I. PARTNERSHIP ENTITY CLASSIFICATION

A. Election Procedures

If planning S corporation tax status, an LLC may file IRS Form 2553, Election by a Small Business Corporation, to simultaneously elect corporate taxation and S corporation status.

B. Single Owner

Final Treasury Regulations were issued on August 16, 2007 to provide that a single-owner LLC, which currently is a disregarded entity, may be treated as a separate entity for employment tax and related reporting requirements. T.D. 9356, 72 Fed.Reg. 45,891 (Aug. 16, 2007). The Treasury Decision includes the following summary:

As provided in the proposed regulations, the final regulations provide that a disregarded entity is treated as a separate entity for purposes of employment taxes and related reporting requirements. The final regulations clarify that the separate entity is treated as a corporation for purposes of employment taxes and related reporting requirements. As provided in the proposed regulations, a disregarded entity continues to be disregarded for other Federal tax purposes. The final regulations clarify that an owner of a disregarded entity treated as a sole proprietorship is subject to taxes under the Self-Employment Contributions Act (SECA) (section 1401, et seq.). Additionally, the final regulations retain the example illustrating that an individual owner of a disregarded entity continues to be treated as self-employed for purposes of SECA taxes, and not as an employee of a disregarded entity for employment tax purposes.

The regulations apply to employment taxes on wages paid on or after January 1, 2009, and to excise taxes imposed, or periods beginning, on or after January 1, 2008.

Until the regulations apply, an individual may be found personally liable for payroll taxes despite using an entity with limited liability under state law. Because an LLC was a disregarded entity for federal tax purposes, the single owner was the employer responsible for payment of employment taxes. McNamee v. Department of Treasury, 488 F.3d 100 (2d Cir. 2007). If the taxpayer in McNamee filed Form 8332 to elect corporate status, then he would not have been personally liable for the unpaid payroll taxes. The Sixth Circuit previously held similarly in Littriello v. United States, 484 F.3d 372, 375 (6th Cir. 2007) (affirming “a determination by the IRS Appeals Office that Littriello was individually liable as a sole proprietor under Treasury Regulation §301.7701-3(b)(1)(ii), as a result of his failure to elect to be treated as a corporation”).

C. Like-Kind Exchanges

In Pvt.Ltr.Rul. 200651030 (Sept. 19, 2006), a testamentary trust was selling real estate on contract when the trust provisions mandated that the trust close. The real estate contracts were transferred to an LLC. The LLC members and the trust beneficiaries were the same individuals. The transfer qualified for like-kind treatment.
In Pvt.Ltr.Rul. 200732012 (May 11, 2007), the taxpayer was an LLC with two members. This LLC was the sole owner of LLC2, which was the sole owner of LLC1. Property owned by LLC1 was sold and the proceeds conveyed to a qualified intermediary for purchase of property to be owned by LLC3, which was also solely owned by the taxpayer. The transaction qualified as a like-kind exchange because LLC1, LLC2, and LLC3 were disregarded entities and therefore, the sold property was exchanged for the replacement property by the same taxpayer.

D. Corporate Restructuring

An S corporation reorganized as an LLC, which elected to be treated as an S corporation, in Pvt.Ltr.Rul. 200719006 (Jan. 25, 2007). The IRS ruled that the reorganization would qualify as a Code §368 reorganization and neither the entities nor the members would recognize gain or loss on the exchange of stock. The LLC members and their ownership percentages were identical to the S corporation shareholders and ownership percentages. In addition, the IRS noted that the governing provisions of the LLC provided for identical rights to distribution and liquidation proceeds thereby satisfying the one class of stock rule to be eligible to elect S corporation tax status.

II. OPERATIONAL TAX ISSUES

A. Partnership Rules Generally Apply

1. Distributions of Cash and Property

In Rev.Rul. 2007-40, 2007-25 Int.Rev.Bull. 1426, the IRS discussed whether “a transfer of partnership property to a partner in satisfaction of a guaranteed payment under section 707(c) [is] a sale of exchange under section 1001, or a distribution under section 731?” The IRS ruled: “A transfer of partnership property in satisfaction of a partnership’s obligation to make a guaranteed payment under section 707(c) is a sale or exchange under section 1001. . . . Accordingly, the nonrecognition rule in section 731(b) does not apply to the transfer.” The partnership realizes a gain equal to the difference between the adjusted basis of the property to the partnership and the property’s fair market value.

