gain treatment on all of the proceeds of the sale of stock.

8. Special allocations of items of income or deduction may be made to a partner by a partnership. Preferential interests are not permitted for S corporations.

9. A partner's capital interest in the partnership is (or should be) protected by reason of liquidating distributions being made in accordance with the partners' capital accounts adjusted to reflect fair market value. An S corporation shareholder is the holder of a certain percentage of the issued and outstanding stock of the corporation. Upon liquidation, the S corporation shareholder will receive his or her percentage of the liquidation proceeds.

10. Largely by reason of the preceding factor, a partner may be given a profits interest in a partnership without recognizing any tax. The tax is avoided provided that the fair market value of the partnership's capital is preserved in the capital accounts of the previously admitted partners. The new partner receives only an interest in future profits and appreciation. Because of the liquidation structure of a partnership, the IRS has been willing to treat the grant of a profits interest in a partnership



as a non-taxable event, provided the value of the capital of the partnership is preserved in the existing partners. Recent efforts in Congress to change this treatment have actually been met with resistance from the IRS. Issuance of stock to a shareholder is subject to general tax principles governing the characterization of the income. If the shareholder is an employee, the value of the stock will be taxable as compensation unless exempt (for instance, under sections 83 or 409A of the Code).

11. An S corporation is treated as a corporation for purposes of section 118 of the Code, thereby making it eligible to receive a state grant on a tax-free basis. Partnerships are not eligible for this treatment. This treatment can make it impossible to use a partnership to own some economic development projects, creating long term problems with refinancing plans and use of basis to distribute cash.

B. Effect of Check-the-Box Regulations.

1. Overview. The Check-the-Box regulations are set forth in the regulations issued pursuant to Section 7701 of the Code. These rules greatly simplified the task of understanding and, under some circumstances, electing a specific tax classification.

The first issue under the regulations is whether the enterprise is a separate taxpayer subject to classification under the Code. Under section 301.7701-1 of the regulations, a distinction is drawn between joint venturers in a business enterprise and certain other joint activities. In addition to automatic taxability of certain types of entities, a joint activity gives rise to a separate taxpayer if the participants "carry on a trade, business, financial operation, or venture and divide the profits therefrom." A separate taxpayer is not formed merely from an agreement to share expenses (which might relate to a shared benefit to two separate taxpayers) and does not include tenants-in-common.

Section 301.7701-2 provides the basic classification definitions. The broad overview is as follows:

*(a) Business entities. --For purposes of this section and §301.7701-3, a business entity is any entity recognized for federal tax purposes (including an entity with a single owner*



*that may be disregarded as an entity separate from its owner under §301.7701-3) that is not properly classified as a trust under §301.7701-4 or otherwise subject to special treatment under the Code. A business entity with two or more members is classified for federal tax purposes as either a corporation or a partnership. A business entity with only one owner is classified as a corporation or is disregarded; if the entity is disregarded, its activities are treated in the same manner as a sole proprietorship, branch, or division of the owner. But see paragraphs (c)(2)(iv) and (v) of this section for special employment and excise tax rules that apply to an eligible entity that is otherwise disregarded as an entity separate from its owner.*

Thus, an enterprise with two or more owners will be classified as a corporation or as a partnership. An enterprise with one owner will be classified as a corporation or will be disregarded as an entity separate from its owner for tax purposes.

Under 301.7701-2, a corporation includes any state or federal entity that is "incorporated" or is described as a "corporation" under the applicable organizational law. Obviously each state's corporations will be so classified. The regulation also provides a list of foreign entities that are treated as corporations for federal tax purposes, such as a *societe anonyme* (France) or a *kabushiki kaisha* (Japan). These are intended to encompass all foreign entities that are similar to the U.S. type of corporation (and generally bearing the four characteristics of a corporation).

Section 301.7701-3 provides rules for electing a tax classification. The first rule is that any entity classified as a corporation under 301.7701-2 cannot elect a different classification. Thus, corporations cannot take advantage of the Check-the-Box rules. The Check-the-Box rules do not create any options for corporations.

The default classifications are provided under section 301.7701-3(b):

- Other than a corporation, an entity with two or more members is by default classified as a partnership.



