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# Planning for the Operation of Pass Through Entities

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**PLANNING FOR THE OPERATION OF PASS THROUGH ENTITIES**

by:

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## **Proposed Self-Employment Tax Regulations**

**Facts:** XYZ is a Delaware limited liability company (LLC) and is in the financial services business. XYZ has 10 members and twenty employees. Earnings are generated on sales commissions taken from sales of stocks and securities. The founder of the enterprise is authorized in the agreement to serve as a member-manager, however, in all respects the LLC agreement resembles a partnership arrangement. In fact, for federal and state income tax purposes, XYZ files partnership tax returns. The remaining nine members are not designated as managers but do have the power to bind the LLC in executing transactions for their customers. All members are active in the business and most average 2,500 hours per year.

**Issue:** Is any XYZ member subject to the federal self-employment tax imposed under IRC Section 1401?

### **Relevant Authorities:**

- o IRC Section 1402(a)(13) (imposing self-employment tax on limited partners)
- o Proposed Regulation Section 1.1402(a)-2 (released January 1997)

The proposed regulations distinguish a general and a limited partner based on whether any one of three functional tests are met: the possession of personal liability; the authority to contract on behalf of the partnership; and participation for more than 500 hours during the year.

- o Taxpayer Relief Act of 1997, Section 935 (moratorium imposed on final regulations)
- o Rev. Rul 74-44, 1974-1 C.B. 287 (minimum compensation required for FICA)
- o Spicer Accounting, 918 F.2d 90 (CA-9, 1991)

## **Compensating LLC Members: Partners or Employees?**

**Facts:** XYZ is a Virginia limited liability company with operations in Richmond. XYZ has three equal owners and is taxed for federal and state tax purposes as a partnership. The company employs approximately 100 individuals in its mini-computer assembly operations. To motivate their management team and their production employees, XYZ is considering offering options to all employees to acquire a special class of interests in XYZ.

**Issues:** Can XYZ issue options to its management and production employees? What are the tax consequences to XYZ, its members and the employees upon the issuance and exercise of these options?

### **Relevant Authorities:**

- o IRC Section 707(a) (payments to partners in capacity other than partner)
- o IRC Section 707(c) (guaranteed payments)
- o Armstrong v. Phinney, 394 F. 2d 661 (CA-5, 1968)
- o IRC Section 83 (transfers of property in exchange for services)
- o Reg. Section 1.721-1(b) (capital interest conveyed for services)

## **Single-Member LLCs: How Disregarded Can They Be?**

**Facts:** John Smith has a number of investments and wants to put them into a Virginia limited liability company which he will own completely. John has an opportunity to invest in an S corporation and wants to put the S corporation stock into his LLC. The LLC will have different investments including stock, real estate and possibly a sole proprietorship that John is thinking about operating out of the LLC.

John is also the owner of an operating C corporation, however, he has created a wholly-owned LLC underneath his operating corporation to conduct some riskier business ventures. As a possible exit strategy from these more risky operations, he wants the flexibility to merge with a similar company in the future.

**Issues:** Will the LLC's ownership of the S corporation stock create an ineligible shareholder problem for the S corporation? How will John report his different activities operated through the LLC on his individual tax returns?

Can John's single-member LLC owned by his operating company merge for federal income tax purposes into another company tax-free under the IRC Section 368 reorganization provisions?

### **Relevant Authorities:**

- o Reg. Section 301.7701-3(b)
- o PLR 9739014 (disregarded LLCs can be S corporation shareholders)
- o PLR 9411035 and PLR 8903074 (both support Type A mergers with disregarded REIT subsidiaries)

## **Electing Small Business Trusts (ESBTs)**

**Facts:** John is the sole owner of XYX, an S corporation, in the business of manufacturing fine gears for sophisticated medical tools. John is forty years old, married and has three minor children ages 14, 11 and 8. John is beginning to think seriously about his estate plan and wants to begin a gifting program to his children. He wants to retain XYZ's S corporation status while at the same time begin transferring some ownership in the company to his children. He is sophisticated and wants to put the stock into trust until his children reach their majority and have established themselves as adults.

As any businessman, John wants to keep the estate planning simple and wants to set up a single trust to hold the S corporation stock for his three children. He wants to generally treat his three children equally but on the other hand recognizes they may have different needs at different times in their lives. His trust agreement is expected to have all the standard boilerplate including a provision covering future minor beneficiaries whose interests would be payable into secondary trusts.

**Issue:** Can John accomplish his objectives by using an electing small business trust?

### **Relevant Authorities:**

- o IRC Section 1361(e)
- o IRS Notice 97-12, 1997-3 I.R.B. 11
- o IRS Notice 97-49, 1997-36 I.R.B. 8