1997

LLCs and LLPs

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# TABLE OF CONTENTS

<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>I.</strong> INTRODUCTION</td>
<td>3</td>
</tr>
<tr>
<td>A. General</td>
<td>3</td>
</tr>
<tr>
<td>B. Definitions</td>
<td>4</td>
</tr>
<tr>
<td><strong>II.</strong> LLC COMPARED WITH OTHER BUSINESS ENTITIES</td>
<td>5</td>
</tr>
<tr>
<td>A. S Corporation</td>
<td>5</td>
</tr>
<tr>
<td>B. General Partnership</td>
<td>7</td>
</tr>
<tr>
<td>C. Limited Partnership</td>
<td>8</td>
</tr>
<tr>
<td><strong>III.</strong> INCOME TAX CLASSIFICATION OF LLCs and LLPs</td>
<td>9</td>
</tr>
<tr>
<td>A. Classification Principles</td>
<td>9</td>
</tr>
<tr>
<td>B. Elective Partnership Classification</td>
<td>9</td>
</tr>
<tr>
<td>C. Characterization of Elective Changes in Classification</td>
<td>12</td>
</tr>
<tr>
<td><strong>IV.</strong> VIRGINIA PROVISIONS INSPIRED BY THE CHECK-THE-BOX REGULATIONS</td>
<td>15</td>
</tr>
<tr>
<td>A. Single Member LLC</td>
<td>15</td>
</tr>
<tr>
<td>B. Elimination of Limited Duration Provision</td>
<td>15</td>
</tr>
<tr>
<td>C. Withdrawal from the LLC</td>
<td>15</td>
</tr>
<tr>
<td>D. Right of Assignee to Become a Member</td>
<td>15</td>
</tr>
<tr>
<td>E. Member Dissociation as a Default Dissolution Event</td>
<td>15</td>
</tr>
<tr>
<td><strong>V.</strong> VIRGINIA REVISED UNIFORM PARTNERSHIP ACT (“VRUPA”)</td>
<td>16</td>
</tr>
<tr>
<td><strong>VI.</strong> APPLICATION OF PARTNERSHIP TAX PRINCIPLES</td>
<td>17</td>
</tr>
<tr>
<td>A. Organization</td>
<td>17</td>
</tr>
<tr>
<td>B. Conversion</td>
<td>18</td>
</tr>
<tr>
<td>C. Pass-through Rules</td>
<td>21</td>
</tr>
<tr>
<td>D. Allocations</td>
<td>21</td>
</tr>
<tr>
<td>E. At Risk Rules</td>
<td>22</td>
</tr>
<tr>
<td>F. Limitations on Passive Activity Losses</td>
<td>24</td>
</tr>
<tr>
<td>G. Tax Matters Partner</td>
<td>26</td>
</tr>
<tr>
<td>H. Method of Accounting</td>
<td>26</td>
</tr>
<tr>
<td>I. Self-Employment Tax and Social Security Earnings</td>
<td>30</td>
</tr>
<tr>
<td>J. Qualified Retirement Plans</td>
<td>33</td>
</tr>
<tr>
<td>K. Liquidation Payments</td>
<td>33</td>
</tr>
</tbody>
</table>
VII. STATE TAXATION .......................................................... 33
A. Income Taxation .......................................................... 33
B. Real Estate Transfer Taxes ........................................ 34
C. Retail Sales and Use Tax ............................................. 34
I. INTRODUCTION

A. General

This outline is intended to provide a report on recent amendments to the Virginia LLC Act, a comparison of the LLC with other pass-through entities, the revision of the Virginia Uniform Partnership Act, and principal tax issues that are encountered with the organization and operation of a limited liability company. It does not purport to be an exhaustive survey of the law.\(^1\)

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1 This outline was generally completed on November 1, 1997.


The principal treatises on the Revised Uniform Partnership Act are Bromberg and Ribstein, Limited Liability Partnerships and the Revised Uniform Partnership Act (1995) and Hillman, Vestal and Weidner, General and Limited...
1. All states have adopted LLC legislation.

2. The only states without LLP legislation are Rhode Island and Wyoming. Most states have tort-only LLPs, but some provide same liability protection as LLC. After July 1, 1997, Virginia moves from the former to the latter category.

3. Some states, including Virginia, permit limited partnerships to register as LLPs to protect the general partners.

B. Definitions

1. Manager

Person designated by members to manage the LLC as provided in the Articles or the Operating Agreement. Va. Code § 13.1-1002.

2. Manager-managed LLC

An LLC that is managed by a manager(s) as provided for in its Articles or Operating Agreement. Va. Code § 13.1-1002. But see Va. Code § 13.1-1021.1.B.1, which provides that a member is not an agent only if the Articles specify that the LLC is manager-managed.

3. Member

Person who is admitted as a member and who has not ceased to be a member. Va. Code § 13.1-1002.

Member's rights include:


b. right to inspect records to obtain information regarding the business and financial condition of the LLC. Va. Code § 13.1-1028.B.


Liability Partnerships under the Revised Uniform Partnership Act (1996).

"Assignee" is not defined by the Act. It is the person to whom a Membership Interest has been assigned, but who may or may not have become a member. A person who owns a Membership Interest is not necessarily a Member. An assignment, without the assignee's becoming a Member, does not entitle the assignee to participate in the management and affairs of the LLC or to become or to exercise any rights of a Member. Va. Code § 13.1-1039.

4. Member-managed LLC

An LLC that is not a manager-managed LLC. Va. Code § 13.1-1002.

5. Membership Interest

Member's share of the profits and losses and right to receive distributions of assets. Va. Code § 13.1-1002.

II. LLC COMPARED WITH OTHER BUSINESS ENTITIES

A. S Corporation

1. LLC Advantages

   a. LLC avoids the restrictions and consequent tax traps of an S corporation, such as limits on number of owners and types of eligible owners, and one class of stock rule.

   NOTE: Rev. Rul. 94-43, 1994-2 C.B. 198, revoked Rev. Rul. 77-220,1977-1 C.B. 263, and held that elections to be treated as S corporations made by separate corporations that were partners in a partnership should be respected even though the principal purpose for forming those separate corporations instead of one was to avoid the S corporation shareholder limitation.

