Tax & Estate Planning for LLCs & S Corporations

LLCs vs. S Corporations
Illinois Institute for Continuing Legal Education
Chicago, Illinois
October 9, 2013

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Tax & Estate Planning Issues for LLCs & S Corporations

I. Introduction

II. LLCs & S Corporations Formation Issues

- A. Election Procedures
- B. Single Owner
- C. Like-Kind Exchanges
- D. Corporate Restructuring

III. Operational Tax Issues for LLCs and S Corporations

- A. Partnership Rules Generally Apply
  1. Distributions of Cash and Property
  2. Charitable Contributions
  3. Code §199: Qualified Production Activities Deduction
- B. Partnership Tax Provisions of Troublesome Application to LLCs
  1. Application of At-Risk and Passive Activity Loss Rules
  2. Code §108: Cancellation of Indebtedness Income
- C. Economic Substance Doctrine

IV. Illinois State Tax Treatment

- A. Franchise Tax Imposition
- B. Withholding for Nonresidents of Pass-Through Entities
  1. Illinois Withholding Requirement
  2. One Class of Stock Requirement for S Corporation Shareholders

V. Advantages and Disadvantages of LLCs in Comparison with S Corporations

- A. Relaxed Ownership Criteria
- B. Advantages of Partnership Taxation
  1. Basis Step-Up for Liabilities
  2. Special Allocations

VI. Self-Employment and Payroll Taxes

- A. LLCs Taxes as Partnerships
  1. Member-Managed LLCs
  2. Manager-Managed LLCs
- B. S Corporations

VII. Medicare Taxes

- A. 0.9 Percent Surtax on Wages
- B. 3.8 Percent Tax on Net Investment Income

VIII. Gift Taxes

IX. Estate Taxes

A. Entity Valuation Adjustments
   1. Discounts for Marketability and Minority Interests
   2. Defined Value Clauses
   3. Taxes Inside an Entity

B. Estate Tax Exclusions for Federal and Illinois

X. Recapitalizations

XI. Tiered Structures

XII. Series LLCs

Estate Planning & Tax Issues for LLCs & S Corporations

I. Introduction

The tax issues for LLCs and S corporations covers their formation, operations, Illinois tax treatment, and compares the advantages and disadvantages of LLCs and S corporations for income taxes, gift taxes, estate taxes, preferred recapitalization, tiered structures, and series LLCs.

II. LLCs & S Corporations Formation Issues

A. Election Procedures

In planning S Corporation tax status for an LLC, the LLC may file IRS Form 2553, Election by a Small Business Corporation, to simultaneously elect corporate taxation and S corporation status. Corporations file the same Form 2553 to elect S Corporation status. Form 2553 is to be filed no later than 75 days after the beginning of the tax year. However, Rev. Proc. 2003-43 provides a procedure for late elections.

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.

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.

III. Operational Tax Issues for LLCs and S Corporations

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 basis adjustment rules of Code §1367 do not apply for S corporations contributing appreciated property to qualified nonprofit organizations. The shareholder's basis reduction from a charitable contribution of appreciated property will equal the shareholder's pro-rata share of the property's adjusted bass. The charitable contribution at its appreciated value flows through to the shareholder.

3. Code §199: Qualified Production Activities Deduction

S corporations and partnerships that meet specific requirements can choose to figure Qualified Production Activities Income (QPAI) at the entity level and allocate QPAI to shareholders and partners who then aggregate their allocated portions on Form 8903. If the entity is not eligible, S corporations and partnerships must report each shareholder's or partner's share of deductions on their respective Schedule K-1. See final Regulation Section 1.199-5(b) and (c) for partnerships and S corporations, respectively.

B. Partnership Tax Provisions of Troublesome Application to LLCs

1. Application of At-Risk and Passive Activity 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). For passive activity losses, Treasury issued Prop. Reg. §1.469-5 76 Fed. Reg. 72,875 (2011) concluding that members of LLCs who have rights to manage the LLC are treated as general partners and generally not subject to the passive activity loss rules.

2. 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.

C. Economic Substance Doctrine

Effective March 30, 2010, Internal Revenue Code §7701(O) codifies the common-law economic substance doctrine for certain transactions to include partnership taxation and S Corporation taxation. In general, a transaction or series of transactions will be disregarded unless, excluding federal tax benefits, it meaningfully changes the taxpayer's economic position and the taxpayer has a substantial purpose for the transaction.

