Chapter 4: Limited Liability Companies

Corrections were made to this workbook through January of 2009. No subsequent modifications were made.

For centuries, the organization of firms was limited to sole proprietorships, partnerships, and corporations. Over the past two decades, it has become clear that organizational options are limited only by the capacity of the human mind to innovate. One of the innovations is the limited liability company (LLC), an unincorporated entity. The LLC was developed to have the limited liability of corporations and the income tax treatment of partnerships. However, that brief description understates the complexities that can be encountered with an LLC.

HISTORY OF LIMITED LIABILITY COMPANIES

Hamilton Brothers Oil Company was involved in international oil and gas exploration during the turbulent period of the 1970s using foreign entities, notably the Panamanian limitada.[1] Unlike the entities available in the United States at that time, limitadas provided limited liability for all owners and the ability to secure partnership classification for tax purposes. Because no similar entity existed in the United States, Hamilton Brothers Oil Co. developed legislation that would authorize an unincorporated entity to be created that resembled the limitada with limited liability and partnership status for tax purposes. An initial effort to obtain legislation in Alaska was unsuccessful, but the same legislation was introduced in Wyoming where it was enacted into law on March 4, 1977. Five years later, a similar statute was enacted in Florida.

A major concern in the period following the initial enactment in Wyoming was whether the IRS would look favorably on a hybrid entity with the corporate feature of limited liability and the partnership feature of pass-through treatment for income tax purposes. After a lengthy effort, the IRS issued Rev. Rul. 88-76,[2] which effectively signaled that the new entity type would be recognized as a partnership for tax purposes. The ruling focused on the basic characteristics of a corporation from the regulations[3] which specify that an entity is characterized as a corporation if it has (1) associates, (2) an objective to carry on business and divide the gains, (3) continuity of life, (4) centralization of management, (5) liability for corporate debts limited to corporate property, and (6) free transferability of interests. The Wyoming LLC in the ruling was considered to have associates and an objective to carry on business and divide the gains, but lacked the other corporate characteristics. Thus, the entity organized as an LLC was classified as a partnership for federal tax purposes.

Following this breakthrough, states proceeded to adopt legislation authorizing LLCs. Within a few years, all 50 states had adopted LLC statutes. However, because there was no model or uniform statute available for guidance for several years, statutes were modeled after the Wyoming and Florida statutes.

1. Hamill, "The Origins Behind the Limited Liability Company," 59 *Ohio St. L.J.* 1459, 1463-1464 (1998)
2. Rev. Rul. 88-76, 1988-2 CB 360
3. Treas. Reg. §301.7701-2(a)(1)

In 1992, a "Prototype Limited Liability Company Act" was proposed by a committee of the American Bar Association and the Uniform Limited Liability Company Act was promulgated by the National Conference on Uniform State Laws in 1996.

The LLC now is a highly popular choice for organization of firms, partly because of its unique features and partly because of its relative simplicity.

FEATURES OF AN LLC

An LLC is a hybrid-type entity with limited liability for all its members, not merely for those not participating actively in management. The veil of an LLC apparently can be pierced in the same way a corporate entity can be disregarded.[4]

If properly structured, an LLC is treated as a partnership for federal income tax purposes.[5] For federal income tax purposes, an LLC must have at least two members.[6]

FORMATION

An LLC is formed by filing brief articles of organization with a state agency, usually the Secretary of State.[7] The resulting entity is an unincorporated business organization governed by management, with transferability and dissolution provisions similar to those of a partnership; but the provisions can be tailored to approach the corporate model. An important feature of the LLC is that it is not subject to restrictions related to finance and management that historically have been imposed on corporations. Thus, there is no requirement to create special "surplus" accounts for dividends and no specific requirement for management by a board of directors or another management body.[8]

An LLC can have as many members as desired, but the IRS requires a minimum of two, apparently based on the definition of a partnership as "an organization of two or more persons to carry on as co-owners a business for profit."[9] Single-member LLCs are permitted in many states, but they are considered disregarded entities by the IRS. If an LLC is disregarded by the IRS, the entity is treated as part of its individual owner. If the owner is an S corporation, the built-in gains tax applies.[10] In a 2004 letter ruling, a trust formed by an LLC as the sole owner was a business trust and both were disregarded.[11]

MANAGEMENT

Legislation authorizing LLCs generally permits LLC owners, referred to as members, to define how the LLC is operated and the relative rights of the members. In the absence of a clear specification in the governing documents, several default provisions apply. For example, unless otherwise provided:

1. The members of an LLC are authorized to vote in proportion to their capital contributions to the LLC as adjusted to reflect contributions and withdrawals;
2. A unanimous vote is required for major decisions such as dissolution, sale of assets, or merger;
3. Management is vested in the members;
4. Profits and losses are allocated on the basis of the respective capital contributions; and
5. Distributions are made on the basis of the members' respective contributions.

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4. For example, see *Hollowell v. Orleans Regional Hospital, LLC,* 217 F.3d 379 (5th Cir 2000).
5. Rev. Proc. 95-10, 1995-1 CB 501
6. Ibid
7. Iowa Code 490A.301 (2008)
8. Keating, et al., "The Limited Liability Company: A Study of an Emerging Entity," 47 *Bus. L*. 378, 385 (1992)
9. Uniform Partnership Act, §6, hereinafter UPA
10. Ltr. Rul. 200107018 (November 16, 2000)
11. Ltr. Rul. 200418028 (January 27, 2004)

The members of an LLC may enter into an operating agreement to establish or regulate the affairs of the LLC. The operating agreement may contain any provision not inconsistent with the enabling legislation or the articles of organization. As the default provision indicates, management of an LLC is vested in its members unless the articles of organization or operating agreement provide for one or more managers.

FIDUCIARY DUTY

Another aspect of importance in an LLC is the scope of fiduciary duties owed by the managers. In particular, should the fiduciary duty owed resemble that of a general partnership, a limited partnership, or a corporation? Moreover, should an LLC be empowered to define the scope of fiduciary duty by its operating agreement? States have adopted varying positions. Early on, California and Illinois provided that an LLC member or manager owes duties to the LLC similar to that of a partnership. The Uniform Limited Liability Company Act adopts an approach that is similar to the duties owed to a corporation.[12] Delaware, in effect, allows each LLC to control the extent of fiduciary duties in accordance with its operating agreement.[13]

FEES ON FORMATION

In selecting a form of organization, the fees (and franchise taxes in some states) may differ markedly from state to state. For example, in one state the annual filing fee is $50 for a corporation but $400 for an LLC.

STATE TAXES

Several states apply state income tax or franchise taxes to LLCs and corporations but not to partnerships or limited partnerships.

SELF-EMPLOYMENT TAXES

The differences in self-employment (SE) tax are discussed below and are in a state of uncertainty because of a 1997 Congressional freeze on new SE tax regulations.

FEDERAL FARM PROGRAMS

Because of the limited liability feature, LLCs are treated as corporations for purposes of federal farm program eligibility. The United States Department of Agriculture directed state Farm Service Agency Offices to treat LLCs as limited partnerships.[14] The Food, Conservation, and Energy Act of 2008[15] provides that, beginning with the 2009 crop, the definition of "person" is changed to mean a natural person and that does not include a legal entity such as an LLC.[16]

12. ULLCA Sec 409(a)-(d)
13. Del. Code Ann. Tit. 6, §18-1101(c)(2)
14. ASCS Handbook 1-PL (Rev. 1), Amend. 1, at 4-112
15. Pub. L. No. 110-246, 110th Cong., 2d Sess. (2008)
16. Pub. L. No. 110-246, Sec. 1603(b), amending 7 USC §1308(a)(4)

OPERATION AS AN LLC

FORMATION OF AN LLC

The formation of an LLC is handled in a manner similar to the way partnerships are formed.[17]

Exchange of Property for Interests in the LLC

Generally, no gain or loss is recognized on the transfer of property to an existing or newly-formed partnership.[18] For federal income tax purposes, an LLC is subject to the rules applicable to partnerships. Persons transferring appreciated property to the partnership do not recognize gain as a result of the transfer[19] and the partnership does not recognize gain as a result of the transfer.[20] The partnership adopts the partners' income tax bases for property transferred and the partners' shares adopt the basis of the transferred property.[21]

To the extent that gain is recognized on a transfer to an LLC, recapture is triggered.[22]

Debt in Excess of Basis

If a person transfers property subject to a debt, or the partnership (or LLC) assumes a debt in connection with the transfer of property, the person must recognize taxable income to the extent the debt exceeds the income tax basis in the transferred property plus his share of the debt under IRC §752.

> **Example 1.** In exchange for a 20% LLC interest, Mimi transfers an asset with a basis of $250,000. It is subject to a $500,000 debt that is assumed by the LLC. She recognizes $150,000 of income and has a zero basis in the partnership (80% of $500,000 debt – $250,000 basis = $150,000 income).

Transfers With Tax Consequence

Disguised Sale. Sometimes, the facts of the transfer may indicate that a disguised sale occurred rather than a tax-free exchange. This happens when a contribution of real property by a partnership to a joint venture is recast as a sale between partners.[23] If a partner transfers money or other property to a partnership (or LLC) and there is a direct or indirect transfer of money or other property to that partner or another partner, the transaction is considered a sale between the partners of property or a partial sale and partial contribution of the property to the partnership.[24] Unless there is an independent purpose for a distribution following a contribution, or a substantial length of time elapses between the contribution and the distribution to the contributor, the contributor risks a challenge by the IRS that the transactions represent a sale of the contributed property under an exception to the nonrecognition rule.[25]

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17. IRC §721
18. IRC §721(a)
19. Ltr. Rul. 200317011 (January 7, 2003) (4-step transaction to form family limited partnership resulted in no gain or loss on exchange of property between husband and wife within IRC §1041, no gain or loss on contributions to the partnership, and no contributions treated as contributions to investment company)
20. IRC §721(a)
21. IRC §721
22. Treas. Reg. §1.1245-4(c)(2) (§1245 property)
23. *Jacobson v. Comm'r*, 963 F.2d 218 (8th Cir. 1992)
24. IRC §707(a)(2)
25. Treas. Reg. §1.721-1(a); *Barenholtz v. Comm'r*, 77 TC 85 (1981)

Transfer of Services in Exchange for a Capital Interest. Under a second exception, a partnership **capital** interest received in exchange for the performance of services triggers compensation income equal to the fair market value (FMV) of the capital interest received by the person rendering the services.[26] The IRS provided guidance on circumstances that can lead to that outcome.[27] In one case, a 1% capital interest received for services was includable in gross income.[28]

If a person receives a **profits** interest for services rendered, it is not a taxable event unless:

1. The profits interest relates to a substantially certain and predictable stream of income from partnership assets, such as from high-quality debt securities or a high-quality net lease;
2. Within two years of receipt, the partner disposes of the profits interest; or
3. The profits interest is a limited partnership interest within the meaning of a publicly-traded partnership.[29]

A partnership capital interest received in exchange for the performance of services may not be includable in income in the year of receipt if the partnership interest has only speculative value.[30] In a 1974 case,[31] a service partner sold his partnership interest shortly after receiving it. The taxpayer became a partner to avoid ordinary income and did not intend to remain a partner. The transaction was taxable.

Transactions Between a Partnership and a Partner Acting in Another Capacity. In another exception to the general rule of partnership or LLC formations being tax-free, a transaction between a partnership and a partner acting in a capacity other than as a member of the partnership is treated as occurring between the partnership and a taxpayer who is not a partner. Gain or loss is recognized in this situation.[32]

Investment Company. If the new entity, including an LLC, is a publicly-traded partnership[33] and is an investment company, gain or loss may be recognized on formation if the partners-members have diversified their investments as a result of formation of the partnership or LLC.[34] The rules determining whether the investment company exception applies are found in the rules applicable to tax-free formation of a corporation.[35] Under those rules, a transfer of property is considered a transfer to an investment company if it results, directly or indirectly, in diversification of any of the transferor's interests and the transferee is an investment company.[36]

Gift Tax Liability. The formation of an LLC (or partnership) may be income-tax free. However, in one ruling, the IRS took the position that a transfer in connection with the formation of a family limited partnership not in the ordinary course of business created taxable gifts. The parents contributed marketable securities and received partnership interests that were worth less than the FMV of the assets contributed. Their children received the remaining partnership interests.[37]

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26. Treas. Reg. §1.721-1(b)(1)
27. *Id.* See Rev. Proc. 93-27, 1993-2 CB 343
28. *Johnston v. Comm'r*, TC Memo 1995-140 (Mar. 29, 1995)
29. Rev. Proc. 93-27, 1993-2 CB 343
30. *Campbell v. Comm'r*, 943 F.2d 815 (8th Cir. 1991)
31. *Diamond v. Comm'r*, 492 F.2d 286 (1974)
32. Prop. Treas. Reg. §§1.707-0 through 1.707-9; Ltr. Rul. 9822002 (October 3, 1997) (partner's exchange of portion of operating business for stock and cash treated as sale of property); Ltr. Rul. 9936011 (June 3, 1999) (payment by LLC to partner-member treated as sale or exchange; not subject to anti-abuse rules)
33. IRC §7704(b)
34. IRC §721(b); Treas. Reg. §1.351-1(c)(1)(i)
35. IRC §351
36. IRC §351(e)(1)
37. FSA 199950014 (September 15, 1999)

Anti-Abuse Regulations

To discourage use of partnerships (and LLCs) for tax-avoidance purposes, anti-abuse regulations were adopted which impose additional requirements on partnerships (and LLCs):

- The partnership or LLC must be bona fide and the form of the transactions must have been entered into for a substantial business purpose and must properly reflect income.[38]
- The IRS has the authority to recast the form of the transactions if those conditions are not met.[39]
- The anti-abuse rules apply only to income tax, not to transfer taxes.[40]

METHOD OF ACCOUNTING

It appears that eligibility for cash accounting requires a case-by-case review of whether the operation is a tax shelter (for nonfarm businesses)[41] or a farming syndicate (for farming businesses).[42]

Nonfarm Businesses

LLCs are subject to the typical method of accounting rules, except an LLC treated as a tax shelter[43] **cannot use the cash method of accounting.**[44] This means that with limited exceptions, the following may not use the cash method of accounting:[45]

1. Any enterprise in which the interests have been offered for sale in any offering required to be registered with any federal or state agency having authority to regulate the offering of securities for sale;
2. Any syndicate;[46] or
3. Any tax shelter.[47]

For C corporations or partnerships with a C corporation as a partner that are not tax shelters, the limits on cash accounting do not apply if the gross receipts for the three taxable years ending with the prior taxable year do not exceed $5 million.[48]

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38. Treas. Reg. §1.701-2(a)
39. Treas. Reg. §1.701-2(b)
40. Notice 95-7, 1995-1 CB 292; TD 8592 (April 12, 1995)
41. Ltr. Rul. 9328005 (December 21, 1992) (LLC not prohibited from using cash accounting where LLC not tax shelter and no interest required to be registered with state or federal securities agency)
42. IRC §464(c)(1)
43. IRC §461(i)(3)
44. IRC §448(a)(3)
45. IRC §448(b)(1)
46. IRC §§461(i)(3)(B), 1256(e)(3)(B)
47. IRC §§461(i)(3)(C), 6662(d)(2)(C)(ii)
48. IRC §§448(b)(3), (c)(1)

Farming Businesses[49]

In determining whether a farming business is a tax shelter, the definition of a farming syndicate applies. A **farming syndicate** is defined as a partnership or another enterprise, other than a corporation which is not an S corporation, engaged in the trade or business of farming if:

1. At any time, interests in the partnership or other enterprise have been offered for sale in any offering required to be registered with a state or federal agency having authority to regulate the offering of securities for sale, or

2. More than 35% of the losses during any period are allocable **to limited partners or limited entrepreneurs.**[50]

In a 1992 case, a medical doctor who owned a cattle-feeding business in which he did not actively participate was considered a limited entrepreneur in the cattle-feeding business. The profit motive was irrelevant. Therefore, if LLC members are considered limited partners, the LLC is precluded from using cash accounting.[51]

There are several categories of owners who are not considered limited partners or limited entrepreneurs:

- Individuals who participated in farming business management for not less than five years
- Individuals residing on a farm
- Individuals actively participating in the farming business, or in the further processing of livestock raised in the business
- Individuals whose principal business activity involves active participation in the farming business (even though it is not the business in question)
- Any interest held by a family member (or a spouse) of a grandparent of an individual in this list who is actively participating in the business[52]

The term **family** includes brothers, sisters, spouse, ancestors, and lineal descendants.[53] If LLC members are deemed limited partners or limited entrepreneurs, the question is whether a sufficient number reside on the farm or actively participate in the business, or whether close relatives are involved to the required degree.