   In addition, use of a partnership of an S corporation and a nonresident alien because admitting the latter as a shareholder of the former would terminate its S corporation election does not violate the anti-abuse regulations. Treas. Reg. § 1.701-2(d), Example 2.

   NOTE: The Small Business Job Protection Act amendments (generally effective for taxable years beginning after 1996):
(i) increased permitted number of shareholders to 75;

(ii) added electing small business trust as a permitted non-individual shareholder;

(iii) granted IRS authority to waive an inadvertent termination (effective after 1982); and

(iv) permitted S corporations to hold subsidiaries.

b. LLC provides the tax advantages that partnerships have over corporations, including S corporations:

(i) May include entity debt in basis of members, which permits greater opportunity to pass through losses and make tax-free cash distributions.

(ii) More liberal requirements for nonrecognition of gain on contribution of appreciated property to entity in exchange for an interest. E.g., no "control" requirement.

(iii) Tax-free distributions of appreciated property. Compare IRC § 731(a) with IRC § 311(b).

(iv) Elections under I.R.C. § 754 to increase the basis of LLC assets in the case of the acquisition from a member of LLC interest is not available for S corporation shareholders.


c. For securities law purposes, an LLC interest is not necessarily a "security."

2. S Corporation Advantages

a. Start-up venture if future tax-free acquisition is desired. The conversion of an LLC to a corporation shortly before an attempted tax-free
acquisition may not be a tax-free incorporation. Rev. Rul. 70-140, 1970-1 C.B. 73.


However, "dividends" paid to shareholders in lieu of reasonable compensation for their services will be treated as "wages" for FICA purposes. Rev. Rul. 74-44, 1974-1 C.B. 287; Joseph Radtke S.C., 895 F.2d 1196 (7th Cir. 1990).

Alternative: LLC with S corporation as manager.

c. Avoid I.R.C. § 704(c)

B. General Partnership

1. LLC advantages

   a. Agency power of members can be limited by manager-management.

   b. Limited liability of all LLC members.

NOTE: Under VRUPA, partners may limit all vicarious liability by becoming an RLLP. Va. Code § 50-73.96.C.

   c. Greater durability. Under VUPA, general partnership was dissolved upon dissociation of a member even where partners had otherwise agreed. Va. Code § 50-31.

NOTE: That result is changed under VRUPA. Va. Code § 50-73.81.A.

   d. Member does not have power to withdraw when he has agreed not to do so. Under VUPA, general partner has power to withdraw even when partners have otherwise agreed. That result will not be changed by VRUPA. Va. Code § 50-73.81.B.4. Partner who wrongfully withdraws may be liable for damages.

f. If LLC is treated as a "corporation" under the Bankruptcy Code, a single member may not file a voluntary bankruptcy petition against the LLC as may a general partner of a general partnership.

2. Partnership advantages.
   a. Many professional partnerships have not converted to avoid revisiting existing agreements.
   b. Well developed body of case law.
   c. Availability of IRC § 736(b).
   d. Clear application of tax provisions expressed in terms of "general partner" (e.g., material participation”).

C. Limited Partnership

1. LLC Advantages.
   a. LLC permits all members to participate in management of the business without risk of the liability to which a limited partner may be subject under similar circumstances under Va. Code § 50-73.24.
   b. No requirement that any LLC member be personally liable for entity debt.

NOTE: A Virginia limited partnership may elect to become an LLP and protect general partners against vicarious liability, Va. Code § 50-73.96C.

c. Broad range of remedies, such as forfeiture, permitted for default in capital contribution obligation.

2. Limited Partnership Advantages.
   a. Same as those of a general partnership.
   b. Dissociation of limited partner does not require dissolution avoidance vote under the statute.
   c. Partnership eligible for Virginia non-profit set aside for low-income housing credit.
d. Limited Partners are entitled to greater protection than LLC members under HUD Notice H95-66.

III. INCOME TAX CLASSIFICATION OF LLCs and LLPs

A. Classification Principles

1. I.R.C. §§ 761(a) and 7701(a)(2) provide that "partnership" includes an unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not a trust, estate or corporation.

2. (a) The pre-1997 regulations set forth the following major characteristics of a corporation:

   (i) associates,
   (ii) an objective to carry on business and divide the gains therefrom,
   (iii) continuity of life,
   (iv) centralization of management,
   (v) liability for corporate debts limited to corporate property, and
   (vi) free transferability of interests.


   (b) The first two characteristics were common to both partnerships and corporations and were disregarded. Treas. Reg. § 301.7701-2(a)(2) (pre-1997).

   (c) If an unincorporated organization lacked two of the remaining four characteristics, it would be classified as a partnership. Treas. Reg. § 301.7701-2(a)(3) (pre-1997). Equal weight was given to each characteristic. Rev. Rul. 93-5, 1993-1 C.B. 227.

B. Elective Partnership Classification

1. Effective January 1, 1997, IRS issued new classification regulations (generally referred to as "check-the-box" regulations) that repealed the then existing classification rules and provide that certain organizations will be classified as corporations automatically, and provide a simple elective regime for classifying other business organizations.
2. General Classification Rules:

a. Is there a separate entity for federal tax purposes? That is a matter of federal tax law and does not depend on whether it is reorganized as an entity under local law. Reg. § 301.7701-1(a)(1).

Certain joint ventures or other contractual arrangement may create separate entity for federal tax purposes if participants carry on a trade, business, financial operation, or venture and divide profits therefrom, regardless of state non-tax treatment. An LLC is generally treated as a separate entity for state non-tax purposes and the Virginia LLC Act expressly so provides. Reg. § 301.7701-1(a)(2).

b. If an organization is a separate entity for federal tax purposes, it will be either a trust or a business entity.

c. Trusts generally do not have associates or an objective to carry on a business for profit. Treas. Reg. § 301.7701-4.

