IV. UNDERSTANDING COMPLEX TAX ISSUES

By Judith S. Lambert

A. CHECK-THE-BOX CLASSIFICATION SYSTEM

The treasury regulations have default classification rules for tax treatment of limited liability companies. The default classification for a single member limited liability company ("LLC") will be a disregarded entity and treated as a sole proprietorship for federal tax purposes.[1] An LLC with two or more members will be treated as a partnership for federal tax purposes under the default rules.[2] The check-the-box regulations allow for certain types of entities to elect how they will be treated for federal tax purposes.[3] The entities do not have to make an election, since the regulations will assign these default classifications.[4] However, an election is necessary if the entity wants a different classification than the one provided in the default rules.

The check-the-box regulations allow a single member LLC and a multiple member LLC to elect to be taxed as a corporation.[5] However, a single member LLC may not elect to be treated as a partnership. Additionally, the procedure for an LLC electing to be taxed as a corporation is by filing a Form 8832 or Form 2553. The Form 8832 is the entity election classification form for federal tax filing purposes. If the LLC also wants to be taxed as a subchapter S corporation then it could alternatively file the Form 2553. The IRS recognizes this form as both the election to be treated as a corporation and for the S corporation election. The Form 2553 has strict time limits and must be filed within two months and 15 days from the time the LLC wants to be taxed as an S corporation. Typically, LLCs would prefer to be either disregarded as an entity or treated as a partnership to allow the pass through of income. However, by electing to be taxed as an S corporation, the LLC still enjoys the benefits of the pass through treatment and avoids the

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[1] Treas. Reg. §301.7701-2(a)
[2] Treas. Reg. §301.7701-2(a)
[3] Treas. Reg. §301.7701-2(b), et seq.
[4] Treas. Reg. §301.7701-3(b)
[5] Treas. Reg. §301.7701-3(b)

double taxation of a C corporation. Although being treated as an S corporation imposes limitations on ownership by different types of shareholders and restrictions on different classes of stock.

B. STATE TAX CLASSIFICATION

All of the states and the District of Columbia have statutes authorizing LLCs. Generally, Florida Statute 608.471 sets forth that an LLC will be treated as it is for federal tax purposes.[6] The Florida Department of Revenue follows the federal classification scheme for determining the tax classification for an entity. The acceptance of the federal classification system includes acceptance of "disregarded entities".[7] In general, this income tax is imposed on corporations that are taxable as corporations under

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[6] **FL Stat. section 608.471 Tax exemption on income of certain limited liability companies.**-

(1) A limited liability company classified as a partnership for federal income tax purposes, or a single member limited liability company which is disregarded as an entity separate from its owner for federal income tax purposes, and organized pursuant to this chapter or qualified to do business in this state as a foreign limited liability company is not an "artificial entity" within the purview of s. 220.02 and is not subject to the tax imposed under chapter 220. If a single member limited liability company is disregarded as an entity separate from its owner for federal income tax purposes, its activities are, for purposes of taxation under chapter 220, treated in the same manner as a sole proprietorship, branch, or division of the owner.

(2) For purposes of taxation under chapter 220, a limited liability company formed in this state or authorized to transact business in this state as a foreign limited liability company shall be classified as a partnership, or a limited liability company which has only one member shall be disregarded as an entity separate from its owner for federal income tax purposes, unless classified otherwise for federal income tax purposes, in which case the limited liability company shall be classified identically to its classification for federal income tax purposes. For purposes of taxation under chapter 220, a member or an assignee of a member of a limited liability company formed in this state or qualified to do business in this state as a foreign limited liability company shall be treated as a resident or nonresident partner unless classified otherwise for federal income tax purposes, in which case the member or assignee of a member shall have the same status as such member or assignee of a member has for federal income tax purposes.

(3) Single-member limited liability companies and other entities that are disregarded for federal income tax purposes must be treated as separate legal entities for all non-income-tax purposes. The Department of Revenue shall adopt rules to take into account that single-member disregarded entities such as limited liability companies and qualified subchapter S corporations may be disregarded as separate entities for federal tax purposes and therefore may report and account for income, employment, and other taxes under the taxpayer identification number of the owner of the single-member entity.

[7] TIP 98C1-05, issued July 1, 1998.

subchapter C of the Internal Revenue Code commonly referred to as "C Corporations." If the entity is determined to be a C Corporation, then it will incur this Florida state income tax. See section G below for further details.