TAX YEAR

All partnerships (and LLCs) are required to have the same taxable year as their owners.[54] A partnership must have the same taxable year as one or more of its partners who have an aggregate interest in partnership profits and capital of greater than 50%.[55] If the partners owning a majority of partnership profits and capital do not have the same taxable year, the partnership must adopt the same taxable year as its principal partners.[56] In the event the principal partners do not have the same taxable year and the majority of its partners do not have the same taxable year, the partnership must adopt a calendar year or other year as specified in the regulations.[57]

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49. IRC §§448(b)(1); 448(d)(1)
50. IRC §464(c)(1)
51. *Estate of Wallace v. Comm'r*, 95 TC 525 (1990), *aff'd*, 965 F.2d 1038 (11th Cir. 1992)
52. IRC §464(c)(2)
53. IRC §§464(c)(2), 267(c)(4)
54. IRC §§706, 441, as amended by the Tax Reform Act of 1986, Pub. L. No. 99-514, §806, 100 Stat. 2817 (1986)
55. IRC §§706(b)(1)(B)(i), (b)(4)
56. IRC §706(b)(1)(B)(ii)
57. IRC §706(b)(1)(B)(iii)

A partnership may have a taxable year other than specified above if the partnership establishes, to the satisfaction of the IRS, a business purpose for a different taxable year. Deferral of income to the partners is not considered a business purpose.[58]

SELF-EMPLOYMENT TAX CONSIDERATIONS

IRC §1402 defines **net earnings from self-employment** as the gross income derived by an individual from any trade or business carried on by such individual. The term includes a person's distributive share (whether or not distributed) of income or loss described in IRC §702(a)(8) from any trade or business carried on by a partnership of which the individual is a member.[59] IRC §702(a)(8) states that each partner is to take into account separately the distributive share of taxable income or loss.

LLC Members SE Tax Liability

IRC §1402(a)(13) specifies that the distributive share of any item of income or loss of a **limited partner** is not included under the definition of net earnings from self-employment. An exception applies if the distributive share is a **guaranteed payment** to that partner for services actually rendered to, or on behalf of, the partnership to the extent that those payments are in the nature of remuneration for those services.

In a 1994 letter ruling involving the conversion of a general partnership to an LLC, the IRS noted that the general partnership was classified as a partnership for federal tax purposes **but that it was not a limited partnership.**[60] As explained in the ruling, members of LLCs are not limited partners, although they may be treated as limited partners for some purposes. Furthermore, members of the new LLC engaged in the daily activities of the LLC and performed substantial services. Accordingly, income allocated to the LLC member was net earnings from self-employment which must be included in each member's SE income for the year. The IRS's position was that LLC members who are active in the LLC's trade or business have SE income.

The 1956 regulations indicate that net earnings from self-employment from any trade or business carried on by the partnership of which the taxpayer is a member must be included as the distributive share of the individual[61] regardless of the nature of his membership.[62] In 1997, regulations were proposed that were withdrawn and replaced with amendments to the existing regulations. These state that an individual's net earnings from self-employment do not include the individual's distributive share of income or loss as a limited partner except for guaranteed payments for **services actually rendered.**[63] These proposed regulations were to be effective beginning with the individual's first taxable year beginning on or after the date these regulations were published as final regulations in the Federal Register.[64] An individual is treated as a limited partner unless the individual:

- Has personal liability for the debts of or claims against the partnership by reason of being a partner;
- Has authority (under the law of the jurisdiction in which the partnership is formed) to contract on behalf of the partnership; or
- Participates in the partnership's trade or business for more than 500 hours during the partnership's taxable year.[65]

State law characterizations of an individual as a limited partner or otherwise are not determinative.[66]

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58. IRC §706(b)(1)(C)
59. IRC §1402(a)
60. Ltr. Rul. 9452024 (Sep. 29, 1994)
61. Treas. Reg. §1.1402(a)-2(d)
62. Treas. Reg. §1.1402(a)-2(g)
63. Prop. Treas. Reg. §1.1402(a)-2(g)
64. NPRM REG-209824-96, 62 Fed. Reg. 1701, 1702 (Jan. 13, 1997)
65. Prop. Treas. Reg. §1.1402(a)-2(h)
66. Preamble to NPRM REG-209824-96, 62 Fed. Reg. 1702 (Jan. 13, 1997)

The Taxpayer Relief Act of 1997 prohibited the IRS from issuing temporary or final regulations defining a limited partner for SE tax purposes before July 1, 1998.[67] The legislation was effective on August 5, 1997. The Senate amendment to the pending legislation, which became the Taxpayer Relief Act of 1997, stated:

> *It is the sense of the Senate that the Department of the Treasury should withdraw the proposed regulations defining limited partner, and that the Congress should determine the tax law governing self-employment income.*[68]

The Conference Agreement changed the focus in stating that any regulations relating to the definition of a limited partner for SE tax purposes shall not be issued or effective before July 1, 1998.

The provision as enacted stated:

> *No temporary or final regulation with respect to the definition of a limited partner under §1402(a)(13) of the Internal Revenue Code of 1986 may be issued or made effective before July 1, 1998.*[69]

Current Status

Since July 1, 1998, nothing has been done by either the Congress (as the Senate insisted should be done) or by the Department of the Treasury, chastened by the passage of the Internal Revenue Restructuring and Reform Act of 1998.[70] It is clear that the IRS and the Department of the Treasury are unlikely to provide further guidance without a signal from Congress.

Farm Programs

Receipt of Farm Program Payments.[71] In addition to LLCs being treated as corporations for purposes of federal farm program eligibility, farm program payments raise additional issues regarding SE tax. Recent IRS audit activity suggests that it believes spouses who receive farm program payments under the 2002 farm program legislation[72] are liable for SE tax on the amounts received.[73] That position is justified if the spouse has net earnings from self-employment from a trade or business carried on by such individual. It is not justified if the involvement by the spouse falls short of that standard.

> **Note.** Only the courts can answer the following question: If the spouse has just enough participation to meet the minimum requirements to be eligible for farm program payments, is the spouse liable for self-employment tax?

Test for Spousal Eligibility for Farm Program Payments. In 1991, the Agriculture Secretary exercised his authority[74] to allow each spouse to be considered a separate person.[75] Under that action, spouses may be considered separate persons if each spouse meets the other requirements necessary to be considered separate persons.[76] That rule did not change the already existing exception that allows a married couple who were engaged in separate farming operations before marriage and who continued to operate separately after marriage to be considered separate persons for purposes of the payment limitation provision.[77]

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67. Taxpayer Relief Act of 1997, Pub. L. No. 105-34, §935, 111 Stat. 788 (1997)
68. S. 949, §734, offered as Senate Floor Amendment No. 584
69. Taxpayer Relief Act of 1997, Pub. L. No. 105-34, §935, 111 Stat.788 (1986)
70. Pub. L. No. 105-206
71. Harl, "Self-Employment Tax for Spouses Receiving Farm Program Payments?" 19 *Agric. L. Dig*. 9 (2008)
72. Farm Security and Rural Investment Act of 2002, Pub. L. No. 107-171, 116 Stat. 134 (2002)
73. IRC §1402(a)
74. News Release, Office of Public Affairs, United States Department of Agriculture, Jan. 7, 1991
75. 7 USC §1308(e) for a discussion of what is a "person" under the payment limitation rules
76. 7 USC §1308(e)(2)(c)(ii); 7 CFR §1400.105(a)(2)
77. 7 USC §1308(e)(2)(C)(i); 7 CFR §1400.105(a)(2)

Actively Engaged in Farming. To be eligible for farm program payments, an individual or entity must be actively engaged in farming.[78] To be actively engaged in farming, three conditions must be met:

1. The individual's share of profits or losses from the farming operation must be commensurate with the individual's or entity's contributions to the operation;[79]
2. The individual's or entity's contributions must be at risk;[80]
3. An individual must make a significant contribution (based on the total value of the farming operation) of:
   - Capital, equipment, or land, and
   - **Personal labor, or active personal management.**[81]

The last item — personal labor and active personal management — is the key factor in comparing the **actively-engaged test** with the **SE income test.** In order to determine if the individual or entity contributes a significant amount of personal labor or active personal management, several factors were taken into consideration in the past:

- The types of crops produced by the farming operation,
- The normal and customary farming practices of the area, and
- The total amount of labor and management which is necessary for such a farming operation in the area.[82]

The Food, Conservation, and Energy Act of 2008 (2008 Farm Bill) specifies that for farming operations, the adult family member who makes a significant contribution of active personal management or personal labor is considered actively engaged in farming. The family farming operation must be conducted by persons, a majority of whom are family members. This is provided the "at risk" and the commensurate sharing of profits and losses requirements are met.[83]

Under the 2008 Farm Bill, minor changes were made to the actively-engaged rules, including separate provisions for six special classes of producers. This includes the rule that if one spouse or the estate of a deceased spouse is determined to be actively engaged, the other spouse is considered actively engaged.[84]

SE Income Test. Net earnings from self employment includes gross income derived by an individual from any trade or business carried on by such individual minus allowed deductions.[85] **Trade or business** is defined as it is used in determining the deductibility of trade or business expenses under IRC §162. There are specified exceptions described in IRC §1402(c) (SE tax).

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78. 7 USC §1308-1(b)
79. 7 USC §1308-1(b)(2)(A)(ii); 7 CFR §1400.201(d)(1)
80. 7 USC §1308-1(b)(2)(A)(iii); 7 CFR §1400.201(d)(2)
81. 7 USC §1308-1(b)(2)(A)(i), amended by Pub. L. No. 110-246, Sec. 1603(d), 110th Cong., 2d Sess. (2008), amending 7 USC §1308-1; see 7 CFR §1400.202 (emphasis added)
82. 7 CFR §1400.201(c)
83. Pub. L. No. 110-246, Sec. 1603(d), 110th Cong., 2d Sess. (2008), amending 7 USC §1308-1
84. Ibid
85. IRC §1402(a)

In general, continuity and regularity of activity are necessary before a venture is considered a trade or business.[86] Several court cases[87] identified when ventures **do not** rise to the level of a trade or business. For example, when the taxpayer's efforts are irregular and sporadic as an inventor,[88] when an investment firm employee's sale of insider information was not a trade or business,[89] when taxpayers were not actively involved in the operation of a night club and restaurant,[90] when securities trading was not conducted with sufficient frequency to constitute a trade or business,[91] and when an attorney was not involved in law practice sufficient to be a trade or business.[92] On the other hand, the U.S. Supreme Court held in *Comm'r v. Groetzinger*[93] that constant and large-scale efforts by the taxpayer in a gambling activity (60 to 80 hours per week, 48 weeks per year) was considered a trade or business. As pointed out in this case, what is considered a trade or business is a facts and circumstances question.

In 1956, **material participation** was added to the statutory authority for SE income **in the context of landlord-tenant relationships.**[94] That concept could be relevant in the context of a husband and wife farming operation **if the relationship is characterized as a landlord-tenant relationship.**

Characterization as a Partnership. If a husband-and-wife farming operation is properly characterized as a partnership, as asserted in some audits over the issue of SE tax liability of spouses, there is authority that all **general** partners in a general partnership have SE tax liability. As stated in *Norwood v. Comm'r*,[95] it is undisputed that the petitioner's interest was a general partnership interest. Accordingly, his distributive share of the partnership's trade or business income, subject to the limitations of §1402(b), is subject to taxes on SE income.

A key question is whether a husband and wife carrying on a farming operation, with the wife involved only to the extent of being "actively engaged in the farming operation" for purposes of eligibility for farm program payments, are a partnership. Although courts in a few states held that husband-wife partnerships are recognized even if the formalities of partnership organization are not evident,[96] the Uniform Partnership Act defines a partnership as an association of two or more persons carrying on a business for profit as co-owners.[97] The sharing of gross returns does not, in itself, establish a partnership.[98] However, receipt of a share of the profits is prima facie evidence that a partnership exists.[99]

If the spouse receiving farm program payments under the actively-engaged test receives **only a portion** of the government payments, this does not indicate a sharing of net income. Consequently, this is not indicative of a partnership. For an LLC, the outcome should not be different inasmuch as the determination is whether or not a partnership exists, not whether a partner has SE income.

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86. *Batok v. Comm'r*, TC Memo 1992-727 (Dec. 28, 1992) (one month's work installing windows not a continuous and regular activity and not a trade or business)
87. For a full list of cases on "trade or business" status under IRC §162, see 2 Harl, *Farm Income Tax Manual* §8.05[3] (2007 ed.).
88. *Stanton v. Comm'r*, 399 F.2d 326 (5th Cir. 1968)
89. *Wang v. Comm'r*, 2002-1 USTC ¶50,443 (9th Cir. 2002)
90. *Wilson v. Comm'r*, 03-2 USTC ¶50,614 (9th Cir. 2003)
91. *Mayer v. U.S.*, 94-2 USTC ¶50,509 (Cls. Ct. 1994)
92. *Sloan v. Comm'r*, TC Memo 1988-294 (July 11, 1988), *aff'd*, unpub. op., 4th Cir. (Feb. 7, 1990)
93. *Comm'r v. Groetzinger*, 480 U.S. 23 (1987)
94. IRC §1402(a)(1)
95. *Norwood v. Comm'r*, TC Memo 2000-84 (Mar. 13, 2000)
96. *Craig v. U.S.*, 451 F. Supp. 378 (D. S.D. 1978); *Kjorvestad v. U.S.*, 81-1 USTC ¶13,401 (D. N.D. 1981)
97. UPA §6
98. UPA §7(3)
99. UPA §7(4). See *Tarnavsky v. Tarnavsky*, 147 F.3d 674 (8th Cir. 1998) (sharing of expenses sufficient to give rise to partnership, especially where income retained by partnership and income tax returns allocated income to partners).