Priv. Ltr. Rul. 9547004 (Aug. 9, 1995) held that proposed charitable remainder trust to be created with grandparents and grandchildren as grantors would be deemed to have associates and an objective to carry on business and divide the gains, and would not be classified as a trust.

d. An entity that is not classified as a trust or otherwise subject to special tax treatment under the Code is designated as a business entity. Treas. Reg. § 301.7701-2(a).

e. Eight specified business entities will automatically be classified as corporations. Treas. Reg. § 301.7701-2(b)(1)-(8).

f. Any other business entity may choose its classification. Treas. Reg. § 301.7701-3(a).

(i) A business entity with at least two members can be classified as either a partnership or an association.

(ii) A business entity with a single member can be classified as an association or may be disregarded as an entity separate from its owner.

3. Corporations
a. A corporation means any of eight specified categories of business entities. Treas. Reg. § 301.7701-2(b). They include:

(i) A business entity organized under a statute that describes or refers to the entity as incorporated or as a corporation, body corporate, or body public.

(ii) An association as determined under Treas. Reg. § 301.7701-3.

(iii) A business entity taxable as a corporation under a Code provision other than § 7701(a)(3).

(iv) Specified business entities formed in specified foreign jurisdictions. Treas. Reg. § 301.7701-2(b)(8).

4. Partnership

A business entity that is not a corporation and that has at least two members. Treas. Reg. § 301.7701-3(b)(1).

5. Disregarded entity

A business entity that is not a corporation and that has a single owner is disregarded as an entity separate from its owner. Treas. Reg. § 301.7701-3(b)(1).

6. Tax Classification of Noncorporate Entities

a. Eligible entity

(i) A business entity that is not classified as a corporation under the automatic rules may elect its federal tax classification. Treas. Reg. § 301.7701-3(a).

(a) An eligible entity with at least two members may elect to be classified either as an association (and thus, a corporation) or a partnership. Treas. Reg. § 301.7701-3(a).

(b) An eligible entity with a single member may elect to be classified as an association or to be disregarded as an
entity separate from its owner. Treas. Reg. § 301.7701-3(a).

7. Procedure for classification

a. There is a default classification for an eligible entity that does not make an election. Thus, elections are necessary only when an eligible entity chooses to be classified initially as other than the default classification or when an eligible entity chooses to change its classification. Treas. Reg. § 301.7701-3(a).

b. Unless otherwise elected, a domestic eligible entity is:

(i) a partnership if it has two or more members; or

(ii) disregarded as an entity separate from its owner if it has a single owner.

Treas. Reg. § 301.7701-3(b)(1).

c. Unless otherwise elected, a foreign eligible entity is:

(i) a partnership if it has two or more members and any member has unlimited liability;

(ii) an association if no member has unlimited liability; or

(iii) disregarded as an entity separate from its owner if it has a single owner that has unlimited liability.

Treas. Reg. § 301.7701-3(b)(2).

C. Characterization of Elective Changes in Classification

The Internal Revenue Service issued proposed regulations on October 27, 1997 describing how elective changes in classification will be treated for federal tax purposes.

1. Changes in Classification Under the Check-the-Box Regulations

a. Elective Changes

(i) Partnership elects to be an association.
(ii) Association elects to be a partnership.
(iii) Association elects to be a disregarded entity.
(iv) Disregarded entity elects to be an association.

b. Change in Number of Members

(i) Partnership converts to a disregarded entity.
(ii) Disregarded entity converts to partnership.

2. Partnership to Association

If a partnership elects to be classified as an association, the following is deemed to occur:

The partnership contributes all of its assets and liabilities to the association in exchange for shares in the association and immediately thereafter, the partnership liquidates by distributing the shares of the association to its partners. Prop. Reg. § 301.7701-3(g)(1)(i).

Proposed regulations do not affect the holdings in Rev. Rul. 84-111, which held that IRS will respect the particular form selected by the taxpayers when a partnership converts to a corporation. See Explanation of Provisions.

3. Association to Partnership

The association is deemed to distribute all of its assets and liabilities to its shareholders in liquidation of the association and, immediately thereafter, the shareholders contribute all of the distributed assets and liabilities to a newly formed partnership. Prop. Reg. § 301.7701-3(g)(1)(ii).


4. Association to Disregarded Entity.

The association is deemed to distribute all of its assets and liabilities to its single owner in liquidation of the association. Prop. Reg. § 301.7701-3(g)(1)(iii).

5. Disregarded Entity to Association.

The owner of the eligible entity is deemed to contribute all of the assets and liabilities of the entity to the association in exchange for shares of the association. Prop. Reg. § 301.7701-3(g)(1)(iv).
6. Change in Number of Members of Entity.
   a. Association classification of an eligible entity as an association is not
      affected by any change in the number of members. Prop. Reg. § 301.7701-3(f)(1).
   b. Partnership. Eligible entity classified as a partnership is disregarded as an
      entity separate from its owner as of the date the entity has only one 
   c. Single Member entity. Single member entity disregarded as an entity
      separate from its owner is classified as a partnership as of the date the
      entity has more than one member. Prop. Reg. 301.7701-3(f)(2).

7. Identify numbers for entities.
   a. Entity that has an employer identification number (EIN) retains that EIN
   b. Disregarded Entities.
      (i) Separate entity becomes a disregarded entity.
      A single owner entity that is disregarded uses the owner’s taxpayer 
      (ii) Disregarded entity becomes a separate entity.
      If the disregarded entity did not already have its own EIN, then the 
      separate entity must acquire an EIN and not use the number of the single 

D. Disregarded Entity - Single Member LLC
   2. No separate income tax return.
   3. If owner of the single member LLC is an eligible S corporation shareholder, 
      then ownership of shares by the LLC does not terminate the S corporation 
      status.
IV. VIRGINIA PROVISIONS INSPIRED BY THE CHECK-THE-BOX REGULATIONS

A. Single Member LLC

1. The two member minimum requirement has been eliminated from the definition of LLC. Va. Code § 13.1-1002 (effective July 1, 1996).


B. Elimination of Limited Duration Provision

Deleted provision in definition of LLC that it is an entity without perpetual duration (Va. Code § 13.1-1002.) and requirement that articles of organization set forth the latest date on which the LLC is to be dissolved (Va. Code § 13.1-1011.A.4 deleted).