2. Charitable Contributions

The Pension Protection Act of 2006, Pub.L. No. 109-208, 120 Stat. 780, amended the basis adjustment rules of Code §1367 for S corporations contributing property to qualified nonprofit organizations. The shareholder’s basis reduction from a charitable contribution will equal the shareholder’s pro rata share of the property’s adjusted basis. The charitable contribution will still flow through to the shareholder as usual. This provision applies to contributions made in tax years beginning after December 31, 2005, and before January 1, 2008.

3. Code §199: Qualified Production Activities Deduction

In Rev.Proc. 2007-34, 2007-23 Int.Rev.Bull. 1345, the IRS “specifies the conditions under which certain partnerships and S corporations may choose to calculate qualified production activities income (QPAI) and W-2 wages as defined by §1.199-2T(e)(2) of the temporary Income Tax
Regulations (W-2 wages) at the entity level, as well as the manner for allocating and reporting QPAI and W-2 wages to partners or shareholders.”

B. Partnership Tax Provisions of Troublesome Application to LLCs

1. Application of At-Risk and Passive Loss Rules

The Sixth Circuit remanded a case to the Tax Court because it did not “explicitly engage in the worst-case analysis called for by the payor of last resort test” in determining whether members of a limited liability company were “at risk” under Code §465 for the LLC’s recourse debt pursuant to a provision in the LLC’s operating agreement obligating its members to satisfy any negative capital accounts upon liquidation of their membership interests. Hubert Enterprises, Inc. v. Commissioner, 230 Fed.Appx. 526, 531 (6th Cir. 2007).

2. Self-Employment Tax

As discussed in §108.5 above, final Treasury Regulations provide that single-owner LLCs may be considered separate entities for purposes of employment and excise taxes. T.D. 9356, 72 Fed.Reg. 45,891 (Aug. 16, 2007). For employment tax purposes, the regulations will be applicable on or after January 1, 2009. For excise tax purposes, the regulations will be applicable beginning on or after January 1, 2008.

3. Code §108: Cancellation of Indebtedness Income

Section 108(e)(8) states:

Indebtedness satisfied by corporate stock or partnership interest. For purposes of determining income of a debtor from discharge of indebtedness, if —

(A) a debtor corporation transfers stock, or

(B) a debtor partnership transfers a capital or profits interest in such partnership,

to a creditor in satisfaction of its recourse or nonrecourse indebtedness, such corporation or partnership shall be treated as having satisfied the indebtedness with an amount of money equal to the fair market value of the stock or interest. In the case of any partnership, any discharge of indebtedness income recognized under this paragraph shall be included in the distributive shares of taxpayers which were the partners in the partnership immediately before such discharge. 26 U.S.C. §108(e)(8).

If a partnership recognizes any discharge of indebtedness income, the income must be allocated to the partners holding interests in the partnership immediately before the debt cancellation. Although the partnership or LLC is insolvent, the exception to recognizing the income by reason of insolvency provided for in §108(a)(1)(B) is applied at the partner/member level, not the entity level. Therefore, a member must recognize his or her allocated portion of the cancellation of indebtedness income. The member may offset the income with a bad debt deduction, but only if the bad debt is classified as a business bad debt, not a nonbusiness bad debt.
In *Hubert Enterprises, Inc. v. Commissioner*, 230 Fed.Appx. 526 (6th Cir. 2007), Hubert Enterprises, Inc. and its subsidiaries (HEI) provided financing of $2.4 million to Arbor Lake Development (ALD). The financing was secured by a promissory note executed by Arbor Lake of Sarasota LLC (ALSL), which owned a 97 percent interest as general partner of ALD. For the most part, the owners of ALSL were the same as HEI. The court held that the financing transaction did not create a bona fide debt and therefore, HEI was not entitled to an ordinary business loss or bad debt deduction. The court found that the funds were constructive dividends paid for the benefit of HEI shareholders. It classified the promissory note as equity, not debt.