IV. Illinois State Tax Treatment

A. 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.

B. Withholding for Nonresident of Pass-Through Entities

1. Illinois Withholding Requirement

Illinois requires that all pass-through entities withhold income taxes from their nonresident owners. See ILCS Chapter 35 § 5/709.5(a); Ill. Admin. Code 86 § 100.7035(a). The amount subject to withholding is equal to (a) the nonresident owner's share of the business income of the pass-through entity that is apportioned to Illinois (whether or not such business income is distributed); (b) multiplied by the applicable tax rate. See ILCS Chapter 35 § 5/709.5(a). For purposes of the above provisions, a "pass-through entity" is defined as an S corporation, partnership or trust and an "owner" is defined as a shareholder in an S corporation, a partner in a partnership or a beneficiary of a trust.

2. One Class Stock Requirement for S Corporation Shareholders

Certain steps must be taken to ensure that the governing provisions of an S corporation are in compliance with the Treasury Regulations provided for under Code §1361(b). The governing provisions for the S corporation should provide that any such withholding and payment of income taxes will be treated as constructive distributions or advances to avoid violating the one class of stock requirement. This provision should be a part of bylaws, but, if not, and nonresidents become shareholders, it is important that S corporations revise their governing provisions to contain these provisions.

V. Advantages and Disadvantages of LLCs in Comparison with S Corporations

A. 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

Members of LLCs generally get a step up in basis for debts incurred by the LLC, but shareholders for S corporations do not get a step up in basis for debts incurred by the S corporation.

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. Special Allocations

Members of an LLC can have special allocations provided there is an economic basis for such allocation, but this is an issue for shareholders of S corporations.

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.

VI. Self-Employment and Payroll Taxes

A. LLCs Taxed as Partnerships

Section 1402(a)(13) of the Internal Revenue Code provides that the "distributive share of any item of income or loss of a limited partner, as much, other than guaranteed payments" is excluded from earnings for self-employment tax purposes. Section 1402(1)(13) was designed to prevent passive investors from including investment income in earnings on which social security benefits are based. It is not clear whether this Code section applies to limited liability company members. Many LLC members may be actively involved in the LLC business and not passive investors, so a uniform application of this rule to LLC members may be inappropriate.

Prop. Treas. Reg. §1.1402(1)-2, 62 Fed.Reg. 1702-01 (Jan. 13, 1997), was an attempt by the IRS to provide guidance on self-employment taxes for members of LLCs. It provides that a partner in a partnership or a member of an LLC is treated as a limited partner unless that person meets any one of the following three conditions: (a) the partner or member has unlimited personal liability; (b) the partner or member has authority to enter into contracts on behalf of the entity; or (c) the partner or member participates in the entity's trade or business activities for more than 500 hours in a tax year. The proposed regulation also provides that fees for services in the fields of health, law, engineering, architecture, accounting, actuarial science, and consulting are subject to self-employment taxes. Senate Floor Amendment No. 584 to the Taxpayer Relief Act of 1997 offered a "sense of the Senate" resolution expressing dissatisfaction with this proposed regulation.

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 are applicable beginning January 1, 2009. For excise tax purposes, the regulations are applicable beginning on or after January 1, 2008.

1. Member-Managed LLCs

Members in a member-managed limited liability company are generally considered equivalent to general partners of a partnership because the members have authority under Illinois LLC law to contract on behalf of the LLC. Thus, each member may be subject to self-employment tax on his or her share of the LLC income.

2. Manager-Managed LLCs

Under manager-managed limited liability companies, the manager, and not the members, has the authority to enter into contracts. Therefore, as long as the non-manager members do not provide more than 500 hours of service to the LLC, the non-manager members should be able to avoid self-employment tax on income from the LLC.

B. S Corporations

Ordinary business income reported on Schedule K-1 is not subject to Federal Insurance Contributions Act (FICA) or self-employment tax. However, the S corporation must pay reasonable compensation to a shareholder-employee. See *Mulcahy, Pauritsch, Salvador & Co. v. Commissioner*, 680 F.3d 867 (7th Cir. 2012); *David E. Watson, P.C. v. United States,* 668 F.3d 1008 (8th Cir. 2012).

VII. Medicare Taxes.

A. 0.9 Percent Surtax on Wages

Effective for tax years beginning on or after January 1, 2013, the employee portion of the Medicare tax will increase from 1.45 percent to 2.35 percent for high-income individuals. Self-employed, high-income individuals will also be required to pay the additional 0.9 percent Medicare tax, which is not deductible. The additional Medicare tax applies to covered wages or net self-employment income in excess of $250,000 for married taxpayers filing a joint return (or a surviving spouse), $125,000 for a married taxpayer filing separate, and $200,000 for all other taxpayers. Internal Revenue Code §3101(b).

