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Choice of Entity: S Corporations and Limited Liability Companies

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CHOICE OF ENTITY: S CORPORATIONS AND LIMITED LIABILITY COMPANIES

by

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I. INTRODUCTION

A. Business and Tax Considerations.

1. Proper selection of the form of doing business involves business as well as tax considerations. A number of business forms can be chosen for tax purposes. Each has unique tax considerations and consequences for its owners.

2. Generally, this outline will focus on the selection process involving the following forms: (1) C corporation; (2) S corporation; (3) Partnership; and (4) Limited Liability Companies.

B. Re-visiting Choice of Business Form.

1. While choice of business entity is one of the first questions an entrepreneur faces upon establishment of his or her enterprise, it should also be re-examined and reconsidered from time to time. Among the many reasons for reconsideration is the dramatic, and often immediate, impact that tax legislation can have on the advantages and disadvantages of the various organizational forms.

2. With the enactment of OBRA 1993, and the re-inversion of the marginal income tax rates with individuals at a maximum stated federal tax rate of 39.6% and corporations at 35%, the decision to use either a corporate or pass through entity is more difficult than ever. Regular corporations are still subject to double tax on their earnings if distributed, but pass through entities are subject to a higher marginal rate of tax whether distributed or not.

3. The biggest factor affecting choice of entity is the advent of limited liability companies recognized by 46 states and the District of Columbia. These entities are enormously flexible from both a business and tax perspective and enjoy a single for federal tax purposes. This makes the LLC a strong contender in the choice-of-
entity sweepstakes and will require the re-examination of business form in certain situations.

C. Possible Legislation.

1. Subchapter S Improvement. Senator David Pryor (D-Ark) and Senator John Danforth (R-MO) introduced S. 1680 (November 1993) and Rep. Hoagland (D. Neb.) introduced H.R. 4056 (March 1994). The provisions in this pending legislation would make a number of changes to subchapter S to remove traps and expand the S corporation’s flexibility.

2. S Corporation Simplification. Other possible legislative changes to subchapter S include those made by the Tax Simplification Act of 1993, H.R. 3419, which was introduced by House Ways and Means Committee Chairman Dan Rostenkowski (D-Ill).

II. ENTITY STRUCTURE FACTORS

A. General.

There are no hard and fast rules for selecting the form in which a business will operate.

1. The decision requires the selection of the ownership entity best suited for the dual purposes of raising capital and operating the business.

2. The choice is dependent upon the individual situation, and should be reexamined on a regular basis.

3. Example—Various stages in the life of a business

   Stage 1: The company is organized and elects S status, so that operating losses can be passed through to its materially participating shareholders and can offset ordinary income from other sources.

   Stage 2: When the company turns profitable but wishes to retain and reinvest most of its earnings after shareholder salaries and other expenses, S corporation status is terminated. The business is operated as a regular corporation, so that the owners will not be taxed on undistributed earnings.
Stage 3: The company launches a new product or embarks on a research and development venture that is expected to lose money for two or three years. This new venture is organized as a partnership, with the corporation itself as general partner so that the losses of the venture can be passed through. Later, when the venture turns profitable, it can be acquired by the corporation.

Stage 4: The company matures, its rate of growth slows, its earnings exceed what is needed for reinvestment, and it begins to pay sizable dividends. It elects S status once again, so as to avoid the double tax on distributed income and also the accumulated earnings tax.

Stage 5: The shareholders decide to go public in order to improve the liquidity of their personal estates. S status is terminated.

B. Business Factors.

The decision is not governed solely by tax factors but requires analysis of competing business, financing and legal considerations.

1. The choice of entity will have a significant impact upon the complexity of the legal and financial affairs of the business operation and upon the degree of investor risk.

2. General business concerns include:
   - cost of formation;
   - reporting requirements and complexities;
   - management flexibility;
   - limitation of liability;
   - investment transferability and liquidity;
   - transferability of assets;
   - duration of existence.

C. Tax Factors.

Tax considerations may override nontax reasons for selecting a flow-through entity. These are:

- level of taxation on earnings and distributions;
- rate of taxation both federal and state;
- loss utilization and ability to allocate income and loss items;
- reporting requirements.

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III. TAX RATE STRUCTURE AND PENDING LEGISLATION

A. Individual Rates.

1. Base rates

The current tax rate structure for individuals imposes a nominal tax rate of 36% for joint filers with taxable income of more than $140,000, or $115,000 for single filers, effective January 1, 1993. This higher rate, taken in conjunction with the continuation of the disallowance of itemized deductions and personal exemptions, make it very likely that the effective tax rate will be higher depending on the amount of adjusted gross income, the amount of itemized deductions, and the number of personal exemptions.

2. Ten percent surtax on individuals with taxable income in excess of $250,000.

A 10% surtax is imposed on individuals with taxable income in excess of $250,000. The surtax is computed by applying a 39.6% rate to taxable income in excess of the applicable threshold. However, capital gains are taxed at a maximum rate of 28%. For married taxpayers filing separate returns, the threshold amount for the surtax is $125,000.

3. Health insurance premium tax.

The dollar limit on wages and self-employment income subject to HI taxes (1.45% for employers and employees, and 2.9% for self-employed individuals in 1993) has been repealed, effective for income received after December 31, 1993. Thus for wages paid beginning in 1994 to covered employees, the HI tax on both the employer and the employee is imposed on all wages paid, and is not limited to the first $135,000 of wages as under current law. The HI tax on self-employed persons is also imposed on an unlimited amount of self-employment income and is not limited to the first $135,000 of wages as under current law.

B. Corporations.

Corporate income is subject to double taxation because of its taxation at the corporate and shareholder levels. Corporations are currently subject to a maximum income tax rate that are about 5-6% lower than those of their shareholders. The federal corporate income tax rates exceeded the individual income tax rates since from 1987 through 1992. The corporate tax rates are as follows:
1. Taxable Income

<table>
<thead>
<tr>
<th>Taxable Income</th>
<th>Tax Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Not over $50,000</td>
<td>15%</td>
</tr>
<tr>
<td>Over $50,000 but not over $75,000</td>
<td>25%</td>
</tr>
<tr>
<td>Over $75,000</td>
<td>34%</td>
</tr>
<tr>
<td>Over $10 million</td>
<td>35%</td>
</tr>
</tbody>
</table>

2. Tax benefits of lower brackets are phased out in income ranges of $100,000 - $335,000. Corporations with income in excess of $335,000, in effect, pay a flat tax at a 34% rate up to $10 million.

C. Capital Gains.

For individual taxpayers, capital gains are taxed at the same rates as ordinary income, except a maximum rate on long-term gains for sales after 1990 is nominally 28%. However, this rate will be increased in some income brackets by the deduction cutback and the phase-out of personal exemptions.

1. There is no change in the maximum 34% capital gains rate for corporations.

2. The return of a capital gains tax differential makes it essential that capital assets are properly defined and categorized as such.

3. Targeted capital gains preference. For certain investments in C corporations, investors covered would be subject to a maximum 14% capital gains rate on the sale of their stock. This preferential rate does not apply to investments in S corporations.

D. Alternative Minimum Tax.

An alternative minimum tax (AMT) is imposed on individuals, trusts and corporations other than S corporations, in order to prevent individuals and businesses from avoiding tax liability through the use of certain deductions, exclusions and credits.