### III. ILLINOIS STATE TAX TREATMENT

#### A. No Franchise Tax Imposition

Increases in paid-in capital subject to additional franchise taxes from a corporate reorganization may not be netted against the reduction in paid-in capital occurring when the corporation merges into another entity. *NDC LLC v. Topinka*, 374 Ill.App.3d 341, 871 N.E.2d 210, 312 Ill.Dec. 810 (2d Dist. 2007). A Delaware corporation authorized to transact business in Illinois reorganized and as a part of the reorganization merged into a Delaware limited liability company. The LLC protested the imposition of over $2 million in additional franchise taxes. The court ruled that increase and decrease in paid-in capital did not occur during the same taxable period as required by §14.30 of the Business Corporation Act of 1983 (805 ILCS 5/14.30) because the statute lists four separate events that require the filing of a report. In addition, the court rejected the LLC’s argument that the franchise tax could not be imposed on an LLC because the LLC was the survivor of the merger and therefore not liable for the debts and liabilities of the merged entity.

The Secretary of State charges a $750 fee for filing articles of organization for an LLC series.

### IV. ADVANTAGES AND DISADVANTAGES IN COMPARISON WITH OTHER FORMS OF DOING BUSINESS

#### A. Comparison with S Corporations

1. **Relaxed Ownership Criteria**

Notice 2005-91, 2005-51 Int.Rev.Bull. 1164, provides guidance on making the election under Code §1361(c)(1)(D) for certain family members to be considered one shareholder for purposes of the S corporation shareholder limit.

A husband and wife who file a joint tax return and who conduct a qualified joint venture together may find increased simplicity in using an entity form other than an S corporation. For tax years beginning after December 31, 2006, Code §761(f) allows a husband and wife to elect to report their respective interests in a qualified joint venture as if they were a sole proprietor (file separate Schedules C, E, or F depending on the case). A qualified joint venture under this section is not considered a partnership for federal tax purposes. It is unclear how the liquidation and
termination rules of subchapter K will apply to taxpayers currently filing as partnerships who elect to file as sole proprietors.

B. Advantages of Partnership Taxation

1. Basis Step-Up for Liabilities

In Maloof v. Commissioner, 456 F.3d 645, 646 (6th Cir. 2006), the taxpayer “claimed significant deductions for losses incurred by S corporations that he owned.” Under Code §1366(d)(1) pass-through loss deductions that individuals may take on their individual tax returns cannot exceed the shareholder’s basis in stock and debt. The issue before the court was whether the taxpayer “properly increased his basis in stock or debt when he became a co-obligor and guarantor” of a $4 million bank loan to the corporations. 456 F.3d at 647. Under Code §1366(d)(1)(B), the taxpayer was required to show that the bank loan created “indebtedness of the S corporation to the shareholder.” The court held that the S corporation was not indebted to the shareholder and “[t]hat Maloof cosigned the loan and that he could one day be asked to pay it does not by itself alter this conclusion because until that contingency transpired the S corporations remained indebted to the bank, not to Maloof.” 456 F.3d at 649. The court further commented that “[i]n applying the ‘economic outlay’ doctrine, the appellate courts have been nearly unanimous in concluding that when a shareholder guarantees a loan, the existence of the guarantee does not by itself increase the indebtedness of the S corporation to the shareholder.” 456 F.3d at 650. Lastly, the court noted that “if his characterization of the transaction is accurate, it follows that the corporations’ payment of the interest on the loans amounted to constructive dividends to Maloof, which he would have to report (but did not report) as income on his tax returns.” 456 F.3d at 652.

In Miller v. Commissioner, 91 T.C.M. (CCH) 1267 (2006), the court found that the taxpayer’s basis in his S corporation stock increased because the “petitioner made an economic outlay, which left him poorer in a material sense, by virtue of becoming the fully recourse obligor on enforceable debt held by an independent, third-parry lender” and because he “then re-lent the proceeds of this indebtedness to MMS, creating direct indebtedness of his S corporation to him, within the meaning of section 1366(d)(1)(B), in sufficient amounts to cover the losses claimed.” The court further rejected the Commissioner’s argument that the taxpayer was not “at risk” on the debt, stating that “there was no certainty that the guarantors would be called upon to satisfy the indebtedness” and “we conclude that petitioner had a realistic possibility of loss thereon.” Next, the court agreed with the Commissioner that the taxpayer should have recognized income from the discharge of indebtedness, noting that he “was at this point released from his obligation . . . because the [investors guaranteeing the loan] had waived any right to reimbursement from petitioner under the guarantor waivers.” However, the court ruled that the discharge of indebtedness income was excluded from income under Code §108(a)(1)(B), which excludes amounts to which the taxpayer is insolvent when the discharge occurs.