- Other than a corporation, an entity is treated as disregarded as an entity separate from its owner if it has one owner.

Each of these entities may elect to be classified as a corporation.<sup>5</sup> The election is made by filing Form 8832 with the appropriate filing center. The effective date of the election can go back in time 75 days or be deferred for no more than 12 months.

If an election to change an entity's classification is filed, the entity cannot change its classification for a 60 month period without the IRS's consent. Consent will be available only where there has been a change of ownership of more than 50 percent of the entity.

2. Effect on LLCs. Because of Check-the-Box, an LLC can be formed with centralized management, limited liability and perpetual existence (similar to a state law corporation) and still be taxed as a partnership. Likewise, an LLC can be used as a substitute for a sole proprietorship without exposing the owner to liability for the enterprise's debts.

An LLC can elect to be classified as a corporation. If such an election is filed, the LLC will be treated as a corporation for tax purposes, but will be governed by the LLC Law and its operating agreement. The LLC Law provides flexibility not available with corporations to customize the management provisions to suit participant's needs.

Complications can arise, however, when changing classification. The change in classification is often a taxable event. If the owner of a disregarded entity transfers a 50% interest to another person, the entity would by default be taxed as a partnership. This transaction can be structured as a sale by Partner 1 to Partner 2 or can be structured as a capital contribution by Partner 2 to a newly formed partnership. If not carefully planned in accordance with then applicable Revenue Procedures, Partner 1 could end up with a taxable sale of assets.

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<sup>5</sup> If treatment as an S corporation is desired, an LLC taxed as a corporation may file an S election, provided it otherwise satisfies the requirements applicable to S corporations. Special attention must be paid to structuring the equity interests of the members to ensure one class of stock that is common in nature.



If in this example the parties were to elect to have the entity taxed as a corporation with respect to the buy-in by Partner 2, the regulations state that it would be treated as a stock sale to Partner 2 and a capital contribution by Partner 1 that would fail to obtain tax-free treatment under section 351 because of the lack of a controlling interest. Partner 1 would recognize gain to the extent the fair market value of the "stock" received exceeds his or her basis in the contributed assets (with recapture a potential hazard as well).

The regulations address affirmative changes in classification as follows:

- A change from partnership to corporation is treated as a contribution by the partnership to a new corporation in exchange for stock of the corporation. The partnership is deemed liquidated and the stock distributed to the partners. This transaction will be taxable only if the partners have insufficient outside basis.
- A change from corporation to partnership is treated as a liquidation of the corporation followed by a contribution to a new partnership. The liquidation will be a taxable event to the members (except for corporate members owning more than 80% of the "stock"). The contribution should be tax-free under section 721 of the Code (with a step up in basis to reflect the recognition of gain on the liquidation).<sup>6</sup>
- A change from corporation to disregarded entity is treated as a liquidation of the corporation. As noted above, except for controlling corporate shareholders eligible for tax-free treatment under section 332 of the Code, this transaction will be a taxable event for the members.
- A change from disregarded entity to corporation is treated as a capital contribution to the corporation by the member. One would assume that, in general, the single-member

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<sup>6</sup> What if the LLC has liabilities in excess of the fair market value of its assets and its basis in such assets? Will the member's deemed contribution include an assumption of a partner liability (despite the fact that the member never actually owned any assets directly and never incurred any personal liability)?



would satisfy the control requirements under section 351 for this transaction to be treated as tax-free.

II. Transfer of Appreciated Property to the LLC.

In general, no gain or loss is recognized by a partnership or a partner upon a contribution of property by a partner to a partnership under section 721 of the Code. This is contrasted with the corporate context, in which a contribution must satisfy section 351 of the Code to be tax-free. Under section 722 of the Code, the partnership receives a carryover basis (increased by any tax recognized by the partner in the contribution).

Certain limits apply to this treatment. If the transaction is treated as disguised sale under the section 707 regulations, the transaction can be recharacterized as a recognition event with respect to the contributing partner and another partner deemed to be selling his or her interest to the contributing partner. Contributions of property subject to liabilities may result in the recognition of income by a partner under section 731 of the Code by reason of the partnership liability for the encumbrances.