1. The AMT attempts to broaden the base of taxable income to insure a minimum level of tax liability. A tax of 28% for individuals and noncorporate taxpayers and 20% for corporations, is calculated on an AMT income base.

2. The corporate AMT applies only to regular corporations. However, partners and S corporation shareholders may be affected by tax adjustments and preference items that are passed through to their returns.

3. Corporations subject to the AMT must deal with a special adjustment item--the adjusted current earnings (ACE) adjustment.
E. Pending Legislative Changes.

1. The S Corporation Reform Act of 1994

   a. Background

(1) House Ways and Means Member Peter Hoagland (D-NE) introduced H.R. 4056, the "S Corporation Reform Act," on March 16. H.R. 4056 currently has 48 co-sponsors, including 18 members of the House Ways and Means Committee. The companion bill, S. 1690, was introduced in the Senate late last year by Senate Finance Committee Members David Pryor (D-AR) and John Danforth (R-MO) and currently enjoys 35 co-sponsors.

(2) This legislation represents the greatest changes to the tax treatment of S corporations in over a decade and would achieve a number of major goals including: improving the ability of S corporations to obtain financing; removing traps for unwary S corporations; making S corporations easier to pass from generation to generation; and removing certain tax barriers that currently impede the ability of S corporations to compete with regular corporations and partnerships.

(3) Below is a summary of the major provisions of the legislation. Please note that the first six provisions summarized are also included in H.R. 3419, the Tax Simplification and Technical Corrections Act of 1993.

b. Provisions of the Legislation

(1) S Corporations Permitted To Hold Subsidiaries. This provision would repeal the current rule that disallows an S corporation from being a member of an affiliated group of corporations thus enabling an S corporation to own up to 100 percent of a C corporation's stock. It does preclude, however, an S corporation from being included in a group filing a consolidated tax return.

(2) Expand Eligible Trust Rules. Trust eligibility rules would be expanded by allowing stock in an S corporation to be held by certain trusts ("electing small business trusts") provided that all beneficiaries of the trust are individuals, estates or exempt organizations. Each potential current beneficiary of the trust would be counted as a shareholder under the
counting conventions of the maximum number of shareholder rules. In a situation where there are no potential current beneficiaries, the trust would be treated as a shareholder. For taxation purposes, the portion of the trust consisting of S corporation stock would be treated as a separate taxpayer and would pay tax at the highest individual tax rate.

(3) Distributions by S Corporations During a Loss Year. Basis adjustments for distributions made by an S corporation during a taxable year would be taken into account before applying the loss limitation for the year. This would result in distributions during the year reducing the adjusted basis for purposes of determining tax status of the distributions made during that year before determining the allowable loss for the year. A similar concept would apply in computing adjustments to the accumulated adjustments account.

(4) Curing Certain Invalid Elections. The legislation would provide the IRS with the authority to extend its current automatic waiver procedure for inadvertent terminations due to defective elections. Additionally, the IRS would be allowed to treat a late Subchapter S election as timely if the Service determines that there was reasonable cause for the failure to make the election timely. The provision would apply to taxable years beginning after December 31, 1982.

(5) S Corporations as Shareholders in C Corporations. The current rule treating an S corporation as an individual in its status as a shareholder of another corporation would be repealed, permitting IRC Section 332 liquidations and IRC Section 338 elections. These rules effectively expand an S corporation's ability to participate in tax-free structuring transactions.

(6) Elimination of Pre-1983 Earnings. S corporation earnings and profits attributable to taxable years prior to 1983 would be eliminated. This change will simplify distributions for those S corporations in existence prior to 1983.

(7) Increase the Number of Permitted S Corporation Shareholders. S. 1690 would increase the maximum number of shareholders in an S
corporation from 35 to 50. Additionally, one family unit per S corporation consisting of no more than seven generations would be treated as a single shareholder, allowing an S corporation to have one family unit and 49 other unrelated individuals as shareholders.

(8) Allow Nonresident Aliens as Shareholders. This provision would provide the opportunity for aliens to invest in domestic S corporations and S corporations to operate abroad with a foreign partner by allowing nonresident aliens (individuals only) to own S corporation stock. Any effectively-connected U.S. income allocable to the nonresident alien would be subject to the withholding rules that currently apply to foreign partners in a partnership.

(9) Allow Exempt Organizations as Shareholders. A new source of financing would be provided to S corporations by allowing certain exempt organizations including pensions, profit sharing plans, and employee stock ownership plans (ESOPs) to acquire S corporation stock. S corporation income that flows through to these organizations would be treated as unrelated business income (UBI) to the organization or entity. In addition, charities would be allowed as shareholders of an S corporation for purposes of allowing more flexibility in estate planning.

(10) Allow the Issuance of Preferred Stock. An S corporation would be allowed to issue certain preferred stock. Generally, the preferred stock would not be convertible and would not participate in corporate growth to any significant extent. Only eligible S corporation shareholders would be allowed to own preferred stock. Payments to owners of the preferred stock would be deemed as interest rather than a dividend and would provide an interest deduction to the S corporation. This provision would afford S corporations and their shareholders more flexibility in estate planning and in capitalizing the S corporation itself.

(11) Repeal Passive Income as a Termination Event. This provision would repeal the current rule that terminates S corporation status for certain corporations that have both subchapter C earnings and profits and that derive more than 25 percent of their gross receipts from passive sources for three consecutive years. S. 1690 Starr-8
would not repeal the rule that imposes a tax on those corporations possessing excess net passive investment income. It would liberalize this tax by raising the threshold triggering the tax to 50% of passive receipts from passive income sources rather than the present law 25% threshold. The rate of the passive income tax would be increased if applicable.

(12) Eliminate Rule Limiting Fringe Benefits For S Corporation Stockholder-Employees. The current rule that limits the ability of "more-than-two-percent" S corporation shareholder-employees to exclude certain fringe benefits from wages would be repealed. Fringe benefits such as medical insurance and group-term life insurance would become excludable from wages for these shareholders.

(13) Certain Financial Institutions Defined as Eligible Corporations. Under the bill, financial institutions that do not use the reserve method of accounting for bad debts would be eligible to elect S corporation status.

(14) Financial Institutions Permitted to Hold Safe Harbor Debt. An S corporation is not considered to have more than one class of stock if outstanding debt obligations to shareholders meet the "straight debt" safe harbor. Currently, the safe harbor provides that straight debt cannot be convertible into stock. However, S. 1690 would permit a convertibility provision so long as that provision is the same as one that could have been obtained by a person not related to the S corporation or S corporation shareholders. Additionally, the straight debt safe harbor would be amended to permit creditors who are aliens or who are persons actively and regularly engaged in the business of lending money.

(15) Charitable Contributions of Inventory. This provision would allow the same deduction for charitable contributions of inventory and scientific property used to care for the ill, needy or infants for subchapter S as for subchapter C corporations. In addition, S corporations are no longer disqualified from making "qualified research contributions" (charitable contributions of inventory property to educational institutions or scientific research organizations) for use in research or experimentation. The S corporation's
shareholders would also be permitted to increase the basis of their stock by the excess of deductions for charitable contributions over the basis of the property contributed by the S corporation.

