

Illinois Institute for Continuing Legal Education
Limited Liability Companies vs. S Corporations
Essential Tax Issues

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Limited Liability Companies vs. S Corporations: Essentials Tax Issues

The Tax Chapter in the manual provides an overview of the tax issues for limited liability companies (“LLC”). This paper will focus on the new regulations regarding the definition of liabilities as it relates to tax basis, disguised sales of membership interests, and the exclusion of LLC income attributable to capital from the definition of net earnings from self-employment.

I. Allocation of Liabilities. On June 23, 2003, temporary and proposed regulations were issued defining liabilities for Internal Revenue Code (“Code”) Section 752. Treas. Reg. Section 1.752-6T and Prop. Treas. Reg. Section 1.752-7.

- A. In general, liability is an obligation to the extent that incurring the liability:
 - 1. Creates or increases the basis of the obligors assets.
 - 2. Gives rise to the immediate deduction to the obligor.
 - 3. Gives rise to an expense that is not deductible in computing the obligors taxable income and is not properly chargeable to capital.

B. Liabilities are classified as either recourse or non-recourse.

1. A LLC liability is a recourse liability to the extent that any member bears an economic risk of loss for that liability. However, because for state law purposes no LLC member is liable for obligations of the LLC, generally recourse liabilities are treated as non-recourse liabilities.

a. In a partnership setting, the recourse liability is allocated to the partner(s) who will be responsible for paying the liability if the partnership were unable to do so. Who bears the economic risk of loss is determined by using a constructive liquidation test. In such liquidation, the partner (1) who would be obligated to pay the creditor or make a contribution to the partnership to pay the creditor and (2) who would not be entitled to reimbursement, bears the economic risk of loss.

b. Notwithstanding state law, all contractual obligations are considered in determining who bears the economic risk of loss, including guarantees, indemnifications, reimbursement agreements, the terms of a loan agreement, the terms of the operating agreement, and obligations to restore a deficit capital account.

c. This analysis is done under the assumption that all members do and can actually perform on their obligations regardless of the ability to pay.

d. Finally, a member is considered to bear the economic risk of loss to the extent the member makes a non-recourse loan to the LLC and such liability is not an obligation of another member.

2. Almost all LLC liabilities are non-recourse because no member bears the economic risk of loss for that liability. A members share of non-recourse liabilities equals the sum of three tiers, defined as follows:

a. The first tier – partnership minimum gain. The LLC minimum gain is the excess of non-recourse liability over the Section 704(b) “book value’ of the property securing the liability.

b. The second tier – Section 704(c) minimum gain. When the contributed property subject to the liability is depreciable, the Section 704(c) minimum gain is the difference between the book and tax depreciation. Over time, when the property is fully depreciated, the second tier allocation will be zero.

c. The third tier – Interest in LLC Profits. The interest in LLC profits is related to the economic arrangement of the partners. It may be allocated between the members as long as the allocation has substantial economic effect under the Section 704(b) regulations.

C. Liability Allocations.

1. Any increase in a member's share of the LLC liabilities or an increase in the member's individual liabilities, for example an enforceable guarantee for all or a portion of the liability with waiver of any right of subrogation, is treated as a contribution of money to the LLC.

2. Any decrease in the member's share of the LLC liabilities or decrease in the member's individual liability is treated as a distribution of money and decreases the member's share of liabilities.

3. Any increase or decrease in a member's liabilities in a single transaction is netted to determine any increase or decrease.

4. Any distribution of money to a member under Section 731(a) provides gain to the member to the extent the money exceeds the basis of the member's interest.

5. In Rev. Rul. 88-77 (1988-2 C.B. 128) the Internal Revenue Service ("IRS") concluded that accrued and unpaid expenses and accounts payable are not considered liabilities for adjusting the basis of a member's interest in the LLC that uses the cash method of accounting.

D. LLC liability allocations to a member maybe available to:

1. A member who enters into a partial or full guarantee of a LLC non-recourse debt while waiving any right of subrogation.

2. A member who enters into a guarantee of a LLC non-recourse debt but only to the extent the creditor has exhausted all its rights and remedies against the LLC (Bottom Guarantee).

3. Although LLCs are treated as partnerships for tax purposes, by operation of state law, no members are liable for obligations of the LLC by being a member of the LLC. In a partnership the general partner in either a general partnership or a limited partnership is liable for the partnership obligations, thus creating a fundamental difference regarding the allocation of liability rules for LLCs compared to partnerships.

4. A recourse liability under state law for LLC purposes is treated as non-recourse because the members are personally not obligated to pay the liability. However, any member's enforceable guarantee of all or a portion of a LLC liability while also waiving a right of subrogation, allows a member to have a greater economic risk of loss than the member's ownership interest in the LLC.