C. CONVERSIONS FROM OTHER ENTITIES

1. CONVERSION OF CORPORATION TO LLC

a. MULTIPLE MEMBER LLCS TREATED AS A PARTNERSHIP

The Internal Revenue Code and the Treasury Regulations do not provide for a tax free reorganization of a corporation into an LLC. Therefore, the conversion of a corporation into an LLC basically requires a liquidation of the corporation. A liquidation of the corporation can cause the corporation and the shareholders to recognize gain on any assets that appreciated while held in the corporation. If there will be a recognition of gain, then a conversion may not be an appropriate method to use, unless the benefits of the LLC structure outweigh the tax consequences.

There are three ways to accomplish the conversion of a corporation into an LLC. The first method is for the corporation to transfer its assets to the LLC in exchange for interests in the LLC; then, the corporation would liquidate its LLC interests to the shareholders in a complete liquidation of the corporation. An alternative to accomplish the conversion would be for the corporation to liquidate its assets in complete liquidation, then, contribute the assets to the LLC. The third method would be for the shareholders to contribute their corporate stock to the LLC and then liquidate the corporation's assets into the LLC.

EXAMPLE: Able and Bob are shareholders in Converting Corporation. Able owns 50 shares for which he paid $10,000 and Bob owns 50 shares for which he paid $20,000. At the time of the liquidation, Converting Corporation owns assets worth $50,000 that cost $30,000 to purchase. Converting Corporation distributes $25,000 in assets each to Able and Bob. Able will recognize $15,000 in gain for the difference between his cost of $10,000 and the fair market value of $25,000. Bob will recognize $5,000 in gain for the difference between his cost of $20,000 and the fair market value of

$25,000. The corporation will recognize gain of $20,000 for the difference in the cost of the assets $30,000 and the fair market value of $50,000. When the assets are contributed to the LLC, then there is no recognition of gain under I.R.C. section 721. If the corporation is an S corporation, then the gain to the corporation of $20,000 will be passed through to the shareholders and the shareholders will be required to recognize the gain of $10,000 each. Then $10,000 recognized gain will increase each shareholders' basis in the assets by $10,000. The increase in shareholder basis will result in the same aggregate amount for the recognition of gain to each shareholder of $15,000 for Able and $5,000 for Bob.

b. LLCS ELECTING TO BE TREATED AS A CORPORATION

If a corporation desires to convert to an LLC and the LLC elects to be taxed as a corporation, then the transaction may be able to qualify as a tax free reorganization, if properly structured. In a tax free reorganization, the corporation and the shareholders do not have to recognize gain or loss.

c. SINGLE MEMBER LLCS DISREGARDED AS AN ENTITY

If a single member LLC is disregarded as an entity for federal tax purposes, then a tax free A reorganization is possible, if the owner of the LLC is a corporation.

2. CONVERSION OF PARTNERSHIP TO LLC

An existing partnership converting to an LLC that continues to be taxed as a partnership will not recognize any loss or gain on the contribution of the assets to the LLC.[8] As long as the business of the partnership continues in the LLC, the existing partnership will not be treated as terminated.[9] Thus, it will not be necessary to file a short year return for the partnership nor obtain a new taxpayer identification number. The partners' cost basis in the LLC will remain the same as their cost basis in the partnership, unless the partner's share of partnership liabilities changes.[10]

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[8] I.R.C.§721(a)
[9] I.R.C.§708
[10] I.R.C.§752

D. DISTRIBUTIONS AND ALLOCATIONS

1. ELECTION TO BE TREATED AS A PARTNERSHIP

a. ALLOCATIONS

The partnership rules and regulations governing partnerships apply to LLCs that are treated as partnerships for federal tax purposes. A member's distributive share of income, gain, loss, and deductions are passed through to the members and included in each member's income for that tax year.[11] Certain items must be separately stated for each member, such as charitable contributions, qualifying dividends, capital losses, rental income, and passive income and losses.[12]

When taxed as a partnership, the LLC is allowed to disproportionately allocate income, gain, loss, and deductions among the members. The LLC Operating Agreement will control the allocation of each member's allocation of income, gain, loss, and deductions.[13] However, the IRS will not allow the disproportionate allocations if (i) such allocation does not have "substantial economic effect" or (ii) the LLC Operating Agreement does not provide for the member's distributive share of income, gain, loss, and deductions.[14] If the IRS disallows the disproportionate allocations, then each member's allocation will be determined in accordance with the member's interest in the LLC.[15]

