Chapter 5: Legal and Tax Implications for LLCs

INTRODUCTION

The limited liability company (LLC) is a business entity created by statute in every state. The LLC is essentially a combination of a corporation and partnership. The owners, usually called members, enjoy the liability protection of a corporation and the taxation and operation options of either a corporation or a partnership. It is also possible to have a single-member LLC which can operate as a sole proprietor or a corporation. These attributes have caused the LLC to be a preferred choice of entity for many new businesses.

HISTORY

In relation to other business entities, the LLC is relatively new. Wyoming was the first state to pass legislation in 1977 to authorize LLCs. Outside Wyoming, the LLC received little attention until 1988, when the IRS declared that LLCs organized under Wyoming’s LLC statute would be considered a partnership for federal tax purposes. Other states quickly realized the advantage of having an LLC business entity available to its business community and enacted their own LLC legislation. By 1996, every state, plus the District of Columbia, had enacted legislation permitting LLC formation.

DIFFERENCES IN STATE LAW

Each state has its own unique LLC statutes. Some of the statutes are binding upon the LLC, such as formation issues. That is, each LLC must submit articles of organization precisely as the statute states. However, most of the statutes are merely default rules for when the LLC members either have no operating agreement or no agreement on a specific issue covered by a default rule. For example, most states’ default rule for voting provides that each member has a vote equal to his ownership interest. However, since this is merely a default rule, the members may agree to override the default rule and have a per capita system of voting.

There is some degree of difference between the states’ default rules. However, since each state’s default rules tend to be a derivative of the original Wyoming statute, there seems to be more similarities than differences among the state default rules. Therefore, concepts discussed in this chapter are generally applied to LLCs over all states. Practitioners should be sure to review their state’s default rules to be aware of any differences between the general LLC issues discussed in this chapter and a specific state’s default rules.

Note. Many states (inc. Illinois) have followed the Revised Uniform Limited Partnerships Act (RULPA) in enacting rules preventing foreclosure of an owner's interest and forced liquidation of the business to satisfy a personal debt liability of the owner. A creditor with a charging order cannot become a member of the LLC, if the operating agreement is worded properly. This gives protection of the LLC assets from personal liabilities of the members. Due to the complexity of the LLC statute, it is imperative that the taxpayer seek competent legal advice.
WHY IS AN LLC UNIQUE?

The LLC combines desired attributes of a corporation and a partnership. Previously, anyone setting up a business typically decided between a corporation and a partnership. Some people would opt for a corporation for its liability protection while others would choose a partnership for its pass-through taxation and more informal structure. With the creation of LLCs, people can now have both.

PRIMARY ATTRIBUTES OF AN LLC

INFORMAL ORGANIZATION

Most states allow LLC members to determine the management structure of the company. Except for a few states that require a centralized corporate-like structure, the LLC members can choose between centralized management and management by the members. Most members of LLCs choose a partnership-like, member-managed governance structure since this system is very flexible and allows for management by committee, management by a sole member, or management by a nonmember manager.

Furthermore, the informal structure of LLCs typically does not require member meetings. Corporations, on the other hand, are required to have shareholder meetings due to their more formal organization. A corporation that does not hold annual shareholder meetings may be in jeopardy of losing its distinction from its owners. Such an event is unlikely to happen in an LLC since member meetings are not required. However, even if meetings are not required, it is strongly recommended that regular periodic member meetings be held.

FLEXIBLE TAX STRUCTURE

Check-the-box tax regulations allow LLC business owners to elect the desired status for federal tax classification. If no election is made, a single-member LLC is taxed as a sole proprietorship and a multi-member LLC is taxed as a partnership. However, circumstances may be such that a corporate tax classification will be advantageous for the LLC. In that case, the owners merely “check the box” and elect a corporate tax classification. The check-the-box regulations make tax classification a very simple matter. The check-the-box regulations are discussed later in this chapter.

NO RESTRICTION ON OWNERSHIP

In most states, there are no ownership restrictions in an LLC. Owners may be persons, trusts, estates, or other business entities. Furthermore, there are no limits on the number of owners in an LLC. Partnerships and C corporations share these characteristics with an LLC. However, an S corporation has specific limitations on the type of ownership and the number of owners allowed.

ALLOCATIONS AND DISTRIBUTIONS OF EARNINGS

Allocations are the proportions of any item of income, loss, deduction, or credit attributed to each member. Each year, an LLC taxed as a partnership files an informational return (Form 1065) with the IRS showing the LLC’s income or loss allocation among the members. The allocation does not have to be in proportion to the members’ contributions. Allocations can be based upon per capita, ownership interest, or any other means of distributing allocations on which the members agree. Each state has default rules as to how the allocations will occur, but the default rules can be overridden by the LLC’s operating agreement.

Caution. If the LLC elects C corporation treatment and then files an S election, it is subject to all S corporation statutes.
RELATIVELY NEW ENTITY

As previously discussed, the LLC is a relatively new business entity. In some states, the concept is less than 10 years old. Therefore, case law surrounding an LLC’s formation, operation, and taxation is limited. The courts have not had the time or the opportunity to interpret many of the LLC statutes. A significant issue that has had limited exposure to the courts is the concept of limited liability for LLC members. Most LLCs are formed relying on the statement that within state statutes there is limited liability. The general understanding is that LLCs have the same limited liability for its members as a corporation provides for its shareholders. However, the scope of the limited liability of LLCs will eventually be subject to court holdings.

Liability Veil Piercing

Corporations are subject to a concept called “piercing the corporate veil” in which the limited liability of the shareholder is challenged. Essentially, a person(s) cannot use a corporation to commit fraud on others, have such complete control over the corporation that the corporation has no separate existence of its own, or cause injury or unjust loss from the shareholder’s wrong. If one of these conditions exists or occurs, the court may pierce the corporate veil of the corporation and declare that the corporation and shareholder(s) are one and the same. Thus, shareholders lose the liability protection of the corporation and become personally liable for the corporation’s acts.

The liability protection provided by an LLC is grounded in corporate liability protection. Therefore, it follows that LLCs can be subject to veil piercing. So far, cases involving LLC veil piercing are few and certainly not enough to predict the future trend. Thus, some uncertainty lies with LLCs in regards to the extent of their liability protection for members. The scenario in which an LLC is most likely to have its limited liability veil pierced is where it is grossly undercapitalized from the outset and the members, by commingling funds and not documenting loans to the LLC, have not treated it as a separate entity.

Tax Issues

Another issue related to the newness of the LLC is tax treatment. Like limited liability issues, some issues of statute and regulation interpretation have not had time to fully develop. For the most part, the tax rules of either a partnership or corporation can be successfully applied to an LLC. However, some nuances still need to be worked out. For example, an issue that is yet to be resolved is the test for determining if an LLC member is an active member or nonactive member. Like a limited partner in a limited partnership, a nonactive member of an LLC is not subject to self-employment tax on his share of the profits. However, there is no precise definition or test as to a nonactive member of an LLC.

The veil piercing, tax treatment, and other unresolved issues will eventually go through the court systems, be adjudicated, and provide practitioners with a clearer understanding of the law of LLCs. In the meantime, established LLC, corporate, and partnership law are reasonable guides to be used.