Electing out of Partnership Status. A provision is available that allows members of an unincorporated organization to elect not to be treated as a partnership.[100] Presumably, an LLC merits the same treatment as a general or limited partnership, although specific authority to that effect is lacking.

However, that election only applies to organizations with investment purposes only and not for the active conduct of a business.[101] Therefore, this provision is of little help to a husband and wife facing an assertion that the spouse has SE income as a general partner (or as a member of an LLC) for receiving farm program payments.

Husband-and-Wife Qualified Joint Ventures. In the case of a qualified joint venture conducted by a husband and wife who file a joint return for the taxable year, an election may be made to not be treated as a partnership.[102]

The husband and wife can be the only members of the electing joint venture **and both must be materially participating within the meaning of IRC §469(h), except IRC §469(h)(5).**[103] Each spouse's share of net income from a qualified joint venture is subject to SE tax.[104] Material participation refers to participation on a regular, continuous, and substantial basis.[105]

> **Note.** This provision probably is not helpful in husband-wife situations inasmuch as the spouse, who barely qualifies for farm program payments under the **actively-engaged test,** generally is not sufficiently involved to meet the higher standard of material participation.
>
> If the actively-engaged test was met, the spouse would be subject to SE tax under the lesser rule of material participation. If the statute providing for the election out of partnership status had specified that the election could be made if **one** of the spouses is materially participating under that higher standard, the election out would provide a good defensive opportunity for the couple.

> **Note.** See Chapter 14, "Agricultural Issues and Rural Investments," for additional information on qualified joint ventures.

TAX RETURN FILING REQUIREMENTS

Form 1065, *U.S. Return of Partnership Income*, is required of all partnerships. This is true even if the partnership has no taxable income for the accounting period. The return is due on or before the 15th day of the fourth month following the close of the taxable year.[106] A penalty of $85 per partner per month may be imposed on the partnership for failure to file a timely or complete Form 1065 (maximum of 12 months' penalty).[107] This penalty is in addition to criminal penalties for willful failure to file a return or supply information.[108] LLCs taxed as a partnership are subject to the same filing rules.

100. IRC §761(a)
101. IRC §761(a)(1)
102. IRC §761(f)
103. IRC §761(f)(2)
104. IRC §1402(a)(17)
105. IRC §469(h)(1)
106. IRC §6072(a); Treas. Reg. §1.6072-1(a)
107. IRC §§6698(a), (b)
108. IRC §7203

For purposes of the penalty, a partnership is defined to mean any partnership required to file a return under IRC §6031(a). There is an exception to the definition of partnership for small partnerships.[109] In general, the term partnership does not include a partnership if it has 10 or fewer partners, each of whom is a natural person (other than a nonresident alien) or an estate. Also, each partner's share of each partnership item must be the same as each partner's share of every other item. For example, a husband and wife and their estates are treated as one partner for this purpose. A partnership falling within the terms of the exception is considered to have met the reasonable-cause test and is not subject to the penalty imposed for failure to file a complete or timely partnership return. This only applies if all partners have fully reported their shares of income, deductions, and credits from the partnership on their own timely-filed income tax return.[110] All other partnerships do not fall within the exception and are subject to the penalty provisions. This includes partnerships having a trust or corporation as a partner, tier partnerships, and partnerships in which each partner's interest in the capital and profits is not owned in the same proportions, or in which all items of income, deductions, and credits are allocated in proportion to the pro rata interests.[111]

Note. It is not clear whether LLCs taxed as partnerships are eligible for the exception. Because an LLC is taxed as a partnership for income tax purposes, it appears that LLCs can utilize the exception.[112]

Observation. It is important to consider whether taking advantage of the exception is wise. Failure to file a complete Form 1065 may complicate the handling of transactions in future years involving the partners and the partnership. This may result in necessary information, which would be included in a complete Form 1065, not being readily available when it is needed.

RECOURSE OR NONRECOURSE DEBT

In general, the IRS characterizes debt as recourse or nonrecourse. For partnership purposes, this is based on whether a partner bears the economic risk of loss for the debt.[113] Therefore, a partnership liability is a recourse liability to the extent that any partner or related person bears the economic risk of loss for that liability.[114] Similarly, a partnership liability is a nonrecourse liability to the extent that no partner or related person bears the economic risk of loss for that liability.[115] LLC debt should be treated as nonrecourse for purposes of Subchapter K of the Internal Revenue Code. A unique feature of nonrecourse debt is that it can be allocated to members' bases disproportionately to the percentage of ownership.

109. IRC §6231(a)(1)(B)
110. Rev. Proc. 84-35, 1984-1 CB 509
111. IRC §6698
112. IRC §6231(a)(1)(B)
113. IRC §752(d); Treas. Reg. §1.752-2
114. Treas. Reg. §1.752-1(a)(1)
115. Treas. Reg. §1.752-1(a)(2)

Economic Risk of Loss

A partner bears the economic risk of loss in several situations identified in the regulations.[116]

1. In general, a partner bears the economic risk of loss for a partnership liability to the extent that, if the partnership liquidated, the partner (or a related person) would be obligated to make a payment or make a contribution to the partnership because the liability is due and payable.[117]

Example 2. Archie and Barney form an LLC taxed as a partnership that is later liquidated. Each contributes $100,000 in cash. The partnership purchases an office building on leased land for $1 million from an unrelated seller. It pays $200,000 in cash and executes a promissory note to the seller for the $800,000 balance. The note is a general obligation of the partnership and neither Archie nor Barney is relieved from personal liability.

The partnership agreement provides that all partnership items are allocated equally, except tax losses, which are allocated 90% to Archie and 10% to Barney. A deficit capital account provision is in effect upon liquidation. Upon liquidation, the $800,000 liability becomes due and payable and all partnership assets are deemed worthless. The $800,000 of partnership liability is classified as a recourse liability because one or more partners bears the economic risk of loss for nonpayment.

	Archie: 90%	Barney: 10%
Initial contribution	$100,000	$100,000
Loss on hypothetical sale (property deemed worthless)	(900,000)	(100,000)
Capital account	($800,000)	$ 0

Archie has an obligation to make a $800,000 contribution to the partnership. This allows the partnership to then pay the debt.[118]

According to the Regulations, it is assumed that the obligation of a partner or related person to make payments is reduced to the extent that the partner or related person is entitled to reimbursement.[119] Moreover, it is assumed that all partners and related persons who have obligations to make payments actually perform those obligations.[120]

2. A partner bears the economic risk of loss for a partnership liability to the extent the partner or related person makes or acquires an interest in a nonrecourse loan to the partnership and the economic risk of loss for the liability is not borne by another party.[121] Under the **partnership** regulations, if no partner bears the economic risk of loss from a debt, the debt is a nonrecourse liability. Nonrecourse liabilities are generally allocated to partners according to their interest in partnership profits. However, this general rule may be overridden with liabilities allocated to partners to cover their shares of the partnership minimum gain.[122] In the case of a **wrap-around debt,** in which the liability includes a nonrecourse obligation encumbering partnership property that is owed to another person, the portion of the partnership liability corresponding to the wrapped debt is treated as a liability owed to another person,[123] except when the interest in partnership items of the partner or related person is 10% or less.[124]

116. Treas. Reg. §1.752-2(b)

117. Treas. Reg. §1.752-2(b)(1)

118. Treas. Reg. §1.752-2(f)

119. Treas. Reg. §1.752-2(b)(5)

120. Treas. Reg. §1.752-2(b)(6)

121. Treas. Reg. §1.752-2(c)(1)

122. Treas. Reg. §§1.704-1(b)(2) and 1.752-3(a)(1)

123. Treas. Reg. §1.752-2(c)(2)

124. Treas. Reg. §1.752-2(d)

3. The party guaranteeing the interest payment is treated as bearing the economic risk of loss **to the extent of the present value of the guaranteed future interest payments** if:[125]

   - One or more partners or related persons guaranteed the payment of more than 25% of the total interest that accrues on a partnership nonrecourse liability over its remaining term, and
   - It is reasonable to expect that the guarantor is required to pay substantially all the guaranteed future interest if the partnership fails to do so.

4. The extent to which a partner or related person bears the economic risk of loss is determined by taking into account any delay in the time when a payment or contribution obligation for a partnership liability is to be satisfied.[126] An obligation is **not considered satisfied** by the transfer of a promissory note by a partner or related person to the obligee unless the note is readily tradeable on an established securities market.[127]

5. A partner is considered to bear the economic risk of loss for a partnership liability to the extent that the value of any of the partner's or related person's separate property is pledged as security for the partnership liability.[128] This means substantially all the items are allocated to the contributing partner and this allocation is greater than the partner's share of other significant items of partnership income, gain, loss, or deduction.[129]

6. For tiered partnerships, the liabilities of a lower-tier partnership are allocated to the upper-tier partnership according to a formula found in the regulations.[130] In a 2004 Technical Advice Memorandum,[131] an LLC's allocation method for excess nonrecourse liabilities was rejected by the IRS because the allocation involved third-tier allocations.

7. An obligation of a partner or related person to make a payment may be disregarded (or treated as the obligation of another person). This occurs if facts and circumstances indicate that a principal purpose of the arrangement is to eliminate the partner's economic risk of loss for that obligation or merely to create the appearance of the partner or related person bearing the economic risk of loss.[132]

8. A single-member LLC is treated as a disregarded entity. An obligation of a disregarded entity is taken into account only to the extent the net value of the disregarded entity as of the allocation date is allocated to the partnership liability in determining whether the member bears the economic risk of loss.[133]

125. Treas. Reg. §1.752-2(e)(1)
126. Treas. Reg. §1.752-2(g)
127. Treas. Reg. §1.752-2(g)(3)
128. Treas. Reg. §1.752-2(h)(1)
129. Treas. Reg. §1.752-2(h)(2)
130. Treas. Reg. §1.752-2(i)
131. TAM 200436011 (April 30, 2004)
132. Treas. Reg. §1.752-2(j)
133. Treas. Reg. §1.752-2(k)

Special Nature of LLC Debt

In applying the above 8 rules to LLCs, difficulties arise. In general, no member of an LLC is liable for the obligations of an LLC, regardless of whether the debt is labeled as recourse or nonrecourse. This is an important feature of LLC-hybrid status: limited liability for the members.[134] Therefore, most LLC debt is considered nonrecourse for purposes of the regulations. However, the following five situations are exceptions:

1. If an LLC member (or a related person)[135] guarantees a loan or makes a loan to the LLC, the debt is considered recourse for purposes of the **partnership** regulations.
2. When an obligation of a member exists otherwise under state law, the debt is recourse. For example, this is the case when a member remains liable for recourse debts of a predecessor organization, such as a partnership.
3. When the debt comes within the interest guarantee rules,[136] or the property pledge rules, the debt is recourse.[137]
4. If debt falls within the anti-abuse rules, it is recourse.[138]
5. LLC statutes generally provide that the conversion from partnership to LLC does not relieve those who were previously obligated on a recourse debt from liability, and those debts continue to be treated as recourse obligations.

Combating Tax Abuse in This Area — The Bigger Picture. Over the past few years, Congress has acted to curb what was thought to be tax abuse in the area of partnership formation in instances where transferors with low-basis, high-value properties, burdened with substantial debt, formed new entities with individuals with different amounts of potential gain and different amounts of debt. An objective was to gain a tax advantage, economic advantage, or both for some or all of the transferors. Regulations have been issued providing guidance on how to navigate through the resulting complexity.

Viewing the problem area from the perspective of a tax practitioner, the question is how to spot the problem, if there is one, and how to make use of the options provided to deal with the problem. The task can be viewed in three steps:

1. Is there a problem? Keep in mind that this is a problem unique to partnerships and those taxed under partnership tax rules (LLCs, LLPs, and LPs, as well as general partnerships). The rules do not apply to C or S corporations.
2. Does the problem represent a **small disparity,** as discussed below? Small disparities can be ignored, according to the regulations.
3. How big is the problem? This requires looking at the income tax basis of assets proposed to be transferred to the new entity grouped by transferor, the fair market values, and the indebtedness involved.

The following examples may be of assistance in determining whether the built-in gain or loss, as the case may be, is best dealt with using the traditional method, the traditional method with curative allocations, or the remedial allocation method.

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134. *Hubert Enterprises, Inc. v. Comm'r*, TC Memo 2008-46 (Feb. 28, 2008) (member of LLC held to be not "at risk")

135. Treas. Reg. §1.752-4(b)(1) for the definition of "related person" by reference to the related party rules of IRC §§707(b)(1) and 267(b), substituting "80% or more" for "more than 50%"

136. Treas. Reg. §1.752-2(e)

137. Treas. Reg. §1.752-2(h)

138. Treas. Reg. §1.752-2(j)

Allocation of Nonrecourse Liabilities

The partners' share of nonrecourse liabilities equals the sum of the partners' share of:[139]

1. Partnership minimum gain under IRC 704(b),[140]
2. Taxable gain under IRC §704(c),[141] and
3. Excess nonrecourse liabilities.[142]

Under Rev. Rul. 95-41,[143] allocations of nonrecourse liabilities for partnerships under Treas. Reg. §1.752-3(a)(1) are not affected by IRC §704(c). Allocations under Treas. Reg. §1.752-3(a)(2) (assumed partnership disposal of the property subject to nonrecourse liabilities) and §1.752-3(a)(3) (partner's share of nonrecourse liabilities of the partnership as determined in accordance with the partner's share of partnership profits) are affected by IRC §704(c).

IRC §704(b) Minimum Gain. To determine the LLC members' shares of debt under the §704(b) minimum gain rules, it is necessary to know:

- The outstanding principal balances of LLC debt that is nonrecourse under the partnership regulations,[144] and
- The §704(b) basis of the LLC's assets that are subject to such debts.

Under the §704(b) regulations, minimum gain for each liability is equal to the gain the partnership would realize if it disposed of the property subject to that liability for no consideration other than the full satisfaction of the liability.[145] In making that calculation, the regulations specify that the §704(b) basis is **the value of the properties on the date they were contributed to the entity, as adjusted for depreciation, amortization, revaluations, and such modifications.**[146]

Example 3. Clyde and Igmar form a partnership. Clyde contributes $100,000 in cash. Igmar contributes property with a gross value of $250,000, which is subject to a $150,000 nonrecourse debt and an income tax basis of $120,000.

The §704(b) book basis of Igmar's property on the contribution date was $250,000. After the property is depreciated by half, the income tax basis is $60,000 and the §704(b) book basis is $125,000. The principal of the debt remains at its original $150,000 level. The §704(b) minimum gain for the $150,000 liability is $25,000. This equals the §704(b) book gain that would be realized if the property was sold for the $150,000 debt.