(16) Repeal Restrictions on Qualified Loans. Provides that subchapter-S shareholder-employees no longer will be deemed to be owner-employees under the rules prohibiting loans to owner-employees from qualified retirement plans.

(17) Treatment of Liquidation Losses. Loss recognized by a shareholder in complete liquidation of an S corporation would be treated as ordinary loss to the extent the shareholder’s adjusted basis in the S corporation stock is attributable to ordinary income that was recognized as a result of the liquidation.

(18) Other Technical Changes. Other technical changes made to current S corporation rules by S. 1690 include expanding the post-death qualification for certain trusts; modifying shareholder election to close the S corporation’s tax years when a shareholder terminates interest; expanding the post-termination transition period; providing a consent dividend for AAA by-pass elections; and allowing at-risk suspended losses to be utilized during the post-termination period.


Other potential legislative changes to Subchapter S include the provisions of the Tax Simplification Act of 1993, H.R. 3419, a bill that was reported out by the House Ways and Means Committee and approved by the House. However, the bill probably will die on the adjournment of this Congress. It will need to be revived again in the next Congress beginning in January 1995. The legislation would modify provisions of Subchapter S in the following areas:

a. Authority to validate certain invalid elections.

Under the bill, the authority of the IRS to waive the effect of an inadvertent termination would be extended to allow the IRS to waive the effect of an invalid election caused by an inadvertent failure to qualify as a small business corporation or to obtain the required shareholder consents (including elections regarding qualified subchapter S trusts),
or both. The technical explanation to H.R. 3419 states that it is intended that the IRS be reasonable in granting waivers of inadvertent invalid elections so that a corporation whose election was inadvertently invalid would be treated as a valid S corporation.

The bill would also allow the IRS to treat a late Subchapter S election as timely where the Service determines that there was reasonable cause for the failure to make the election timely. The technical explanation to H.R. 3419 states that it is intended that the IRS adopt a standard similar to the standard currently set forth in Treasury Reg. §1.9100-1 in applying this provision. The provision is proposed to apply to taxable years beginning after December 31, 1982.

b. Treatment of distributions by S corporations during loss year.

H.R. 3419 would provide that the adjustments for distributions made by an S corporation during a taxable year would be taken into account before applying the loss limitation for the year. Thus distributions during a year reduce the adjusted basis for purposes of determining the allowable loss for the year, but the loss for a year does not reduce the adjusted basis for purposes of determining the tax status of the distributions made during that year.

Another provision contained in the bill would modify current law so that when determining the amount in the accumulated adjustment account for purposes of determining the tax treatment of distributions made during a taxable year by an S corporation having accumulated earnings and profits, net negative adjustments (i.e., the excess of losses and deductions over income) for that taxable year would be disregarded.

These provisions are proposed to apply to distributions made in taxable years beginning after December 31, 1994.

c. Treatment of S corporations as shareholders in C corporations.

The bill would repeal the rule that treats an S corporation as an individual in its capacity as a shareholder of another corporation. Thus, the liquidation of a C corporation into an S corporation will be governed by the generally applicable

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subchapter C rules, including the provisions of IRC §§332 and 337, allowing the tax-free liquidation of a corporation into its parent corporation under the provisions of the bill. Following a tax-free liquidation, the built-in gains of the liquidating corporation may later be subject to tax under IRC §1374 upon a subsequent disposition. Under the bill, an S corporation would also be eligible to make a IRC §338 election, resulting in immediate recognition of all the acquired C corporation’s gains and losses. The provision is proposed to take effect upon the date of enactment.

d. S corporations permitted to hold subsidiaries.

The bill would repeal the rule that an S corporation may not be a member of an affiliated group of corporations. Thus, an S corporation would be allowed to own up to 100 percent of stock of a C corporation. However, an S corporation would not be permitted to be included in a group filing a consolidated return.

Under the bill, if an S corporation owns 100 percent of the stock of a C corporation that, in turn, held 100 percent of the stock of another C corporation, the two C corporations would be permitted to elect to file a consolidated return, but the S corporation would not be permitted to join in the election. These provisions are proposed to take effect on date of enactment.

e. Elimination of pre-1983 earnings and profits of S corporations.

Under the bill if a corporation is an S corporation for its first taxable year beginning after December 31, 1993, the accumulated earnings and profits of the corporation as of the beginning of that year are reduced by the accumulated earnings and profits (if any) accumulated in any taxable year beginning before January 1, 1983, for which the corporation was an electing small business corporation under subchapter S. Thus, such a corporation’s accumulated earnings and profits would be solely attributable to taxable years for which an S election was not in effect. The provision is proposed to apply to taxable years beginning after December 31, 1993.

f. Treatment of items of income in respect of a decedent held by an S corporation.
Under this provision, a person acquiring stock in an S corporation from a decedent would treat as income in respect of a decedent (IRD) his pro rata share of any items of income of the corporation which would have been IRD if that item had been acquired directly from the decedent. Where an item is treated as IRD, a deduction for the estate tax attributable to the item generally would be allowed under the provisions of IRC §691(c). The stepped-up basis in the stock would be reduced by the extent to which the value of the stock is attributable to items consisting of IRD. The provision would apply to decedents dying after the date of enactment.

g. Repeal of application of the TEFRA audit rules to S corporations.

The bill would repeal the unified audit procedures for S corporations. However, the bill would retain the requirement that shareholders report items in a manner consistent with the corporation's return. The rationale for this repeal is that since an S corporation generally is limited to 35 investors, and the majority of exiting and new S corporations qualify for the small S corporation exception from the unified audit and litigation rules (S corporations with 5 or fewer shareholders are not subject to TEFRA), the application of the unified audit rules is unnecessary.

h. Clarify the statute of limitations for items from pass-through entities.

The bill would clarify that the return that starts the running of the statute of limitations for a taxpayer is the return of the taxpayer and not the return of entity from which the taxpayer has received an item of income, gain, loss, deduction, or credit. The technical explanation of the bill provides that it is not intended to create any inference as to the proper interpretation of the present law. The provision is proposed to be effective for taxable years beginning after the date of enactment. Note: H.R. 3419 was introduced before the Supreme Court issued its opinion.

3. Self-Employment Tax for More-Than-2% Shareholders of S Corporations

Two versions of health care legislation pending in Congress could increase for certain S corporation shareholders and limited partners their exposure to the 2.9% health insurance premium tax (this rate includes the combined employer and employee share). The legislation
would apply the Medicare and social security payroll taxes to certain S corporation income and to partnership income of certain limited partners; the proposals do not distinguish between income from labor and income from capital.

a. S Corporations.

(1) Legislation reported by the House Ways and Means Health Subcommittee applies to certain owner-employees of S corporations involved in "service" businesses. Each two-percent shareholder who materially participates in the corporation's activities must include in "net earnings from self-employment" (NESE) their pro rata share of taxable income from an S corporation involved in a "service" business. Exclusions from NESE that are currently available to limited partners for their passive income would be available for S corporation shareholders.

(2) Service-related businesses are those defined under IRC Section 1202(e)(3)(A) and include: the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees.

(3) The Senate Finance Committee version of this provision would include in NESE only 80% of a shareholder’s pro rata share of taxable income or loss from "service-related business" carried on by the S corporation. Additionally, a new exclusion from self-employment taxes would be created for all taxpayers for certain income derived from inventories.

