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Choice of Entity - Tax Issues

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CURRENT DEVELOPMENTS

CHOICE OF ENTITY - TAX ISSUES

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I. Tax Classification

A. Limited Liability Companies

1. IRS Ruling Guidelines Regarding LLC Classification

a. Revenue Procedure 95-10. On December 29, 1994, the IRS issued a revenue procedure to define the guidelines under which it will issue a ruling that an LLC lacks at least two corporate characteristics and, therefore, will be classified as a partnership and not as an association taxable as a corporation. The guidelines also apply to an organization formed under non-U.S. laws if such laws provide for limited liability of the organization's members. See Rev. Proc. 95-10, 1995-3 I.R.B. 20.

b. Revenue Procedure 89-12. The IRS will continue to apply the guidelines under Revenue Procedure 89-12 to evaluate classification rulings of partnerships and domestic organizations other than LLCs. Rev. Proc. 95-10, § 1.02.

c. Single Member LLCs. Revenue Procedure 95-10 specifically provides that the ruling guidance applies only to LLCs with at least two members. Notice 95-14 (the "check the box" classification proposal) requests comments on the proper tax treatment of unincorporated organizations with a single member.

2. Analysis of Corporate Characteristics under Revenue Procedure 95-10

a. Continuity of Life.

(1) Generally. The "Kintner" Regulations provide that an organization lacks continuity of life if "the death, insanity, bankruptcy, retirement, resignation, or expulsion of any member" causes a dissolution of the organization. Reg. § 301.7701-2(b)(1). A limited partnership formed under a state statute that conforms to ULPA will be treated as lacking continuity. Reg. § 301.7701-2(b)(3). Under a statute conforming to ULPA, the death, insanity, bankruptcy, retirement, resignation, expulsion, or other event of withdrawal of a general partner of a limited partnership causes a dissolution of the partnership, unless (i) the remaining general partner(s), or (ii) at least a "majority-in-interest of the remaining partners" vote to continue the business of the partnership. This type of contingent continuity does not constitute the corporate characteristic of continuity of life.

(2) Continuity of Life of an LLC.

(i) If an LLC is managed by one or more designated or elected members, the LLC lacks continuity of life if the death, insanity, bankruptcy, retirement, resignation, or expulsion of any member-manager causes a dissolution of the LLC without further action of the members, unless the LLC is continued by the consent of not less than a majority-in-interest of the remaining members. Rev. Proc. 95-10 § 5.01(1).

(ii) If an LLC is managed by its members, the LLC lacks continuity if the enumerated dissolution events of any member causes a dissolution of the LLC, unless the LLC is continued by the consent of not less than a majority in interest of the remaining members. Id. at § 5.01(2).

(iii) If the LLC has non-member managers, the LLC is not required to be dissolved upon the occurrence of a dissolution event to those managers. Further, if an LLC is managed solely by non-member managers, continuity is absent only if the dissolution events apply to all members.

(iv) Revenue Procedure 94-46 controls the determination regarding what constitutes a "majority-in-interest" under

Revenue Procedure 95-10. Id. at § 5.01(3). Under Revenue Procedure 94-46, a majority-in-interest is a majority of both capital and profits.

(v) If the dissolution of an LLC occurs upon the happening of some but less than all of the dissolution events under state law or the operating agreement, then the IRS will not rule on continuity of life unless the events that do result in dissolution "provide a meaningful possibility of dissolution". Id. at § 5.01(4). The regulations specifically use "or" in listing the dissolution events. See Reg. § 301.7701-1(b)(1). Also, the courts and the IRS have indicated that no all of the specified dissolution events must trigger a dissolution to avoid the continuity characteristic. See e.g., Larson v. Comm'r, 66 T.C. 159 (1976), acq. 1979-1 C.B. 1; Rev. Rul. 93-4, 1993-1 C.B. 225. Therefore, an LLC may lack continuity even though only one of the specified events cause a dissolution. That one event, however, must provide a meaningful possibility of dissolution. For example, dissolution of an LLC only upon the death of any member would not provide a meaningful possibility of dissolution if all of the members were corporations.

b. Free Transferability

(1) Generally. Under the regulations, an organization has free transferability of interests if "each of its members or those members owning substantially all of the interests in the organization have the power, without the consent of the other members, to substitute for themselves in the same organization a person who is not a member." Reg. § 301.7701-2(e)(1). A right to assign an interest to a transferee without the power to substitute the transferee as a member of the organization does not constitute free transferability. Id. at § 301.7701-3(b)(2), Ex. 1. An assignee of a partnership interest may be treated as a partner for tax purposes even though the assignee has not been admitted as a substitute partner. Rev. Rul. 77-137, 1977-1 C.B. 178.