	Book Basis	Tax Basis
Starting basis	$250,000	$120,000
All depreciation	(125,000)	(60,000)
Remaining basis	$125,000	$ 60,000
Sale price	$150,000	
Remaining basis	(125,000)	
IRC §704(b) gain	$ 25,000	

139. Treas. Reg. §1.752-3(a)
140. Treas. Reg. §1.752-3(a)(1)
141. Treas. Reg. §1.752-3(a)(2)
142. Treas. Reg. §1.752-3(a)(3)
143. Rev. Rul. 95-41, 1995-1 CB 132
144. Treas. Reg. §1.752-2
145. Treas. Reg. §1.704-2(d)(1)
146. Treas. Reg. §§1.704-1(b)(2)(iv)(d), (f), (g)

Partnership Minimum Gain for an LLC. To calculate the partnership minimum gain for an LLC, it is necessary to determine which assets are subject to the entity's liabilities. All LLC assets are subject to its state-law recourse obligations. The LLC assets in which a creditor has a security interest are subject to its state-law nonrecourse obligations. In applying the priority rules prescribed by the regulations,[147] basis is allocated first to the debt for which the creditor has a security interest, and the remaining amount is allocated to the remaining recourse liabilities. For LLCs, minimum gain can be calculated for recourse debt by comparing the face value of recourse debt to the total book basis of all LLC property (after a reduction for secured, nonrecourse liabilities).

Note. Remember, the unique feature of LLCs is that what appears to be recourse debt is generally treated as nonrecourse debt under the partnership rules.[148]

IRC §704(c) Minimum Gain. In general, §704 requires that any difference between the tax basis and the FMV of the property contributed to a partnership must be eliminated through depreciation as well as gain or loss on its sale.[149] Recapture of depreciation must take into account the way the depreciation was allocated under the partnership regulations which depends upon what allocation method was utilized.[150]

Example 4. Fernando contributes land with a value of $100,000 and a basis of $60,000 to the FN Partnership in exchange for a 50% partnership interest. A few years later, the land is sold for $130,000. Under §704(c), the first $40,000 of gain is allocated to Fernando, which is the difference between the property's basis and its FMV at the time of contribution. The remainder is split equally between Fernando and Ned ($15,000 each).

The regulations under §704(b) specify the circumstances under which a revaluation of partnership property is allowed. The contribution (or distribution) of a greater than de minimis amount of property in exchange for a partnership interest is considered a **revaluation event.** A revaluation generally brings the capital accounts of the partners in line with the economic reality of their partnership arrangement. The revaluation results in the adjustment of §704(b) book basis of partnership property to reflect the value of the property. Any differences between book value and income tax basis caused by the revaluation are resolved using the principles of §704(c) as explained in **Example 4.**[151]

Example 5. Ramsey and Sid each contributed $30,000 to the RS Partnership, which purchased land for $60,000. Several years later, the land was worth $100,000. At that time, Tony contributed $50,000 for a one-third interest in the partnership. This activity constitutes a revaluation event. A difference arises by adjusting the land upward to its value of $100,000.

The land is later sold for $130,000. Under the principles of §704(c), $70,000 of gain is recognized ($130,000 – $60,000). The first $40,000 ($100,000 contribution value minus $60,000 basis) is properly allocated to Ramsey and Sid equally ($20,000 each) and the remaining $30,000 is split equally among Ramsey, Sid and Tony ($10,000 each).

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147. Treas. Reg. §1.704-2(d)(2)(ii)

148. IRC §§704(b) and 752

149. IRC §704(c)(1)(A)

150. Treas. Reg. §1.704-3(a)(11)

151. Treas. Reg. §1.704-1(b)(2)(iv)(f)

The regulations under §704(c)[152] allow taxpayers to recover built-in gain or loss using any reasonable method, or any one of three methods specified in the regulations:

1. **The traditional method** — This method applies the sharing rules without regard to any ceiling problem that arises. The partnership cannot allocate more gain or loss to a partner than is available to the partnership.[153]
2. **The traditional method with curative allocations** — This method permits the partnership to make tax allocations (but not §704(b) book allocations) to deal with any deficiencies caused by the ceiling rule.[154]
3. **The remedial allocation method** — This method eliminates distortions caused by the ceiling rule.[155]

Example 6. LLC Allocation. Ned and Rod form an LLC. Ned contributes $100,000 cash. Rod contributes machinery with a $100,000 FMV and a $60,000 basis. The property is depreciable using the straight-line method over five years.[156] Each year, there is $20,000 of §704(b) book depreciation and $12,000 of tax depreciation. The book depreciation is allocated in accordance with the LLC agreement, $10,000 to each member. Ned's tax depreciation is limited by his book depreciation, or $10,000. Therefore, the first $10,000 of tax depreciation is allocated to the contributor of cash (Ned). Rod receives the remainder of the tax depreciation, or $2,000.

	Ned			Rod			
	FMV	Basis	Depreciation Allocation	FMV	Basis	Depreciation Allocation	Total
Cash	$100,000	$100,000					
Machinery				$100,000	$60,000		
Book depreciation (§704(b))			$10,000			$10,000	$20,000
Tax depreciation			10,000			2,000	12,000

Example 7. Traditional Method — Ceiling Limitation. Use the same facts as **Example 6,** except the property's basis on the contribution date is $40,000. Consequently, the annual tax depreciation is $8,000. This amount is not enough to allocate sufficient deductions to Ned to match his book allocation ($10,000). This lack of tax depreciation is referred to as a **ceiling limitation.** Under **the traditional method,** Ned receives all $8,000 of deductions and qualifies for no other relief.

	Ned			Rod			
	FMV	Basis	Depreciation Allocation	FMV	Basis	Depreciation Allocation	Total
Cash	$100,000	$100,000					
Machinery				$100,000	$40,000		
Book depreciation (§704(b))			$10,000			$10,000	$20,000
Tax depreciation			8,000			0	8,000

Under **the traditional allocation method with curative allocations,** $2,000 of existing tax deductions from other assets otherwise allocable to Rod (see **Example 6**) are re-allocated to Ned.

Under **the remedial allocation method,** a deduction is created to allocate to Ned, and an identical offsetting amount is allocated to Rod to cure the shortfall.

152. Treas. Reg. §1.704-3

153. Treas. Reg. §1.704-3(b). See 2 Harl, *Farm Income Tax Manual* §6.02[1][a][i][A][II] (2007 ed.)

154. Treas. Reg. §1.704-3(c). See 2 Harl, *Farm Income Tax Manual* §6.02[1][a][i][A][III] (2007 ed.)

155. Treas. Reg. §1.704-3(d). See 2 Harl, *Farm Income Tax Manual* §6.02[1][a][i][A][IV] (2007 ed.)

156. Rev. Proc. 87-56, 1987-2 CB 674

Multiple Properties Subject to Debt (State-Law Recourse LLC Debt). For a state-law recourse LLC liability, all the entity's assets are subject to the debt inasmuch as the creditor can have its debt satisfied out of any or all of the LLC assets. If that recourse debt is considered nonrecourse for purposes of §752, then **all the LLC's properties, other than those securing another specific priority debt, are considered** when calculating §704(c) minimum gain. The complexities that can arise in calculating §704(c) minimum gain are unique to LLCs because of the LLC members' position in terms of bearing economic loss. If a partnership (general or limited) borrows on a recourse basis and secures the debt with multiple properties, the same issues and complexities can arise.

As debt is paid down, the debt reduction is spread among the assets based on the previous allocation of debt.[157] An LLC with numerous assets and liabilities that constantly change through asset trades, acquisitions, and dispositions might be required to continually appraise its assets. Unfortunately, that is often the case with small business LLCs operating a going business rather than an LLC holding a major asset for investment.

Using the §704(c) Remedial Allocation Method. Another complication can arise if an LLC uses the remedial allocation method under §704(c). In that circumstance, the §704(c) minimum gain could exceed the excess of the debt less the income tax basis of the contributed property. As explained at the end of **Example 7,** shortfalls in allocable tax items are cured with tax allocations of created income items or gain (phantom allocations) that are, in turn, offset by identical allocations of deduction or loss.[158]

The purpose of §704(c) is to prevent the shifting of tax consequences among partners with respect to precontribution gain or loss. Therefore, a partnership must allocate income, gain, loss, or deduction with respect to property contributed by a partner so as to take into account any variation (other than a small disparity) between the adjusted tax basis of the property and its FMV at the time of the contribution. This applies to property contributed to a partnership if the book value (which is the FMV at the time of the contribution as adjusted for depreciation, for example) differs from the partner's adjusted tax basis. The built-in gain is the excess of book value (FMV) over the contributing partner's adjusted tax basis at the time of the contribution.

The regulations state that a small disparity can be ignored. This is defined as the situation in which the book value (FMV) of all properties contributed by one partner during the partnership taxable year does not differ from the adjusted tax basis by more than 15% (of the adjusted tax basis), and the total disparity does not exceed $20,000.

In a 1995 ruling,[159] the IRS confirmed that electing to use the remedial allocation method under §704(c) enables a contributing partner to receive an increased allocation of nonrecourse liabilities.[160] Elimination of gain may also be possible by an allocation of excess nonrecourse liabilities.

Excess Nonrecourse Liabilities. If any nonrecourse debt is not allocated under the regulations,[161] the partnership can allocate the remainder to the partners by any one of three methods:

1. An allocation based on the partners' shares of profits;
2. An allocation based on the probable allocation of deductions attributable to the debt; or
3. An allocation to any partner up to the amount of built-in gain allocable to that partner based on §704(c) property, to the extent the gain was not allocated. If the third method leaves excess nonrecourse debt unallocated, the partnership is required to allocate the remainder by either of the first two methods.

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157. Treas. Reg. §1.752-3(b)(2)

158. Ibid

159. Rev. Rul. 95-41, 1995-1 CB 132

160. Treas. Reg. §1.752-3(a)(2)

161. Treas. Reg. §1.752-3

Determining profit shares under the first method poses no particular problems for an LLC. However, the amount of excess §704(c) gain allocated under the third method is not limited to the amount of debt associated with any specific property. Therefore, when the liability is secured by multiple assets, the debt does not need to be allocated among the properties as required in §704(c) calculations. Rather, the excess §704(c) amount is calculated on an aggregate basis. However, the excess §704(c) gain must be attributable to property subject to the allocated debt.

In a 2008 Technical Advice Memorandum, an LLC's allocation method for excess nonrecourse liabilities was rejected by the IRS. The allocation involved **third-tier allocations.** [162]

Allocation of Recourse Liabilities

The allocation of recourse LLC debt among LLC members generally follows the rules for partnerships that are not LLCs. That is, the recourse debt is allocated based on the economic risk of loss.

In a 2004 Tax Court case,[163] an LLC's recourse liabilities were allocable to a member but not to an S corporation as another member/guarantor. This was the case because the S corporation did not bear the risk of loss.

CHECK-THE-BOX REGULATIONS

Before 1997, when the check-the-box regulations became effective,[164] business entities were classified based on the historical differences between partnerships and corporations. Thus, an unincorporated association was taxed as a partnership and not as a corporation unless it had more corporate than noncorporate characteristics.[165] In that period, a partnership was taxed as a partnership and not as a corporation if it lacked at least two of the specified corporate characteristics. The characteristics were given equal weight:[166]

1. Continuity of life
2. Centralized management
3. Limited liability
4. Free transferability of interests

Two additional characteristics were considered present:

1. Associates
2. An objective to carry on business and divide the gains

In Notice 95-14,[167] the IRS announced its intention to simplify the entity classification regulations. The shift was driven by modern state laws governing the organization of businesses. For tax purposes, these laws allow taxpayers to classify LLCs as partnerships even though they are almost indistinguishable from corporations.

Effective January 1, 1997, the Treasury adopted a proposal to simplify entity classification to allow taxpayers to treat domestic unincorporated business organizations as partnerships or as associations taxed on an elective ("check-the-box") basis.[168]

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162. TAM 200436011 (Apr. 30, 2004)

163. IPO II, 122 TC 295 (2004)

164. 61 Fed. Reg. 66584 (Dec. 18, 1996)

165. Rev. Proc. 92-88, 1992 CB 496 (guidelines under which limited partnership would be treated as lacking corporate characteristics of continuity of life and limited liability); generally 8 Harl, *Agricultural Law* §61.02[1][a] (2008)

166. *Leasing v. Comm'r,* 66 TC 159 (1976), *acq.,* 1979-1 CB 1. See *Chaffin v. Comm'r,* TC Memo 1976-132 (Apr. 28, 1976), *app. dism'd,* 9th Cir. (July 3, 1978)

167. Notice 95-14, 1995-1 CB 297

168. Treas. Reg. §§301.7701-1, 2, and 3

Classification Process

As a preliminary matter, the classification process is based on four steps:

1. Determine whether a separate entity exists for federal tax purposes. Mere sharing of expenses or co-ownership of property does not constitute a separate entity.[169]
2. Ascertain whether a provision of the Code directs how an entity must be treated. If one exists, that provision controls, and check-the-box provisions cannot be used.[170]
3. Determine if the business entity is an eligible entity. Being eligible is a necessary condition to be able to elect tax status. Corporations[171] are **not** eligible entities. Therefore, they cannot elect their classification.[172]
4. Determine how many owners the eligible entity has. Other than for corporations, single-owner entities are disregarded unless the entity elects to be classified as an association. In this situation, the entity is taxable as a corporation.

Disregarded entities are treated in the same manner as a sole proprietorship, branch, or division of the owner.[173] The proposed regulations on corporate reorganizations with disregarded entities were withdrawn.[174]

An **eligible entity** owned by more than one person may elect the desired classification, and the owners are then taxed consistent with that classification.[175] Consequently, an eligible entity with **at least two members** has two choices. The entity can be:

- A partnership, or
- An association taxed as a corporation.

An entity with **one owner** also has two choices:

- Elect to be classified as an association taxed as a corporation, or
- Be a disregarded entity.