(4) Senate Majority Leader Mitchell suggested an alternative that would eliminate the restriction that the S corporation be engaged in a service related business. It also capped the amount of income that would be treated as "self-employment earnings."

b. Limited Partners.

(1) [WHICH PROPOSAL]. The House Ways and Means Health Subcommittee proposal also would change the rules for limited partners by excluding
limited partners’ partnership income from NESE only if the limited partner does not materially participate in the partnership’s activities. The partnership provisions would not be limited to service related businesses.

(2) The Mitchell proposal would apply similarly to limited partners.

c. Prognosis.

Whether or not health care reform is enacted, this issue is likely to reappear in future legislative proposals because it raises revenue and prevents the potential abuse of the current rules by some shareholders and partners.

IV. LIMITED LIABILITY COMPANIES

A. Background

1. Limited liability companies ("LLCs") are hybrid entities that under state law are neither partnerships nor corporations. From a state law standpoint, they purport to offer the owners of a business a very desirable benefit, the protection from personal liability for the debts of the business.

2. From a federal tax standpoint, the Internal Revenue Service ("IRS") recognizes that an LLC can be classified as a partnership so long as the LLC lacks at least two of the four corporate characteristics that distinguish a partnership from an association taxable as a corporation, namely limited liability, centralized management, continuity of life, and free transferability of interests. If treated as a partnership for tax purposes, the LLC provides a combination of limited liability, flow-through of tax items, and the absence of S corporation restrictions on ownership and other attributes.

3. In general, for state law purposes, an LLC is treated as a separate legal entity. Organizers must file articles of organization with the designated state authority, at which time the LLC is issue a certificate of organization and its existence begins.

4. Although a uniform provision is currently being drafted by the National Conference of Commissioners on Uniform State Laws, at present there is no uniform LLC Act. Instead, statutes have developed through an evolutionary process as states have added various provisions to the basic concepts introduced by Wyoming and Florida. To
date, forty-five states\(^1\) and the District of Columbia have enacted LLC statutes, and practically all remaining states are considering LLC statutes. Due to this wave of acceptance, use of LLCs will no doubt continue to increase. However, before proceeding down the primrose path of LLCs, taxpayers are well-advised to consider some of the possible traps that await them, not the least of which is the general uncertainty of the LLC rules governing formation and operation. In addition, many specific tax issues are as yet unsettled in the LLC context.

5. By comparison, if the S corporation form is chosen, all these day-to-day business decisions are hampered by stringent eligibility rules imposed by Subchapter S. Although the C corporation would be more flexible than the S corporation, the C corporation leaves much to be desired from a federal income tax standpoint because C corporation income is subject to double taxation.

6. In sum, from a tax perspective, the LLC offers all the flexibility of the partnership form, and, from a business perspective, the LLC generally offers limited liability for intrastate operations in states that recognize the LLC business form. Thus, at first blush, the LLC seems to be nearly the perfect entity.

B. LLCs Compared to Corporations.

1. Limited Liability.

a. Any new investor needs to consider not only the investment potential for economic rewards, but also the economic risk associated with making the investment. For clients considering any business form, the liability protection afforded any particular form of business is a crucial factor to making the investment. Presently, the states that recognize LLCs would give individual members of the LLC virtually complete personal liability protection from any company debt or obligations, including tort liability.

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\(^1\) Alabama, Alaska, Arizona, Arkansas, Colorado, Connecticut, Delaware, Florida, Georgia, Idaho, Illinois, Indiana, Iowa, Kansas, Kentucky, Louisiana, Maine, Maryland, Michigan, Minnesota, Mississippi, Missouri, Montana, Nebraska, Nevada, New Hampshire, New Jersey, New Mexico, New York, North Carolina, North Dakota, Ohio, Oklahoma, Oregon, Rhode Island, South Carolina, South Dakota, Tennessee, Texas, Utah, Virginia, Washington, West Virginia, Wisconsin, and Wyoming. The California legislature has approved LLC legislation but it has not been signed by the Governor.
b. Although states may not impose minimum capital requirements, query whether personal liability protection would be available if the LLC is thinly capitalized or the members somehow "pierce" the LLC's liability protection by using it for personal purposes? Under the LLC rules, it is not clear whether there is a comparable concept to "piercing the corporate veil" commonly known to corporate owners who use their corporation as an incorporated pocketbook. Under the Colorado statute, there is a specific provision that allows the limited liability veil to be pierced. Colo. Rev. Stat. §7-80-107 (Supp. 1990).

2. Presence of Governing Board.

a. A fundamental principle to the governance of the corporate entity is management through a board of directors and corporate officers. From a business point of view, this management structure may well be attractive to investor shareholders. They do not need to partake in day-to-day decision-making and can rely on management's fiduciary responsibilities to investors to carry out management duties in a reasonable way.

b. By comparison, the LLC may or may not have a separate board-like group that manages the entity's business. For example, the Wyoming statute allows for the choice of management by the members at large or management by select managers. Wyo. Stat. §17-15-116 (1977).

3. Perpetual Life.

Many LLCs are structured to lack continuity of life for tax classification purposes. Because local law may require unanimous consent to continue the LLC, any dissenting member at the time of dissolution could withhold consent to extract concessions from any remaining members. This could present a practical problem for those entities where continuing the business enterprise is important. However, in most cases, the fact that the LLC must lack continuity of life will serve more as an inconvenience to members than anything else. Generally, a dissolution of the LLC will not require an actual liquidation of the LLC for tax purposes. An accounting of varying ownership interests for the year may be all that is required so that income and loss items can be appropriately allocated among the members.
4. Restrictions on Transferability.

To be classified as a partnership for federal tax purposes, the LLC generally will lack the corporate characteristic of free transferability of interest. For many closely held business entities, whether partnerships or corporations, real restrictions (principally in the form of buy-sell agreements) are imposed on an owner's ability to transfer ownership interests. Thus, for all practical purposes, even though the LLC will probably lack free transferability of interests, this feature will not make it any less attractive than the closely held corporate form of doing business.

5. Professional Liability; Limited Liability Partnerships.

Many states have long recognized professional service corporations as an appropriate form of doing business for professionals within their states. The professional service corporation does not protect owner-professionals from liability exposure due to their negligent professional conduct, or any individual under the owner-professional's supervision or control. On the other hand, the corporate form does offer the professional liability protection from vicarious liability and general claims against the corporation.

Twenty one states\(^2\) and the District of Columbia presently recognize the limited liability partnership (LLP) in their states or at least recognize foreign LLPs. The LLP, a modified general partnership, is designed specifically for the professional to operate as a partnership with liability protection at the owner level from vicarious liability, but not for general claims of the LLP or for breaches of personal professional responsibility or supervisory liability. The LLP is extremely attractive because of the flexibility of the partnership form and it compares favorably to the personal service corporation in the liability protection afforded to its members. Because it is a general partnership, the LLP does not present some of the tax difficulties faced by LLCs.