(2) Free Transferability of Interests of an LLC.

(i) The IRS will rule that a manager-managed LLC lacks free transferability if each member, or those members owning in the aggregate more than 20% of all interests in capital, income, gain, loss, deduction, and credit, "does not have the power to confer upon a non-member all the attributes of the member's interests in the LLC without the consent of not less than a majority of the non-transferring member-managers." Rev. Proc. 95-10, § 5.02(1).

(ii) The IRS will rule that a member-managed LLC lacks free transferability if each member, or those members owning more than 20 percent of all interest in the LLC's capital, income, gain, loss, deduction, and credit, does not have the power to confer upon a non-member all the attributes of the member's interests in the LLC without the consent of not less than a majority of the non-transferring members. Rev. Proc. 95-10 § 5.02(2).

(iii) A "majority-in-interest" for purposes of applying the free transferability test, means (A) a majority in interest as defined in Revenue Procedure 94-46, (B) a majority of either the capital or profits interests, or (C) a majority determined on a per capita basis. Rev. Proc. 95-10, § 5.02(3).

(iv) Note that for a limited partnership, only the consent of the general partner is required to transfer a limited partnership interest with full substitution of the transferee. For an LLC, at least a majority in interest of the non-transferring member-managers or of the non-transferring members, as the case may be, must consent to allow the substitution.

(3) "Lack of Separate Interests" Doctrine.

(i) The IRS has indicated that the consent requirement is not a meaningful restriction if the members are commonly controlled. See e.g., Rev. Rul. 93-4, 19923-1 C.B. 225 (organization had free transferability characteristic because the two members were wholly-owned by the same parent organization).

(ii) To avoid the single-member LLC problem, an organization may be established with an individual member and a corporation having that individual as its sole shareholder. If the standard provision requiring consent of the other member to transfer is included in the operating agreement, then the LLC may possess the corporate characteristic of free transferability. The IRS has issued a private ruling based on those facts and stated that the LLC had the corporate characteristic of free transferability because the individual's ability to control the corporate-member's consent meant that no meaningful consent requirement existed. See PLR 9433007.

(iii) On the other hand, the IRS ruled that an LLC lacked free transferability in a case in which the two members of the LLC were wholly-owned subsidiaries of the same parent corporation. See PLR 9510037. In that ruling, however, the assignment by either

member was prohibited and any attempted assignment caused a dissolution of the LLC.

c. Centralized Management.

(1) Generally. Under the regulations, an organization has centralized management "if any person (or any group of persons which does not include all the members) has continuing exclusive authority to make the management decisions necessary to the conduct of the business for which the organization was formed." Reg. § 301.7701-2(c)(1). Centralized management ordinarily exists in a limited partnership if "substantially all" of the interests are held by limited partners. For ruling purposes, the IRS has stated that centralized management does not exist if a general partner that is not controlled by the limited partners owns 20% or more of the partnership interests. See Rev. Proc. 89-12 § 4.06. If a general partner owns 20% or more of the partnership interests, the general partner may be viewed as managing its own interests in the partnership, rather than as managing the partnership on behalf of the limited partners.

(2) Centralized Management of an LLC. Under Revenue Procedure 95-10, the following guidelines will be applied to determine if an LLC lacks centralized management:

(i) The LLC will lack centralized management if the LLC is managed by the members exclusively in their membership capacity.

(ii) The LLC will lack centralized management if the LLC is managed by one or more members who are elected or designated as managers and the member-managers own, in the aggregate, at least 20% of the total LLC interests. Even if the 20% test is satisfied, the IRS will consider all relevant facts and circumstances, focusing particularly on direct or indirect control of the member-managers by the other members, to determine whether centralized management is lacking. The IRS will not rule that a manager-managed LLC lacks centralized management if "the member-managers are subject to periodic elections by the members, or, alternatively, the non-managing members have a substantially nonrestricted power to remove the member-managers.

(iii) In a ruling request, the LLC is required to describe all direct and indirect relationships between the members and the managers that would suggest that the managers "may not at all times act independently of the members." Such relationships include (A) ownership by the non-manager members of 5% or more of the vote or value of a manager's stock or other beneficial interests, (B) over-lapping

ownership by the same person or persons of 5% or more of the vote or value of the stock or other beneficial interests in any manager and any non-manager members, and (C) relationships described in section 267(b) or 707(b)(1).

(iv) Centralized management also will exist if the elected managers are non-members. In that case, the 20% exception is not available since the managers have no ownership interest.

d. Limited Liability.