If a partner contributes appreciated property to a partnership, section 704(c) of the Code will control the treatment of items of income and deduction with respect to such property. Assuming property worth \$100 is contributed to a partnership with a carryover basis of \$50. The tax capital account value of the property is \$50. The book capital value of the property is \$100. When gain is realized on the sale of the property, that gain is allocated to the contributing partner until the difference between book and tax amounts is eliminated. Thus, if the property were sold for \$100, the \$50 difference between the sale proceeds and the carryover basis would be allocated to the contributing partner. If the contributed property is depreciable property, the contributing partner will not be allowed the depreciation deductions until the amount of the disallowed deductions equals the amount of unrecognized built-in gain. The special allocations made under section 704(c) can have other effects. One is that nonrecourse debt may be specially allocated to partners having 704(c) minimum gain. This increase in basis may allow for tax-free distribution of loan proceeds or other available cash.



The recognition principles of section 704(c) upon a disposition of the appreciated property also apply if the property is distributed to a partner other than the contributing partner. If property contributed to a partnership is distributed to a different partner within seven years of the original contribution, the contributing partner will recognize the built-in gain. This rule prevents the utilization of the tax-free treatment afforded partnership distributions under section 731 of the Code.

There are two exceptions to the recognition of gain by the contributing partner where the property is distributed by the partnership. First, if the property is distributed to the contributing partner, no gain is recognized. Second, if the contributing partner receives like-kind property in distribution by the partnership, the contributing partner will not recognize the built-in gain, provided the property received qualifies as like-kind under section 1031 of the Code and the distribution to the contributing partner occurs within 180 days of the distribution to the other partner.

A second restriction regarding contributions of appreciated property is imposed under section 737 of the Code. Under section 737, if a partner contributes appreciated property to a partnership and receives a distribution of property other than money by the partnership within seven years of the contribution, the contributing partner will recognize gain equal to the lesser of (1) the fair market value of the distributed property minus the partner's outside basis, or (2) the gain that would have been recognized under section 704(c) had the property been distributed to another partner within seven years of the contribution. Through the operation of the first part of the formula, section 737 attempts to only affect abusive transactions. If the partner has significant other basis in his or her partnership interest, no gain will be recognized under section 737.



III. Compensation Planning and Distributions.

The tax provisions of an operating agreement must be driven by and reflect the business terms of the agreement among the members. If the tax provisions do not reflect the business terms, re-allocations may occur to surprise of one or more of the members.

Distributions are at the core of the economic deal. When will distributions be made (if at all)? Who determines whether a distribution will be made? Who determines how much will be distributed? Are distributions mandatory? How do you define what is to be distributed? If net cash is to be distributed, does the definition of net cash account for any reserves and does it include the proceeds of the sale of assets (other than inventory and accounts receivable)? Is a member providing personal services to the LLC and will that member be specially compensated for such services? Is a member to receive a preferred rate of return on a capital contribution? Will tax distributions be made? The issues can be endless.

In most situations, the distribution provisions deal with four situations: (1) tax distributions, (2) guaranteed payments, (3) distributions of annual net cash flow, and (4) liquidating distributions.

A. Tax Distributions.

*Except as prohibited by applicable law, the Limited Liability Company shall distribute an amount that approximates the federal and state income tax generated by the pass-through of the income of the Limited Liability Company to the Members (or, as the case may be, the more remote owners of Members ultimately taxable on income allocated by the Limited Liability Company) on or before April 15 of the year subsequent to the year in which the income was earned.*

Because an LLC taxed as a partnership is a pass-through for tax purposes, the members must be concerned with generating the cash necessary to pay the tax on allocated income. Unless required to make a distribution, members may recognize income from the operations of the LLC without receiving



any cash to pay the tax on the income. The clause above rectifies this situation by requiring that a tax distribution be made annually unless prohibited by law (such as certain distributions by an insolvent LLC). The distribution must approximate the federal and state tax that would be owed by the members. If there are members in a variety of states or if tax brackets are significantly tiered, a more specific clause may be desired. The clause envisions that the member in question may be another partnership, an S corporation or a disregarded entity. Because the actual member in such a circumstance would not owe any tax, the tax distribution is based upon the tax to be paid by the ultimately taxable owner.