6. Familiarity.

Now that most states recognize LLCs, perhaps the biggest drawback to using the LLC is the fact that to date many

\(^2\) As of August 15, 1994, these states are: Arizona, Connecticut, Delaware, Georgia (foreign LLPs), Illinois, Iowa, Kansas, Kentucky, Louisiana, Maryland, Minnesota, Mississippi (foreign LLPs), New Jersey (foreign LLPs), New York, North Carolina, Ohio, South Carolina, Texas, Utah, and Virginia.
state law issues relating to formation and governance remain unclear and will need to be resolved in years to come in future litigation. Until a body of law develops around the LLC, it will not be as "comfortable" an entity as the time-challenged corporate form. Third parties such as banks, creditors, and joint ventures may be reluctant to transact business with an entity with which they are not familiar. However, as time passes, and LLCs become more popular, this lack of comfort and familiarity will simply disappear.

C. Tax Factors to Consider in Choosing the LLC.

Following are the major tax factors to consider in deciding whether to adopt the LLC/partnership form or the S or C corporate form. Except as otherwise noted, the discussion below assumes that the LLC will be treated as a partnership for federal income tax purposes.


Under current law, as a pass-through entity the LLC’s members are exposed to a maximum marginal income tax rate of 39.6% on the LLC’s earnings compared to the maximum corporate rate of 35%. In this regard, the LLC and its members share the higher individual tax rate with the S corporation and its shareholders. Assuming the absence of dividend distributions to owners, from a pure cash-flow perspective and without regard to any future tax benefits, the 39.6% rate imposes a cash-flow disadvantage on LLC members and S corporation shareholders when compared to the corporate form.


As a partnership, the LLC enjoys a single tax on earnings since its earnings flow up to the members to be taxed once at the member level. In this regard, the LLC is similar to the S corporation. On the other hand, the C corporation’s earnings are subject to the 35% corporate tax and, if distributions are made, a 39.6% tax on dividends at the individual shareholder level (roughly a 60% double tax). Compared to the LLC, the double tax imposed on the C corporation and its shareholders is its biggest drawback in the choice-of-entity sweepstakes.

3. Certainty of Tax Classification.

Different types of entities are treated differently for federal and state purposes. As mentioned, corporations are subject to a corporate level tax, while S corporations, partnerships, and LLCs pass their earnings to their owners where they are taxed once.
The corporation's tax classification under Regs. §301.7701-2 is reasonably settled. On the other hand, when a corporation makes an election to be treated as an S corporation, its "S" status can be challenged or undermined by failure to pay strict adherence to the S corporation eligibility rules. Similarly, an LLC can have its tax classification as a partnership undermined if it has too many of the characteristics of an association. Extreme care needs to be exercised in preparing the LLC agreement to assure the appropriate characteristics of an association taxable as a corporation are avoided, and that the LLC is classified as a partnership.

4. Formation.

When forming and capitalizing a corporation, unless the 80% control requirement of §368(c) of the Code is met, the contribution of property in exchange for the corporation's stock is a taxable recognition transaction. In addition, if liabilities contributed exceed the basis of contributed property, gain will be recognized to the extent of this excess.

In forming a partnership, or an LLC classified as a partnership, there is no control requirement to qualify the formation for nonrecognition treatment. Likewise, there is generally no corresponding consequence of gain recognition if liabilities exceed the basis of contributed property. However, to the extent the partnership assumes liabilities, there is a possibility that deemed distributions could exceed a partner's basis, triggering gain recognition.

5. Corporate Alternative Minimum Tax.

Like the S corporation, the LLC is not subject to the corporate alternative minimum tax ("AMT"), the adjusted current earnings adjustment or the §59A environmental tax. This considerably simplifies an LLC's federal income tax burden. On the other hand, the LLC's members will need to concern themselves with the individual AMT adjustments, such as for research and development costs.

6. Entity Level Debt.

A member's basis in an LLC includes the member's share of the LLC's debt. Basis in the LLC is important if the LLC will be generating any losses that will flow up to the individual members. So long as the LLC is classified as a partnership for federal income tax purposes, its members can take advantage of one of the key benefits afforded partners in partnerships, the ability to deduct entity level losses against basis and yet not have
personal liability with respect to the debt that generates the deductions.

This advantage compares quite favorably to the S corporation and its shareholders in that an S corporation shareholder's basis is limited to the amount of the shareholder's contributions to capital and any loans that the shareholder makes to the S corporation. However, this analysis ignores the §§465 and 469 rules that may further limit the use of losses of the LLC's individual members.


With respect to the passive activity rules, it appears that an LLC member generally should be treated in a manner similar to a limited partner in a partnership. Regulations under §469 create a presumption that a limited partner does not materially participate in partnership activities. This presumption is overcome only if a limited partner spends more than 500 hours in the activity during the taxable year or materially participated during any five of the last ten years (three preceding years if the activity constitutes a personal service activity). In this regard, if the LLC member is treated as a limited partner for this purpose, the S corporation shareholder could enjoy an advantage over the LLC member because shareholder status would not create a similar presumption. An S Corporation shareholder is entitled to use all seven tests, including the facts and circumstances test contained in Temp. Regs. §1.469-5T(a)(7), to establish material participation.

8. Special Allocations.

One of the most important characteristics that makes the LLC more attractive than the S corporation is the ability of the LLC to specially allocate income, gains, losses, deductions, and credits among its members. Generally, as long as the allocations have substantial economic effect or otherwise satisfy §704(b), members can receive special allocations to benefit their individual tax situations.

By comparison, under §1377 items of income, gain, loss, deduction, and credit earned by an S corporation are allocated on a per-share/per-day basis to all shareholders. This inability to make special allocations severely hampers the flexibility of the S corporation.

Partnerships, and LLCs classified as partnerships, are also subject to highly technical contributed property rules. In essence, if a partner or member contributes property to the partnership or LLC, the built-in gain upon contribution must be allocated back to that partner or member. Corporations do not have a comparable rule.
9. Eligibility Requirements.

Subchapter \( S \) requires that the electing \( S \) corporation meet strict eligibility rules. In order to qualify for \( S \) status the electing corporation must have 35 or fewer shareholders, a single class of stock, no affiliated subsidiaries, and only individuals, estates, and certain trusts as shareholders.

None of those limitations apply to the LLC. The LLC can have as many members as needed, multiple ownership interests, wholly-owned corporate subsidiaries, and any kind of shareholders desired. The lack of eligibility requirements and the limited liability afforded LLC members make the LLC a hands-down contender as a preferred choice of entity compared to the \( S \) corporation.

Although the LLC has no eligibility requirements to meet, one disadvantage of the LLC is the relative unfamiliarity of attorneys and accountants with such entities and the difficulties in drafting appropriate LLC agreements. Also, because LLC statutes are in a state of flux and its recognition is not uniform from state to state, the LLC suffers a handicap when compared to the ever-familiar and well-established corporate entity.

10. Cash Method of Accounting.

Most C corporations are precluded from using the cash method of accounting. Much uncertainty exists in determining whether LLCs will be eligible to use the cash method of accounting. The \( S \) corporation appears to enjoy an advantage over the LLC in qualifying to use the cash method of accounting because it is less likely to be classified as a "tax shelter."

11. Taxable Year.

Without a doubt, the C corporation enjoys maximum flexibility in choosing a taxable year. This is as it should be because the C corporation is a separate taxpaying entity. On the other hand, the LLC must conform its tax year to its members' tax years which will usually be the year of its members holding a majority in interests of profits and capital (if individuals, a calendar year), unless stringent business purpose tests can be met or required payments are made under §§444 and 7519. The \( S \) corporation is subject to similar constraints on use of fiscal years and therefore is comparable to the LLC with respect to this feature.