A single-owner entity cannot be a partnership for federal tax purposes. According to the IRS, a partnership requires two or more owners under state law.[176]

If an eligible entity fails to elect a classification, the entity is automatically classified under the default rules. In general, domestic organizations default to partnership classification; foreign entities generally default to association classification.[177]

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169. Treas. Reg. §§301.7701-1(a)(1) and (2)
170. Treas. Reg. §301.7701-1(b)
171. Ibid for the definition of a corporation
172. Treas. Reg. §301.7701-3(a)
173. Treas. Reg. §§301.7701-3(b)(1) and 301.7701-2(a)
174. Ann. 2001-121, 2001-2 CB 584; Ltr. Rul. 200139020 (June 29, 2001) (new entity proposed under state Cooperative LLC Act qualified as eligible entity under Treas. Reg. §301.7701-3(a)) Notice 2003-46, 2003-2 CB 53 (the IRS announced that it will withdraw "extra-ordinary transaction" rule from the entity classification regulations)
175. Treas. Reg. §301.7701-3(a)
176. UPA §6
177. Treas. Reg. §301.7701-3(b)(2)

Special Rule for S Corporations

A taxpayer whose default classification is a partnership or a disregarded entity may seek to be classified as an S corporation. Before the requirements were simplified, the taxpayer had to follow a 2-step process:

1. They elected to be classified as an **association** by filing Form 8832, *Entity Classification Election,* and then
2. They elected to be an **S corporation** by filing Form 2553, *Election by a Small Business Corporation.*

Beginning July 20, 2004, the requirements were simplified by eliminating, in certain cases, the requirement that the entity elect to be classified as an association. Instead, an eligible entity making a timely and valid election to be classified as an S corporation is deemed to have elected to be classified as an association taxable as a corporation.[178]

The IRS also issued simplified procedures for late classification elections. This procedure requires filing Form 2553 and Form 1120-S, *U.S. Income Tax Return for an S Corporation,* in lieu of requesting a private letter ruling.[179]

Making the Election. An eligible entity can achieve its desired classification[180] in one of two ways:

1. The entity can affirmatively elect its classification on Form 8832,[181] or
2. The eligible entity can obtain its classification by falling within the default rules for the desired status.[182]

Obviously, an election is necessary if the entity wishes to elect a federal tax status **other than its default status. If the entity had previously elected a status other than its default status,** it is necessary to make an affirmative election if it desires to be taxed as an entity under its default status. For example, a domestic LLC must elect to be taxed as a partnership or a disregarded entity under its default status if the LLC had previously elected to be taxed as an association (corporation). An election under the check-the-box regulations applies to all provisions of the Code.

An election must be signed by either:

- Each member of the electing entity who is an owner at the time the election is filed, or
- By an officer, manager, or member of the electing entity who is authorized to make the election under state law or the entity's organizational documents.[183]

If the election is to be effective for any period prior to the time it is filed, each additional person who was an owner between the date the election is to be effective and the date the election is filed must also sign the election.[184] The IRS has provided relief for failure to make timely entity classification elections.[185]

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178. Treas. Reg. §§301.7701-3(c)(l)(v)(C), -3(c)(1)(i)

179. Rev. Proc. 2007-62, 2007-2 CB 786

180. *Littriello v. U.S.*, 05-1 USTC ¶50,385 (W.D. Ky. 2005), *aff'd*, 484 F.3d 372 (6th Cir. 2007), *cert. denied*, S. Ct. (Feb. 19, 2008) (check-the-box regulations upheld; individual member of single-member LLCs liable for payroll taxes; taxpayer did not elect for entities to be taxed as corporations)

181. Ann. 97-5, IRB 1997-3, 15

182. Treas. Reg. §§301.7701-3(a), (b)

183. Treas. Reg. §301.7701-3(c)(2)(i)

184. Treas. Reg. §301.7701-3(c)(2)(ii)

185. Rev. Proc. 2004-48, 2004-2 CB 172; Rev. Proc. 2002-15, 2002-1 CB 490 (guidance on late elections for newly formed entities)

CONVERSIONS TO AND FROM LLC STATUS

Tax consequences are one of the most important considerations of changing entity classification status.

DEEMED TREATMENT OF CHANGES IN CLASSIFICATION

The regulations identify rules describing the deemed treatment of elective changes in classification. The elective changes are effective at the start of the day for which the election is effective. The deemed transactions are considered to occur immediately before the close of the day before the election is effective.[186] Therefore, transactions resulting from an election effective on January 1, 2009, are deemed to occur on December 31, 2008.

There are four identified elective changes:[187]

1. **Electing to shift from an entity taxed as a partnership to an entity taxed as an association (corporation).[188]** When the entity shifts from partnership taxation to corporate taxation status, the partnership-type entity is deemed to contribute all its assets and liabilities to the association in exchange for the association's stock. This is followed by an immediate liquidation of the partnership.

   If a different procedure is desired, the partnership may elect one of the three alternatives outlined in Rev. Rul. 84-111.[189] These transitions can be accomplished as either (a) an asset contribution by the partnership, (b) an asset contribution by the partners, or (c) the transfer of partnership interests by the partners.

2. **An association wishing to be taxed as a partnership.** When an association wishes to shift to partnership taxation status, it distributes all its assets and liabilities to its shareholders in liquidation of the association (as a corporate entity). The shareholders then contribute those assets to a newly-formed partnership.[190]

3. **An eligible entity classified as an association electing to be a disregarded entity.** When an association wishes to shift to a disregarded entity, the eligible entity distributes all its assets and liabilities to its single owner in liquidation of the association.[191]

4. **A disregarded entity electing to be taxed as an association.** When a disregarded entity wishes to shift to an association, the owner of the disregarded entity is deemed to have contributed all assets and liabilities of the entity to the association in exchange for stock in the association.[192]

CONSEQUENCES OF OTHER CHANGES IN CLASSIFICATION

The governing authority for conversions other than those of **deemed** treatment of elective changes in classification is largely in the form of private letter rulings, chief counsel's advice rulings, and a few court cases.

Single-Member LLCs (SMLLCs)

As previously stated, the IRS considers SMLLCs as disregarded entities for federal tax purposes.[193] Several states, however, specifically recognize single-member LLCs.

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186. Treas. Reg. §301.7701-3(g)(3)(i)
187. Treas. Reg. §301.7701-3(g)(1)
188. Treas. Reg. §301.7701-3(g)(1)(i)
189. Rev. Rul. 84-111, 1984-2 CB 88
190. Treas. Reg. §301.7701-3(g)(1)(ii)
191. Treas. Reg. §301.7701-3(g)(1)(iii)
192. Treas. Reg. §301.7701-3(g)(1)(iv)
193. Treas. Reg. §§301.7701-3(b)(1)(ii), 301.7701-2(a)

Conversion of an SMLLC to a multi-owner entity classified as a partnership is treated as a formation of a partnership.[194] Conversion of a domestic LLC as a multi-owner entity, classified as a partnership, to an SMLLC creates a disregarded entity.[195] The process involves a liquidation of the partnership (LLC).[196] A two-member LLC may be treated as an SMLLC (disregarded for federal tax purposes) if one of the members has no economic interest in the entity.[197]

The IRS issued regulations for taking into account obligations of a business entity that is disregarded (such as an SMLLC) for purposes of characterizing and allocating partnership liabilities.[198]

As previously stated, if an LLC is disregarded by the IRS, the LLC is treated as part of its owner.[199] If the owner is an S corporation, the built-in gains tax may apply.[200] In a 2004 private letter ruling, a trust formed by a disregarded LLC resulted in both entities being disregarded.[201]

Under the regulations, a disregarded entity could be treated as the employer for federal employment tax purposes. In this situation, the disregarded entity rather than the disregarded entity owner is liable for employment taxes on wages paid to employees and responsible for satisfying other employment tax obligations.[202] However, in several court cases, an SMLLC owner was held personally liable for unpaid payroll taxes when the election to be taxed as an association was not made.[203]

Partnership to LLC and LLC to Partnership

The IRS determined in a variety of letter rulings that conversions involving LLCs and partnerships resulted in no recognition of gain or loss. Also, the consequences of the conversion are the same whether the resulting LLC is formed in the same state or in a different state from the converting partnership. The stated outcomes from various letter rulings are listed below:

- A limited partnership can be converted to an LLC without recognition of gain or loss.[204]
- A partner's interests can be exchanged for LLC interests followed by distribution of assets to the LLC.[205]
- A combination of two related limited partnerships and the subsequent merger into a newly-formed LLC owned by the same investors did not result in gain or loss.[206]
- No gain or loss was recognized on conversion of a general partnership interest to an LLC; the partners' capital accounts in the LLC were the same as the capital accounts in the partnership.[207]

194. Rev. Rul. 99-5, 99-1 CB 434. See 2 Harl, *Farm Income Tax Manual* §6.01[5][b][v][B] (2007 ed.)

195. Rev. Rul. 99-6, 99-1 CB 432

196. See 2 Harl, *Farm Income Tax Manual* §6.03[2][c] (2007 ed.)

197. Ltr. Rul. 9911033 (Dec. 18, 1998) (considered direct acquisition by trust; entity disregarded for tax purposes); Ltr. Rul. 200418028 (Jan. 27, 2004) (trust formed by LLC was business trust; both disregarded). See CCA Ltr. Rul. 200501001 (Sep. 21, 2004) (the IRS was unable to ascertain whether LLC was single or multi-member in face of conflicting evidence and testimony; involved father and son)

198. Treas. Reg. §§1.704-2, 1.752-2

199. Rev. Rul. 2004-68, 2004-2 CB 118 (eligible entity not taxed as partnership when one of two owners is a disregarded entity)

200. Ltr. Rul. 200107018 (Nov. 16, 2000)

201. Ltr. Rul. 200418028 (Jan. 27, 2004)

202. Treas. Reg. §301.7701-2(a)

203. *McNamee v. IRS*, 488 F.3d 100 (2d Cir. 2007); *Kandi v. United States*, 06-1 USTC ¶50,231 (W.D. Wash. 2006) (the IRS could pursue collection of employment taxes from single-member LLC); *Stearns & Co., LLC v. U.S.*, 499 F.Supp.2d 899 (E.D. Mich. 2007) (sole proprietor liable for employment taxes; owner did not elect to be association)

204. Ltr. Rul. 9443024 (July 26, 1994)

205. Ibid. The ruling applied Rev. Rul. 84-52, 1984-1 CB 157 to Ltr. Rul. 9443024 (July 26, 1994); Ltr. Rul. 9738013 (June 18, 1997) (merger of limited partnership to LLC).

206. Ltr. Rul. 9741018 (July 10, 1997); Ltr. Rul. 9741021 (July 10, 1997)

207. Ltr. Rul. 200414013 (Dec. 10, 2003); Ltr. Rul. 200022016 (Feb. 29, 2000) (no gain recognized)

- The same treatment was accorded a conversion of a general partnership to an LLC with no gain recognized.[208]
- Upon conversion, the tax year of the converting partnership does not close for any or all of the partners and the resulting LLC does not need a new taxpayer identification number.[209]
- No gain or loss is ordinarily recognized on the contribution of LLC property to a limited partnership in exchange for a partnership interest.[210]
- On merger of a limited partnership into an LLC, no gain or loss was recognized.[211]
- The IRS held that a parent corporation could merge its wholly-owned subsidiary into an LLC with no tax consequence. [212] Local law treated the transaction as a merger, but the IRS treated it as the formation of an LLC[213] with the subsidiary transferring the assets into the LLC in exchange for an interest in the LLC. That was followed by a tax-free liquidation of the subsidiary into the parent corporation with a deemed distribution of the LLC interest to the parent.[214]

Note. This ruling indicates that the conversion of a subsidiary corporation is likely to be treated as a liquidation and reformation transaction.

Partnership to Corporation

For incorporating a partnership, the IRS identified three different routes that can be used.[215] The three situations are often referred to as the **assets-over form,** the **assets-up form,** and the **interest-over form.** Depending upon which route is taken, the income tax basis and the holding periods of the assets can vary.[216]

Corporation to LLC

On the conversion of a C corporation to an LLC, both the corporation and the shareholders are required to recognize gain on the distribution of the corporation's property to its shareholders in liquidation.[217] The tax at the corporate level is imposed at ordinary income rates inasmuch as corporations are not eligible to utilize the preferential rates on long-term capital gains.[218] The tax at the shareholder level is imposed on the gain. This is measured by the difference between the distribution and the shareholder's stock basis.[219] The likelihood of a double tax, with the corporate-level tax imposed at ordinary income tax rates, usually renders a corporation-to-LLC conversion economically unacceptable.

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208. Ltr. Rul. 200022016 (Feb. 29, 2000); Rev. Rul. 95-37, 1995-1 CB 130
209. Ltr. Rul. 9809003 (Mar. 18, 1997) (conversion of two-person general partnership to LLC tax-free); Ltr. Rul. 9841030 (July 14, 1998) (same)
210. Ltr. Rul. 9720008 (Feb. 4, 1997)
211. Ltr. Rul. 9738013 (June 18, 1997)
212. Ltr. Rul. 9404021 (Nov. 21, 1993)
213. IRC §721
214. IRC §§332, 337
215. Rev. Rul. 84-111, 1984-2 CB 88
216. See Harl, *Farm Income Tax Manual* §6.03[2][c][v] (2008 ed.)
217. IRC §336(a)
218. IRC §§1(h)(1) (capital gains rates limited to individuals), 55(b)(3), amended by JGTRRA, Pub. L. No. 108-27, §301(a), 117 Stat. 758 (2003)
219. IRC §331(a)

Some believe that a C corporation-to-LLC conversion can be accomplished without a transfer of the assets; however, there is no authority on how the IRS would characterize a corporate conversion into an LLC when no transfer (or retitling) of assets occurred. Presently, this strategy seems fraught with risk.

Following are summaries of various IRS rulings related to S corporation-to-LLC conversions:

- For an S corporation merging into an LLC, the IRS ruled that the transaction is treated as a transfer of assets to the LLC followed by a distribution of the interest to the S corporation shareholder.[220] In the 1995 ruling, the merger was treated as an asset transfer followed by a complete liquidation. For an S corporation liquidation, if built-in gains tax does not apply,[221] no gain or loss is normally recognized at the corporate level. In this situation, gain or loss is recognized at the shareholder level, as with C corporations.[222]
- In a 2006 ruling, the merger of an S corporation into a disregarded entity (SMLLC) was treated as a deemed sale of the assets.[223]
- In a 2000 ruling, the merger of a corporation and a newly-formed corporation whose sole shareholder was an LLC was treated as an exchange of stock for interests in the LLC with no gain or loss recognized. The transaction was governed by IRC §721.[224]
- In a 2005 letter ruling, an S corporation conversion to an LLC was considered a type F reorganization[225] with no gain or loss recognized.[226] A type F reorganization is one in which a corporation changes its entity form.
- In a 2007 letter ruling, a conversion of an S corporation to an LLC was part of a type D reorganization[227] which was undertaken to resolve management issues.[228] A type D reorganization involves spin-offs, split-offs, and split-ups.

Note. This discussion indicates that, in most cases, a direct corporation-to-LLC conversion is likely to be accompanied by significant income tax consequences, with the greatest tax burden imposed on C corporation-to-LLC conversions.

Conversions Involving Divisions and Mergers

In some states, a relatively simple procedure is available for converting a partnership to an LLC that involves notifying the appropriate state office about the conversion. In general, this transaction should be relatively uncomplicated and have minimal tax consequences.[229] Another approach for converting a partnership to an LLC is to merge the existing partnership into an LLC, or divide an existing partnership into several LLC entities.