LIABILITY PROTECTION FOR MEMBERS

A primary reason for starting a business under a limited liability entity is to protect the owner(s) from the liability of the business.
ENTITIES WITH NO LIABILITY PROTECTION

A sole proprietorship not only has the investment of the business at risk but also the sole proprietor’s personal assets. Partners in a general partnership are jointly and severally liable for the partnership and other partners. That is, any one partner can be liable for the actions of the partnership and the other partners. The only requirement for all partners to be jointly and severally liable is that the partner at fault was in some way conducting partnership business. This liability includes partnership investments and personal assets. A party seeking damages or credit, once partnership assets have been depleted, can file a claim against a partner’s or all partners’ personal assets to recover excess damages.

Example 1. Arnold, Bob, and Carter form a partnership; each is a general partner. Arnold negligently injures another driver in an automobile accident while performing work for the partnership. The injured party can seek damages from the partnership. If the partnership assets are insufficient, the injured party can seek the personal assets of Arnold, Bob, and Carter. Bob and Carter have joint and several liability for the partnership and for Arnold’s liability since he was performing partnership work.

LIMITED LIABILITY ENTITIES

Conversely, a business established as a limited liability entity, such as an LLC, has only the business investment at risk and not personal assets, unless personal assets were used to guarantee loans of the business. There are two primary business entities that provide limited liability: The corporation and the LLC. The limited liability concept of the two entities are very similar. The members or shareholders do not risk their personal assets solely because they are members or shareholders. Consequently, this discussion focuses on limited liability protection for LLC members only. Case law regarding the fine points of liability protection of LLCs is still being developed and sorted out by the courts. However, without a doubt, LLCs provide a substantial amount of liability protection to its members, not just the inactive investors.

Observation. It should be noted that limited partnerships provide limited liability protection to limited partners. The general partners, however, remain subject to joint and several liability as discussed above. The definition of a limited partnership requires that there must be one or more general partners and one or more limited partners. The advent of LLCs, the refinement of state laws relating to LLCs, and the gradual gaining of confidence in LLCs has greatly reduced the use of limited partnerships. The LLC provides limited liability protection to all its members, not just the inactive investors.

In every state, members of an LLC have no personal liability due to their status as a member of the LLC.

Example 2. Rapid Printing, LLC is successfully sued for breach of contract. Therefore, each member’s interest in the LLC is at risk to be lost to or attached by the plaintiff. However, the member’s personal assets are not affected by the lawsuit. It is important to recognize that the limited liability protection of LLCs is subject to veil piercing. If, in Example 2, the LLC was established to commit fraud or had no separate existence of its own, then a court may pierce the limited liability veil. In such a case, the members’ personal assets are at risk. Also, any personal assets a member uses to guarantee a loan for the business are not protected by limited liability.

LIMITATION TO LIMITED LIABILITY

An individual does not enjoy limited liability if his own actions caused harm.

Example 3. Jones Delivery, LLC is owned by Louise, Bertha, and Cecilia. If Louise is negligent in injuring another driver in a car accident while performing work for the LLC, her LLC interest and personal assets are at risk. Bertha and Cecilia will have their LLC interest at risk, but not their personal assets. Bertha and Cecilia were not personally responsible for the injury. Therefore, limited liability protection of the LLC limits Bertha’s and Cecilia’s risk to only their LLC interest.
Example 4. A nonmember employee of Jones Delivery, LLC injures another driver in a car accident while working for the LLC. In this case, none of the members has her personal assets at risk since they were not personally responsible for the harm caused. Only the member’s LLC interest is at risk, and only the employee’s personal assets are at risk. This limited liability characteristic is similar whether the business entity is an LLC or a corporation.

Observation. If the member who hired the driver knew she had a bad driving record, the court might hold the LLC liable for damages.

In some situations, limited liability is a moot point. Many entrepreneurs or closely-held businesses use most or all of their personal assets to help capitalize a new business or personally guarantee loans for the new business. In this situation, the limited liability related to the credit risk is of little help. Since most or all of the individual’s assets are either in the business or used to guarantee loans, they are freely accessible to creditors and claims.

Liability arises from several sources, such as:

- Credit risks,
- Accidents, and
- Tax issues.

As noted above, it may be possible for a member to have limited liability from some risks and not others.

FORMATION

Formation of the LLC requires filing an organizational document, usually called the articles of organization (articles) with the secretary of state or other similar official in the state where the LLC is formed. The articles perform a similar function to articles of incorporation for corporations and require only a minimal amount of information. Most states have standard forms that can be retrieved from the secretary of state via the Internet, mail, or other means.

Every state requires that the articles contain the name of the LLC. The LLC name may include the name(s) of the member(s) or a unique name selected by the members, but it must be distinguishable from other names already reserved by other business entities. Furthermore, most states require the name to include some reference to being an LLC such as “LLC,” “Ltd.,” or “Limited Liability Company.” The selected name is approved and registered by the secretary of state.

The articles also require the name and address of a statutory agent. The statutory agent is a person who is a resident of the state where the LLC is organized and is authorized to accept service of process for the LLC. Any legal process or notice required by law is served on the statutory agent. For example, if an LLC is sued, the court documents are served on the statutory agent, who is then responsible for passing them on to the company. The statutory agent may be a member of the LLC, but it is not a requirement. Often a nonmember, particularly the LLC’s attorney or accountant, serves as statutory agent. Typically, the statutory agent must sign the articles declaring that he has accepted appointment as statutory agent.

Other information that may be required in the articles, depending on the state, is an address for the company, purpose for the LLC, and when the LLC is to be dissolved. States may impose an annual report filing requirement along with fees.

Every new LLC must file a Form SS-4, Application for Employer Identification Number, with the IRS to secure an employer identification number (EIN). There is an exception if the LLC is the result of a conversion from another business entity that had an EIN, or if the LLC is being taxed as a sole proprietor. In the case of a conversion from another business entity, the EIN of that entity is continued by the LLC; if it’s a single-member LLC, the individual’s social security number is used. If state returns are required, a state registration may be necessary.
Every state has a default rule that puts the management of the LLC in the hands of the members. However, an operating agreement can override these rules. Therefore, an LLC can have any number of management systems.

**CENTRALIZED MANAGEMENT**

One management system that is available for an LLC, but is not typically used, is a centralized management system. The centralized system is typical of a corporation. In such an organization, the shareholders elect a board of directors that makes policy decisions for the company. The board of directors in turn selects officers that run the business and make the day-to-day operating decisions. This structure is effective in some situations, such as in an LLC with a large number of members and where keeping the company closely held is not an issue. However, this system of management is more structured and formal than most LLCs require and takes the management out of the member’s hands.

**MEMBER MANAGED**

The vast majority of LLCs have some type of member-managed governance system. In a true member-managed LLC, each member has the actual and apparent authority to bind the company. That is, each member can bind the company to ordinary business transactions in the day-to-day operation of the company. The operating agreement typically defines ordinary business transactions and other transactions. The members can only enter into other transactions upon an affirmative vote. For example, a farming operation organized as an LLC may allow any member to purchase inputs for the operation and enter into ordinary business transactions, but require a vote of the members before any land can be bought or sold, which is not an ordinary transaction.