Employers are required to take the additional Medicare tax into account in withholding tax from employees, but they only need to consider the employee's wages in excess of $200,000 and not income of an employee's spouse. In addition, taxpayers must account for the additional Medicare tax when making estimated income tax payments. Code §3102(f).

B. 3.8 Percent Tax on Net Investment Income

Effective for tax years beginning in 2013, the Health Care Act expands the Medicare tax base for high-income individuals to include unearned income or net investment income. Internal Revenue Code § 1411. Net investment income includes interest, dividends, royalties, rents, gross income from a trade or business involving passive activities, and net gain from disposition of property excluding property held in a trade or business. The amount subject to the additional Medicare tax is 3.8 percent of net investment income in excess of $250,000 for married taxpayers filing a joint return (or a surviving spouse), $125,000 for a married taxpayer filing separate, and $200,000 for all other taxpayers. Code § 1411(b). See Prop. Treas. Reg. §§ 1.1411-5 and 1.1411-7 for rules relating to determining net investment income from passive trades and businesses and relating to dispositions of interests in partnerships and S corporations. 77 Fed.Reg. 72,612 (Dec. 5, 2012).

VIII. Gift Taxes

For estate planning, individuals frequently use a business entity. The scenario usually involves family members transferring assets to an entity, followed by their transferring interests in that entity, equal in value to the annual gift tax exclusion amount, and some or all of the applicable exclusion amount to other family members. If the LLC's operating agreement places restrictions on the LLC's membership interests to the point of eliminating the holders' use and enjoyment of the property, then the transfer of such units may be deemed gifts of future interests, which do not qualify for the annual gift tax exclusion. *Hackl v. Commissioner*, 118 T.C. 279 (2002); *Price v. Commissioner*, T.C. Memo 2010-2.

Further, a single-member LLC is not necessarily a disregarded entity for gift tax purposes. *Pierre v. Commissioner*, 133 T.C. 24 (2009), *supplemental opinion* at T.C. Memo 2010-106.

IX. Estate Taxes

A. Entity Valuation Adjustments

1. Discounts for Marketability and Minority Interests

Limited liability companies and limited partnerships have been used as part of an individual's estate planning because ownership of the entity may not be as valuable as pro rata ownership of the entity's assets. The difference in market values may be attributable, in part, to valuation adjustments for lack of marketability and for lack of control (minority interest).

The four *Strangi* cases and a host of subsequent cases have raised questions regarding the continued use of these entities. *Strange v. Commissioner,* 115 T.C. 478 (2000) (*Strangi III), aff'd in part*, *rev'd in part*, *Estate of Strangi v. Commissioner,* 293 F.3d 279 (5^{th} Cir. 2002) (*Strangi II), remanded, Strangi v. Commissioner,* T.C. Memo 2003-145 (*Strangi III), aff'd, Strangi v. Commissioner,* 417 F.3d 468 (5^{th} Cir. 2005) (*Strangi IV).* The pre-death transfers of the decedent's assets into limited liability partnerships were disregarded pursuant to Code §2036 for federal estate tax purposes. The net asset values of the partnership assets were included in the gross estate rather than the value of the decedent's ownership interests in the partnerships. The Fifth Circuit in *Strangi IV* held that the transfers of assets into the partnerships were not "bona fide" as required by Code §2036(a). See *Estate of Kelly v. Commissioner*, T.C. Memo 2012-73 (ruling for taxpayers in §2036 case but without relying on the "bona fide" sale exception).

LLCs and limited liability partnerships that are used at least in part to achieve valuation adjustments for gift or estate tax purposes should be reviewed in light of the *Strangi* decisions and the more recent decisions in *Estate of Jorgensen v. Commissioner,* T.C. Memo 2009-66; *Estate of Miller v. Commissioner*, T.C. Memo 2009-119; *Estate of Malkin v. Commissioner,* T.C. Memo2009-212; *Estate of Shurtz v. Commissioner*, T.C. Memo 2010-21; and *Estate of Stone*, T.C. Memo 2012-48. See also *Linton v. United States*, 630 F.3d 1211 (9^{th} Cir. 2011), for a discussion of the step transaction analysis.