(1) Generally. Under the regulations, an organization lacks limited liability "if under local law there is not member who is personally liable for the debts or claims against the organization." Personal liability exists with respect to each general partner of a limited partnership corresponding to the Uniform Partnership Act, except where the general partner "has no substantial assets (other than his interest in the partnership) which could be reached by a creditor of the organization and when [it] is merely a 'dummy' acting as the agent of the limited partners." Reg. § 301.7701-2(d). The IRS has provided a "safe-harbor" concerning a corporate general partner's liability. The corporate general partners collectively must have a net worth of 10% or more of the partners' total contributions to the limited partnership or of at least $1 million. A note receivable from a shareholder of a corporate general partner may be included in determining the general partner's net worth if the note is negotiable, payable on demand, accrues interest at a reasonable market rate, and the shareholder has sufficient assets to satisfy the note.

(2) Limited Liability of Members of an LLC

(i) A fundamental reason for choosing an LLC is the fact that the members are statutorily protected from personal liability for the claims of the LLC's creditors.

(ii) Certain state statutes allow members to waive limited liability protection and assume personal liability for LLC debts. Revenue Procedure 95-10 provides that the IRS will not rule that an LLC lacks limited liability "unless at least one assuming member validly assumes personal liability for all (but not less than all) obligations of the LLC, pursuant to a controlling statute."

(iii) The IRS generally will not rule on this issue unless the assuming members have an aggregate net worth at the time of the

ruling request of at least 10% of total contributions throughout the life of the LLC. Rev. Proc. 95-10, § 5.04.

e. Application of Minimum Ownership Prerequisites

(1) Generally.

(i) Revenue Procedure 95-10 requires that certain minimum ownership requirements are satisfied to ensure that certain members own a sufficient interest in the LLC to be treated as partners for tax purposes. Revenue Procedure 89-12 also requires minimum ownership requirements which a general partner must satisfy in order for a limited partnership to obtain a classification ruling. Also, Revenue Procedure 92-88 outlines similar requirements for a limited partnership to satisfy a safe harbor regarding limited liability and continuity of life.

(ii) The minimum ownership requirements under Revenue Procedure 95-10 must be satisfied by (i) member-managers if the LLC requests a ruling that the entity lacks continuity of life or free transferability of interests, if the dissolution event or right to approve transfers applies solely to member-managers and (ii) liability-assuming members if the LLC requests a ruling that the LLC lacks limited liability. (hereinafter, the "applicable member") Rev. Proc. 95-10, § 4.02.

(2) Profit and Loss Interests. The applicable member must own in the aggregate at least a 1% interest in each material item of LLC income, gain, loss, deduction or credit throughout the term of the LLC. The operating agreement must expressly provide for this 1% interest. A temporary allocation required by Sections 704(b) or 704(c) which causes the applicable member to be allocated less than 1% will be disregarded. Any other temporary allocation will not be disregarded unless the LLC clearly establishes that the applicable member will have a "material interest in net profits and losses" throughout the life of the LLC. Id. at § 4.02. Further, if the LLC has total contributions exceeding $50 million, the 1% rule is not applicable. Instead, the applicable members must at all times maintain an interest in each material item that is at least equal to the result of the following: 1%/(actual contributions/$50 million).

(3) Capital Interests.

(i) The applicable members must maintain throughout the entire term of the LLC, in the aggregate, a minimum account balance equal to the lesser of (i) 1% of the total positive capital account

balances, or (ii) $500,000. Further, if members contribute additional capital, the applicable members must be obligated, under the terms of the operating agreement, to contribute 1.01% of the amount contributed by the other members (or such lesser amount as is necessary to comply with the basic rule). The applicable members, however, are allowed to go negative if no other member has a positive capital account balance. Id. at § 4.04

(ii) The minimum capital account requirement does not apply if at least one applicable member has or will contribute substantial services in his capacity as a member (other than services that will be compensated with Section 707(c) guaranteed payments). In such a case, the guidelines require that all applicable members be required, upon dissolution of the LLC, to contribute to the LLC the lesser of (i) the aggregate negative balance in their capital accounts, or (ii) the shortfall between the amount of capital such applicable members had previously contributed to the LLC, in the aggregate, and 1.01% of the total capital contributions made by all other members. Id. § 4.05.

B. Limited Liability Partnerships

1. General. Many states have adopted statutes that permit a general partnership to elect limited liability partnership status. Generally, a general partner of an LLP has liability only for obligations arising from his own acts and the acts of those he supervises. Each state statute varies regarding the extent of the liability limitations.