When a vote goes to the members, most states default to an interest-based voting system. That is, each member has voting power proportionate to his ownership interest in the company. Other states provide for a per capita system — one member, one vote. Regardless of the state default rules, the members can decide which voting system to implement as part of the operating agreement. The proportional-share system tends to favor the members with larger ownership interests, while the per-capita system tends to better protect the minority members. Regardless of the voting system, each member has some say in the management of the LLC.

**MANAGING MEMBER**

Many LLCs use a modified member-managed system that is similar to a limited partnership. In this system, one or more members are declared the managing members and the remaining members are nonmanaging members. The managing members are like general partners in a limited partnership. It is their duty to manage the LLC on behalf of all members. Only the managing member(s) have the authority to bind the company in day-to-day transactions. The nonmanaging members have no authority to bind the company and in fact, may be liable to the company and other members if they do bind the company without authorization.

**Note.** The managing partner in a limited partnership is a general partner. Therefore, he does not have the liability protection an LLC offers the managing member.

Like the member-managed systems discussed previously, the managing member(s) often have authority to bind the company as limited in the operating agreement. Many states limit the managing members’ authority by statute. Furthermore, some states require the managing member system to be declared when filing the articles of organization. Using the previous farm operation example, the managing members have authority to buy inputs for the farm but require an affirmative vote by the members before entering into a nonordinary transaction such as buying or selling land. The managing member(s) may also be liable to the company and other members if they exceed the scope of their authority.
The managing member system has several advantages over the member-managed system.

- It places management into the hands of the member(s) who have the talent, skills, and desire to manage the company.
- It allows those members to be inactive who do not want a managing role and thus benefit by not being subject to self-employment (FICA) taxes.
- Only a limited number of members have the authority to bind the company.

Caution. An LLC member’s liability for SE tax has not been clearly defined by the IRS.

NONMEMBER MANAGER

Members of an LLC can agree to put the management of the company in a nonmember. This is very similar to a corporation’s board of directors selecting a president to run the affairs of the company. In most cases, the manager is an employee of the LLC and has full authority to bind the company. Often, the manager’s authority is more limited than authority granted to managers who are also members. The advantage to this system is that members can be mere investors with a casual interest in management. The disadvantage is that a hired manager may not have the same devotion and interest in managing the company as a vested member.

THE OPERATING AGREEMENT

The operating agreement is the equivalent of bylaws for a corporation or a partnership agreement for a partnership. It is an agreement among the members that governs the operating and management aspects of the LLC. In some states, an operating agreement is required, but in most states the operating agreement is optional. A notable exception to the optional requirement of most states is that if the member wishes to vary any of the default rules provided by state law, the LLC must have an operating agreement. The operating agreement usually incorporates many of the default rules but most can be overridden if the members so choose.

There are several key items the operating agreement should address.

DURATION OF THE LLC

Most LLCs are formed with the theoretical intent of lasting perpetually. However, the members can agree to dissolve the LLC at a given date in the future or upon a specific triggering event. For example, the members can agree that the LLC is to last for 10 years and be dissolved. As another example, the members might agree that upon the sale of the last parcel of land owned by the LLC, the LLC is dissolved.

HOW THE LLC IS MANAGED

The operating agreement should define which management system is used. In the case of a member-managed system, the initial managing members are identified and a process for naming additional or successor managing members is also defined. In addition, the scope of the authority of the managing members is well defined and should coincide with any state law requirements.

RESTRICTION ON TRANSFER OF MEMBER’S INTEREST

For many LLCs, restriction on transfer may be the most important component of the operating agreement. Transfer of ownership interest most often occurs as a result of a member’s death, retirement, disability, or removal. For closely-held LLCs, particularly those involving family members, the members may want a control over who can become members in the company. The concept of transfer restriction is discussed in detail in the following section.
PROCEDURE FOR LIQUIDATION AND DISSOLUTION

The operating agreement should have a contingency plan in the event the LLC is dissolved. The LLC may be dissolved voluntarily by member agreement, upon the expiration of a specified length of time, or upon a triggering event. Many state statutes list withdrawal, bankruptcy, and incapacity or death of a member as triggering events for LLC dissolution. The operating agreement can add to or subtract from the list and members can agree to waive an event as a trigger for dissolution.

Upon dissolution, a plan for paying creditors and distributing capital should be laid out. Typically, outside creditors are paid first, followed by member creditors. Members then receive their capital contributions and finally, any remaining capital is distributed proportionally to the members.

ARBITRATION AND MEDIATION

There are times when members cannot resolve a conflict among themselves. In such an event, the operating agreement can force the parties to arbitration and/or mediation before resolving the conflict in the judicial system. Mediation and arbitration are often less costly and move more quickly than a lawsuit or other legal action. The members can agree either to be absolutely bound by the mediation/arbitration or merely use it as a means of resolving a dispute before going to court. Arbitration and mediation clauses are designed to save both the members and the LLC time and money in the process of resolving disputes.

REQUIREMENT FOR INITIAL CAPITAL AND FUTURE CONTRIBUTIONS

The operating agreement should state the amount and type of capital each member contributes to the LLC. Most state statues allow LLC contributions to be in the form of money, property, services rendered, a promissory note, or for future contributions of money, property, and services. Many state statutes require a record be kept of each member’s contribution. Regardless of the statutory requirement, member contributions should always be recorded. The initial record of contributions allows the percentage of ownership interest of each member to be calculated upon the formation of the company. As members further contribute or take distributions from the company, the ownership record can be updated.

A more important issue is additional contribution of capital. There may be times when the LLC requires additional capital to either finance capital purchases or to supplement the operating capital of the company. The critical question is whether members may voluntarily contribute additional capital or if they are required to contribute additional capital. Typically, the operating agreement calls for a voluntary contribution of additional capital. Any and all members, upon request from the company or managing members, may contribute capital. Those members contributing capital see their ownership interest increase in relation to those members who contribute less or no capital. The negative aspect of voluntary contribution is that members with greater resources can quickly increase their ownership interest over those members with lesser resources.

The less common approach is mandatory contributions. This approach requires each member to contribute additional capital upon the request of the managing members or the company. This approach can subject the members to financial strain on their personal assets, particularly for large contributions that arise unexpectedly. The benefit to this approach is that membership interest percentages do not change. The ownership interests are in the same proportion after the contribution as they were before the contribution.

Example 5. Jones Delivery, LLC (Example 3) just acquired a very lucrative government delivery contract. In order to comply with the contract terms, it must add a number of new vehicles and employees. The LLC can finance the purchases or the members can contribute capital for the purchases. Louise and Bertha have the financial ability to fund the purchase and Cecilia does not. Louise and Bertha increase their ownership percentages in the LLC and consequently receive a larger share of the future profits. In this case, Cecilia may insist the purchase be financed so her ownership percentage is not diluted.
Transferability of ownership interests refers to how ownership interests may be transferred and who may own interest in the LLC. Most states’ default rules allow LLC ownership interest to be transferred to any party, but unless they are admitted to the LLC as a member by unanimous consent of the other members, they are only entitled to an economic interest in the LLC. Someone having only an economic interest in an LLC, usually called an assignee, is entitled to any profits and distributions made by the LLC, but is not entitled to participate in management and may not vote in company matters.