Losses that are allocated to a member will be limited to the extent of the member's adjusted tax basis of his or her interest.[16] If a loss is limited, then it is held until the member has a sufficient basis.[17] The member's adjusted basis equals the amount of money and property that he or she contributed to the LLC, plus the member's share of the LLC liabilities. The member's share of LLC liabilities is considered a contribution of

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[11] I.R.C.§706(a)
[12] I.R.C.§702(a); §703(a)
[13] I.R.C. §704(a)
[14] I.R.C. §704(b)
[15] *Id.*
[16] I.R.C. §704(d)
[17] I.R.C. §704(d)

money by such member to the LLC.[18] If the member personally guarantees the liability, then the member can increase their adjusted basis for that liability, known as recourse liability. However, if no member guarantees repayment of the liability and it is solely secured by partnership assets, then the liability is considered nonrecourse. If the debt is nonrecourse, then all of the members share equally in the liability and their basis are adjusted accordingly.

b. DISTRIBUTIONS

Distributions refer to the actual receipt of cash or other property to a member. Distributions are generally not a taxable event and affect the member's tax basis in their LLC interest. The LLC Operating Agreement determines each member's distributive share of property. The member's tax basis is adjusted based on such distributions. The member's tax basis is increased for his or her distributive share of income and decreased for the member's distributive share of losses.[19] The member's tax basis is never reduced below zero and any losses that exceed the member's tax basis are carried over to the next tax year.[20] The cash or property received by a member reduces the member's basis in his or her LLC interest. This distribution is generally not a taxable event to the member or the LLC.[21] If the cash received by the member is in excess of the member's basis in his or her LLC interest, then the member will recognize gain.[22] This gain will generally be treated as gain from the sale or exchange of the LLC interest.[23]

2. ELECTION TO BE TREATED AS A CORPORATION

If the LLC chooses to be taxed as a corporation, then the rules for taxation of corporations apply. S corporations will allocate the income, gains, losses, and deductions in accordance with each member's interest and it will pass through and be reportable on each member's personal income tax return. The S corporation election will prevent

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[18] I.R.C. §752(a)
[19] I.R.C. §705(a)
[20] I.R.C. §704(d)
[21] I.R.C. §733
[22] I.R.C. §731
[23] I.R.C. §751(b)

disproportionate allocations and caution should be used to make certain that the interests are not considered as more than one class of stock. If the interests are considered as more than one class of stock it will result in a disqualification of the subchapter S election.[24]

The general rule is that a corporation that has more than one class of stock does not qualify as a small business corporation (S corporation).[25] A corporation is treated as having only one class of stock if all outstanding shares of stock of the corporation confer identical rights to distribution and liquidation proceeds.[26] The determination will be based on the Operating Agreement. The LLC being taxed as an S corporation also needs to be careful when issuing debt instruments so that such instruments are not treated as a second class of stock. The treasury regulations provide safe harbor rules to prevent such classification. Straight debt will not be treated as a second class of stock if the instrument does not provide for an interest rate or payment dates that are contingent on profits, is not convertible to stock, and is held by a qualifying individual.[27]

If an LLC being taxed as a corporation does not choose the subchapter S election, then the LLC will incur a corporate level tax. Since the C corporation incurs the tax and the income does not pass through to the member, the member will not recognize gain or loss on the income of the corporation. The member will only recognize income if a dividend is declared and paid to the member. These dividends will be allocated to each member in accordance with their interest in the LLC.

E. PASSIVE ACTIVITY LOSS RULES

If the business is determined to be a passive activity for a member, then the losses from the LLC will only be allowed to the extent that they exceed passive activity income. [28] Passive activities include activities involving the conduct of a trade or business and in which the taxpayer does not materially participate.[29] A taxpayer will be treated as

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[24] I.R.C. §1361
[25] Regs. Sec. 1.1361-1(l)
[26] *Id.*
[27] *Id.*
[28] I.R.C. §469(a)(1)(A)
[29] I.R.C. §469(c)(1)

materially participating if the taxpayer is involved in the operations of the activity on a basis which is regular, continuous, and substantial.[30]

Except as provided in the treasury regulations, no interest in a limited partnership as a limited partner shall be treated as materially participating.[31] A limited partner will be treated as materially participating in an activity if the limited partner: (1) participates in the activity for more than 500 hours during the year; (2) materially participated in the activity for any five of the preceding ten years; or (3) materially participated in the activity in any three preceding years if the activity is a personal service activity.[32] These regulations specifically apply to limited partnerships and it not entirely clear whether they are applicable to limited liability companies.