5. If an LLC member under an operating agreement has a deficit restoration obligation (DRO) with a negative capital account, then no liability allocation will

probably be available to the member because under the constructive liquidation rules, the deficit capital account balance would end up being zero. The DRO then would not require a payment to the LLC.

6. If a LLC member with a positive capital account has a DRO, then creditors should be able to pursue a LLC member's capital account, which in turn provides for the member to have an allocation of the liabilities.

7. If a LLC member without a DRO makes a capital contribution up to a certain dollar amount, then to the extent that the fair market value of the assets in the LLC are not enough to satisfy the debt (through the constructive liquidation rules), a capital contribution irrespective of a deficit capital account balance should provide for an allocation of the liabilities.

E. In an S Corporation, a shareholder's capital contribution and loans to the corporation increases the basis of the shareholder's interest. A corporate loan, a guarantee of a corporate loan, and substitution of a shareholder note for a guaranteed corporate debt or assumption of a corporate debt (provided in both cases the corporation is released), may also add to the shareholder's basis. Often a substitution or an assumption is difficult because the third party creditor wants to have the collateral in the corporation secure the loan.

II. Section 704(b) Temporary Regulations Regarding Allocation of Foreign Taxes

(Temp. Reg. Section 1.704-IT).

- A. A member's distributive share of income, gain, loss, deduction, or credit is determined by the member's interest in the LLC, provided the allocation to the member has substantial economic effect.

- B. Substantial economic effect means that the allocation must have economic effect and that the economic effect must be substantial, i.e. after tax economic tax consequences.

- C. Substantial economic effect does not include non-recourse deductions, certain recapture items, and tax credits.

- D. The Section 704(b) temporary regulations provide that allocating creditable foreign taxes does not have a substantial economic effect. Therefore, foreign taxes must be allocated in accordance with the member's interest in the LLC. A credible foreign tax is a foreign tax paid or accrued for US tax purposes by a LLC that is eligible for the foreign tax credit.

III. Disguised Sales of LLC Interests.

A. When Section 707(a)(2)(B) was added to the Code, the provision granted the Treasury the authority to promulgate regulations concerning both (1) disguised sales of property between members and the LLC and (2) disguised sales of LLC interests. The property regulations were promulgated in September of 1992 (T.D. 8439, 1992-2 C.B. 126). These final regulations, however, reserved on the issue of disguised sales of LLC interests.

1. There is a potential for deferral in the fact that a member receiving a cash distribution is generally permitted to recover the full amount of basis in his or her LLC interest before recognizing gain on a distribution. A member of a LLC selling a portion of his or her membership interest is permitted to recover only a pro rata portion of this basis before recognizing gain.

2. The recharacterization of a contribution and distribution as a disguised sale of a LLC membership interest has tax consequences beyond deferral. For example, the “hot assets” of a LLC would be governed by Section 751(a). The interest acquired by the contributing partner would include a portion of the Section 704(c) attributes of the distributee member’s interest, and if a 754 election is in effect, adjustments would be made pursuant to section 743 rather than section 734. A disguised sale could also give rise to a termination under Section 708(b).

3. The Treasury has indicated that it may come out with some new proposed regulations regarding disguised sales of LLC membership interest.

B. In an S Corporation, a shareholder's sale of stock to another person or redemption by the corporation does not affect the basis of the corporation's assets. There is no equivalent of a disguised sale or Section 754 basis step-up election with an S Corporation.

IV. Excluding LLC Income Attributable to Capital From Net Earnings For Self-Employment.

A. H.R. 4137, called the Small Business Tax Modernization Act of 2004, is proposed legislation attempting to unify the income taxation of all pass-through entities.

1. The proposed legislation includes a section attempting to define how much of the share of net income to a member is subject to self-employment tax. For determining net earnings for self-employment tax purposes, the legislation proposes the exclusion of the net income attributable to capital. The proposed legislation would exclude amounts attributable to capital by the following two amounts:

a. The amount in excess of what constitutes reasonable compensation for services by the member, and

b. An amount equal to a reasonable rate of return on unreturned capital of a member determined at the beginning the year.

2. The proposed legislation includes a definition for unreturned capital and it uses as a reasonable rate of return 150 percent of the highest applicable federal rate determined at the beginning of the LLC's taxable year.

B. In an S Corporation, reasonable compensation for services by the shareholder determines the net earnings for self-employment taxes.

V. Conclusion.

In trying to put a limited liability company in the framework of a partnership for tax purposes creates conflicts with general partnership and limited partnership tax law, but with some uncertainty creates flexibility. Using an S Corporation which has many years of existence in the Code does not present these tax problems, but it also does not present tax opportunities that are available with the use of limited liability companies.