Like other aspects of the LLC, a state’s default rules regarding ownership interest may be overridden by an agreement among the LLC members. The agreement controlling transferability of ownership interest is typically called a “buy-sell agreement” and may be integrated into the operating agreement or may be a separately executed document. There are several key concepts that every operating agreement should address.

WHO MAY BECOME A MEMBER

The first and probably most important issue is who may become a member. In some situations, the buy-sell agreement has a very liberal policy of allowing new members. This allows the LLC to attract more investors and capital. In other situations, a very strict policy may be implemented to limit or entirely restrict the admission of new members into the LLC. A typical LLC will fall somewhere in between. There are some restrictions on additional members, but the restrictions are not so severe as to prevent any new members.

Generally, closely-held LLCs tend to have more restrictive buy-sell agreements. There are several reasons for this. First, a closely-held company typically has a small number of members that may have majority control over the LLC. The control may be in the form of management rights and/or voting rights. Each time a new member is added to the LLC, the existing members’ management and or voting power is diluted. The existing LLC members may restrict new members to protect their control over the company.

Second, closely-held companies are often family businesses. The members of such an LLC may go to great lengths to keep the company in the family, particularly if the underlying business and assets are tied to the family heritage. For example, a farm family that establishes an LLC to hold farmland that has been in the family for generations will likely make it very difficult, if not impossible, for anyone other than family members to have an ownership interest in the LLC.
OPTIONS TO PURCHASE

Most buy-sell agreements provide the members of the LLC and perhaps the company itself with an option to purchase another member’s interest before it can be transferred to a nonmember. This is yet another technique for limiting the ability of nonmembers to be admitted to the LLC.

**Example 6.** Greg dies and leaves all of his LLC ownership interest to his wife. The buy-sell provision provides that before the wife can take ownership as either a member or assignee, LLC members Roy and Dale, as well as the company, have an opportunity to buy Greg’s membership units from his estate. If Roy, Dale, or the LLC buys Greg’s interest, the estate receives all the proceeds from the purchase.

**Example 7.** The same process can be used if Greg receives an offer from a nonmember to buy his LLC interest, if Greg becomes bankrupt and creditors attempt to attach his interest, or if Greg divorces and his LLC interest is given or awarded to his wife. The concept of purchase options gives the company and the other members first chance at purchasing other members’ interest before it is transferred to a nonmember.

The LLC operating agreement can allow for certain persons or classes of persons to be permitted owners. The permitted owners usually are not currently owners, but LLC interests may transfer by gift, inheritance, or sale to such permitted owners without forcing a buyout. Sometimes a vote is required of the continuing owners before anyone is admitted as a permitted owner. The permitted-owner concept sometimes allows for a trust of a deceased member to be an owner with the spouse being a beneficiary. Then, upon the death of the spouse, the interest might pass to lineal descendents of the deceased member. This plan can allow a surviving spouse to receive income from a deceased member’s interest and allow for the deceased member’s lineal descendents to become members eventually without having to purchase an interest.

DISCOUNTING VALUE OF MEMBER’S INTEREST

Another aspect of ownership interest transfer is discounting. In closely-held LLCs, discounting is often used to account for the lack of marketability, lack of control, minority holdings, or other factors that affect the value of a member’s holdings. The members may agree to a predetermined discount value that is included in the operating agreement. Discount values can be as high or low as the members wish, but typically discount rates will be 10–30%. Sometimes the operating agreement allows for the discount to be determined by an appraiser at the time of a triggering event rather than at a preset discount.

**Example 8.** An LLC is formed to hold real estate and the agreement restricts transfer of ownership interests to family members only. The real estate within the LLC has an FMV value of $1 million. The five members, having equal ownership, have agreed to a 20% discount. If Tom Member wishes to sell his entire interest to Brad Member, Brad will pay Tom $160,000 ($200,000 ownership interest × 20% discount).

The discounting percentage is appropriate because even though the FMV of the assets are $1 million, the ownership interest of the LLC is not available to the open market. Only a very few buyers exist, usually the current LLC members and their families. Therefore, with such a limited pool of potential buyers, the value of any member’s interest in the LLC is something less than FMV.

It is important to note that while the discounting is binding upon the LLC members, the discounting is not binding upon the IRS. It is always possible that the IRS will use a different discount rate when calculating estate or gift tax liability.

Discounting is often used in closely-held LLCs as a deterrent to transfer ownership interest to other parties.

**Example 9.** A two-member LLC holds land valued at $1 million with a 20% discount and purchase options for the members. If Sally attempts to sell her interest to another party, Verne can exercise his option and buy Sally’s interest for $400,000 ($500,000 × 20% discount). Sally has essentially sold $500,000 worth of land for $400,000 to Verne.
FINANCING PURCHASE OF A MEMBER’S INTEREST

There may be times when an LLC member wishes to buy another member’s ownership interest but does not have the money to pay the selling member. As a solution to this problem, the buy-sell agreement may contain a financing mechanism which makes the purchase more feasible for the buyer.

**Example 10.** The operating agreement states that a member selling his LLC interest is paid 10% down and the balance financed over 10 years. The purchase agreement may be documented with a secured or unsecured promissory note.

An interest rate usually accompanies such purchase agreements. Often agreements state that the interest rate on the unpaid balance will be at the lowest applicable federal rate as published by the IRS. The financing mechanism is another means of keeping the LLC membership in the family or closely-held group of persons. The agreement makes it financially feasible to continue the LLC.

**Example 11.** Kim Member owns interest in the LLC (Example 10). Kim exercises her option to purchase Grant Member’s ownership interest for $400,000. Kim also chooses to use the financing mechanism, which is 10% down and the balance paid over 10 years. Kim will pay $40,000 in cash at the time of the sale and can pay the remaining $360,000 over the next 10 years with interest paid on the unpaid balance.

TAX CONSIDERATIONS

TAX OPTIONS

When an LLC is formed, the member(s) elect how they want the LLC to be taxed. If a single person is forming an LLC, the LLC can elect to be taxed as an individual, unless electing a C or S corporation status. If there are two or more members forming an LLC, they are taxed as a partnership, unless they elect to be taxed as a C or S corporation.

**Caution.** Election by an LLC to be taxed as a C corporation or S corporation subjects the entity to all the relevant provisions for the particular type of entity for tax purposes. For example, electing S status will restrict membership in the LLC to those entities that are eligible as S corporation shareholders.

MAKING THE ENTITY ELECTION FOR TAXATION

If the members wish the LLC to be taxed as a corporation, an affirmative election is required. The election is made using IRS Form 8832, *Entity Classification Election*. The use of this form is what is often referred to as “check the box.” If this form is not filed, or the box is not checked, then the default for a single-member LLC is to be taxed as a sole proprietor. The default for an LLC with two or more members is to be taxed as a partnership. **Form 8832 need not be filed if the LLC wishes to be taxed as a partnership.**

**Example 12.** Tina’s Beauty Supply, LLC, wishes to be taxed as a C corporation. She must file Form 8832.
For Example 12

**Entity Classification Election**

<table>
<thead>
<tr>
<th>Name of entity</th>
<th>EIN</th>
</tr>
</thead>
<tbody>
<tr>
<td>TINA'S BEAUTY SUPPLY LLC</td>
<td>33333333</td>
</tr>
</tbody>
</table>

1. **Type of election** (see instructions):
   a. ✔ Initial classification by a newly-formed entity.
   b. □ Change in current classification.