Any passive activity losses that are disallowed are carried forward to the next year.[33] When the taxpayer disposes of his or her entire interest in the passive activity, the suspended losses are allowed in full.[34] Rental activities are specifically included in the definition of passive activity, even if the taxpayer actively participates.[35] There are exceptions to these rules relating to rental activities. Generally, a member may deduct up to $25,000 (subject to phaseout) of rental activities if the member actively participates.[36]

F. SELF-EMPLOYMENT TAX

A tax is imposed on the self employment income of every individual.[37] This tax consists of the 12.4% for old-age, survivor and disability insurance (OASDI) and 2.9% for hospital insurance.[38] The amount of the individual self employment earnings that are included in self employment income is limited to the contribution base in effect for each year. The contribution base for the calendar year 2008 is equal to $102,000.[39] These taxes

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[30] I.R.C. §469(h)(1)
[31] I.R.C. §469(h)(2)
[32] Regs. Sec. 1.469-5T(e)(2)
[33] I.R.C. §469(b)
[34] I.R.C. §469(g)
[35] I.R.C. §469(c)(2)
[36] I.R.C. §469(i)
[37] I.R.C. §1401(a)
[38] *Id.*
[39] Notice 2007-92

are typically referred to as the self employment tax. The net earnings from self employment include a partner's distributive share of income or loss from a partnership.[40] The self employment net earnings do not include income from rent, dividends, interest, and capital gains.[41] A limited partner's distributive share of income or loss is excluded from self employment net earnings.[42]

The IRS issued proposed regulations that define which partners are to be considered limited partners for purposes of the self employment tax. These proposed regulations provide that an individual will be treated as a limited partner unless the individual (i) has personal liability; (ii) has authority to contract on behalf of the partnership; or (iii) participates in the partnership's business for more than 500 hours during the partnership's taxable year.[43] However, there is an exception if the partner is involved in a service partnership in the fields of health, law, engineering, architecture, accounting, actuarial science, or consulting.[44] To date, these proposed regulations have not been finalized.

If the LLC elects to be taxed as a corporation, then only the income paid to the member as salary will be subject to the employment tax for employees. Employees are required to pay FICA (social security) and FUTA (unemployment) taxes on their wages. Distributions of dividends paid to shareholders of a C corporation are not subject to the self employment tax. Likewise, income passed through to individuals from an S corporation are not included in self employment earnings and not subject to the tax. However, courts have held that stockholder/officers of an S corporation who receive compensation for their services are employees whose wages are subject to FICA and FUTA taxes.[45] The S corporation should pay reasonable compensation to the shareholders

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[40] I.R.C. §1402(a)
[41] I.R.C. §1402(a)
[42] I.R.C. §1402(a)(13)
[43] Prop. Regs. Sec. 1.1402(a)-2(h)(2)
[44] Prop. Regs. Sec. 1.1402(a)-2(h)(5)
[45] *Radtke v. United States*, 895 F.2d 1196 (7th Cir. 1990); *Fred R. Esser, P.C. v. United States*, 750 F. Supp. 421 (D. Ariz. 1990).

and then the remaining distribution can be classified as a distribution with respect to the individual's ownership interest.

G. STATE INCOME TAXATION

The state of Florida taxes the net income for certain taxpayers. Florida imposes a tax in an amount equal to five and one-half percent (5 ½ %) on the taxpayer's net income for the taxable year.[46] If the entity is determined to be a C Corporation, then it will incur this Florida state income tax.

The statute provides that corporations include all domestic corporations, foreign corporations qualified to do business in this state or actually doing business in this state, limited liability companies, common-law declarations of trust, corporations not for profit, professional service corporations, foreign corporations not for profit which are carrying on their activities in this state; and all other organizations, associations, legal entities, and artificial persons which are created by or pursuant to statutes of this state, the United States, or any other state, territory, possession, or jurisdiction.[47]

The statute excludes from the term "corporation" proprietorships (even if using a fictitious name), partnerships of any type, limited liability companies that are taxable as partnerships for federal income tax purposes, estates of decedents or incompetents, testamentary trusts, or private trusts.[48] Taxable income in the case of an S corporation only includes those amounts subject to tax as built-in gains or passive investment income.[49] An S corporation will not be subject to built-in gain or passive investment income, if it has never been a C corporation nor acquired assets from a C corporation. A limited liability company is only subject to the state income tax if it is taxable as a corporation for federal tax purposes.[50]

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[46] F.S. 220.11
[47] F.S. 220.03(e)
[48] F.S. 220.03(e)
[49] F.S. 220.13(2)(i)
[50] F.S. 220.13(2)(j)