220. Ltr. Rul. 9543017 (July 26, 1995)
221. IRC §1374
222. IRC §331(a)
223. Ltr. Rul. 200628008 (Mar. 28, 2006)
224. Ltr. Rul. 200019020 (Feb. 10, 2000)
225. IRC §368(a)(1)(F)
226. Ltr. Rul. 200528021 (Apr. 8, 2005)
227. IRC §368(a)(1)(D)
228. Ltr. Rul. 200716012 (Jan. 11, 2007)
229. Rev. Rul. 95-37, 1995-1 CB 130

The General Rule. If two or more partnerships merge or consolidate, the resulting partnership is considered the continuation of any merging or consolidating partnership whose members own an interest of more than 50% of the capital and profits interests of the resulting partnership.[230] In the case of a division, a resulting partnership is treated as a continuation of a prior partnership if more than 50% of the resulting partnership's capital and profits interests are held by partners of the prior partnership.[231]

Steps for Safe-Harbor Merger or Division Treatment. The regulations provide guidance on partnership mergers, divisions, or consolidations. The mergers and divisions are respected for federal income tax purposes if the transactions are structured using the steps in either one of two prescribed forms:[232]

1. The default treatment for **partnership mergers** is **assets-over form.** Under the **assets-over form,** the terminating partnership is treated as contributing its assets and liabilities to the resulting partnership in exchange for interests in the resulting partnership. Immediately thereafter, the terminating partnership distributes interests in the resulting partnership to its partners in liquidation of the terminating partnership.[233] A transaction not characterized as coming under the **assets-up form** defaults into the **assets-over form.**

   The default treatment for **partnership divisions** is **assets-over form.** In the case of partnership divisions, the **assets-over form** treats a prior partnership as transferring certain assets and liabilities to a resulting partnership in exchange for interests in the resulting partnership interests to partners who are designated to receive interests in the resulting partnership.[234]

2. Alternatively, the **assets-up form,** if properly structured, can be used if the terminating partnership liquidates by distributing its assets and liabilities to its partners, who contribute the assets and liabilities to the resulting partnership. With the **assets-up form,** the prior partnership distributes certain assets and liabilities to some or all of its partners, who contribute the assets and liabilities to a resulting partnership in exchange for interests in the resulting partnership.[235]

The choice between assets-over and assets-up merger or division can have important tax consequences. This is particularly true if the inside basis (of the assets) and the outside basis (of the partnership interests) are significantly different. Under the assets-up form, if outside basis is greater than the inside basis, the assets take on the greater outside basis as a result of the merger or division transaction.[236]

For mergers involving disregarded entities, the regulations permit a target corporation to merge into a disregarded entity wholly owned by another corporation. Such a transaction involves the equivalent of merging a corporate target into a division of an acquiring corporation.[237]

Adapting the Resulting Entity

One step to consider in conversions, mergers, or consolidations is the advisability of adapting the governing documents of the surviving or resulting entity to reflect the income tax status of the entity. If an LLC elects to be taxed as an association (corporation), the LLC governing documents should be revised to contain the same provisions typically found in corporate operating agreements.

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230. IRC §708(b)(2)(A)
231. IRC §708(b)(2)(B)
232. Treas. Reg. §§1.708-1(c)(3), (d)(3)
233. Treas. Reg. §1.708-1(c)(3)
234. Treas. Reg. §§1.708-1(c)(3), (d)(3)
235. Ibid
236. IRC §732(b)
237. Treas. Reg. §1.368-2(b)(1)

Other Transfers

There are other types of transfers that can occur. For example, the IRS ruled that a transfer of assets from an LLC to a REIT involved a valid §351 exchange (transfer of corporation controlled by transferor).[238] The LLC was terminated because more than 50% was transferred.[239]

In a 2007 ruling, the conversion of a trust to an SMLLC followed by distribution to the beneficiaries avoided the rule that investment companies could not qualify for a tax-free exchange. The transaction involved a portfolio of securities.[240]

MAKING ELECTIONS

A **partnership** is eligible to make two key elections to adjust the income tax basis of the property owned by the entity. These elections are §754 elections and §732(d) elections. **LLCs are permitted to utilize both elections.**[241] These elections are a distinct advantage for partnerships and LLCs. Corporations, including S corporations, have no comparable provision for adjusting the income tax basis of underlying assets after the death of a shareholder or sale of a corporate interest.

IRC §754 Election

A partnership (or LLC) may make an election for a new partner to adjust the basis of the partnership property to apply to property distributions and to all transfers of interests in the partnership.[242] A partnership may make an election to adjust the basis of partnership property in the case of a distribution of property or a transfer of a partnership interest.[243]

A partnership with a §754 election:

- Increases the adjusted basis of partnership property by the excess of the transferee's basis for the transferred partnership interest less the transferee's share of the adjusted basis to the partnership of the partnership's property, or
- Decreases the adjusted basis of partnership property by the excess of the transferee's share of the adjusted basis to the partnership of the partnership's property less the transferee's basis for the transferred partnership interest.[244]

Example 8. Tony contributes land with a basis of $150,000 to an LLC in which he owns a 50% interest. At the time, the land's value was $200,000. Therefore, it has a §704(c) built-in gain of $50,000 ($200,000 – $150,000).

Subsequently, Tony sells his interest to Rhonda when the FMV of the land is still $200,000. If the land is ever sold by the LLC at a price of $200,000 or more, Rhonda would be allocated the first $50,000 of built-in gain ($200,000 – 150,000). However, given that a §754 election is in effect when Rhonda purchases her interest from Tony, this built-in gain will effectively disappear due to the step-up to the inside basis of the land that occurs in the LLC.

For the transfer of a partnership interest by sale, exchange, or as a result of a partner's death, the transferee's basis in the transferred partnership interest is determined under IRC §742.

Interestingly, if a later installment sale of assets is implemented and a loss results to the electing partner (because of the new, higher basis), the partnership can report a gain and the electing partner can report a loss.[245]

238. Ltr. Rul. 200450018 (Aug. 17, 2004)
239. IRC §708(b)(1)(B)
240. Ltr. Rul. 200734003 (May 15, 2007)
241. Ltr. Rul. 200815008 (Jan. 9, 2008) (§754 election); Ltr. Rul. 200637008 (June 6, 2006) (§732(d) election)
242. IRC §754
243. Treas. Reg. §1.743-1(a)
244. Treas. Reg. §1.743-1(b)
245. Rev. Rul. 79-72, 1079-1 CB 278

When a partner dies, the opportunity to make this election expires when the next income tax return of the partnership is filed.[246] Extensions may be granted for good cause.[247] However, extension requests may be denied if the request was not made promptly.[248]

IRC §732(d) Election

Because of the possible negative effects of a §754 election on other partners (or members), a §732(d) election **by the new member or partner** could be made. This assures an increased basis for property distributed within two years of when the partnership interest was acquired.[249] The regulations provide guidance for the election procedure and for a statement to be attached to the return.[250]

In a 1985 private letter ruling, even without an election, a new partnership was entitled to take the recontributing partners' bases without having to make a special basis adjustment.[251]

The adjustment in income tax basis must be allocated among the assets.[252]

APPLICATION OF VARIOUS RULES TO LLCs

As previously discussed, the LLC concept was developed and implemented at the state level with initial success only in one state. As might be expected, the IRS tended to ignore the new idea until fact situations began to emerge in the audit process. As a result, the LLC was not shaped to fit neatly within existing tax law at the federal level. Consequently, questions arise on a regular basis about how the LLC concept fits within existing tax law. This section includes several major areas that received the IRS's attention regarding how the LLC should be treated.

LIKE-KIND EXCHANGES

LLCs encounter like-kind exchange rules[253] in two ways:

1. How SMLLCs are treated in a like-kind exchange, and
2. Whether LLCs with two or more members face the same scrutiny as partnerships in terms of eligibility for like-kind exchange treatment because of the statutory provision specifying that partnership interests are not considered like-kind.[254]

Single-Member LLCs (SMLLCs)

As previously discussed, the IRS disregards SMLLCs.[255] If an SMLLC is disregarded in a like-kind exchange, the exchange is treated as a direct receipt of the assets by the single member.[256] In two private letter rulings,[257] properties were transferred to SMLLCs (election had not been made to treat entities as associations). The IRS followed the check-the-box regulations and disregarded the entities as separate from their owners and treated the replacement properties as received directly by the single-member owners in an exchange qualifying for like-kind exchange treatment.

246. Treas. Reg. §1.754-1(b)

247. Ltr. Rul. 200648010 (Aug. 25, 2006) (LLC granted extension of time to file §754 election; inadvertently failed to file)

248. Ltr. Rul. 200626003 (Feb. 28, 2006) (LLC denied request)

249. Treas. Reg. §1.732-1(d)(1)

250. Treas. Reg. §1.732-1(d)(2). The election is authorized by statute. IRC §732(d)(2)

251. Ltr. Rul. 8517004 (Jan. 4, 1985)

252. Treas. Reg. §1.755-1

253. IRC §1031. See 1 Harl, *Farm Income Tax Manual* §§2.07[4], 2.07[8][f] (2007 ed.)

254. IRC §1031(a)(2)(D)

255. Treas. Reg. §301.7701-3(b)(1)(ii)

256. Ltr. Rul. 200118023 (Jan. 31, 2001) (involved receipt of real property)

257. Ltr. Rul. 9807013 (Nov. 13, 1997), Ltr. Rul. 9751012 (Sep. 15, 1997)

Problem with Exchanges of Fractional Interests. Generally, partnership interests are not considered like-kind.[258] That statutory rule has been in effect since 1984,[259] which is well before LLCs were a popular choice for the organization of businesses. Even with the 1984 amendment, there were serious problems of eligibility of property for like-kind exchange tax treatment. This was because the IRS alleged the property was partnership property when in fact it was not technically partnership property. The problem arose in 1997 when the IRS raised a question that, in some instances, fractional interests in property could be deemed a partnership and thus be ineligible for tax-free transfer under the like-kind exchange rules. In a 1997 letter ruling, the co-ownership of rental properties was deemed to be a partnership. This was primarily because the co-owners had filed a Form 1065, *U.S. Return of Partnership Income*, for the prior five years.[260] Consequently, the property was ineligible for a like-kind exchange.[261]

Note. It appears that an LLC would face the same statutory provision denying like-kind exchange treatment with an exchange **of LLC interests** unless 100% of the interests in the LLC are acquired in an exchange.[261] In that event, the transaction is treated as an acquisition of the assets, which is eligible for §1031 treatment.[262] Keep in mind that the statutory reference does not prevent an exchange of LLC-owned **property** from being eligible for a like-kind exchange. That is also true for **partnership** property.

In 2002, the IRS issued a revenue procedure addressing the circumstances under which advance rulings are issued in situations involving co-ownership of rental real property in an arrangement classified under local law as a tenancy-in-common. The revenue procedure specifies 15 conditions that must be met for an advance ruling.[264]

DISCHARGE OF INDEBTEDNESS

The income tax consequences of discharge of indebtedness arising from a conveyance of LLC-owned property to the creditor depends upon whether the debt is recourse or nonrecourse.[265] **Nonrecourse debt** normally results in gain or loss. This is measured by the difference between the property's basis and the amount of debt on the property.[266] **Recourse debt** usually produces gain or loss. This is measured by the difference between the property's basis and its FMV,[267] and the discharge of indebtedness income. The discharge of indebtedness income is measured by the difference between the property's FMV and the amount of debt on the property.[268]

258. IRC §1031(a)(2)(D)
259. Deficit Reduction Act of 1984, Pub. L. No. 98-369, §77(b)(5), amending IRC §1031(a)(2)
260. Ltr. Rul. 9741017 (July 10, 1997)
261. Ibid. See generally 4 Harl, *Agricultural Law* §27.04 (2008)
262. IRC §1031(a)(2)(D)
263. Ltr. Rul. 200807005 (Nov. 9, 2007)
264. Rev. Proc. 2002-22, 2002-1 CB 733
265. 2 Harl, *Farm Income Tax Manual* §9.02[2] (2007 ed.)
266. *Comm'r v. Tufts*, 461 U.S. 300 (1983)
267. IRC §1001
268. IRC §61(a)(12); Treas. Reg. §1.1001-2(c), Ex. 8

The following figures illustrate the payment of debt with property.[269]

Figure 1. Paying Recourse Debt with Property

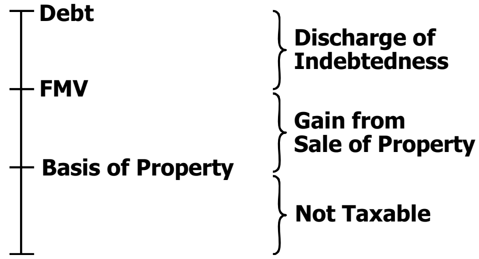


Figure 2. Paying Recourse Debt with Property (Debt Exceeds FMV)

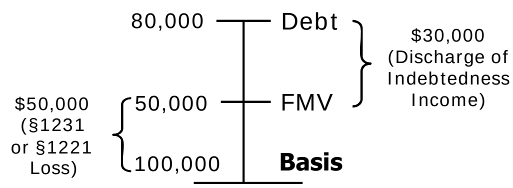


Figure 3. Paying Nonrecourse Debt with Property

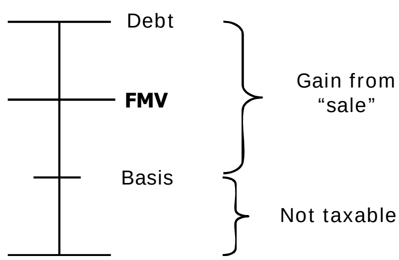
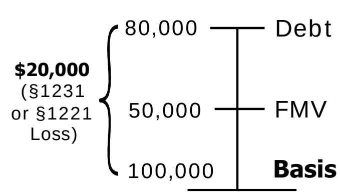


Figure 4. Paying Nonrecourse Debt with Property (Debt Exceeds FMV)



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[269]. Harl, *Farm Income Tax Manual*, Ch. 9 (2007 ed.)

Recourse debt is generally treated more favorably inasmuch as part of the amount at issue is discharge of indebtedness income, which may be eligible for relief provisions for:

- Debtors in bankruptcy;[270]
- Insolvent debtors not in bankruptcy, to the extent of their insolvency;[271]
- Real property business debt;[272]
- Discharge of indebtedness for a solvent farm debtor;[273]
- Purchase price adjustment;[274] and,
- For 2007, 2008, and 2009, discharge of indebtedness on a principal residence.[275]

With nonrecourse debt, the entire difference between the basis of the property conveyed to the creditor and the amount of the debt is treated as gain or loss. There is no relief from the income tax consequences for gain triggered on the discharge of debt.[276]

As previously noted, if the definition of recourse and nonrecourse is based on the **regulatory** definition,[277] then the debt of an LLC is generally characterized as nonrecourse for purposes of the partnership regulations. This is because no member bears the economic risk of loss for the debt.[278]

There are exceptions for characterizing LLC debt as nonrecourse:

- For nonrecourse loans made or guaranteed by a member (or related person);[279]
- For predecessor recourse debt when an obligation of a member exists otherwise under state law, such as when a member remains liable for recourse debts of a predecessor organization, such as a partnership;
- When the debt comes within the interest-guarantee rules;[280]
- When the debt comes within the property-pledge rules;[281] or
- When the debt comes within the anti-abuse rules.[282]

The characterization based on the regulatory definition is generally not favorable for an LLC debtor. The characterization is based on the obligations of the members as owners of the LLC, with most LLC debt being nonrecourse.

