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LLC Vs. S. Corporation

***289 LIMITED LIABILITY COMPANY VS. S CORPORATION**

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A singularly difficult decision for a tax adviser is whether to recommend operating a new business as a partnership or an S corporation. LLCs seem to make the choice easier, but many factors should influence the decision as to which form to use.

The most significant obstacle to LLC formation--at least from a tax standpoint--is about to be removed. Under Rev. Proc. 95-10, [FN1] an LLC must qualify as a partnership under the general four-factor entity classification rules to be taxed as a partnership. Because of the variety of state enabling statutes, this presents some uncertainty as well as expense. Recently issued Proposed Regulations would allow non-corporate entities to elect a tax classification. [FN2] Therefore, unless otherwise noted, it is assumed here that LLCs are taxed as partnerships. Once assured of how the LLC is taxed, it appears, in general, that the LLC is clearly the superior form of business. Predictions of the death of S corporations would be premature, however. As discussed below, the S corporation retains vitality as a situational planning device. Moreover, as evidenced by amendments made by the recently enacted Small Business Job Protection Act of 1996, [FN3] in time, many of the rigidities of the S corporation form may be eliminated.

Comparative tax analysis

S corporations and partnerships are both pass-through entities. This common attribute has been mistaken by many for the proposition that both entities are subject to identical taxing schemes. In fact, the similarities start and end here. The rules of Subchapter K differ markedly from those of Subchapter S and, generally, the former are much more advantageous than the latter.

Financing flexibility.

A significant advantage of the LLC form is the flexibility afforded it in capitalizing its operations. This advantage is very broad, encompassing both the number and type of potential financiers, as well as the nature of the capital invested.

Number of equity holders.

Effective for tax years beginning after 1996, an S corporation is limited to 75 shareholders, [FN4] while an LLC has no upward limit on its membership. For tax years beginning before 1997, an S corporation is limited to 35 shareholders. As a practical matter, LLCs tend to be vehicles for closely held businesses due to the necessity of meeting the present partnership classification requirements. Moreover, except for LLCs whose income is derived from certain statutorily prescribed sources, a publicly traded LLC will lose its flow-through status. [FN5] One advantage ***290** enjoyed by S corporations is they can be used in a single-owner situation. Many states require LLCs to have two or more members, and in the states that sanction single-member LLCs (e.g., Texas and New York) it is uncertain whether single-member LLCs will be allowed flow-through tax treatment. The Proposed Regulations disregard single-member LLCs as separate entities, so the member must report the LLC's activity directly. [FN6]

The shareholder limit is easily avoided by conducting business through a partnership made up of S corporations. In Rev. Rul. 94- 43, [FN7] the IRS sanctioned and revoked conflicting authority. [FN8] Multiple entities, however, mean multiple sets of documents, books, tax returns, and the administrative burdens that follow. For instance, multiple corporate documents, such as articles of incorporation, by-laws, and redemption and cross-purchase agreements will be required. State filing fees and minimum capital stock taxes may also be duplicated. In addition, the use of the partnership structure overlays, on top of Subchapter S, the complexity of Subchapter K--the avoidance of which is perhaps one of the reasons the S corporation retains some vitality.

Type of equity holder.

Eligible shareholders in S corporations are limited to individuals who are citizens or residents of the U.S., and certain estates trusts. [FN9] The 1996 legislation expanded the list of eligible shareholders to include pension and profit sharing trusts, tax-exempt Section 501(c)(3) organizations, and electing small business trusts. [FN10] Small business trusts are limited to those having only individuals, estates, and certain tax-exempt organizations as beneficiaries. [FN11] In contrast, an LLC is not restricted in the type of persons or entities comprising its membership.

Although this distinction has significant estate planning implications, it also has the effect of restricting the pool of available equity capital. In light of the increasing aggressiveness of retirement plans and tax-exempt entities, opening up equity ownership to these entities provides much needed flexibility to S corporations. Given the globalization of financial markets, however, precluding foreigners from equity participation may be a significant impediment to expansion. Moreover, recent trends in industry point toward increased use of outsourcing and partnering, thereby increasing the

likelihood of potential equity financing from large C corporations--which an S corporation cannot make use of.