2. Code §704(b) Special Allocations

In Pvt.Ltr.Rul. 200730009 (Apr. 25, 2007), an S corporation made disproportionate distributions, which would have disqualified the S status for having more than one class of stock. The S corporation made corrective distributions, but a timing difference in the taxation of the disproportionate distributions with the corrective distributions may have been considered the creation of a second class of stock. However, the IRS determined that the timing difference did
not create a second class of stock because under the entity’s governing provisions the stock had identical distribution and liquidation rights. In addition, the timing difference was not caused by a binding agreement concerning distribution or liquidation rights.

V. PREFERRED PARTNERSHIPS

Preferred partnership recapitalizations are being considered as a way to restructure an entity in preparation for transferring ownership to the next generation. Senior member’s exchange common partnership units (or non-preferred units) for preferred partnership units, with the preferred units providing preferential rights to dividends and liquidation proceeds. Current law provides little guidance on this subject. Code §2701; Treas.Reg. §§25.2701-1 (special valuation rules in case of transfers of certain interests in corporations and partnerships), 25.2701-2 (special valuation rules for applicable retained interests), 25.2701-3 (determination of amount of gift).

VI. SERIES LLC

The Illinois Limited Liability Company Act (LLCA), 805 ILCS 180/1-1, et seq., was amended by P.A. 94-607, effective August 16, 2005 to provide for series LLCs. Illinois is one of the seven states to provide for series LLCs. When establishing series LLCs the tax issue is whether each serial LLC will be treated as a separate eligible business entity or whether all the series will be treated as one single eligible business entity. The tax law is unclear and there has been no guidance from the Treasury Department on the tax treatment of series LLCs.

The check-the-box tax is a place to begin. This federal tax law question is determined by federal law, not local law. A business entity recognized for federal tax law purposes is an eligible entity if it is not classified as a trust (Treas.Reg. §301.7701-4) and not treated as a “per se” corporation (Tres.Reg. §301.7701-2(b)). An entity is not defined for federal tax law purposes but, in general, an organization is an entity if the organization changes the economic relationship between the owners of the organization and their assets. Sometimes the organization’s legal existence is sufficient to show a change in this economic relationship. To create a separate serial LLC, the LLCA requires the filing of a certificate of designation. This legal existence may be sufficient to show a change in this economic relationship but the provisions in the operating agreement need to be reviewed to determine its effect on this economic relationship.

The creation of a serial LLC generally alters the legal rights and obligations of the owner or owners. Establishing a serial LLC should affect a member’s ability to partition the contributed property and requires votes for making decisions rather than unilateral decisions. In a like tax law area, the IRS and the courts have approved separate series trusts as separate trust taxpayers. Pvt.Ltr.Rul. 9819002 (Jan. 27, 1998), Pvt.Ltr.Rul. 9721007 (Feb. 9, 1997); National Securities Series — Industrial Stock Series v. Commissioner, 13 TC 884 (1949).

An organization is a business entity if it conducts business. If a serial LLC holds property not in a trade or business it may not be a business entity that is eligible to be treated as a separate taxpayer. However, the IRS has a low threshold for finding business activity. Gen.Couns.Mem. 39,395 (Aug. 15, 1985).
In summary, a serial LLC in a series LLC may be considered a separate taxpayer because it is an eligible business entity that is not a trust or “per se” corporation, has changed the economic relationship between the owners and their assets, and conducts a business activity.

Thus, each serial LLC requires a separate analysis. Even if each serial LLC is an eligible business entity, the federal tax treatment is unclear. Perhaps the series LLC and each serial LLC may file as one taxpayer, but maybe each serial LLC needs to file as a separate taxpayer. And, for a serial LLC that is not conducting a business activity, it may need to be grouped with another serial LLC or the series LLC that is conducting a business activity.

In conclusion, the formation of LLCs with two or more members has been slowed by the lack of guidance for federal tax treatment. However, single member series LLCs have more certainty for federal tax purposes because the series LLC with serial LLCs will collapse into a single disregarded entity and be treated as one taxpayer.