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270. IRC §108(a)(1)(A)
271. IRC §108(a)(1)(B)
272. IRC §108(c)
273. IRC §108(g)
274. IRC §108(e)(5)
275. IRC §108(h)
276. *Comm'r v. Tufts*, 461 U.S. 300 (1983)
277. IRC §752; Treas. Reg. §§1.752-1, -2
278. Treas. Reg. §1.752-1(a)(1)
279. Treas. Reg. §1.752-2(c)(1)
280. Treas. Reg. §1.752-2(e)
281. Treas. Reg. §1.752-2(h)
282. Treas. Reg. §1.752-2(j)

On the other hand, if discharge of indebtedness determinations are based on the discharge of indebtedness rules,[283] which emphasize the rights of the creditor against the debtor, more of the debt is likely to be characterized as recourse debt with a more favorable outcome for the debtor.

> **Note.** It is unclear which approach is the correct one. It appears that the discharge-of-indebtedness rules[284] should apply to discharge of indebtedness for an LLC based on state law recourse obligations. The debt should be treated as a recourse obligation, and guaranteed nonrecourse obligations should be treated as nonrecourse because that is their nature under the discharge-of-indebtedness rules. The partnership regulations produce the opposite result.

In the case of a partnership, the discharge-of-indebtedness provisions are applied at the partner level.[285]

PASSIVE ACTIVITY LOSS RULES

The hybrid nature of LLCs contributes to uncertainty about how the passive-activity-loss rules are applied to LLCs.[286]

> **Note.** See Chapter 14, "Agricultural Issues and Rural Investments," Issue 7, for more information on passive loss rules.

Nature of Passive Activity Limitations

In general, deductions from passive trade or business activities may not be deducted against other income. They can only be deducted against passive-activity income. This is to the extent deductions exceed income from all passive activities (exclusive of portfolio income).[287] An activity is considered passive if it involves the conduct of a trade or business and the taxpayer does not materially participate in the activity.[288] For this purpose, a taxpayer is treated as materially participating in an activity only if he is involved in the operations of the activity on a regular, continuous, and substantial basis.[289]

Treatment of Pass-Through Entities Generally

In determining whether the material-participation test is met, the statute specifies:

> *Except as provided in regulations, no interest in a limited partnership as a limited partner shall be treated as an interest with respect to which a taxpayer materially participates.*[290]

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283. IRC §1001; Treas. Reg. §1.1001-2(c)

284. IRC §1001

285. IRC §108(d)(6)

286. IRC §469. See Case, Garre-Lohnes, Rosenberg, Schmalz and Starr, "Limited Liability Companies," TM 725-2d, *BNA*, 2006, pp. A-46–A-47

287. IRC §469. See, e.g., *Hillman v. Comm'r*, 114 TC 103 (2000), *rev'd*, 250 F.3d 228 (4th Cir. 2001), *on remand*, 118 TC 323 (2002) (owner of S corporation providing management services to real estate partnership could not offset passive loss deductions from partnership against nonpassive income from management fees earned by S corporation)

288. IRC §469(c)(1)

289. IRC §469(h)(1)

290. IRC §469(h)(2)

The passive activity loss regulations do not refer to LLCs (or LLPs). However, they do refer to limited partners in a limited partnership.[291] Under those rules, losses attributable to limited partnership interests are treated as arising from a passive activity[292] unless a limited partner satisfies any one of three regulatory requirements:

1. Participates for more than 500 hours in the activity[293]
2. Materially participated in the activity in five or more of the 10 preceding years[294] or
3. The activity is a personal service activity in which the limited partner materially participated for any three preceding years.[295]

If an LLC member is not classified as a limited partner, material participation under the higher passive activity loss standard can be reached by satisfying any one of the above three tests or if:

- The LLC member's participation for the year constitutes substantially all participation by all individuals in the activity,[296]
- The member's participation exceeds 100 hours during the year and the individual's participation is not less than any other individual's participation in the activity during the year,[297]
- The activity is a **significant participation activity** and the aggregate participation by the taxpayer in all such significant participation activities exceeds 500 hours,[298] or
- The member can satisfy the facts and circumstances test.[299]

Under the regulations, a partnership interest (LLC interest) is treated as a limited partnership interest if so designated in the organizational documents **or the liability of the holder of the interest is limited to a fixed, determinable amount under state law,** such as the amount contributed to the entity.[300]

Whether an LLC Member is a Limited Partner

The critical question is whether an LLC member holds a **limited partnership interest** for purposes of the passive activity loss rules.[301]

Distinction between Limited Partner and LLC Member. The passive activity loss regulations define a **limited partnership interest:**

> *The liability of the holder of such interest for obligations of the partnership is limited, under the law of the State in which the partnership is organized, to a determinable fixed amount..."*[302]

> **Note.** This indicates, with the focus on liability, that the limited liability of an LLC member results in each owner being treated as a limited partner. However, if the focus is on participation in management, and the committee reports lend some support to that interpretation,[303] the position of an LLC member is arguably not that of a limited partner when a limited partner cannot be active in the partnership's business.

291. Temp. Treas. Reg. §1.469-5T(e)
292. Temp. Treas. Reg. §1.469-5T(e)(2)
293. Temp. Treas. Reg. §1.469-5T(a)(1)
294. Temp. Treas. Reg. §1.469-5T(a)(5)
295. Temp. Treas. Reg. §1.469-5T(a)(6)
296. Temp. Treas. Reg. §1.469-5T(a)(2)
297. Temp. Treas. Reg. §1.469-5T(a)(3)
298. Temp. Treas. Reg. §1.469-5T(a)(4)
299. Temp. Treas. Reg. §1.469-5T(a)(7)
300. Temp. Treas. Reg. §1.469-5T(e)(3)
301. IRC §469
302. Temp. Treas. Reg. §1.469-5T(e)(3)(i)(B)
303. See Conf. Report to H.R. 3838, Tax Reform Act of 1986; Joint Committee on Taxation, Staff Description (JCS-10-87), Tax Reform Act of 1986 ("Blue Book")

In *Gregg v. United States,*[304] the court considered whether an LLC member should be classified as a limited partner or general partner for passive activity loss purposes. The court agreed with the taxpayer that the limited partnership test,[305] which looked only to the feature of limited liability under state law, is inappropriate when applied to an LLC and its members. As the court noted, the LLC statutes have created a new and different type of entity that is distinguishable from a limited partnership and the limited partnership test is not applicable to all LLC members. As the court recognized, LLCs are designed to permit LLC members to be engaged in active management of the business without losing their limited liability as occurs with a limited partnership.

The court held that, in the absence of a regulation stating that LLC members were treated as limited partners in a limited partnership, it was inappropriate for the IRS to treat LLC members as limited partners.[306] Accordingly, the court made it clear that an LLC member can show material participation on the basis of the seven tests set forth in the regulations[307] rather than the higher standard set forth in the regulations for limited partners.[308]

Note. The *Gregg* case was decided using the Oregon LLC statutes. A different result is possible using the laws of other states. See information in Chapter 14, "Agricultural and Rural Investments," regarding the *Gregg* case.

A 2005 Tax Court case[309] involved an LLC owned equally by a husband and wife as members. The LLC owned an office building with space rented to law firms. The LLC also provided extensive legal support services to the tenants. The wife, who was an attorney, managed the legal support service enterprise. The LLC also provided consulting services to attorneys and health maintenance organizations. The husband was a medical doctor who worked full-time in a medical school. The LLC incurred losses during the years at issue from the real estate leasing and support services activities. These losses were used to offset gains from the consulting activity, with the net loss passed through to the LLC owners. The taxpayers classified the losses as nonpassive which allowed the netting of the losses. The IRS took the position that the LLC's leasing activities were per se passive and were therefore limited by the passive activity rules.

The Tax Court agreed with the taxpayers and rejected the IRS argument that the leasing activities were per se passive. It held that the taxpayers qualified for the **extraordinary personal services exception** under the passive activity rules for rental property.[310] In addition to proving that the extraordinary personal services exception applied, the taxpayers also had to show that they had materially participated in the activity.[311] The Tax Court found the testimony compelling that the wife's involvement exceeded the 500 hours required in the first of the seven tests for material participation[312] without mention of the higher tests for limited partners.[313]

Active-Participation Rule

In a provision easing the passive activity rules for lower income taxpayers, the statute allows a taxpayer to annually deduct up to $25,000 of passive activity losses (and the deduction equivalent of passive activity credits) attributable to **rental real estate activities** in which the taxpayer **actively** participates.[314] The $25,000 allowance phases out ratably as the taxpayer's AGI (determined without regard to passive activity losses) increases from $100,000 to $150,000.[315]

304. *Gregg v. U.S.*, 186 F.Supp.2d 1123 (D. Or. 2000)
305. Temp. Treas. Reg. §1.469-5T(e)(3)(i)(B)
306. Ibid
307. Temp. Treas. Reg. §§1.469-5T(a)(1) through (7)
308. Temp. Treas. Reg. §1.469-5T(e)(2)
309. *Al Assaf v. Comm'r*, TC Memo 2005-14 (Jan. 31, 2005)
310. Temp. Treas. Reg. §1.469-1T(e)(3)(ii)(C)
311. *Al Assaf v. Comm'r*, TC Memo 2005-14 (Jan. 31, 2005)
312. Temp. Treas. Reg. §1.469-5T(a)(1)
313. Temp. Treas. Reg. §1.469-5T(e)(2)
314. IRC §469(i)
315. IRC §469(i)(3)

The $25,000 allowance is not available to corporations.[316] Moreover, an individual is not considered actively participating in a rental real estate activity if he has less than a 10% interest in the activity.[317]

Are LLC members eligible for the deduction of up to $25,000? The statute states:

> *Except as otherwise provided in regulations, no interest as a limited partner in a limited partnership shall be treated as an interest with respect to which the taxpayer actively participates.*[318]

If LLC members were characterized as limited partners, they would not be eligible for the deduction. If characterized on the basis of participation in management, an opposite conclusion would be reached.

Exception for Rental Real Estate Activities for Professionals

Rental real estate activities in which the taxpayer materially participates are not subject to limitation under the passive activity loss rules. This is true if the taxpayer meets the eligibility requirements relating to real property trades or businesses in which the taxpayer performs services.[319] Taxpayers satisfying the requirements can treat their rental real estate activities as nonpassive.[320] The requirements are:

- More than half the personal services performed in trades or businesses by the taxpayer during the year must be performed in real property trades or businesses in which the taxpayer materially participates, and
- The taxpayer must perform at least 750 hours in real property trades or businesses in which the taxpayer materially participates.[321]

Note. Again, are LLC members treated as limited partners? If the focus is on management, rather than on limited liability, LLCs would be substantially more advantageous for rental real estate activities than limited partnerships. An amendment to the regulations in 1995 seemingly lends some support to that conclusion,[322] although the matter is not fully resolved.

Grouping Activities

The regulations provide special rules for grouping a taxpayer's trade or business and rental activities.[323] In general, activities may be treated as a single activity if the activities constitute **an appropriate economic unit** under a facts and circumstances test.[324] Certain activities defined under the at-risk rules cannot be grouped together if the interests in those activities are owned by a limited partner or limited entrepreneur. The definition of limited entrepreneur targets:

- Those with an interest in an activity other than as a limited partner, and
- Those who do not actively participate in the management of the enterprise.[325]

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316. IRC §469(i)(1)
317. IRC §469(i)(6)(A)
318. IRC §469(i)(6)(C)
319. IRC §469(c)(7)
320. IRC §469(c)(7)(A)
321. IRC §469(c)(7)(b)
322. TD 8645, 60 Fed. Reg. 66,496, Dec. 22, 1995
323. Treas. Reg. §1.469-4
324. Treas. Reg. §1.469-4(c)(2)
325. IRC §464(e)(2)

The example in the regulations[326] indicates that an LLC member is treated as a limited entrepreneur if the LLC member does not actively participate in management. This implies that an LLC member actively participating in management is not a limited entrepreneur.[327] The conclusion from that provision is that an LLC with member interests held by those not active in management should not be grouped with other activities. A 2007 District Court case in Texas[328] held that an LLC and a related lessee partnership could be grouped as a single economic unit.

VALUATION DISCOUNTS FOR LLC INTERESTS

As a method of organization that is still developing, discounting LLC interests is less well documented than is the case with corporate entities.[329] Discounts for minority interest and nonmarketability have been allowed for an LLC.[330]

The courts are split on whether discounts for potential built-in capital gains tax liability should apply in the context of LLCs, although they have been allowed for corporations since 1998.[331] In two estate cases before the Circuit Courts of Appeal,[332] the court approved dollar-for-dollar discounting for the potential tax liability.

TAXATION OF FRINGE BENEFITS AND EMPLOYEE BENEFITS

The handling of employee benefits for an LLC depends on whether an LLC member is treated the same as a limited partner in a limited partnership rather than as an employee.

> **Observation.** Focusing on the limited liability aspect, the limited partner treatment would seem to be the case. However, examining the issue from the standpoint of participation in management could produce a different result. Unfortunately, there is no clear guidance on this point.

One issue is whether a partner can be an employee of the partnership for purposes of participating in employee benefits and in the treatment of meals and lodging. A long-standing rule does not permit this.[333] Some cases have disagreed, although the authority to the contrary has been considered of questionable precedential value. In *Armstrong v. Phinney,*[334] the court held a partner to be an employee of the partnership for purposes of excluding the value of meals and lodging from income.[335] In a 1969 Tax Court case,[336] a partner was considered an employee for purposes of the foreign earned income exclusion.

Another issue is whether an LLC member can make a stronger case for employee status than a limited partner in a limited partnership. Presently, with the available authority, it seems prudent to consider treating an LLC member like a limited partner. This is in light of the fact that an LLC is considered a partnership for federal income tax purposes.

326. Treas. Reg. §1.469-4(d)(3)(ii)

327. Treas. Reg. §1.469-4(d)(3)(ii)

328. *Candelaria v. U.S.*, 518 F.Supp.2d 852 (W.D. Tex. 2007)

329. See, e.g., *Estate of Thompson v. Comm'r*, 499 F.3d 129 (2d Cir. 2007), *cert. den.* 2008 US LEXIS 4998 (U.S. June 16, 2008) (closely-held publishing company stock valued with 15% minority interest discount and 30% discount for nonmarketability).

330. *Temple v. U.S.*, 423 F.Supp.2d 605 (E.D. Tex. 2006) (also involved discounts for limited partnerships)

331. *Eisenberg v. Comm'r*, 155 F.3d 50 (2d Cir. 1998), *acq.*, 1999-1 CB xix

332. *Estate of Jelke III*, 507 F.3d 1317 (11th Cir. 2007); *Dunn v. Comm'r*, 301 F.3d 339 (5th Cir. 2002)

333. Rev. Rul. 69-184, 1969-1 CB 256

334. *Armstrong v. Phinney*, 394 F.2d 661 (5th Cir. 1968)

335. IRC §119

336. *Miller v. Comm'r*, 52 TC 752 (1969), *acq.*, 1972-2 CB 2

LLC MEMBER AS LIMITED PARTNER

The proper treatment of partnership distributions as guaranteed payments for services, as a loan, or as a partnership distribution depends upon the parties' intent, the economic reality, and the applicable partnership documents.