2. Defined Value Clauses.

In *Wandry v. Commissioner,* T.C. Memo 2012-88, the Tax Court ruled for the taxpayer in a case involving a defined value clause, and a charitable organization was not involved as with prior court cases ruling for taxpayers. *Knight v. Commissioner*, 115 T.C. 506 (2000), *Estate of Christiansen v. Commissioner,* 130 T.C. 1 (2008), *Hendrix v. Commissioner,* T.C. Memo 2011-133, *Estate of*

Petter v. Commissioner, 653 F.3d 1012 (9th Cir. 2011) *aff'g* T.C. Memo 2009-280.

3. Taxes Inside an Entity.

Entity level taxes have also been considered in estate tax valuation cases. *Estate of Litchfield v. Commissioner*, T.C. Memo 2009-21 (finding built-in capital gains taxes relevant in reducing value of both C corporation and S corporation stock); *Estate of Jensen v. Commissioner*, T.C. Memo 2010-182 (finding the present value of long-term capital gains taxes relevant in reducing value of estate's stock interest in closely held C corporation).

B. Estate Tax Exclusions for Federal and Illinois

In 2013, the federal estate tax exclusion is $5.25 million. The Illinois estate tax exemption is $4 million, and the rate is based on the "state death tax credit" calculated under IRC §2011, as it would have been computed on December 31, 2001. Because the federal estate tax exclusion is now $5.25 million, estates transferring between $4 million and $5.25 million may be exempt from federal estate tax but liable for Illinois estate tax in 2013. Note that for 2012, the Illinois estate tax exemption was $3.5 million, and for 2011 and earlier, it was $2 million.

Illinois estates valued over $4 million must file Illinois Form 700, *Estate & Generation Skipping Transfer Tax Return.* The Illinois return must include a copy of the estate's federal Form 706, *United States Estate (and Generation-Skipping Transfer) Tax Return.* If the estate has an Illinois filing requirement but is not required to file a federal estate tax return, the Illinois return should contain the same information required by the federal return, including all schedules, appraisals, wills, trusts, and attachments.

An Illinois qualified terminal interest property (QTIP) marital trust election is available and can be made separate and apart from a federal QTIP election. Making the Illinois QTIP election allows the estate to maximize the $5.25 million federal estate tax exclusion without incurring Illinois estate tax on the additional $125 million until the surviving spouse's death.

Illinois does not provide for any portability of the decedent's state estate tax exclusion, as is allowed under the new federal tax law.

X. Recapitalizations

Preferred partnership recapitalizations are being considered as a way to restructure an entity in preparation for transferring ownership to the next generation. Senior members exchange common partnership units (or non-preferred units) for preferred partnership units, with the preferred units providing preferential rights to dividends and liquidation proceeds. The objective of preferred units is to shift the future appreciation of the partnership to the younger members and to provide more stable cash flow to the senior members.

Current law provides little guidance on the gift tax consequences in using preferred partnership units. The relevant Code section is §2701. Treas.Reg. §25.2701-1 provides special valuation rules in case of transfers of certain interests in corporations and partnerships. Treas.Reg. §25.2701-2 provides special valuation rules for applicable retained interests. Treas.Reg. §25.2701-3 provides for how to determine the amount of a gift. The following paragraphs briefly summarize these Treasury Regulations.

The senior members receive qualified payments at a fixed rate, but the payments may be variable if the rate bears a fixed relationship to a specific market interest rate. The payments must be payable and cumulative. If the payments are not made, a four-year grace period is allowed to make the payments, which are treated as if made on the due date.

The younger family members are entitled to income and liquidating distributions only after the senior members have been paid. The value of the younger members' non-preferred units in the partnership must exceed ten percent of the total value of all equity interests plus the debt owned by the entity to the senior members.

To avoid gift taxes, the payments to the senior family members must have both an adequate yield and sufficient coverage considering the entity's earnings. The liquidation preference protection must consider the value of the entity's net assets to the liquidation amount. These valuations should be done by appraisers familiar with the industry.

XI. Tiered Structures

In tiered structures, a parent limited liability company would form a single-member limited liability company as its subsidiary. This single-member limited liability company would be treated as a disregarded entity for federal income tax purpose. The parent entity accomplishes two things: (a) the parent entity can separate the assets and business activities of the various entities for state law purposes and receive greater liability protection; and (b) the parent entity is able to receive flow-through treatment for federal income tax purposes.

XII. Series LLCs

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. 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 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.