2. **Form of entity** (see instructions):
   a. ✔ A domestic eligible entity electing to be classified as an association taxable as a corporation.
   b. □ A domestic eligible entity electing to be classified as a partnership.
   c. □ A domestic eligible entity with a single owner electing to be disregarded as a separate entity.
   d. □ A foreign eligible entity electing to be classified as an association taxable as a corporation.
   e. □ A foreign eligible entity electing to be classified as a partnership.
   f. □ A foreign eligible entity with a single owner electing to be disregarded as a separate entity.

3. **Disregarded entity information** (see instructions):
   a. Name of owner
   b. Identifying number of owner
   c. Country of organization of entity electing to be disregarded (if foreign)

4. **Election is to be effective beginning** (month, day, year) (see instructions) 01 / 01 / 05

5. **Name and title of person whom the IRS may call for more information**
   TINA MORSE
   Phone number: 555-5555

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**Consent Statement and Signature(s)** (see instructions)

Under penalties of perjury, I (we) declare that I (we) consent to the election of the above-named entity to be classified as indicated above, and that I (we) have examined this consent statement, and to the best of my (our) knowledge and belief, it is true, correct, and complete. If I am an officer, manager, or member signing for all members of the entity, I further declare that I am authorized to execute this consent statement on their behalf.

<table>
<thead>
<tr>
<th>Signature(s)</th>
<th>Date</th>
<th>Title</th>
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If the members wish to have the LLC taxed as a S corporation, then IRS Form 2553, *Election by a Small Business Corporation*, must be filed. No Form 8832 is required. The rules for making the S election are the same as for any corporation wishing to be taxed as an S corporation.

**TAX UPON FORMATION AND LINGERING TAX ISSUES**

Generally, there is no tax to a member upon formation of an LLC. The LLC assumes the member’s basis in the contributed property.¹

Another item to consider for LLCs taxed as partnerships is when a member has contributed property with a low basis and that property is distributed to another member within seven years of the date the property was contributed. The contributing member is deemed to have sold the property and must recognize the gain.² Often with farmers, this rule can apply to grain sales or machinery sales of contributed property. Knowing this rule causes members to be very selective about which assets to put in or leave out of the LLC.

**DEBT EXCEEDING BASIS**

Upon formation, if debt contributed to an entity exceeds the basis of the contributed property, the contribution may constitute a taxable event to the contributing member. If the debt contributed exceeds the basis of the contributed asset, the contributing member is deemed to have sold the property for the difference between the basis and the debt. If an asset is left out of the LLC because of this tax concern, it can be rented by that owner to the LLC until the debt is paid down and the tax is no longer an issue.

**TAX FILING**

An individual who owns a single-member LLC reports the LLC profits or losses on his personal Form 1040, Schedule C or Form 1040, Schedule F. No separate filing is required for the LLC. If the LLC is taxed as a partnership, then a Form 1065, *U.S. Return of Partnership Income*, must be filed. The members receive a Schedule K-1 from the LLC, which provides the information for their tax filing. If the LLC is taxed as a C corporation, a Form 1120, *U.S. Corporation Income Tax Return*, must be filed, and members receive Forms 1099 to reflect dividends and interest payments and Forms W-2 to reflect wages. If the LLC is taxed as an S corporation, a Form 1120S, *U.S. Income Tax Return for an S Corporation*, is filed, and the members receive Forms 1099 and Forms W-2 in addition to Schedules K-1 reporting their share of the corporate gain or loss.

**§754 ELECTIONS**

If an LLC elects to be taxed as a partnership, the filing of a §754 election should be considered. Filing a §754 election allows the inside basis of the acquiring member to be increased to match the outside basis. The election may not be desired if the inside basis decreases. Making this election allows the acquiring member to depreciate the step-up of the inside basis and to have less taxable gain the next time a transfer of the LLC interest occurs. The §754 election is made with the next tax return following the transaction which qualifies for §754 treatment. Once a §754 election is made, it remains in effect until a request is made to the IRS for its revocation.

The §754 election may be beneficial when a member dies or when a member’s interest is sold and the acquiring member’s outside basis is different than the outside basis of the selling member. When either of these situations occurs, the outside basis of the acquiring member is adjusted to the estate appraisal or purchase price. By making this election, the acquiring member may be able to obtain a current tax benefit.

¹ IRC §§351 and 704(c)(1)(A)

² IRC §704(c)(1)(B)
LIQUIDATION

There are liquidation costs upon the dissolution of any business entity. One of these costs may be the tax which will be incurred. The fact that the entity is an LLC does not change the impact of the taxes. The taxes need to be analyzed under the same rules as:

- Sole proprietors for single-member LLCs,
- Partnerships for LLCs taxed as partnerships,
- C corporations for LLCs being taxed under the C corporation rules,
- S corporations for LLCs taxed under the S corporation rules.

If liquidating, a single-member LLC is usually selling its assets. Thus, ordinary income, depreciation recapture, capital gains, and self-employment taxes are the primary items to be analyzed. Just like an individual, if an LLC is taxed under the partnership rules and a liquidation occurs, usually ordinary income, depreciation recapture, capital gain, and self-employment tax are analyzed. However, if the assets are distributed, then IRC §751 guides the tax analysis. Section 751 provides that if unrealized receivables are distributed to members in proportion to their ownership percentage, no income tax is triggered as a result of the property distribution. Unrealized receivables are assets which incur ordinary income tax or depreciation recapture if sold. After this asset is distributed tax-free, the member has the responsibility of paying the tax if the asset is later sold.

If an LLC, taxed as a C corporation, is liquidated or dissolved, the corporation incurs tax as if the property were sold. As a result, the tax on a corporation which distributes assets is going to be the same as if it sold those assets. The effect is that the corporation first recognizes the ordinary income, the depreciation recapture and the capital gains at the time of the dissolution. Then, the member recognizes gain or loss on the difference between his basis in his LLC investment and the value of the property he receives.

The primary difference between a C corporation and an S corporation is that the S corporation does not pay federal income tax. Therefore, in a liquidation or dissolution involving the distribution of property to members, the difference between the member’s basis in the LLC and the value of property received is subject to tax. The primary items to consider are the ordinary income, depreciation recapture, and capital gain.

Another factor to consider in a C or an S corporation liquidation or dissolution is that the underlying assets do not receive a step-up in basis upon the death of a member. However, the basis of the inherited units are stepped up to FMV at date of death.

**Example 13.** Land is held by the LLC, taxed as a corporation. It has a basis of $1,000 per acre. Morty Member dies. The value of the $1,000-per-acre land is not increased on the corporation books, even if the land is appraised at $3,000 per acre at the time of Morty’s death. Thus, this $2,000 increase is taxed upon a corporate liquidation or dissolution. The heirs of Morty’s interest have a $3,000 basis in the units.