B. Guaranteed Payments. In the situation where one or more of the members is providing personal services to the LLC, such member will likely desire to be paid a reasonable salary for such services, separate and apart from such member's interest in the capital and profits of the enterprise. A guaranteed payment is a payment to a partner by a partnership for personal services or for the use of capital provided such payment is not based upon the income of the partnership.

The guaranteed payment is included as ordinary income by the receiving partner and is either a deductible expense or a capitalized item to the partnership. In the case of payment for services, it will be deductible, but only if the payments qualify as reasonable compensation under section 162 of the Code.

A guaranteed payment may be structured in similar fashion to a preferred return for preferred stock in a C corporation. However, because dividend tax rates and ordinary income tax rates may differ, the tax cost of the use of an LLC or a corporation may differ.

*The Limited Liability Company may pay compensation to one or more of the Members as determined by the Manager as a guaranteed payment pursuant to Code Section 707(c), which guaranteed payment may be set forth in an employment agreement. The payment may be made periodically during the Fiscal Year as the Manager, in its sole discretion, shall determine or as set forth in the employment agreement. Any such payments shall be credited against the overall compensation package of the Member with the Limited Liability Company and all of its Affiliates under any employment agreement or otherwise.*



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-or-

*The Limited Liability Company may pay compensation to the Members as a guaranteed payment pursuant to Code Section 707(c). The payment may be made periodically during the Fiscal Year. Any such payments shall be credited against the overall compensation package of the Member with the Limited Liability Company and all of its Affiliates under any employment agreement or otherwise. The initial guaranteed payments, determined on a calendar year basis and reduced to reflect the actual number of days of such calendar year during which such person is paid such guaranteed payment, and payable to the Members shall be as follows:*

*Member A - \$135,000*

*Member B - \$105,000*

*The guaranteed payments to the Members shall remain in the same proportion with respect to the total guaranteed payments to the Members as are the initial guaranteed payments, and any increase or reduction shall apply proportionately to all guaranteed payments to all of the Members. The Manager may increase the guaranteed payments to the Members once per annum. The Manager may reduce the guaranteed payments to the Members at any time that the Manager reasonably determines that the cash flow needs of the Limited Liability Company would make it unwise to pay the full amount of the guaranteed payments.*

In general, provided the amount of the guaranteed payment is reasonable, the guaranteed payment is separate and apart from a member's interest in the profits and capital of the LLC. In making the business deal between the members, the distribution and allocation provisions should account for the economic effect of the guaranteed payment.

C. Annual Distributions.



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*Other than any guaranteed payments to the Members, distributions of Net Cash Flow and Net Cash Proceeds (other than in the Event of Dissolution and Liquidation) for each Fiscal Year shall be made only in the sole and absolute discretion of the Manager.*

-or-

*The Manager shall distribute all Net Cash Flow and all Net Cash Proceeds (other than in the Event of Dissolution and Liquidation) to the Members. Such distribution shall be made within 180 days of the end of the fiscal year of the Limited Liability Company.*

-or-

*Other than the tax distributions, distributions of Net Cash Flow and Net Cash Proceeds (other than in the Event of Dissolution and Liquidation) for each Fiscal Year shall be made only in the sole and absolute discretion of the Members.*

Annual distributions can appear simple from the above examples. In the first, the Manager has the sole discretion regarding whether any annual distribution is made. In the second, all Net Cash Flow and Net Cash Proceeds must be distributed annually. In the third, the members have retained the right to determine by member vote whether to make any annual distribution. These distribution provisions must be examined carefully because of the business and tax effects the distributions may have.

The first issue is – what is available to distribute? It is not taxable income, because taxable income will exclude certain items of income (tax-exempt investments for example) and exclude certain expenditures (repayment of principal on LLC debt for example). Thus, distributable cash may bear little relationship to taxable income or loss. Corrections for these differences are found in many operating agreements in the definition of Profits and Losses:



*"Profits" and "Losses" means, for each Fiscal Year or other period, an amount equal to the Limited Liability Company's taxable income or loss for such year or period, determined in accordance with Code Section 703(a) (for this purpose, all items of income, gain, loss or deduction required to be stated separately pursuant to Code Section 703(a)(1) shall be included in taxable income or loss), with the following adjustments:*