C. Withdrawal from the LLC

A member may resign only to the extent provided for in writing in the Articles or Agreement. Va. Code § 13.1-1032. Va. Code § 13.1-1033, which permitted a member to require that his interest be redeemed, has been repealed.


D. Right of Assignee to Become a Member

Except as otherwise provided in writing in the Articles or Agreement, assignee may become a member only by consent of a majority of the member-managers (other than assignor member) of a manager-managed LLC of which one or more members is a manager, or by a majority vote of the members (other than the assignor member) of any other LLC. Va. Code § 13.1-1040.A.
E. **Member Dissociation as a Default Dissolution Event**

Default dissolution avoidance vote changed from majority in interest of the remaining members to a majority vote of the remaining member managers of a manager-managed LLC of which one or more members is a manager or by a majority vote of the remaining members of any other LLC. Va. Code § 13.1-1046.3.

Compare Va. Code § 50-73.49.3, which provides that upon an event of withdrawal of a general partner of a limited partnership when there is no remaining general partner, the partnership is dissolved unless all parties agree to continue. Under VRULPA, the unanimous consent requirement under those circumstances may not be varied by agreement.

V. **VIRGINIA REVISED UNIFORM PARTNERSHIP ACT (“VRUPA”)**

A. **LLPs.**

2. Eliminates requirement for annual renewal.
3. Eliminates insurance requirement.

B. Clarifies fiduciary duties and authority for partners to vary the rules by agreement. Va. Code §§ 50-73.102 and 50-73.81.B.


D. Revises rules on partnership dissolution to permit partners to avoid dissolution by agreement. Va. Code § 50-73.81.A.

E. VRUPA effective for partnerships formed after July 1, 1997, and for existing partnerships on July 1, 2000 unless partners elect earlier effective date. Va. Code § 50-73.147.2.

An existing partnership may elect by amendment to its agreement. However, to limit liability to third party who had done business with the partnership within one year preceding the election, the third party must know or have received notification of the election. Va. Code § 50-73.147.C.

**NOTE:** In order to become a full protection LLP under the new statute, it will be necessary to file a statement of registration under Va. Code § 50-73.132.A even if
registration under the present act is still effective. Does filing statement of registration under § 50-73.132.A meet the creditor notification requirement of the transition rule?

VI. APPLICATION OF PARTNERSHIP TAX PRINCIPLES

A. Organization

1. General rule: No gain or loss recognized to LLC or any member on the contribution of property to the LLC in exchange for an interest in the LLC. I.R.C. § 721(a).

Contribution of installment note to a partnership is not a taxable disposition under IRC § 453 B, but a transfer, including a gift, of the partnership interest, may be a disposition. See 2 McKee, et al. ¶ 15.08[1]; Rev. Rul. 60-352, 1960-2 C.B. 208.

2. Exceptions:

3. Basis of property contributed to LLC by a member equals the adjusted basis of such property to the contributing member. I.R.C. § 723.

4. Basis of member’s interest in LLC
   a. Member’s basis in his LLC interest is the amount of money and adjusted basis of property contributed. I.R.C. §§ 705, 722. For that purpose an increase in the member’s share of liabilities of the LLC is treated as a contribution of money and a decrease in the member’s share is treated as a distribution of money. I.R.C. §§ 752(a) and (b).
   b. A member’s share of LLC liabilities is determined under the Section 752 regulations, with different rules applicable to recourse liabilities and nonrecourse liabilities.
   c. Recourse liability. A member or related person bears the "economic risk of loss" for that liability. Treas. Reg. § 1.752-1(a)(1).
d. Nonrecourse liability. No member or related person bears the economic risk of loss for that liability. Treas. Reg. § 1.752-1(a)(2).

e. As in the case of the allocation rules, absent a member guarantee, all LLC debt should be treated as nonrecourse debt.

B. Conversion

1. Partnership to LLC

a. Rev. Rul. 84-52, 1984-1 C.B. 157 prescribed federal income tax consequences of conversion of general partnership into limited partnership and limited partnership into general partnership.

   (i) Exchange of interest in general partnership for interest in limited partnership will be treated as an exchange under I.R.C. Section 721, so that no gain or loss will be recognized by partners under §§ 741 or 1001 except under Section 731.

   (ii) If business of converted entity will continue after the conversion, then because under Treas. Regs. § 1.708-1(b)(1)(ii) a transaction governed by I.R.C. Section 721 is not a sale or exchange under I.R.C. Section 708, the converted entity is not terminated.

Therefore, it should not be necessary to obtain a new tax identification number for the LLC, to remake various elections under subchapter K, or file a short year tax return.

Priv. Ltr. Rul. 9422035 (March 3, 1994) held that since the LLC conversion did not result in a Section 708 termination, the LLC was required to continue to use the partnership’s May 31 taxable year unless it received permission to change.

Priv. Ltr. Rul. 9501033 (Oct. 5, 1994) (taxable year does not close with respect to all partners or any partner).

   (iii) If there is no change in partners’ shares of liabilities under I.R.C. Section 752, there will be no change to the adjusted basis of their interests in the entity.
(iv) If there is a change in the partners' shares of liabilities and the change causes a deemed contribution of money or a deemed distribution of money, basis will be adjusted and gain may be recognized under I.R.C. Section 731.

Since persons who were general partners will remain liable for obligations of the converted partnership, there should be no change in their share of the liabilities solely as a result of the conversion. Cf. Weiss v. Commissioner, 956 F.2d 242 (11th Cir. 1992). As the partnership liabilities are satisfied and new obligations incurred, there may be a change.

(v) No change in the holding period of any partner's interest in the entity.

b. Rev. Rul. 84-52 applied to partnership to LLC conversions


d. Alternative forms of nonstatutory conversions

(i) Partners contribute their partnership interests to LLC in exchange for interests in LLC; partnership dissolves because only one partner remains and distributes its assets to the LLC. Priv. Ltr. Rul. 9226035; Priv. Ltr. Rul. 9333032.