INTANGIBLE TAXES

Some states have intangible taxes on the investments in LLC interests the same as they do for partnership and corporate investments. State and local laws need to be checked to determine if an intangible tax exists.

PERSONAL PROPERTY TAX

Some states and local jurisdictions assess ad valorem (personal property) taxes on assets of business entities. Review state and local laws to determine applicability.
**FREQUENT USES OF LLCs**

LLCs are used in many different ways by taxpayers. However, there are a few uses that are more prevalent than others. Below are some of the more common uses of LLCs.

**OPERATING ENTITIES**

The most obvious use is that of an operating entity. This is a company that maintains bank accounts, conducts business, runs the day-to-day affairs of the business, and may own property. An LLC is used as an operating entity for everything from small family businesses to law and medical practices to very large businesses. The flexibility of an LLC allows its adoption for nearly any type of business.

**There is one notable exception to using an LLC for an operating entity.** Practitioners working with farms should be careful in selecting the type of business entity to serve as the farm’s operating entity. Many farms rely on farm payments from the Farm Service Agency (FSA) for cash flow management. In most cases, direct FSA payments are limited to $40,000 per person. Large farms often have several persons in the operation and therefore receive a $40,000 payment for each person. The FSA considers an LLC, and any other business entity with limited liability protection, as one person regardless of the number of members. Therefore, if there is any chance that a farm may receive more than $40,000 in FSA payments, the operating entity should not be an LLC. General partnerships with the characteristic of joint and several liability are the entities selected by farming operations to qualify to receive more than one $40,000 FSA payment.

**Example 14.** A large grain farm has four family members, each of whom qualify to receive a $40,000 direct FSA payment, or $160,000 in total. If the four family members create an LLC and operate the farm business through the LLC, they are allowed one payment limitation, or $40,000. Conversely, the four members can create a general partnership for the operating entity, thus having no liability protection, and receive all four payments totaling $160,000. Other payment limitations may apply.

**Caution.** The regulations pertaining to farm payment limitations and business entities are extremely technical. Therefore, before establishing an operating entity for a farm receiving more than the $40,000 single-payment limitation, it is recommended that a professional who is familiar with the regulations governing FSA payments be consulted.

**REAL ESTATE HOLDING ENTITIES**

Many LLCs are formed with the sole intent of holding real estate. The title to the land is transferred by deed from the individual owner(s) to the LLC. This transaction provides the LLC members with several benefits. First, the members receive limited liability protection for their ownership of the land as discussed previously. Second, the transfer of interest from one family member to another is much easier.

**Example 15.** A husband and wife jointly own 100 acres of land and wish to gift 10 acres to each of their two children. If the land is not in an LLC, they have two options:

1. They can survey off two 10 acre parcels and execute two deeds, transferring 100% ownership of each parcel to each child individually.

2. They can execute a deed giving each child an undivided 1/10 interest in the 100 acres and have joint ownership between four people.

Both scenarios present challenges to the parents. The first requires the parents to obtain a survey and to entirely give up ownership and control over each 10 acre parcel. The second requires the consensus of all four family members before the land can be sold in its entirety, or a partition proceeding if some family members wish to sell their interest and others do not.
Example 16. Use the same facts as Example 15, except the parents place the 100 acres in an LLC and make themselves the managing members. Upon transferring the land to the LLC, each parent can be assigned 50 membership units each, one for each acre. Each parent may elect to give each child 10 membership units as a gift. The children now own 10 units each out of the total 100 LLC units, the equivalent of 10 acres. They become nonmanaging members of the LLC.

With this method, the parents avoid both problems discussed above. First, they gift the equivalent of 10 acres to each child while maintaining control of the property as the managing members of the LLC. The transfer is executed with a simple paper transaction rather than a formal execution of a deed.

Second, if one or more family members wish to sell their interest in the LLC, the other members can simply buy the selling members interest without executing new deeds or requiring a partition of the jointly owned land.

Observation. Transferring the property to an LLC and filing Form 1065 to report income or loss will make the property ineligible for §1031 if all members do not wish to participate in the like-kind exchange. See Chapter 10, “Like Kind Exchange,” pages 361 and 362 of this workbook, for additional information regarding this problem.

CONVERTING NONLIQUID ASSETS TO LIQUID ASSETS

Nonliquid assets can be converted to liquid assets by placing them in an LLC. Example 16 is a case in point. The parents took a nonliquid asset, 100 acres of land, and converted it into a liquid asset, 100 units of LLC ownership interest. Having assets in a liquid form is much more conducive for gifting strategies, inheritance, and sales to other family members. The same process can be performed with partnerships and corporations. However, the LLC provides the liability protection of a corporation while maintaining the less formal formation and organization requirements of a corporation.

Note. As discussed earlier, the value of the LLC interest can be reduced for minority and marketability discounts, which results in more units available for gift or a smaller estate value.

Land is easily converted from a nonliquid asset to a more liquid asset via an LLC. However, any mortgage on land going into an LLC must be examined closely. Many mortgages contain trigger provisions that require the immediate payment of the mortgage upon the sale or transfer of the land. Many, but not all, creditors allow the land to be transferred into the LLC without triggering the due-on-sale clause. Permission must always be sought from the mortgage holder before transferring the mortgaged land into an LLC.

FAMILY VACATION HOMES

Often family members are looking for ways to jointly own a vacation home. A tenants-in-common ownership is not the recommended way of owning such property. Partition proceeds, divorce, and real estate ownership by minors are all problems with any form of joint real estate. An LLC operating agreement can address all of these issues. The vacation home may not be regarded as a business but could be thought of as an investment.

SUMMARY

The LLC has become the entity of choice for many new businesses. The ease of creation, flexibility of management, limited liability protection, tax treatment, and the many uses of an LLC make it ideal for large and small business alike. The LLC has many advantages over other business entities as shown in the table below. Other than a few issues yet to be resolved through the judicial system, the LLC has established itself as a valuable and reliable business entity in a short period of time. The future of the LLC looks to be unlimited as business owners and investors find new and creative ways to use LLCs.
# Business Entity Comparison Chart