*(1) Any income of the Limited Liability Company that is exempt from federal income tax and not otherwise taken into account in computing Profits or Losses pursuant to this Section shall be added to such taxable income or loss;*

*(2) Any expenditures of the Limited Liability Company described in Code Section 705(a)(2)(B) or treated as Code Section 705(a)(2)(B) expenditures pursuant to Regulations Section 1.704-1(b)(2)(iv)(I), and not otherwise taken into account in computing Profits or Losses pursuant to this Section shall be subtracted from such taxable income or loss;*

*(3) In the event the Gross Asset Value of any Limited Liability Company asset is adjusted pursuant to paragraphs 3.1(1)(2) or (3) of the definition of Gross Asset Value hereof, the amount of such adjustment shall be taken into account as gain or loss from the disposition of such asset for purposes of computing Profits or Losses.*

*(4) Gain or loss resulting from any disposition of Limited Liability Company assets with respect to which gain or loss is recognized for federal income tax purposes shall be computed by reference to the Gross Asset Value of the property disposed of, notwithstanding that the adjusted tax basis of such property differs from its Gross Asset Value;*



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(5) *In lieu of the depreciation, amortization, and other cost recovery deductions taken into account in computing such taxable income or loss, there shall be taken into account Depreciation for such Fiscal Year or other period; and*

(6) *Notwithstanding any other provision of this paragraph, any items which are specially allocated pursuant to paragraph 7.2 shall not be taken into account in computing Profits or Losses pursuant to this Section.*

It is this adjusted amount that affects the members' capital accounts and accurately reflects a member's interest in the LLC (at such times as a fair market valuation is performed).

A second issue is how much of the cash on hand is available for distribution? The LLC needs cash for current payables. It will need cash to pay any short term debt obligations. It may turn the cash into other property used in the business. It may be necessary to establish cash reserves to ensure the continuing viability of the business of the LLC. If any one or more of these items is excluded from the definition of Net Cash Flow, there is a reduction in the amount of cash available for distribution (regardless of whether distribution is mandatory or discretionary). It is important to clearly define who determines whether cash will be used for capital expenditures and whether reserves (and how much) will be established.<sup>7</sup> After all of these decisions have been made, distributable cash may be very different from taxable income and profit.

#### IV. Dispositions of a Membership Interest.

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<sup>7</sup> The power to determine distributions can have other tax effects. For example, the ability to establish reserves may impact upon the effectiveness of a gift under section 2036 of the Code in the situation where a family LLC or LP is used for gift tax purposes.



One of the basic issues in any LLC is how a member "exits". Under what circumstances will a member be allowed to "withdraw" from the LLC? Under what circumstances will a member be allowed to sell or otherwise dispose of his or her interest? In the case of a liquidation of or by the partnership, how much will the member be paid?

If the intent is that the member receives fair market value for their interest upon a withdrawing event, one method for defining the purchase price is to pay the withdrawing partner their capital account, adjusted to reflect fair market value (and going concern value and goodwill in an operating business). In performing these adjustments to the capital account, the operating agreement may provide for appraisal mechanisms, whether performed by a valuation expert, the company's certified public accountant, or an MAI appraiser.

A. The Retiring Partner. The tax treatment of payments to a retiring partner is governed by section 736 of the Code. The general rule provided in section 736(b) is that such payments are treated as distributions by a partnership and not as a distributive share or guaranteed payment. Because of the treatment as a partnership distribution, the distribution will generally not be taxable to the extent of the partner's outside basis in his or her membership interest. If in excess of basis, the distribution will generally be taxed as a capital gain (subject to holding period rules and other provisions applicable to capital gains). Under section 736(a), in the case of a partnership where capital is not a material income-producing factor, the retiring partner may recognize ordinary income to the extent that the payments by the partnership are for unrealized receivables of the partnership. These distributions will be characterized as a distributive share or as a guaranteed payment. If a distributive share, the other partners will benefit from the reduction in items allocated to them. If a guaranteed payment, the partnership will receive a deduction. If the payments to the retiring partner are to be made in installments and there are both 736(b) and 736(a) items, generally the items will be recognized proportionately over the payment stream (with each payment being treated as a percentage of each).