If the members of the LLC are compensated by the LLC for services rendered, any fringe benefits received could be includible in the recipient member's income as a §707(c) guaranteed payment or could possibly be treated as an in-kind distribution. If characterized as a guaranteed payment, the fringe benefit payment would be deductible to the LLC subject to the capitalization requirement in Section 263. Fringe benefits taxable to LLC members would include medical insurance coverage, group-term life insurance, and similar items.

Shareholder-employees of C corporations qualify for the statutory exclusion of their fringe benefits while more-than-2% shareholder-employees of S corporations are treated like partners in partnerships under §1372. This means that their fringe benefits will be deductible by the S corporation but not excludible from the shareholder-employee's compensation.


Two deficiencies of the C corporation are the accumulated earnings tax and exposure to unreasonable compensation issues. Generally, neither of these is an issue for the LLC because of its partnership status. In limited situations, the S corporation can have reasonable compensation issues raised, e.g., under the built-in gain or passive income tax rules, which put it at a slight disadvantage when compared to the LLC.


The LLC is an enormously flexible entity from a business structuring point of view. It can be organized tax-free by its various members without concern for the 80% control requirement imposed on incorporation under §351. Various combinations of corporations, partnerships, and LLCs can be used to accomplish a myriad of business goals. On the other hand, under §708(b)(2), the LLC is limited for federal income tax purposes to merging tax-free with other partnerships only. They cannot be merged with corporations although they generally can be incorporated on a tax-free basis if the requirements of §351 are satisfied and if the excess of debt over basis provisions of §357(c) are not triggered.
V. CONVERTING TO LLC STATUS

A. Existing Corporations.

1. Existing C Corporations.

a. Exiting corporate solution without incurring a tax consequence with respect to appreciated assets is not possible. Under §§331 and 336, both the shareholders and the corporation could be required to recognize gain on the distribution of the corporation's property to shareholders in liquidation. This double tax could be an enormous price to pay for converting to LLC status and probably will prove to be impractical in most instances. The LLC is attractive because of its enormous flexibility and the single tax it enjoys. But for existing corporations these benefits come at a high price.

b. Example: XYZ Company is an existing subchapter C corporation. Its shareholders have recently heard of the attractiveness of operating in LLC form, especially from a single tax perspective. XYZ's assets have a fair market value of $1,100,000 and an adjusted basis of $100,000. To convert to LLC status and remove XYZ's assets from corporate solution, XYZ would need to be liquidated. XYZ would recognize $1,000,000 gain (at a maximum rate of 35%, or $350,000) and XYZ's shareholders' would report capital gain (to the extent liquidating assets exceed their basis in stock). The shareholders would have a FMV basis in the assets and could then drop them in to a newly formed LLC, taking a substituted basis in their LLC interests.

c. There may be certain limited situations where the price to liquidate a corporation may be worth entering the LLC's single tax regime, as could be the case where the assets' FMVs are not significantly greater than their bases. For a corporation with excess earnings that cannot be reinvested in the business, the accumulated earnings tax exposure could possibly warrant consideration of liquidating the corporation. When reorganized as an LLC, there would no longer be any exposure to the accumulated E&P tax and the E&P would have been eliminated on liquidation without being subject to the ordinary income tax rates. Furthermore, any assets would now have a stepped-up basis in the hands of the LLC.
d. Electing S Corporation Status.

To avoid triggering the liquidation tax, a better approach would be for the regular corporation to simply elect S corporation status to move assets into the single tax. Although dispositions of assets carried into S solution would be subject to a built-in gains tax under §1374 on their pre-subchapter S appreciation, earnings henceforward would be subject to only one tax at the shareholder level.

2. Existing S Corporations.

Like the C corporation, an existing S corporation would find itself subject to a toll charge if it attempted to liquidate its operations in order to drop them into an LLC.

a. When an S corporation liquidates, it is subject to the same subchapter C liquidation rules. Gain is recognized at the corporate level on any appreciated property and this gain flows up to the shareholders, increases their basis in stock and is taxed once. The liquidation proceeds then are distributed to the shareholders in exchange for their stock.

b. Generally, a corporate level tax is avoided by an S corporation (unless the built-in gains tax applies), but the single tax on liquidation is normally sufficient to deter reorganizing operations in the LLC form.

3. Liquidation-Reformation as LLC.

While it might be argued that the liquidation-reincorporation doctrine (which essentially would treat this transaction as one motivated primarily for tax avoidance purposes and which would treat the liquidating distributions as ordinary) could be used to deter corporate liquidations with subsequent formations of LLCs, such an argument should be rejected out of hand since liquidating and reforming as an LLC is inherently different from liquidating a corporation and reentering corporate solution in the form of another corporation.

a. Given the current rate structure, treating distributions as ordinary would incur tax at the maximum ordinary income tax rate of 39.6%. On the other hand, treating such distributions as liquidating distributions would only trigger the 28% capital gains tax. However, since the assets will actually have been removed from corporate solution and put into the single tax regime (rather than into
a second corporation), it would seem the IRS would be hard pressed to argue an ordinary distribution was made in the context of an existing corporation liquidating to form an LLC. In this case, distributions out of the corporation are patently liquidating distributions and could not be characterized as operating distributions.

b. Under pre-1986 rules, when there was no corporate level tax on distributing assets in complete liquidation of a corporation, there may have been situations where the liquidation-reincorporation doctrine was exercised. Although now it would seem that there will be relatively few instances where a liquidation followed by a reincorporation will make sense. Former §§336 and 337 repealed. See Bittker and Eustice, Federal Income Taxation of Corporations and Shareholders, ¶12.64 (1994).

c. In PLR 9404021, the IRS held that a parent corporation could "merge" its wholly owned subsidiary into a Louisiana LLC tax-free. In this case, local law treated the movement of the subsidiary's assets to the LLC as a merger. However, for federal tax purposes, the IRS treated this so-called merger as (i) the formation of the LLC tax-free under §721 with the subsidiary dropping its assets into the LLC in exchange for an interest in the LLC; and (ii) the tax-free liquidation under §§332 and 337 of the subsidiary into the parent corporation with a deemed distribution of its LLC interest up to the parent. Also see PLRs 9409014 and 9409016.

4. Comment: Whether a C or an S corporation is involved, there is a toll charge imposed on the removal of assets from corporate solution and putting them into an LLC. For an existing C corporation electing S corporation status, this toll charge is collected in the form a the built-in gains tax. As a practical matter, for existing corporate operations, electing S corporation status will make more sense than converting the operations into LLC form through a full-scale liquidation.

B. New Operations.

As an alternative to the liquidation-LLC formation, the shareholders of an existing corporation might consider shifting new operations into a newly formed "brother-sister" LLC. Existing operations would remain with the existing corporation, but new activity would be undertaken in the LLC.

1. This transaction would certainly be more attractive than a straightforward liquidation of corporate operations.
However, it suffers from the same exposure as any distribution because the IRS may well be tempted to treat the transaction as an ordinary distribution of assets (going concern value) out of the existing corporation with a subsequent formation of the LLC tax-free. The IRS would be able to collect a tax from the corporation on any deemed sale under §311(b) and from the shareholders on any deemed "dividend" paid to them as a result of forming the LLC and starting new operations there.