<table>
<thead>
<tr>
<th></th>
<th>Sole Proprietorship</th>
<th>General Partnership</th>
<th>Limited Partnership</th>
<th>Limited Liability Company</th>
<th>Corporation</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Definition</strong></td>
<td>One person owns all the assets, owes all the liabilities, and operates in his or her personal capacity</td>
<td>A voluntary association of two or more persons who jointly own and carry on a business for profit</td>
<td>A partnership with one or more general partners and one or more limited partners</td>
<td>Statutorily authorized company that is characterized by limited liability and management by members or managers</td>
<td>Having lawful authority to act as a single person distinct from the shareholders who own it</td>
</tr>
<tr>
<td><strong>Formation</strong></td>
<td>No formal requirements</td>
<td>No formal requirements</td>
<td>Filing with state</td>
<td>Filing with state</td>
<td>Filing with state</td>
</tr>
<tr>
<td><strong>Governing Documents</strong></td>
<td>None</td>
<td>Partnership agreement</td>
<td>Partnership agreement</td>
<td>Articles of organization and operating agreement</td>
<td>Articles of incorporation and bylaws</td>
</tr>
<tr>
<td><strong>Owners</strong></td>
<td>Sole proprietor</td>
<td>General partners</td>
<td>General/limited partners</td>
<td>Members</td>
<td>Shareholders</td>
</tr>
<tr>
<td><strong>Number of Owners</strong></td>
<td>1</td>
<td>Unlimited</td>
<td>Unlimited</td>
<td>Unlimited</td>
<td>Unlimited except 100 shareholders for S corp.</td>
</tr>
<tr>
<td><strong>Personal Liabilities of Owners</strong></td>
<td>Unlimited liability for the obligations of the company</td>
<td>Unlimited liability of partners for obligations of company</td>
<td>Unlimited liability for general partner(s), generally no liability for limited partners</td>
<td>Generally no liability of members for obligations of company</td>
<td>Generally no liability of shareholders for obligations of company</td>
</tr>
<tr>
<td><strong>Taxation</strong></td>
<td>Pass-through</td>
<td>Pass-through</td>
<td>Pass-through</td>
<td>Typically pass-through but may elect taxation as corporation</td>
<td>Entity taxation unless elect subchapter S</td>
</tr>
<tr>
<td><strong>Applicable Tax Rates</strong></td>
<td>Individual tax rates</td>
<td>Tax rate of partner</td>
<td>Tax rate of partner</td>
<td>Tax rate of partner or shareholder if taxed as a partnership or S corp.; if taxed as a C corp. the C rates apply</td>
<td>Corporate tax rates for C corporation; tax rates of shareholders for S corporation</td>
</tr>
</tbody>
</table>
Business Entity Comparison Chart (continued)

<table>
<thead>
<tr>
<th></th>
<th>Sole Proprietorship</th>
<th>General Partnership</th>
<th>Limited Partnership</th>
<th>Limited Liability Company</th>
<th>Corporation</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Tax Treatment of Liquidation</strong></td>
<td>No tax</td>
<td>Generally no tax</td>
<td>Generally no tax</td>
<td>Generally no tax if taxed as partnership; generally will be corporate- and shareholder-level taxes if taxed as corporation</td>
<td>Generally will be corporate and shareholder level taxes</td>
</tr>
<tr>
<td><strong>Management</strong></td>
<td>Sole proprietor has full control</td>
<td>Typically each partner has an equal voice</td>
<td>General partners manage; limited partners have limited management authority</td>
<td>Either member-manager or manager managed (controlled by operating agreement)</td>
<td>Board of directors elected by shareholders</td>
</tr>
<tr>
<td><strong>Cost of Creation</strong></td>
<td>Low</td>
<td>Medium</td>
<td>Medium to high</td>
<td>Medium to high</td>
<td>Medium to high</td>
</tr>
<tr>
<td><strong>Raising Capital</strong></td>
<td>Proprietor’s own funds</td>
<td>Contributions from partners or adding partners</td>
<td>Contributions from partners or adding partners</td>
<td>Contributions, add members, or sell interest, determined by operating agreement</td>
<td>Sell stock for contributed property or for cash</td>
</tr>
<tr>
<td><strong>Transfer of Ownership</strong></td>
<td>Freely transferable</td>
<td>May be limitations</td>
<td>May be limitation</td>
<td>May be limitations; controlled by operating agreement</td>
<td>Freely transferable</td>
</tr>
<tr>
<td><strong>Converting the Entity Form</strong></td>
<td>Converting to corporation, partnership, or LLC is generally tax free</td>
<td>Converting to corporation, limited partnership, or LLC is generally tax free</td>
<td>Change to LLC or corporation is generally tax free</td>
<td>Converting from a partnership to a C or S corporation generally tax free</td>
<td>Change to S from C or to C from S is generally tax free; otherwise may be a liquidation with tax consequences</td>
</tr>
<tr>
<td><strong>Dissolution and Liquidation Costs</strong></td>
<td>Low</td>
<td>Medium</td>
<td>Medium</td>
<td>Medium if taxed as partnership and high if taxed as corp.</td>
<td>High</td>
</tr>
</tbody>
</table>
PARTNERSHIPS

Typically, an LLC elects partnership treatment for federal income tax purposes. Partnerships are covered by IRC §§701 through 761. Partnership taxation is very confusing and results in many incorrectly prepared tax returns.

In 2005, the IRS released an updated version of the MSSP Audit Technique Guide for partnerships. This is the guide a revenue agent who is not experienced in partnership audits studies before beginning an audit of Form 1065. Consequently, it is an excellent resource for tax professionals who prepare a partnership tax return.

The guide not only explains the various partnership code sections, it tells the auditor what questions to ask and what to inspect related to each code section.

The following is the actual table of contents from the audit guide and the discussion related to §754. The §754 election is often misused or omitted on partnership returns. Failure to make the election may cause a partner to lose substantial tax benefits.

The entire 362-page audit technique guide can be downloaded from the following web site: www.unclefed.com/SurviveIRS/MSSP/partnershpsatg12-16.pdf (or www.tinyurl.com/85qxl).
# Partnerships

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Glossary G-1
The following pages are an excerpt from the IRS MSSP on partnerships.

**ISSUE: OPTIONAL BASIS ADJUSTMENTS — IRC §754 ELECTION**

The purpose of an IRC §754 election is to provide a way to alleviate differences between inside and outside basis caused by:

- Transfer of a partnership interest,
- Distribution to a partner.

IRC §755 describes how to allocate the adjustments.

**IRC §743(b)**

The following types of transactions will trigger inside basis and outside basis discrepancies for IRC §743(b):

- Sale or exchange of a partnership interest
- Transfer of a partnership interest by inheritance

If there is a transfer of a partnership interest and the FMV of the interest is different than the adjusted basis in the partnership interest then a discrepancy will occur. The discrepancy will occur between the partnership’s inside basis in its assets which reflects adjusted basis, and the outside basis of the new transferee partner’s share of the partnership assets (partnership interest) which reflects FMV. This causes an inequity because the new transferee partner has paid for the unrealized gain or loss in the partnership assets. If no IRC §754 election is in effect, then the discrepancy will create a permanent difference between inside and outside basis until the partnership is liquidated. If there is an IRC §54 election in effect then it is resolved by taking into account the gain or loss and depreciation associated with the transaction, and attributing it all to the new transferee partner. The other partners outside basis remain unchanged. All partners must agree to the IRC §754 election.

**Example 2-5.** A and B share in profits, losses and capital 50% each. The partnership has the following:

<table>
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<th>Capital Accounts</th>
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<td>A/B</td>
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<td>Land</td>
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The adjusted basis in the partnership assets (inside basis) is $60. A and B’s outside basis is $30 each. B sells his partnership interest to C for $50. C’s outside basis is now $50. C’s share of partner’s adjusted basis in the partnership assets (inside basis) is $30. There is now a discrepancy. Now, if the partnership sold the land for $100 FMV there is a gain of $40. A $20 gain would be allocated to both A and C. C has already in effect paid for his or her share of the unrealized gain at the time of the acquisition.