B. The Deceased Partner. There are three effects of the death of a partner – income tax consequences, estate tax consequences, and the sale or liquidation of the partner's interest. The partnership tax year does not terminate upon death. The deceased partner's tax year does close upon



death. The value of the deceased partner's interest is included in the deceased partner's estate for estate tax purposes. A bona fide buy-sell agreement can control the valuation.

Various sections of the Code require maintaining the deceased's tax accounting method, require a carryover basis for the recognition of income on items not yet taxed, and taxes the estate when the payment is received. These items are referred to as income in respect of a decedent. Income in respect of a decedent generally covers income items earned but not paid prior to death where the decedent did not recognize the income prior to death. Pursuant to T. Reg. 1.742-1, the estate's basis in the partnership interest is equal to the fair market value of the partnership interest, increased by any liabilities, and decreased by IRD items.

If the partnership liquidates the deceased partner's estate, IRD items are treated as section 736(a) items (generally ordinary income to the estate). In addition, upon a sale of the interest (rather than a liquidation), some income items inside the partnership will maintain their character and be recognized by the estate as ordinary income (using the partnership's inside basis in the assets). This would include the partnership's receivables.

Basis problems can arise where a partner's interest is liquidated by the partnership. If the partnership pays cash to a partner (retiring or deceased) for his or her partnership interest, the amount of cash may exceed the partner's outside basis and the partner will recognize gain on the difference (or ordinary income on certain types of items). If the excess amount paid to the partner reflects appreciation in the value of the partnership's assets, without a basis adjustment in those assets, the remaining partners will recognize the same gain when those assets are disposed of. Under section 734(a), no adjustment to inside basis is made upon a distribution of property to a partner.

If a section 754 election is in place, section 734(b) provides for an inside basis adjustment. If the receiving partner recognizes gain, there is an adjustment in inside basis equal to such gain. If the receiving partner's basis is less than the partnership's basis in the property (by operation of section 732), the amount of the difference is an adjustment to inside basis. If the receiving partner recognizes a loss on the distribution, there is a downward adjustment in inside basis. If the receiving partner's basis is greater



than the partnership's inside basis in a liquidating distribution subject to section 732(b), the inside basis is subject to a downward adjustment.

Under section 755, the additional basis must be added to the same class of asset as the distributed property was from (capital or ordinary income). Likewise, any disappearing basis must be allocated to the same class of asset.

C. The Selling Partner. Pursuant to section 741, the selling partner recognizes gain or loss from the sale of a capital interest, except as provided in section 751. Pursuant to section 751, any amount received by the selling partner in respect of unrealized A/R or inventory is treated as ordinary income to the selling partner. These assets are sometimes referred to as "hot assets". The acquiring partner's basis is determined in accordance with section 1011 et seq. (the general basis provisions) and will generally reflect the amount paid for the interest together with the new partner's share of partnership liabilities.

The selling partner will recognize a long-term capital gain on the sale proceeds (other than section 751 related payments) provided the partnership interest has been held for more than a year. This gain would be taxed at a current maximum 15% federal long term capital gain rate (too soon to revert to 20%), except that collectibles owned by the partnership are taxed at a higher rate and any unrecaptured section 1250 amount (relating generally to real estate depreciation) will be recognized at ordinary income rates.

Under 743(a) there is no adjustment to inside basis upon the purchase of a partnership interest. Thus, even though a purchaser may pay for receivables, the receivables when collected would have zero basis and be fully-taxable to the purchaser (if allocated to the purchaser). This is so even though the selling partner already recognized ordinary income on the same unrealized receivables. Adding insult to injury, any loss recognized by reason of the increase in basis attributable to the ordinary income recognition would be a capital loss.

If a section 754 election is in place for the partnership, section 743(b) provides for an inside basis adjustment with respect to the purchaser's interest in the partnership. Assume a partnership has \$150,000



of accounts receivable and no other assets and a purchaser pays \$50,000 for a 1/3 interest in the partnership. In the absence of a section 754 election, upon collection of the A/R, partnership would allocate \$150,000 in ordinary income to the partners (\$50,000 to the purchaser). If there is a section 754 election in place, the purchaser has a different inside basis in the accounts receivable than the other partners. The purchaser would not recognize any ordinary income because the purchaser has \$50,000 of basis in the accounts receivable. The other partners would recognize their share of the accounts receivable.