(ii) Partnership contributes its assets to LLC in exchange for LLC membership interests; the partnership then distributes LLC interests to its partners in liquidation. E.g., Priv. Ltr. Rul. 9321047 (Feb. 25, 1993) (Pursuant to assignment and assumption agreement partnership contributes its assets to LLC in exchange for membership interests and assumption of partnership's liabilities.)

confirmed private letter rulings and held that tax consequences described in Rev. Rul. 84-52 apply to conversion of domestic partnership into domestic LLC classified as a partnership: whether resulting LLC is formed in same or different state from converting partnership; and regardless of manner in which conversion is achieved under local law. See Priv. Ltr. Rul. 9633021 (May 15, 1996) (nonstatutory conversion).

conversion is not a sale, exchange or liquidation of converting partner's entire interest for purposes of IRC § 706(c)(2)(A), and therefore, will not cause taxable year of partnership to close with respect to all partners or with respect to any partner.

confirmed that no new tax ID number is required.

2. Corporation to LLC

a. C corporation

Will be treated as a transfer by the corporation of its assets to the LLC in exchange for an interest in the LLC followed by a distribution of the LLC interest to the corporation's shareholders in complete liquidation of the corporation. Priv. Ltr. Rul. 9409014 (Nov. 29, 1993). The shareholder of the deemed liquidated corporation was itself a corporation so that the distribution was tax-free to the shareholder under I.R.C. Section 332 and to the distributing corporation as well.

In a transaction that does not come within Section 332:

(i) Gain or loss recognized to corporation on distribution of property as if property were sold to distributee at fair market value. I.R.C. § 336(a).

On conversion of professional corporation to professional LLC, there may be a deemed distribution of "practice goodwill," as distinguished from "professional or personal goodwill," Christhart S. Schilbach v. Commissioner, 62 T.C.M. (CCH) 1201 (1991).

(ii) Gain or loss recognized to shareholders. I.R.C. § 331.
b. **S corporation**

(i) Corporate tax imposed on net recognized built-in gain. I.R.C. § 1374(a).

(ii) Gain or loss recognized to corporation on distribution of property as if property were sold to distributee at market value. I.R.C. § 336(a).

(iii) Gain or loss recognized to shareholders. I.R.C. § 331. However, gain under I.R.C. Section 336 that passed through to the shareholders increases basis in shares. I.R.C. § 1367(a).

c. **Conversion by "statutory merger" of corporation into LLC**

I.R.C. § 368(a)(1) is not applicable. "Party to a reorganization" includes only corporations. I.R.C. § 368(b).

C. **Pass-through Rules**

1. LLC is not subject to tax. I.R.C. § 701

2. Members are liable for income tax in their individual capacities, each taking into account his distributive share of partnership items. I.R.C. §§ 701, 702(a).

3. Loss allowed only to extent of adjusted basis of partner's interest in the partnership. I.R.C. § 704(d).

D. **Allocations**

1. Under the I.R.C. § 704(b) regulations, generally allocations of income, gain, loss, deduction, or credit (or item thereof) will be respected if the allocation has substantial economic effect taking into account all facts and circumstances, is in accordance with the partner's interest in the partnership, or is deemed to be in accordance with the partner's interest in the partnership pursuant to one of the special rules. Treas. Reg. § 1.704-1(b)(1)(i).

2. An allocation of an item of loss, deduction, or Section 705(a)(2)(B) expenditure attributable to nonrecourse liabilities ("nonrecourse deductions") of the partnership cannot have economic effect and must be allocated in
accordance with the partners' interest in the partnership. Treas. Reg. § 1.704-2(b)(1).

3. Regulations provide a test under which certain allocations of nonrecourse deductions will be deemed to be in accordance with the partners' interest in the partnership. Treas. Reg. § 1.704-2(e).

4. Nonrecourse liability of a partnership is a liability of the partnership (or portion thereof) for which no partner bears the economic risk of loss. Reg. §§ 1.704-2(d)(3), 1.752-1(a)(2).

5. Absent a guarantee by a member of an LLC obligation, or a member or related member as lender, all debt of the LLC should be treated as nonrecourse debt because no member will bear the economic risk of loss with respect to the debt. That should include debt to which the general assets of the LLC are liable, such as trade debt, which is not ordinarily thought of as nonrecourse.

Debt that is recourse to a partnership as an entity but "explicitly not recourse to any partner" is referred to as "exculpatory liability." See preamble, Section V.A to the nonrecourse debt regulations, Treas. Reg. § 1.704-2.

The preamble points out that the application of the nonrecourse debt rules, specifically the calculation of minimum gain, may be difficult in the case of exculpatory liability because the liability is not secured by specific property and the basis of the assets that can be reached by the creditor may fluctuate greatly. The regulations do not prescribe precise rules addressing the allocation of income and loss attributable to those liabilities, and they leave the taxpayer to treat allocations attributable to those liabilities in a manner that reasonably reflects the principles of I.R.C. Section 704(b).


E. At Risk Rules


1. Generally, under I.R.C. Section 465 in the case of individuals and certain closely held C corporations, a loss from activity subject to the section is allocable only to the extent of the aggregate amount with respect to which the taxpayer is at risk. I.R.C. § 465(a)(1).
2. Except in the case of "qualified nonrecourse financing," a taxpayer is at risk with respect to amounts borrowed for use in an activity only to the extent that he is personally liable for repayment of such amounts, or has pledged property as security for the debt. I.R.C. § 465(b)(2).

3. If a taxpayer guarantees repayment of an amount borrowed by another person for use in an activity, the guarantee does not increase the taxpayer's amount at risk. Even if the guarantor pays the debt, the amount at risk is not increased until the taxpayer has no remaining legal rights against the primary obligor. Prop. Treas. Reg. § 1.465-6(d).

4. Exception for qualified nonrecourse financing
   a. A taxpayer is considered at risk with respect to his share of any qualified nonrecourse financing that is secured by real property used in the activity. I.R.C. § 465(b)(6).
   b. Qualified nonrecourse financing is debt with respect to which no person is personally liable for repayment. I.R.C. § 465(b)(6)(B)(iii).