2. Even though no hard assets could be traced from the existing corporation to the newly formed LLC, intangible assets arguably could be treated as distributed to shareholders and recontributed to the LLC. Such assets might be going concern value or know how from existing operations transferred to the newly formed LLC.

3. **Comment:** If carefully structured, shifting new operations to a newly formed brother-sister LLC could be a viable planning opportunity. Bringing in new owners, changing business operations, and adding new markets might all be reasons for establishing this structure while at the same time placing future operations under the single tax.

4. An alternative to this transaction would involve variations on dropping corporate assets into a lower-tier LLC with the corporation's shareholders holding direct interests in the LLC. In this way at least some if not a greater portion of the LLC's operations would find their way into the single tax regime.

C. **Converting Personal Service Corporations to LLCs.**

Many personal service corporations ("PSCs") might prefer to organize as an LLC because of its greater flexibility as compared with PSCs. Presently, PSCs must pay a corporate tax at 35% without the advantage of graduated rates. There are special classification issues for PSCs as to whether they can use the cash method of accounting or elect to use §444 fiscal years. These same classification issues could be avoided by moving into LLC status.

1. Converting to an LLC may be relatively easy for the single-owner PSC. In these situations, the PSC probably pays little if any corporate tax because earnings are paid out as deductible compensation to the shareholder-employee.

2. The most substantial asset that the PSC has is its accounts receivable and possibly a partnership interest in a lower-tier partnership. If on the cash method of accounting, a distribution out of the receivables would trigger a §336 gain on liquidation to the extent of the...
fair market value reflected in the zero basis receivables. Thus, rather than liquidating immediately, the receivables could be retained in the PSC until collected and income recognized on their receipt. Any cash would then be paid out in the form of compensation and the corporation liquidated without any further tax (unless there is a partnership interest distributed).

3. While the PSC is winding down, the shareholder-employee can organize the LLC for future activities. This transaction would be similar to that discussed above in that future operations are shifted into the LLC. However, because professional services are involved, it would be less likely that this transaction could be attacked under a liquidation-reformation transaction.

D. Converting Partnerships to LLCs.

Normally converting an existing partnership to an LLC is accomplished by dropping the partnerships assets into a newly established LLC in exchange for ownership interest in the LLC. This transaction will generally be afforded nonrecognition treatment under §721. Rev. Rul. 84-52, 1984-1 C.B. 157. See, e.g., PLR 9226035 (general law partnership converts to LLC). The existing partnership is then liquidated, with the LLC interests distributed to the partners in the original partnership.

1. Termination of Existing Partnership.

a. Certain existing partnerships may want to consider converting to an LLC. This conversion would seem comparable to the conversion of a general partnership to a limited partnership, which the IRS blessed in Rev. Rul. 84-52, 1984-1 C.B. 157. Under the revenue ruling’s rationale, no §708 termination of the existing partnership would be deemed to have occurred because the formation of the LLC would be considered a §721 transaction.

b. Under the partnership termination rules, the §721 contribution of a partnership interest back to the partnership is not considered to be a sale or exchange of an interest in that partnership. Regs. 1.708-1(b)(1)(ii). Only sales or exchanges of 50 percent or more of total interests in capital and profits within a 12-month period technically terminate the partnership under §708. By avoiding a termination of the partnership, no liquidation will be deemed to have occurred and the partnership can continue for tax purposes in LLC form essentially as the previously existing partnership.
c. In general, if the conversion does not change ownership interests in profits, losses, or capital, the conversion will be a nonrecognition transaction under §721. Similarly, if the conversion results in no change of the partners' shares of the partnership's liabilities under §752, there would be no change in the individual partners' bases in the LLC.

d. If the conversion to LLC status were to alter the partners' shares of liabilities, then any increase or decrease in liabilities with respect to any member in the LLC would create either positive or negative adjustments to the individual members' bases in the resulting LLC, with gain resulting to the extent a partner's reduction in liabilities exceeded his basis. Under §1223(1), there would be no change in the member's holding periods with respect to their interest in the LLC; i.e., their holding period in their former partnership interests would tack onto their holding period in their LLC interests.

2. Cash Method of Accounting.

a. Under §448, partnerships are generally permitted to use the cash method of accounting as long as the partnership has no corporate members and is not treated as a tax shelter. Generally, professional service general partnerships use the cash method accounting for their receivables. If this partnership were to convert to LLC status, there is a question as to whether the resulting LLC could continue to use the cash method. If an LLC conversion required the change to the accrual method of accounting, a §481 adjustment would result, and the desirability of LLC status would be greatly reduced.

b. The issue arises under §448(a)(3) which denies "tax shelters" the use of the cash method. As a general partnership, the professional services firm need not concern itself with possibly being classified as a tax shelter. However, if the general partnership converts to LLC status, then there is a possibility under §448(d)(3) that the entity could be treated as a tax shelter under the expansive definitions therein. This would occur because the general partners would have limited liability and this could have the resulting effect of classifying the LLC as a "syndicate" with limited entrepreneurs.
3. Unrealized Receivables and Inventory.

If the conversion of an existing partnership results in a shift in profits, loss, or capital interests, then §751 could trigger the ordinary income recognition on a partner’s share of unrealized receivables or inventory shifted within the partnership. Specifically, under §751(a), if a "transferor partner" receives money or property in exchange for his or her interest in profits, loss or capital, then any income recognized must be allocated to the partner’s proportionate interest in the partnership’s unrealized receivables or inventory.

4. Disguised Sales.

Section 707(a)(2)(B) provides that if a partner contributes property to, and receives a distribution from, a partnership and the two, when viewed together, more properly reflect a sale of property to the partnership, the transfers will be recharacterized as a sale.

a. The IRS has issued regulations relating to these so-called disguised sale transactions, which provide, inter alia, that if the purported contribution and distribution occur within two years of each other, a disguised sale will be presumed to exist. Regs. 1.707-3(c) and (d). If outside of two years, a disguised sale will be presumed not to exist.

b. The regulations also provide detailed rules relating to the treatment of shifts in a partner’s share of partnership liabilities as consideration for a sale of property to the partnership. Regs. §1.707-5. Generally, consistent with established tax law permitting borrowings to be made on a tax-free basis, the regulations exclude from the amount of consideration in a disguised sale the "selling" partner’s share of partnership liabilities. Under these rules, if a partner borrows against property immediately prior to contribution and pockets the loan proceeds, the contribution will be treated as a sale only to the extent that that liability is allocated to other partners. Generally, the §707 debt allocation rules mirror the §752 debt allocation rules with respect to recourse debt obligations; i.e., if the contributing partner bears the economic risk of loss for the debt, there will be no consideration since the debt will be entirely allocable to the contributor.

c. The conversion of a partnership to an LLC could potentially pose a trap for the unwary if the conversion would cause a change in the nature of
debt from recourse to nonrecourse. If a partner avoided disguised sale treatment because he bore the economic risk of loss for a debt prior to conversion, a disguised sale may occur to the extent that that debt is re-allocated to the other members.

(1) **Comment:** To avoid a disguised sale, consider having the member retain the economic risk of loss for the debt or sign on to a deficit restoration obligation.