In practice, LLCs may have less flexibility in this regard due to other tax provisions. For example, the partnership tax scheme may expose a nonresident alien to U.S. income and estate taxes, [FN12] require a tax-exempt organization to pay income taxes on its share of income, or establish a nexus so that a C corporation is subject to state tax. These practical limitations imposed on LLCs are preferable, however, to the per se restrictions imposed on S corporations for one important reason--in any given situation, practical issues may not be present or may be overcome.

Nature of financing.

Several restrictions impede the use of creative financing techniques by S corporations. Although differential voting rights are permissible, [FN13] an S corporation may issue only one class of stock. [FN14] This precludes the use of special allocations, preferred returns, and other features that enable an entity to adjust its cost of capital to a perceived optimum. The use of a partnership of multiple S corporations may partially alleviate this drawback, but such a structure entails the disadvantages discussed above. Moreover, whatever special features are provided would be embodied in a partnership agreement as opposed to the equity instrument itself, and this may or may not provide identical legal protections.

A second set of restrictions concerns debt financing. Creative debt financing may include participation features, conversion privileges, options, and other equity-flavored attributes. The use of straight debt will avoid any second class of stock issue. Despite the fact that the 1996 legislation has significantly expanded the potential use of straight debt by including financial institutions as eligible creditors, straight debt hardly allows room for creativity. [FN15] Options and conversion features will not, by themselves, terminate an S election, but they will do so if exercised by ineligible persons. [FN16] In the event debt is, for tax purposes, reclassified as equity, an LLC faces income and loss allocation issues. Prior allocations of income and loss may be shifted among the debt holder and members, and members' basis will be reduced to account for the decrease in debt. An S corporation faces a much more draconian result--loss of its S status if the putative debt holder is an ineligible shareholder. Because entity-level taxes may be imposed on the corporation, *291 a lender would be expected to be more reticent in taking on this risk because the asset position of the borrower may be directly and adversely affected.

If an obligation is satisfied by issuing equity, the consequences to an S corporation are clear and unfavorable. Unless the lender is an eligible shareholder, the S election will terminate. Moreover, except where the corporation is insolvent or bankrupt, the excess of the discharged debt over the value of the equity issued will result in income under Section 108(e)(8). Although not free from doubt, it is arguable that Section 721 will allow an LLC to avoid discharge of debt income. The discharge of debt will result in a constructive distribution to the members. Depending on the members' basis, this result may trigger gain. [FN17]

Finally, members of debt-financed LLCs enjoy the benefit of obtaining additional basis for their share of entity-level debt. [FN18] The determination of members' share of debt is made under the complex Section 752 rules and will depend on which members bear the economic risk of loss with respect to such debt. If no member bears such risk, the debt is allocated under the nonrecourse debt rules. [FN19] In contrast, an S corporation shareholder does not obtain additional basis for entity-level debt, [FN20] regardless of whether the debt is guaranteed by the shareholders. Because a member's or shareholder's basis provides the limitation for the ability to absorb both losses and tax-free distributions, this distinction is a major advantage for the LLC form-- particularly highly leveraged businesses.

S corporation shareholders do obtain additional basis for loans made by them to the corporation. Consequently, third-party financing may flow directly to shareholders who, in turn, reloan the proceeds to the corporation. Practical difficulties can arise in implementing this technique. If multiple shareholders are involved, the documentation burden can become significant. Also, care must be taken that the substance matches the form of the transaction. Finally, collateralization could be problematic as shareholders may be required to expose personal assets to creditors. Moreover, if the shares serve as collateral, a host of legal issues may arise--such as voting rights--that would otherwise not be present in a traditional corporate loan setting.

Asset flexibility.

In two respects, LLCs provide greater latitude with respect to the type of assets that may be contributed by owners. For tax years beginning before 1997, an S corporation cannot be a member of an affiliated group of corporations. Consequently, stock of an 80% or more controlled corporation cannot be contributed. This could be a problem if the S corporation's operations are dependent on another entity, e.g., a supplier or distributor. If the shareholdings of the entity are not closely mirrored by the shareholdings in the S corporation, it may be difficult to assure all shareholders that the essential relationship will be maintained indefinitely.