If the Section 752 definition of nonrecourse applies, since recourse liability exists only to the extent that any partner or related person bears the economic risk of loss, then debt secured by LLC real property that is not restricted to the security would be qualified nonrecourse financing. However, the at-risk rule, in addition to referring to the Section 752 test to determine a partner's share of qualified nonrecourse financing, describes it as financing with respect to which "no person" (not merely no member or related person) is personally liable for repayment. I.R.C. § 465(b)(6)(B)(iii).

Personal liability of an entity classified as a partnership for repayment of a financing shall be disregarded in determining whether the financing is qualified nonrecourse financing, if the only assets of the partnership are either real property used in the activity of holding real property or both such real property and other property that is incidental to the activity of holding such real property, and no other person is liable for repayment of the financing. Prop. Reg. § 1.465-27(b)(3).

Limited guarantee of members that would protect lender upon fraud or violations of the loan documents will not preclude loan from being

c. A partner's share of qualified nonrecourse financing is determined on the basis of that partner's share of partnership liabilities increased in connection with the financing within the meaning of Section 752. I.R.C. § 465(b)(6)(C).

F. Limitations on Passive Activity Losses

1. Section 469 disallows a deduction for the passive activity loss of an individual, trust, estate, personal service corporation, and closely held C corporation. I.R.C. § 469(a)(1)(A).


3. Passive activity means any rental activity and any activity that involves the conduct of any trade or business and in which the taxpayer does not materially participate. I.R.C. § 469(c)(1).

4. A natural person may deduct up to $25,000 of passive activity losses attributable to all real estate activities with respect to which that individual actively participated during the year. I.R.C. § 469(i)(1), (2).

5. Material participation

Generally an individual is treated as materially participating in an activity for a taxable year if he meets one of seven tests: Temp. Treas. Reg. § 1.469-5T(a) (1993).

(i) The individual participates for more than 500 hours;

(ii) The individual's participation constitutes substantially all of the participation of all individuals;

(iii) The individual participates for more than 100 hours, and that participation is not less than that of any other individual;
(iv) The activity is a significant participation activity and the individual's aggregate participation in all significant participation activities exceeds 500 hours;

(v) The individual materially participated for any 5 taxable years during the 10 immediately preceding taxable years;

(vi) The activity is a personal service activity and the individual materially participated for any 3 preceding taxable years; or

(vii) Based on all facts and circumstances, the individual participates on a regular, continuous and substantial basis.

6. Limited partner material participation

a. A limited partner is deemed to materially participate only by qualifying under tests (1), (5) or (6). Temp. Treas. Reg. § 1.469-5T(e)(2) (1993). By contrast an S corporation shareholder may satisfy any of the 7 tests.

b. "Limited partner" is an individual whose liability for obligations of the partnership is limited, under the law of the state in which the partnership is organized, to a determinable fixed amount, such as capital contributions and contractual obligations to make additional capital contributions. Temp. Treas. Reg. § 1.469-5T(e)(3)(B) (1993).

c. A membership interest falls within the definition of a limited partnership interest.

Commentators have argued that manager-members should not be treated as limited partners for purposes of the material participation tests. Jordan and Kloepfer, The Limited Liability Company: Beyond Classification, 69 Taxes 203, 210 (1991).

A partnership interest is not treated as a limited partnership interest if the individual holder is a general partner at all times during the year. Temp. Treas. Reg. § 1.469-5T(e)(3)(B)(ii) (1993). In the absence of a definition of "general partner" in the Section 469 regulations, they look to the definition under Rev. Proc. 89-12, which states that for organizations other than partnerships "general partner" will mean the members "with significant management authority relative to the other members." If that definition applied, then the interests of member-managers would not be treated as limited partners.
While the argument in favor of such a position by IRS is reasonable, it would seem to require an amendment of the regulations to reach that result. IRS has stated that an LLC member will be treated as a limited partner under the material participation regulations. 1996 Partner's Instructions for Schedule K-1 (Form 1065, p.2); Priv. Ltr. Rul. 9452025 (Oct. 5, 1994). Under the activity regulations an LLC member who does not actively participate in the management of the LLC's business is denominated as a limited entrepreneur rather than a limited partner. Treas. Reg. § 1.469-4(d)(3)(ii), Exp. (iii).

7. Limited Partner active participation

Except as provided in regulations, no interest as a limited partner in a limited partnership shall be treated as an interest in which the taxpayer actively participates. I.R.C. § 469(i)(6)(C). The IRS has not so provided in the regulations.

G. Tax Matters Partner

1. Only a general partner may be designated by the partners as the "tax matters partner" for purposes of partnership audits. I.R.C. § 6231(a)(7).

2. If there is no general partner, the IRS is authorized to designate the tax matters partner. I.R.C. § 6231(a)(7).

3. The Code does not define a general partner. If the term were deemed to mean a partner with personal liability for the organization's liabilities, then in an LLC there would be no one whom the partners may designate.

4. Regulations address circumstances under which an LLC member will be treated as a "general partner" under the TMP Rules Reg. § 301.6231(a)(7)-2.

   a. Only a member-manager of an LLC will be treated as a general partner. Treas. Reg. § 301.6231(a)(7)-2(a).

   b. "Member-manager" is a member who, alone or with others, is vested with continuing exclusive authority to make the management decisions necessary to conduct the business for which the organization is formed. Treas. Reg. § 301.6231(a)(7)-2(b)(3).

   c. If there is no designated or elected member-manager as so defined, each member will be treated as a member-manager. Treas. Reg. § 301.6231(a)(7)-2(b)(3).
H. **Method of Accounting**

1. Generally, a taxpayer may compute taxable income under any specified "permissible methods" of accounting, including cash or accrual. I.R.C. § 446(c).

2. However, a "tax shelter" may not use the cash method. I.R.C. § 448(a)(3).

3. I.R.C. Section 448(d)(3) refers to Section 461(i)(3) for the definition of "tax shelter," which means:
   
   a. an enterprise (other than a C corporation) if at any time interests have been offered for sale in an "offer required to be registered" with any federal or state agency;
   
   b. any "syndicate" (within the meaning of Section 1256(e)(3)(B)); and
   
   c. any "tax shelter" (as defined in Section 6662(d)(2)(C)(ii)).