Because the section 754 election can also cause a downward adjustment under section 743(b), careful planning is required before putting the election in place.

In a built-in loss situation, section 743(b) may require an inside basis adjustment, regardless of whether a section 754 election is in place. The mandated adjustment occurs when adjusted basis exceeds fair market value by more than \$250,000.

#### V. Use of Disregarded Entities in Mergers, Acquisitions and Dispositions

There are numerous ways in which to utilize disregarded entities in asset and stock transactions. These disregarded entities include single-member LLCs and qualified subchapter S subsidiaries. The tax treatment of such transactions follows from the disregarded nature of the LLC. A sale of a disregarded LLC is treated as an asset sale for tax purposes. The seller recognizes gain on the allocation of the proceeds to the individual assets. The buyer receives a basis in the assets in accordance with such allocation. By using a disregarded entity to acquire assets, the ultimate purchaser shields itself from liabilities that may attach to such assets (such as environmental liabilities and ERISA issues), but is treated as having purchased the assets directly for tax purposes.

Apparently due to perceived or potential abuses, in 2006 the IRS issued rules clarifying the use of disregarded entities in tax-free reorganizations. After years of wrangling with the issue, the IRS came up with a difficult set of rules (but provided numerous examples to help apply the rules).



The rules are based upon the following concept – for purposes of tax-free reorganizations, a disregarded entity is inseparable from its ultimate taxpayer owner. With this basic rule in mind, the complexity of the rules is greatly reduced.

The "combining unit" is the basic family of disregarded entities owned by a "combining entity". The combining entity must be a corporation. The combining unit is made up of a combining entity and each disregarded entity owned by such combining entity.

In order for a merger to qualify as a statutory merger under section 368(a)(1)(A), (i) all of the assets and liabilities of all members the target combining unit must become the assets and liabilities one or more members of another combining unit, and (ii) the separate existence of the target combining entity must terminate.

For example, assume Corp X is the sole owner of LLC, a disregarded entity. Corp Y, another corporation, does not own any disregarded entities. Corp Y merges into LLC pursuant to New York law. This transaction is treated as if Corp Y merged into Corp X for tax purposes and it qualifies as a statutory merger. Corp Y is the sole member of the target combining unit. All of the assets and liabilities of Corp Y became the assets and liabilities of one or more members of the acquiring combining unit made up of Corp X and LLC.

If instead LLC had merged into Corp Y, the transaction would fail because Corp X, the combining entity of the target combining unit, would still exist with its assets and liabilities. This transaction would properly be treated as an asset sale by Corp X to Corp Y.

Even within a business organization, a restructuring might be undertaken to help resolve liability issues. Assume (as is too often the case) that Corporation A (an S corporation) has over time developed two lines of business (one a motor trucking operation, the other a series of landfills). The owners built the business from scratch and did not pay close attention to the risks inherent in each activity and the exposure of the other business to such liabilities. A section 355 spin off is a risky type of transaction that



bears close scrutiny by the IRS. This type of transaction is available and may safely be used in the rarest of circumstances.

Another alternative (that has a regulatory example to back it up in the section 1362 regulations) is to engage in a Type D reorganization structured as follows:

- Shareholders form Corporation B and Corporation B makes an S election.
- Shareholders contribute 100% of the stock of Corporation A to Corporation B in a contribution qualifying under section 351 of the Code for tax-free treatment (in the absence of the step transaction doctrine).
- Corporation B makes a qualified subchapter S subsidiary election for Corporation A, causing Corporation A to become a disregarded entity.
- Corporation B organizes either (i) New LLC treated as a disregarded entity under the Check-the-Box regulations or (ii) Corporation C for which it makes a qualified subchapter S subsidiary election.
- Corporation A transfers the assets and operations relating to one of its two lines of business (either motor trucking or landfills) to New LLC or Corporation C, as the case may be.

This transaction will qualify for tax-free treatment as a reorganization described in section 368(a)(1)(D) of the Code.

In asset sales and stock transactions, disregarded entities provide an opportunity to isolate liabilities from the purchaser without changing the tax treatment of the transaction, provided the parties understand the disregarded nature of the entities and structure their transaction accordingly.