(2) **Comment:** Sections 704(c)(1)(B) and 737 should be inapplicable to a conversion. A conversion should not give rise to a distribution of partnership assets previously contributed, making §704(c)(1)(B) inapplicable. Further, if there is a shift in partnership liabilities that exceeds basis, gain may arise under §731, which would preclude gain under §737.

VI. BUSINESS PROFILES AND RECOMMENDED BUSINESS FORMS

A. **Cash Rich, Very Profitable Corporations.**

1. The classic entity for electing S corporation status is the very profitable, cash rich closely held corporation. If this entity’s activities can be conformed to an S corporation structure, then the single-level of tax imposed on the S corporation can maximize tax savings and allow for the generally tax-free distribution of earnings.

2. With an S corporation election, this entity need not be concerned with unreasonable compensation claims, personal holding company tax or accumulated earnings tax. Presumably any mechanical problems encountered with operating as an S corporation are overshadowed by the tax savings that will flow to shareholders by virtue of the single level of tax.

3. The LLC also can serve as a choice entity for the cash rich and profitable business.

B. **Interstate Operations.**

Over the past few years, uncertainty regarding an LLC’s limited liability for doing business in states not recognizing LLCs has gradually been resolved by the fact that virtually all states and the District of Columbia now recognize LLCs.

1. Many of these recognize the limited liability of foreign LLCs operating within their state boundaries. What was a worrisome patchwork of states not recognizing LLCs has
become almost a universal blanket across the United States recognizing the LLC members' limited liability. Thus, business operations in LLC form are no longer as compelled to confine their activity to their home state. Companies engaging in interstate activity can adopt the LLC format, and be reasonably comfortable that their members will enjoy limited liability in the LLC's interstate activity.

2. However, if there is any concern as to limited liability for interstate operations, the S corporation form could be adopted. The corporate entity is universally recognized throughout the fifty states for limited liability offered to owners.

C. Manufacturing Operations.

Because manufacturing businesses generally are high liability operations, the S corporation may be preferable to the LLC. Where many outside investors are necessary to provide the capital for operations, the regular corporation is the most flexible and preferred entity. However, the S corporation may indeed be an ideal entity for a closely held situation because it will provide the same protection against liability claims as afforded to a regular corporation.

D. Natural Resources.

The LLC is particularly appropriate for the natural resources industry. By placing interests in natural resources in an LLC classified as a partnership, the members will enjoy the tremendous flexibility of the LLC’s partnership features for tax purposes while protecting themselves from general liabilities. In fact, the Wyoming LLC statute, the first LLC statute enacted in the U.S., was purportedly enacted with natural resources in mind.

E. Real Estate.

LLCs have been used frequently in the real estate industry as a substitute for limited partnerships. As long as the LLC is adequately capitalized for state law purposes, the LLC form should limit the liability of members and does not require a general partner to expose its assets in the real estate venture.

1. The LLC should be a highly attractive entity for holding real estate because, unlike a corporation, the real property can be liquidated out of the LLC without triggering an entity level tax. In addition, the owners of the real estate can shield themselves from liability compared to a limited partnership, and the LLC members can participate in day-to-day activities without losing their liability protection. And, the LLC is not required
to have a "general partner" as one of its members subject to unlimited liability.

2. Because of stock basis, limits on special allocations and gain on liquidation, the S corporation has not served well for holding real estate. However, an S corporation acting as the general partner of a limited partnership may provide the necessary protection to the general partner form liability claims while providing flow-through treatment.

F. Startups.

1. New operations can easily be placed into the LLC form. In these situations, if operations are limited to one state recognizing the LLC form, the flow-through of losses to its members may well be an attraction to using the LLC. If operations later expand and involve several states, incorporating can be accomplished easily if deemed necessary for third party purposes, e.g., dealing with outside creditors or buyers.

2. In addition, high-tech companies engaged in risky research might find the LLC to be attractive while at the same type offering a flexible entity for tax planning purposes. The LLC would give the high-tech company the ability and flexibility to flow initial losses up to its owner-members, to structure preferred equity interests, to compensate employees with special ownership interests, and to joint venture with other high-tech companies.

3. The S corporation also would allow for the creation of IRC §1244 stock so that if the stock needs to be sold or exchanged for a loss, the loss will be treated as an ordinary loss. By electing S corporation status for a brand new entity, a built-in gains tax and passive income tax can be avoided.

G. Venture Capital.

The LLC can readily be used by venture capitalists as an investment vehicle while at the same time allowing the LLC members to actively engage in the investment activities. As long as the LLC is classified as a partnership, the venture capital fund can make special allocations of earnings generated from their investments to its members. The LLC could invest in a myriad number of corporations and partnerships and its ownership can be structured to give different ownership interests to lenders, underwriters, employees, and other investors.

H. General Partner in Limited Partnership.

1. Using the LLC as a general partner in a limited partner-
ship would give the members of the LLC flow-through status while at the same limiting their liability. This structure is preferable to using a general corporate partner, but in the LLC, a general partner's earnings would be subject to only one level of tax.

2. This structure is somewhat comparable to using an S corporation general partner, a familiar arrangement for structuring partnerships to date.

I. Professional Service Organizations.

As an alternative to forming professional organizations as general partnerships, the LLC presents an attractive option whereby partnership tax treatment can be obtained while at the same time the liability of the individual professionals providing services is limited to their own personal misdeeds. A number of the LLC statutes specifically allow professionals in their states to use the LLC as a form for doing business. As an alternative, some states permit or require professionals such as attorneys and accountants to conduct operations through a Limited Liability Partnership if liability limitation is sought.

J. Corporate Joint Ventures.

A joint venture between two or more corporations could be conducted through an LLC. In general, the corporate members would consist of single purpose subsidiaries which would hold the LLC interest. This constitutes a layered defense against liabilities of the business.

Consideration could also be given to using the LLC as a leveraged-buyout vehicle. In this case, the target corporation could drop its assets into an LLC and the investors (e.g., senior management) could take direct LLC interests along with any third-party banks and underwriters. The LLC as an LBO vehicle has the practical limitation of being unable to freely transfer interests, and therefore generally cannot be used in a publicly traded context.

K. Substitute for Trust.

Another possible use of the LLC is as a substitute to an irrevocable life insurance trust, or other gift trusts used in an estate planning context. The distribution and investment limitations generally used in a trust instrument can be used in the LLC as well. The LLC has a clear advantage of trusts because its members are subject to the 39.6% tax rate much less quickly than are trust (39.6% applies at $7,500 of income or more).
VII. CONCLUSION

A. Selecting the appropriate form of business operation—whether to use a regular corporation, a partnership, S corporation, or an LLC—is a difficult decision complicated by business and tax considerations. Each situation will need to be evaluated on its own facts, and the relative oversight of operating as one entity over another will need to be considered or reexamined from time to time.

B. Since 1982, various tax acts have made the S corporation more attractive by simplifying its use, reinforcing its certainty as a taxable entity, enhancing its flexibility and giving it favorable tax treatment. However, the recent enactment of LLC statutes across the nation has clearly changed the balance in the choice-of-entity sweepstakes in favor of the LLC. In any event, current rules favor the flow-through entity whether an S corporation or LLC.