4. "Enterprise"
   
   a. Registration requirement

   Offering is "required to be registered" if, under applicable federal or state law, failure to file a notice of exemption from registration would result in violation of applicable federal or state law, regardless of whether notice is in fact filed. Temp. Treas. Reg. § 1.448-1T(b)(2) (1993).

   Virginia exempts from registration any sale of securities by issuer or registered broker-dealer on behalf of the issuer, if, after the sale, the issuer has not more than 35 security holders and if its securities have not been offered to the general public by advertisement or solicitation. Va. Code § 13.1-514.B.7. 1995 amendment added an exception from the definition of "security" for interests in a professional practice. Va. Code § 13.1-514.B.17 (effective July 1, 1995). If there are more than 35 holders, then it depends on whether LLC membership interest is a "security," that is, is it an "investment contract" under the Howey facts and circumstances test?

   b. In Priv. Ltr. Rul. 9321047, a law firm LLC represented that it had not ever and would not ever offer any interest in itself for sale to the general public. Based on that representation, the LLC was held not to be an enterprise. See also Priv. Ltr. Rul. 9328005 (Dec. 21, 1993).
5. "Syndicate" means any partnership or other entity other than a C corporation if more than 35% of the losses of the entity during the taxable year are allocable to limited partners or limited entrepreneurs (as defined in I.R.C. Section 464(e)(2)). I.R.C. § 1256 (e)(3)(B).

a. Losses allocable:

(i) Losses. "Losses" - means the excess of the deductions allocable to the enterprise over the amount of income recognized by the enterprise under its tax method of accounting, excluding gains or losses from the sale of capital assets or Section 1221(2) assets. Temp. Treas. Reg. § 1.448-1T(a)(4) (1993).

(ii) "Allocable" - Regulations use "allocated" rather than "allocable." Temp. Treas. Reg. § 1.448-1T(a)(4). Consequently, in a year in which an LLC has no "losses," it should not be a syndicate regardless of how allocable.

Cf. Priv. Ltr. Rul. 8911011 (Dec. 14, 1988), held that with respect to profit years, a limited partnership will not be a "syndicate" within I.R.C. Section 1256(e)(3)(B) because "there will be no losses allocable to partners" whether limited or otherwise.

Priv. Ltr. Rul. 9321047 used "allocated" rather than "allocable" in paraphrase of the statute, but made no ruling on that point. Also Priv. Ltr. Rul. 9328005.

Priv. Ltr. Rul. 9415005 (June 10, 1994) adopted that interpretation and held in the case of a law firm that had consistently reported taxable income rather than loss, that the firm would not be a syndicate for any year in which it does not incur losses. Significant ruling for LLC that cannot meet the active participation requirement to be described next.

b. Classification of members to whom losses allocable

An interest in any entity is not treated as held by a limited partner or a limited entrepreneur in five situations, including any period during which the interest is held by an individual who actively participates at all times during the period in the management of the entity or if the interest is held by an individual who actively participated in the management of the entity for a period of not less than five years.
However, note that the interests must be held by an individual. That could create a problem for a professional LLC converted from partnership including professional corporations. I.R.C. § 1256(e)(3)(C)(i), (iii).

In Priv. Ltr. Rul. 9321047 (Feb. 25, 1993), although the agreement provided for members to elect five managers as the management committee with authority to conduct business for the firm, it further provided that all members would be required to vote in order for the firm to take certain actions, including the following: election of members to the management committee and compensation committee; removal of a member from either committee; admission of a member or provisional member; dismissal of a member; amendment of the agreement; dissolution of the firm; major decisions; and approval of compensation committee recommendations subject to prescribed procedures.

Based on the representation that the members would continue to engage in the practice of law and participate in the various described management activities, it was held that the LLC will meet the active participation requirements.

In Priv. Ltr. Rul. 9328005 (Dec. 21, 1993), an executive committee will manage the LLC, but vote of all members is required for the LLC to take certain actions: admit or expel a member; determine compensation of members; make expenditures in excess of a specified amount; borrow funds in excess of a specified amount; open or close a branch office; change the name of the LLC or the location of its principal office; sell or otherwise dispose of all or substantially all of the assets of the LLC; dissolve the LLC; amend the agreement under which the LLC is operated.

In addition, "each member will, in varying degrees, participate in the following management activities attributable to the Business": handling client relations; supervising services provided to clients; billing, collecting, and negotiating fees; participating in business and practice development activities; staffing projects, including the selection and use of specialists; and supervising, training, and evaluating LLC employees.

Participation in the "various management activities set forth above" was held to constitute active participation.

In Priv. Ltr. Rul. 9421025 (Feb. 24, 1994), the Service ruled favorably on the basis of less extensive participation and included non-equity members who had no vote.

See also Priv. Ltr. Rul. 9501033 (Oct. 5, 1994).
Therefore, an LLC will not be a "syndicate" if either it has no losses, so that there are none to be allocated, or at least 65% of any losses are allocated to persons who actively participate in management and are consequently not limited partners or limited entrepreneurs.

6. Tax shelter within I.R.C. Section 6662(d)(2) (C)(ii). Any arrangement whose principal purpose is the avoidance or evasion of federal income tax.

In Priv. Ltr. Rul. 9321047 (Feb. 25, 1993), based on representation that members will participate in management, will be organized to practice law, and will not be organized for any federal income tax avoidance motive, the LLC was held not to be a tax shelter. Also Priv. Ltr. Rul. 9328005.

7. Cash method is also not available for a partnership that has a C corporation as a partner. I.R.C. § 448(a)(1). However, for purposes of that rule, a qualified personal service corporation is treated as an individual, not a C corporation.

That exception is important to a professional partnership, including C corporations, that converts to an LLC.

I. Self-Employment Tax and Social Security Earnings

1. Self-employment income of every individual, is subject, in addition to income tax, to a tax for old age, survivors and disability insurance, and for hospital insurance. IRC § 1401.

The OASDI tax is 12.40% on the earnings of the Social Security "contributions and benefits" base. IRC §§ 1401(a); 1402(b)(1). The hospital tax is at 2.9% on the entire amount. IRC § 1401(b). One-half of the tax is deductible. I.R.C. § 164(f)(1).