2. Revenue Ruling 95-55. The IRS ruled that a New York general partnership that registers as an LLP continues to be classified as a partnership for tax purposes. The LLP lacked continuity of life because under New York law any partner may dissolve the LLP at any time. The LLP lacked centralized management because every partner is an agent of the LLP under New York law and the act of any partner binds the partnership. The LLP also lacked free transferability because a transferee cannot become a partner of a New York LLP without the consent of all partners.

C. Proposed "Check the Box" Classification Approach

The IRS announced on March 29, 1995 that it is studying the possibility of revising the Kintner regulations to allow unincorporated organizations to elect pass-through entity treatment. Notice 95-14, 1995-14 I.R.B. 7. Domestic unincorporated organizations would be taxed as partnerships unless an affirmative election to the contrary were made. Unincorporated organizations that are in existence when the

regulations become effective would be required to make an election to change their tax status. Foreign entities would be treated as associations unless a contrary election were made. The Notice would deny pass-through entity tax status to any "corporation" organized as such under state law.

II. Conversions

A. Partnership to Limited Liability Company

The IRS has ruled that the conversion of a domestic partnership to a domestic LLC which was classified as a partnership for tax purposes will be analyzed under the principles of Revenue Ruling 84-52. As a result, the members are treated as having contributed their interest in the partnership to the LLC in exchange for interests in the LLC pursuant to a Section 721 exchange. The members would recognize no gain or loss except to the extent that a partner has a Section 752 liability shift which results in a constructive distribution of money in excess of the member's basis in his interest. A Section 708 termination of the entity will not result. The member's adjusted basis and holding period in his partnership interest will carry over to his membership interest. Also, the LLC is not required to obtain a new taxpayer identification number.

B. Registration of a General Partnership As An LLP

Similarly, in Revenue Ruling 95-55, the IRS ruled that the registration of a New York general partnership as a limited liability partnership is treated as a partnership conversion under Revenue Ruling 84-52.

III. Self-Employment Taxes

A. General.

On December 29, 1994, the IRS issued Proposed Regulation Section 1.1402(a)-18 to address the self-employment tax treatment of members of an LLC that is classified as a partnership.

B. Proposed Regulation Section 1.1402(a)-18

1. General Rule. Unless an exclusion is applicable, a member's net earnings from self-employment includes the member's distributive share of income or loss from any trade or business carried on by an LLC.

2. Limited Partner Treatment

a. If a member of an LLC is treated as a limited partner, then the member's distributive share of LLC income will not be subject to self-employment tax under the Section 1402(a)(13) exclusion.

b. A member of an LLC will be treated as a limited partner if (i) the member is not a manager, and (ii) the entity could have been formed as a limited partnership rather than an LLC in the same jurisdiction and the member could have qualified as a limited partner in that limited partnership under applicable law.

c. A manager is a person who, alone or together with others, is vested with the continuing exclusive authority to make the management decisions necessary to conduct the business for which the LLC was formed.

d. If there are no designated or elected managers of the LLC (the LLC is member managed) who have continuing exclusive authority to manage the LLC, then all of the members will be treated as managers, even if some members have greater management authority than others under the applicable LLC statute and the LLC's controlling documents. Accordingly, no member would qualify for the Section 1402(a)(13) exclusion.

e. The proposed regulation will be effective for a member's first taxable year beginning on or after the date of publication of the final regulations.

IV. Publicly-Traded Partnerships

A. General.

1. General Definition. Section 7704(b) defines a "publicly traded partnership" (a "PTP") to include any partnership if interests therein are traded on an established securities market or are readily tradable on a secondary market (or the substantial equivalent thereof).

2. Tax Effect. If an entity classified as a partnership is a PTP, the entity will be treated as a corporation for all purposes of the Code, unless the partnership satisfies the 90% passive income exception or qualifies as an "existing partnership". IRC § 7704(a). Further, the passive activity loss rules are applied to a PTP on a separate-basket basis

so that passive losses from other activities cannot offset a partner's income from the PTP. Id. 469(k)(2).

B. **Proposed Regulations**.

1. General. On May 1, 1995, the IRS issued proposed regulations to define the terms "established securities market", "secondary market", and "the substantial equivalent of a secondary market" for purposes of Section 7704(b). The proposed regulations would be effective for all partnerships for all taxable years beginning on or after the date the regulations are finalized. If finalized, the proposed regulations would make some significant changes to the framework provided by Notice 88-75 for determining if a partnership is a PTP.