- If there was no IRC §754 election in effect, this will create a permanent difference until the partnership is liquidated.
- If there was an IRC §754 election in effect then the $20 gain step-up is all attributable to C by virtue of increasing the basis in the land to $80. The gain of $20 (100 – 80 = 20) on the sale of the land is all allocated to A. It is important to keep in mind that a basis step-down may result if the FMV is less than the adjusted basis of the partnership interest when an IRC §754 election is in effect.

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3. IRS MSSP – Partnerships, pages 2-29 through 2-34
4. IRC §743(b)
5. IRC §734(b)
IRC §734(b)

The following types of transactions will trigger inside and outside basis discrepancies under IRC §734(b):

- Distributions to a partner where gain or loss is recognized (that is, cash in excess of basis)
- Distributions of property to a partner resulting in a lower or higher basis in the hands of the partner than the partnership’s adjusted basis in the same property

If there is a property distribution to a partner and there is a gain or loss recognized or the partner takes a higher or lower basis in the asset than what the partnership’s basis reflected, then an inequity results to the remaining partners.

**Example 2-6.** ABCD Partnership has one asset, land with $60 adjusted basis and $100 FMV. The partnership agrees to liquidate C’s 1/4 partnership interest for $25. C’s outside basis is $15. C is receiving excess cash over the adjusted basis in the partnership interest of $10. C recognizes a capital gain of $10.

- If there was no IRC section 754 election in effect and the property was sold after liquidating C’s interest for the $100 FMV, the remaining partners will recognize a $40 gain instead of a $30 gain.
- If there was an IRC §754 election in effect, then the $10 gain that was already reported by C would be taken into account by stepping up the inside basis and allocating it to the remaining partners so that they would report the correct amount of gain.

**Note.** If there is a distribution of property other than cash to a partner within two years of acquiring a partnership interest, the partner may elect, without an IRC §754 election in place, to adjust the basis in the property in the distributee partner’s hands. There is no effect on the property still remaining in the partnership. IRC §732(d)

If depreciable property is involved, it makes it more complicated because of the depreciation deduction. If there is IRC §704(c) property contributed, either nondepreciable or depreciable, there are further complications because of the various allocation methods, such as traditional, curative allocations, and remedial allocations, mentioned above, that must be considered under the IRC §704(c) principles. It is necessary to consider all of these factors when reviewing the IRC §754 election computations.

IRC §755

IRC §755 is the allocation method used to reduce the differences between the adjusted basis and the FMV of partnership property. Final Regulations, effective December 14, 1999, allow offsetting positive and negative adjustments between classes and within classes. The final regulations adopted the proposed regulations, effective January 1998. The rules prior to 1998 did not allow offsetting positive and negative adjustments. Different rules apply to the allocation under IRC §§743(b) and 734(b). There are numerous examples in the regulations that describe the allocation calculations.

**Recordkeeping** for this election is very cumbersome and is done by the partnership. Under normal circumstances, once a partnership elects under the provisions of IRC §754, this election is irrevocable without the Commissioner’s consent. Final regulations effective on December 14, 1999, for IRC §§743(b), 734(b), and 755, allows partnerships a one-time revocation of the IRC §754 election. This may be done if the partnership had an election in place in a tax year that included December 15, 1999. If they choose to revoke this pre-existing election, they must follow the rules in Treas. Reg. §1.754-1(c)(2). These rules stipulate that the statement of revocation must be attached to a timely filed partnership return (including extensions). It must include the name and address of the partnership along with a signature by an authorized partner. The front of the partnership return must state at the top of the first page that the “return is filed pursuant to Treas. Reg. §1.754-1(c)(2).” Many partnerships will make this one-time revocation

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6 IRC §755(b) and Treas. Reg. §1.755-1(a)
because of; 1) their massive recordkeeping requirements, and 2) an IRC § 754 election can be a two-edged sword because it can not only cause increases in basis, but decreases to assets which can result in larger gains. It is a crucial election to the partnership so it is important to request all recordkeeping.

**Examination Techniques**

- Analyze the balance sheet to see if there is an IRC §754 election in effect, because there should be a change in the value of the assets.
- Analyze the Schedule K and Schedule K-1 to determine if depreciation deductions are being allocated to a new partner.
- Analyze the Schedule K-1 to determine if there has been a change in the ownership interests.
- Analyze the Schedule M-2 to determine if there have been any distributions of property that may trigger the IRC §754 election, if it is in effect.
- Analyze the Line 22 and 23 on Schedule K to determine if the distribution was cash or other property. Review prior and subsequent years to determine if there were any changes in ownership.
- Request a copy of the IRC §754 election.
- Request a copy of any IRC §754 revocation of the election.
- Request the partnership agreement. It may state how the IRC §754 election will be made and the details surrounding the partnership making the election.
- Analyze the Schedule M-sm1 for increases or decreases in book depreciation versus tax depreciation. This may alert the examiner that there is either an IRC §754 election in effect and there was a transaction involving depreciable property which now has an increased or decreased basis, or that there was an IRC §704(c) property contribution.
- Request the IRC §§743(b), 734(b), and 755 calculation for the IRC §754 elections. The partnership must keep the books and records to account for these.

**Issue Identification**

If an IRC §754 election is in effect, then is the partnership treating all transactions that fall within this category according to the rules of IRC §754? Sometimes the election is not to the benefit of the partnership at a later date, but unless there was a valid revocation, the appropriate basis adjustments must be made.

Analyze and review all subsequent transactions that may have occurred regarding IRC §743(b) and IRC §734(b) to make sure that the proper partners are allocated the correct amounts. These types of transactions may occur every year.

Analyze prior year partner contributions to determine if IRC §704(c) property was contributed and there is an IRC §754 election in effect. There will be special allocations to partners taking into account the methodologies used to account for the book/tax differences such as remedial allocations, etc., as mentioned above.
**Documents to Request**

1. Partnership agreement
2. Prior and subsequent year partnership tax returns
3. Partnership books and records
4. Partnership elections for IRC §754
5. Partnership revocations of IRC §754
6. Partnership calculations of the IRC §§743(b) and 755 adjustments
7. Partnership calculations of the IRC §§734(b) and 755 adjustments
8. Documents regarding any sales and exchanges of partnership interests
9. Schedule of distributions to partners of property
10. Outside basis calculations to partners that are affected by the IRC §754 election in current year
11. Depreciation schedules
12. Valuations or appraisals for any property distributed

**Interview Questions**

1. Does the partnership have an IRC §754 election in effect?
2. Has the IRC §754 election been revoked?
3. Were there any property distributions in the current year?
4. Were there any partnership transfers of interests?
5. Did any of the partners receive their interest from an inheritance?
6. Does the partnership have calculations to support the IRC §§743(b), 734(b), and 755 adjustments?

**Supporting Law**

*Internal Revenue Code - Subchapter K: §§754, 743, 734, and 755*

Supporting regulations and specific regulations

**Resources**

*RIA U.S. Tax Reporter – Income Taxes 2005*
*CCH Standard Federal Tax Reporter 2005*
*Practitioners Publishing Co., Guide to Partnerships 2005*