Self-employment income is an individual's "net earnings from self-employment income (NESE)" subject to certain exclusions. IRC § 1402(b).

NESE includes an individual's distributive share whether or not distributed of income or loss from any trade or business carried on by a partnership of which he is a member with certain adjustments. IRC § 1402(a).

2. Significant exclusions include:

   a. Rentals from real estate and personal property leased with real estate; § 1402(a)(1), dividends; § 1402(a)(2), interest; § 1402(a)(2), gain or
loss on capital assets; § 1402(a)(3)(A), other property that is neither inventory-type property held for sale to customers in the ordinary course of business. § 1402(a)(3)(C). Significant types of income from real estate are not excluded by type, such as hotel operations, sale of condominium units, and house and lot sales.

b. Certain income that is not within the specific exclusions by source may be excluded based on the status of the investor.

Distributive share of any item of income or loss of a limited partner, as such, other than guaranteed payments for services is excluded from "net earnings from self-employment." I.R.C. § 1402(a)(13).

Parallel statutory scheme in the Social Security Act in the calculation of excess earnings that reduce monthly benefits. NESE under that act similarly includes a partner's distributive share other than that of a limited partner. 42 U.S.C. § 411(a)(12).

3. Under what circumstances will an LLC member be treated as a limited partner for purpose of the exclusion?


a. Individual owner of an entity classified as a partnership for federal tax purposes will be treated as a limited partner unless the individual:

(i) Has personal liability for the debts of or claims against the partnership by reason of being a partner;

(ii) Has authority to contract on behalf of the partnership under the statute or law pursuant to which the organization is formed; or

(iii) Participates in the partnership’s trade or business for more than 500 hours during the partnership’s taxable year. Prop. Reg. § 1.1402(a)-2(h)(2).
Even if an individual does not fall within any of those three tests, if substantially all of the activities of the partnership involve the performance of services in any of seven specified fields of personal service, any individual who provides more than a de minimus amount of services as part of that trade or business will not be considered a limited partner. Prop. Reg. § 1.1402(a)-2(h)(5).

Fields that result in per se exclusion from the limited partner exemption: health, law, engineering, architecture, accounting, actuarial science, or consulting. Prop. Reg. § 1.1402(a)-2(h)(6)(iii).

b. Bifurcation of Interest

If an individual is both a limited partner and general partner in the same partnership, the distributive share received as a general partner is treated as self-employment income while that attributable to the limited partnership interest is not. H.R. Rep. No. 95-702, 91st Cong., 1st Sess. Pt. 1 at 40 (1977); Reprinted in 1978-1 C.B. 469, 477.

Unlike the 1994 proposed regulations, the 1997 proposed regulations extended to LLC members the bifurcation rule. The objective was to permit an individual to exclude from net earnings from self-employment amounts that were returns on invested capital.

An individual holding more than one class of interest in an LLC was treated as a limited partner under the three test provisions is treated as limited partner with respect to a specified second class of LLC interest held by that individual if persons who are limited partners under the three test provisions own a substantial, continuing interest in that specific class of membership interest and that individual’s rights and obligations with respect to that specific class are identical to those of the individuals who are treated as limited partners. Prop. Reg. § 1.1402(a)-2(h)(3) and (b)-2(h)(6)(i).

“Substantial interest” in a class is based on the facts and circumstances, but in all cases ownership of at least a 20% interest of a specific class is considered substantial. Prop. Reg. § 1.1402(a)-2(h)(6)(iv).

Even if an individual owns only one class of interest and participates in the partnership’s trade or business for more than 500 hours, that individual will be treated as a limited partner if limited partners under the three test provision own a substantial, continuing interest in that same class and that
individual's rights and obligations with respect to that specific class are the same as theirs. Prop. Reg. § 1.1402(a)-2(h).


J. Qualified Retirement Plans

For purposes of qualified retirement plans under I.R.C. Section 401, "employee" includes "self-employed individual." I.R.C. § 401(c)(1)(A). "Self-employed individual" means an individual who has "earned income." I.R.C. § 401(c)(1)(B). "Earned income" means net earnings from self-employment (as defined in Section 1126 and Section 1402(a). I.R.C. § 401(c)(2)(A). Deduction for contributions for self-employed individuals is based upon earned income. I.R.C. § 404(a)(8). Thus, if an LLC member is treated as a limited partner for purposes of Section 1402(a)(13), his distributive share that is not guaranteed payments could not be taken into account for purposes of calculating retirement plan contributions.

K. Liquidation Payments

Before the 1993 tax act, payments made in liquidation of the interest of a retiring partner or deceased partner attributable to good will and unrealized receivables could be treated as a distributive share or guaranteed payment that could give rise to a deduction or its equivalent. That special treatment has been repealed except with respect to payments made to a general partner in a partnership in which capital is not a material income-producing factor. I.R.C. § 736(b)(3). The House Committee report makes clear that the special rule was intended to preserve the prior law treatment for personal service businesses. However, in order to benefit personal service LLCs, the retiring or deceased member would have to be treated as a "general partner." I.R.C. § 736(b)(3)(B). "General partner" is not defined, so it is an open question as to whether an LLC member will be included.

VII. STATE TAXATION

A. Income Taxation

1. Under the Virginia conformity statute an LLC that is classified as a partnership for federal income tax purposes should be similarly treated for Virginia income tax purposes. Va. Code § 58.1-301.A. Confirmed by P.D. 92-181 (9/10/92).
2. Partners are liable for Virginia income tax only in their separate or individual capacities. Va. Code § 58.1-390.

   b. LLC that elects to be disregarded as a separate entity for federal income tax purposes is not required to file a Virginia income tax return. P.D. 97-343 (8/28/97).

4. Permission granted for foreign LLC, all of whose members are nonresident individuals, to file a unified nonresident individual income tax return on behalf of the members. P.D. 97-335 (8/27/97).

B. Real Estate Transfer Taxes

1. Transfers to and from 50% owned LLCs are exempt from recordation tax as in the case of partnerships. Va. Code § 58.1-811.A.10 and .11.


C. Retail Sales and Use Tax