2. Established Securities Market. Under the proposed regulations, an established securities market includes (i) a national securities exchange registered under the Securities Act of 1934, (ii) a nation securities exchange exempt from registration because of the limited volume of transactions, (iii) a foreign securities exchange, (iv) a regional or local exchange, and (v) an interdealer quotation system that regularly disseminates firm buy or sell quotations by identified brokers or dealers by electronic means or otherwise. Prop. Reg. § 1.7704-1(b).

3. Readily Tradable on Secondary Market or Substantial Equivalent

a. General Definition. The proposed regulations provide that partnership interests are readily tradable on a secondary market or the substantial equivalent thereof "if the partners are readily able to buy, sell or exchange their partnership interests in a manner that is comparable, economically to trading on an established securities market." Prop. Reg. § 1.7704-1(c)(1).

b. Firm-Quote Trading.

(i) The proposed regulations also provide that interests are treated as readily tradable on a secondary market if (A) any such interests are "regularly quoted by any person, such as a broker or dealer, making a market in the interests" or (B) "any person regularly makes available to the public (including customers or subscribers) bid or offer quotes with respect to interests in the partnership and stands ready to effect buy or sell transactions at the quoted prices for itself or on behalf of others." Prop. Reg. § 1.7704-1(c)(2).

(ii) The regulations also provide that partnership interests are treated as readily tradable on the substantial equivalent of a secondary market if (A) the holder "has a readily available, regular and ongoing opportunity to sell or exchange the interest through a public means of obtaining or providing information of offers to buy, sell or exchange interests in the partnership," or (B) "prospective buyers and sellers have the opportunity to buy, sell, or exchange interests in the partnership pin a time frame and with the regularity and continuity that the existence of a secondary market would provide. Prop. Reg. § 1.7704-1(c)(3).

c. Disregarded Transfers.

(i) Private Transfers. Certain private transfers are disregarded in determining whether interests are readily tradable on a secondary market or the substantial equivalent. These private transfers include (A) carryover basis transfers and transfers in which the transferee's basis is determined under Section 732, (B) transfers at death, (C) transfers between members of a family, (D) new issuances of interests for cash, property or services, (E) transfers from retirement plans or individual retirement accounts, (F) certain "block transfers" by a single partner that occur within a 30-calendar day period and which aggregate more than 2% of the total interests in partnership capital or profits, (G) transfers pursuant to a right under a redemption or repurchase agreement which is exercisable upon death, disability, or mental incompetency of a partner or upon the retirement or termination of a service partner, (H) transfers pursuant to a closed-end redemption plan, and (I) transfers by one or more partners that aggregate more than 50% of the total interests in partnership capital and profits in a single transaction or series of related transactions. Prop. Reg. § 1.7704-1(d).

(ii) Certain Redemptions. The transfer of interests pursuant to a redemption or repurchase agreement are disregarded if: (A) the agreement requires at least 60 days prior notice of the partner's intent to redeem, (B) the agreement either provides that the redemption price is not established until at least 60 days after receipt of such notification or the price is established not more than four times during the partnership's taxable year; and (C) the sum of the interests in capital or profits transferred during the year (other than private transfers) to not exceed 10% of the total interests in capital or profits.

(iii) Transfers Through Qualified Matching Service. Transfers through a "qualified matching service" (generally, a service that meets a number of requirements, including that the service can

display only nonfirm quotes or nonbinding indications of interest and cannot provide firm quotas or two-sided quotes) are disregarded.

d. Private Placement Safe Harbor.

(i) Notice 88-75 provides a private placement safe harbor under which interests are not considered to be readily tradable on a secondary market or the substantial equivalent thereof if (A) all of the interests were issued in transactions not registered under the Securities Act of 1933 and (B) either (aa) the partnership does not have more than 500 partners or (bb) the initial offering price of each partnership agreement provides that the units may not be subdivided for resale into units smaller than a unit the initial offering price of which would have been at least $20,000. Many partnership have relied on this exemption as long as the partnership never had no more than 500 partners and the interests were not traded on an established securities market.

(ii) The proposed regulations base the private placement safe harbor on the provisions of Notice 99-75, but with several significant differences. For instance, compliance with the regulatory private placement exemption only means that the interests are not treated as readily tradable on the substantial equivalent of a secondary market; it would not preclude the interest from being treated as readily tradable on a secondary market. Also, if the partnership has more than 50 partners at any time during the taxable year, the sum of the interest in partnership capital or profits transferred during the taxable year cannot exceed 10% of the total interests in capital and profits.

e. Lack of Actual Trading Safe Harbor. Also, interests are not treated as traded on the substantial equivalent of a secondary market if the sum of the percentage interests in partnership capital or profits transferred during the partnership's taxable year do not exceed 2% of the total interests in capital or profits.