In a 1990 Tax Court case, payments to a partner were considered guaranteed payments taxed as ordinary income.[337] The partner worked for the partnership on a full-time basis. The regulations provide that a partner who receives guaranteed payments is not, by virtue of the payments, regarded as an employee for purposes of income tax withholding, deferred compensation plans, and for other purposes.[338] Because guaranteed payments are treated as distributive shares of partnership income, and partners are considered self-employed, the cash amount or value of employee benefits provided to a partner is included in the recipient partner's income and is not excludable under the general employee benefit rules.

Accident and Health Insurance

For accident and health insurance premiums paid by the partnership, there are two possible treatments for the premiums:

- If the premiums are paid for services rendered in the capacity of partner, to the extent they are determined without regard to partnership income, the amounts are guaranteed payments.[339]
- If the premiums are considered paid on behalf of a partner, it is considered as a distribution to the partner.[340]

As guaranteed payments, the premiums are deductible by the partnership[341] and includable in the recipient partner's gross income.[342] If the requirements are met, the partner may deduct the cost of premiums to the extent provided by IRC §162(l) for himself, his spouse, and his dependents.[343] The deduction is limited to the taxpayer's net earned income **derived from the trade or business for which the plan was established** minus the deductions for 50% of the SE tax.[344] Amounts eligible for the deduction do not include amounts paid for any period during which the self-employed individual is eligible to participate in a subsidized health plan maintained by his employer or his spouse's employer.[345] Unreimbursed amounts or expenses which are not ordinary and necessary business expenses cannot be claimed on Schedules C or F.[346]

A partnership must report the amount of accident and health insurance premiums that are guaranteed payments on Form 1065 and Schedule K-1. It is not required to file Forms 1099 or W-2 for health and accident insurance premiums.[347] Inactive limited partners generally do not have guaranteed payments and are not eligible to deduct health and accident insurance premiums.

The rules for health savings accounts are similar.[348]

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337. *Grubb v. Comm'r*, TC Memo 1990-425 (Aug. 7, 1990)
338. Treas. Reg. §1.707-1(c)
339. IRC §707(c); Rev. Rul. 91-26, 1991 CB 184
340. IRC §168(l)
341. IRC §162
342. IRC §106
343. IRC §162(l)(1)(A)
344. IRC §162(l)(2)(A); *Reynolds v. Comm'r*, TC Memo 2000-20; IRS Pub. 535, *Business Expenses*, p. 25; Ltr. Rul. 200524001 (May 17, 2005) (self-employed sole proprietor could deduct medical insurance premiums for sole proprietor and family to extent of income from trade or business for which insurance purchased)
345. IRC §162(l)(2)(B); *Reynolds v. Comm'r*, TC Memo 2000-20, *aff'd on another issue*, 296 F.3d 607 (7th Cir. 2002)
346. *Albers v. Comm'r*, TC Memo 2007-144 (June 7, 2007); *Stephens v. Comm'r*, TC Summ. Op. 2008-18 (deductible only above the line)
347. IRC §162(l)(1)(A)
348. Notice 2005-8, 2005-1 CB 368

Meals and Lodging

Meals and lodging furnished **to an employee** on the employer's business premises are excludable from income.[349] The cost of meals is treated as a de minimis fringe benefit and is thus fully deductible[350] and fully excludable from income.

No deduction is available for meals and lodging for a sole proprietor[351] or a tenant.[352]

Observation. Although there is no direct authority on this point, it appears that an LLC member is likely ineligible for the benefit, especially **if the LLC member is treated as a limited partner.**

Group-Term Life Insurance

For group-term life insurance **on employees,** premium payments are deductible to the employer. Premiums paid in excess of $50,000 of coverage are taxed to the employee and are subject to FICA tax.[353] Proceeds from a group-term life policy are excludable from a beneficiary's taxable income.[354]

As with meals and lodging, it appears that an LLC member is ineligible for this benefit. This is true at least if the LLC member is treated as a limited partner.

Cafeteria Plans

Cafeteria plans typically permit **employees** to choose from an array of qualified benefits within established dollar limits or to receive cash.[355] As with other employee benefits, an LLC member who is characterized as a limited partner is likely to be ineligible to participate in a cafeteria plan.

LLC MEMBER AS EMPLOYEE

The argument that an LLC member should be considered an employee and eligible for the array of employee benefits rests upon the fact that the LLC is a hybrid entity with the structural features of a corporation, at least as far as limited liability is concerned. It is further argued that those who work for corporations and are subject to the control and direction of the corporation should be considered employees. The counterargument is that, **for federal income tax purposes,** the LLC is deemed a partnership, not a corporation.

One possible argument in support of employee status for LLC members is that IRC §707(a)(1) states:

> *If a partner engages in a transaction with a partnership other than in his capacity as a member of such partnership, the transaction shall, except as otherwise provided in this section, be considered as occurring between the partnership and one who is not a partner.*[356]

If an LLC member provides services to the LLC, it is possible that a member could be classified as an employee.[357] This could happen if there is a related direct or indirect allocation or distribution to that member, and if the services and the distribution could be viewed together as occurring between the LLC and the member **other than in his capacity as a member.** However, this outcome seems somewhat unlikely.

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349. IRC §119(a)(1)

350. IRC §§132(e)(2) and 119

351. FSA Ltr. Rul. 200031003 (Mar. 16, 2000)

352. *Weeldreyer v. Comm'r*, TC Memo 2003-324 (November 25, 2003)

353. IRC §§79, 3121(a)(2)(C)

354. IRC §101(a)(1)

355. IRC §125

356. IRC §707(a)(1)

357. See McKee, Nelson, and Whitmire, *Federal Taxation of Partnerships and Partners* ¶3.02[4][b] (3d ed., 1997)

> **Note.** In two private letter rulings,[358] the IRS determined that since an LLC is classified as a partnership[359] and the LLC members are considered partners,[360] the LLC members are considered partners for purposes of the transfer-for-value rule for life insurance policies.[361] While this involves a different issue, it seems to suggest that the IRS is likely to rule the same way with employee benefits.

Options to Acquire Interests in an LLC

Because an LLC does not have stock, an LLC cannot issue stock options. However, an LLC can issue nonqualified options to acquire interests in the LLC.

In general, there should be no tax consequences to the LLC in granting an option to purchase LLC interests, either to an existing member or to an employee who is not an equity holder in the LLC. In the event an option is granted to an LLC member in exchange for services, the excess of the option's FMV (adjusted for restrictions that will not lapse) less what was paid for the option is includable in the recipient's gross income. This occurs in the year the option becomes transferable, or the option is no longer subject to a substantial risk of forfeiture.[362] An election can be made to report the income amount in the year the option is transferred to the individual.[363]

BUSINESS REASONS FOR LLCs

The unique features of an LLC provide flexibility in meeting estate and business planning objectives. Other choices of entity can be used to meet those objectives as well. However, the LLC provides a relatively low-cost alternative for assuring control over the management and transfer of the assets involved. It provides for reduced organizational expenses in setting up and maintaining the entity, insulation of assets from creditors, protection of the members from liability, and a flexible system for handling disputes.

RETAINING CONTROL OVER THE ASSETS

The LLC can be an effective way for older family members to make transfers of assets to younger family members and yet retain control over the LLC, hence over its assets. Artfully structuring the LLC can ensure that senior family members are in a position to control decision making in the entity and restrict the transfer of member interests. However, control can be pushed to the point where the transfer of assets by gift may not be eligible for the federal gift tax annual exclusion, which requires a present interest in the gifted property.[364] The 2008 annual per donee exclusion is $12,000. For donors who are husband and wife, the amount is $24,000, even though only one donor owns the gifted property. The LLC is an important estate planning tool for transferring family wealth to succeeding generations.

In *Hackl v. Commissioner*,[365] the taxpayers gave their children and grandchildren membership units in an LLC. The LLC was formed to hold and operate tree-farming properties. Tracts of land which had been purchased by the taxpayer and conveyed to the LLC had little or no existing stands of timber. The timber management plan pursued by the taxpayers assured that income from the venture would commence several years in the future. The LLC arrangement contained

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358. Ltr. Rul. 9625013 (Mar. 20, 1996); Ltr. Rul. 9625022 (Mar. 20, 1996)

359. IRC §7701(a)(2)

360. IRC §761(b) ("For purposes of this subtitle, the term 'partner' means a member of a partnership.") "This subtitle" includes sections 1-1563 of the Internal Revenue Code

361. IRC §101(a)(2)

362. IRC §83(a)

363. IRC §83(b)

364. IRC §2503(b)

365. *Hackl v. Comm'r*, 118 TC 279 (2002), *aff'd*, 335 F.3d 664 (7th Cir. 2003)

several provisions that led the Tax Court and the Seventh Circuit Court of Appeals to hold that the transfers were gifts of future interest and ineligible for the federal gift tax annual exclusion. The provisions that indicated the transfers were gifts of future interest were:

- The LLC operating agreement prohibited the donees from selling their ownership interests without the donor's approval;
- The LLC operating agreement gave the donor, as the LLC's manager, discretion to make or not make cash distributions to the members;
- The LLC operating agreement prevented the donees as LLC members from withdrawing their capital accounts or redeeming their interests without the donor's approval; and
- The LLC operating agreement specified that no single owner could dissolve the LLC.

Under the LLC operating agreement, the LLC members had several rights:

- The voting members had the right to remove the manager and elect a successor by majority vote.
- The voting members had the right to amend the operating agreement by an 80% vote.
- Voting and nonvoting members had the right to access the books and records of the LLC.
- Voting and nonvoting members had the right, jointly, to decide whether the LLC would be continued following a dissolution.
- If the donor was no longer manager of the LLC, voting members could dissolve the LLC by an 80% vote.

The Tax Court held that, because the gifts failed to confer a substantial present economic benefit on the donees, the gifts failed to qualify for the federal gift tax annual exclusion.[366] The court specifically rejected the taxpayer's argument that, when a gift takes the form of an outright transfer of an equity interest in property or in a business entity, the transfer involves the conveyance of a present interest and no further analysis is needed or justified.[367] Rather, the court noted that the federal gift tax regulations specify that a present interest requires an "unrestricted right to the immediate use, possession, or enjoyment of property or the income from property..."[368] The court recognized that cases involving transfers in trust have established the proposition that when the use, possession, or enjoyment is postponed to some contingent or uncertain future event, or when there is no assurance of a steady flow of funds from the trust, the gift fails to qualify for the federal gift tax annual exclusion.[369] Likewise, transfers made to a business entity have been similarly treated.[370] The court further noted that the taxpayer bears the burden of showing that a gift "is other than a future interest."

Note. The decision in *Hackl* poses a threat to many gifts of interests in business entities whether organized as an LLC or any other organizational option. Business and estate planners are left with uncertainty on what will assure the outcome of a present interest for gifts of entity-ownership units. Of course, in smaller estates, when the loss of the applicable exclusion amount from a gift of a future interest would not pose a serious problem for the taxpayer, the outcome in *Hackl* may not lead to an unacceptable outcome.

366. IRC §2503(b)

367. *Hackl v. Comm'r*, 118 TC 279 (2002), *aff'd*, 335 F.3d 664 (7th Cir. 2003)

368. Treas. Reg. §25.2503-3

369. *Comm'r v. Disston*, 325 U.S. 442 (1945); *Fondren v. Comm'r*, 324 U.S. 18 (1945); *Ryerson v. U.S*, 312 U.S. 405 (1941); *U.S. v. Pelzer*, 312 U.S. 399 (1941)

370. *Estate of Stinson v. U.S.*, 214 F.3d 846 (7th Cir. 2000); *Chanin v. U.S.*, 393 F.2d 972 (Ct. Cl. 1968) (gifts to family-controlled corporation)

When inability to qualify for the federal gift tax annual exclusion is unacceptable, the focus turns to a limited number of ways to relax the limitations on owner rights in the entity. Those possibilities include:

- A provision for mandatory distribution of earnings from the entity;
- Allowing ownership unit owners to sell their interests without restriction (a right of first refusal granted to the entity) may be acceptable;
- An assured right on the part of the donees to sell their ownership interests back to the entity, or to have the interest redeemed by the entity for a stated period after the gift; or
- The right to sell ownership interests for a limited time to anyone.

The last two are similar to the widely-used right under the so-called "Crummey" powers.[371] The Tax Court and Seventh Circuit Court of Appeals decisions in *Hackl* suggest that planners would be well-advised to review all files involving active gifting programs of ownership interests. It is also advisable to review the alternatives for assuring a present-interest outcome when that is desirable with clients who are creating entities.

INSULATION FROM CREDITORS

LLC members generally benefit from limited tort liability arising from the entity's operations. This is true unless the members themselves were personally involved in the acts or omissions causing the liability and then only if the same members were acting negligently. Members also enjoy limited liability from contractual undertakings of the LLC unless the members co-signed or guaranteed the obligation.

The LLC member's limited liability is broader than the limited liability of limited partners. With an LLC, the limited liability feature extends to all members, not just those who are not involved in management as is the case with limited partners. Limited partners can lose their limited liability for claims against the limited partnership if they participated in the partnership's affairs or third parties relied upon the limited partners as general partners in extending credit to the limited partnership. However, some states allow a general or limited partnership to file as a limited liability partnership or limited liability limited partnership which gives the owners much the same limited liability as LLCs and corporations.

HANDLING DISPUTES

Although the matter of handling disagreements is generally far from anyone's mind when setting up an entity, it is a fact of life. Even family-owned firms can have differences arise which sometimes lead to litigation. That is especially the case when deaths, dissolution of marriages, or abrupt changes in career trajectories alter the membership group. The grip of older family members may be lessened as transfers of ownership interests to younger members of the family occur over time.

The threat of partition or partition and sale actions can be raised by any co-owner of property, even by those with a minority interest. This is a major weapon that can be exercised by unhappy owners. It is generally unavailable to owners of an entity, and is certainly unavailable to those in entities such as corporations or LLCs.

In most formally-organized entities, voting rights are specified in some detail and minority owners are vulnerable inasmuch as minority owners may lose their employment rights with the firm but remain involuntary owners of their interests in the firm. Such unhappy, locked-in minority owners can be protected by well-drafted buy-sell or first option provisions in the governing documents. In reality, the best protection for disgruntled minority owners is to provide a market for their ownership interests at a fair price and on fair terms. The LLC operating agreement, although often brief, can be drafted with built-in protections for unhappy minority owners. Moreover, arbitration or other alternative dispute-resolution procedures can be required in the governing documents as a way to settle differences among the owners.

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371. *Crummey v. Comm'r*, 397 F.2d 82 (9th Cir. 1968); Rev. Rul. 75-415, 1975-2 CB 374; Ltr. Rul. 200123034 (March 8, 2001) (transfers to irrevocable trusts were present interests (Crummey powers))