Effective for tax years beginning after 1996, an S corporation may own stock in a "qualified Subchapter S subsidiary." To qualify, the subsidiary must be a domestic corporation, be wholly owned by the S corporation, and the S corporation must elect to treat the subsidiary as a qualified Subchapter S subsidiary. [FN21] The separate existence of the subsidiary is ignored and its assets, liabilities, and items of income, deduction, and credit are treated as belonging directly to the parent corporation. [FN22] In addition, the 1996 legislation has removed the prohibition on S corporation membership in an affiliated group of corporations. Dividends from 80%-or-more-owned corporations will not be treated as passive investment income for purposes of Section 1362 to the extent attributable to earnings and profits of an active trade or business. [FN23] The removal of the affiliated group restriction provides much needed flexibility in cases where qualified Subchapter S subsidiary status is not possible and eliminates one of the significant advantages enjoyed by LLCs. For example, 80%- or-more interests in foreign corporations can be held by an S corporation. Moreover, holdings in domestic corporations with

minority interests will be possible--a potentially significant change in an age of continuing relationship investing with suppliers and customers.

To a greater extent than S corporations, LLCs may take assets subject to debt or assume debt on an asset contribution without triggering income recognition to the contributing owner. A decrease in a member's individual liabilities by reason of the assumption of liabilities by the LLC is deemed a distribution of money to the *292 member. [FN24] As such, relief of a member's individual liabilities will trigger gain only if the deemed distribution exceeds the member's basis in the LLC. [FN25] Because a member's basis in the LLC will include his or her share of the LLC's debt, at least a portion of the debt assumed will find its way back into the basis of the interest. Moreover, depending on the method selected for determining Section 704(c) allocations, it is quite possible the majority of the debt will be allocated to the partner from whom it was relieved. In the S corporation context, liability relief is governed by Subchapter C rules, in particular Sections 351 and 357. Not only does Section 351 impose an 80%-control requirement, but it also is less flexible with respect to liability transfers. In general, liabilities assumed, or to which contributed property is taken subject to, will require recognition of gain to the extent such liabilities exceed the adjusted basis of contributed assets. [FN26]

Example 1. Abel and Baker form a limited liability company, AB, with each owning 50% membership interests. Abel contributes \$500,000 in cash and Baker contributes land, building, and intangible assets with an FMV of \$1.5 million, subject to \$1 million of nonrecourse liabilities. The property contributed has a basis to Baker of \$800,000. AB's governing document contains no special provisions for allocating liabilities. If AB elects the traditional method or the traditional method with curative allocations under Reg. 1.704-3(b)-(c), Baker will have no gain on the contribution of the encumbered property. His basis in the partnership is \$300,000 (\$800,000 (basis of the property contributed) + \$500,000 (his share of AB's liabilities) - \$1 million (debt from which he was relieved)). If the remedial method of allocation was chosen under Section 704(c), his share of AB's debt would increase to \$850,000 because the first \$700,000 of debt (the built-in gain on the property) would be allocated to him. His basis would increase to \$650,000. If Abel and Baker had formed an S corporation, Baker would recognize a gain of \$200,000 (the excess of the debt relief over the basis of the assets contributed).

Marketability.

In addition to the flexibility afforded LLCs in raising equity, they also have two advantages that serve to enhance the marketability of equity investments.

1. The broad latitude Subchapter K provides in allocating income and losses among partners.
2. The ability to give a purchasing member the benefit of a step up in the basis of assets.

An LLC may allocate income and loss to members pursuant to its operating agreement, provided such allocations have substantial economic effect. [FN27] The detailed nature of these rules offer a measure of security that, if the rules are meticulously followed, allocations will be respected. Not only may preferred returns be provided, but allocations

may be tailored to take into account the different tax postures of the individual participants. So long as the allocations are not transitory or merely shift tax consequences, they will be respected. [FN28] An S corporation may issue only one class of stock and must allocate income and loss on a per share basis. [FN29]

In addition, Subchapter K provides a mechanism that ameliorates the potential for a cash-contributing partner to be charged with the pre-contribution gains attributable to the assets held by the LLC. Section 704(c) provides that the taxable gain or loss inherent in the property at the time of contribution must be allocated to the contributing member. Moreover, for depreciable or amortizable property, cost recovery deductions must be allocated to eliminate book-tax disparities. [FN30] This generally results in additional depreciation or amortization deductions to the cash-contributing partner. The Section 704(b) regulations provide similar rules in the event a cash contribution is made to an existing partnership. [FN31]

No such provision exists in the S corporation context. A cash-contributing shareholder will bear a portion of the tax consequences that are inherent in the properties held by the S corporation. This distortion will be corrected only when the shareholder disposes of his or her stock. Consequently, the timing and character of income and loss may differ markedly. Whether this effect is reflected in the price paid for the stock depends on the bargaining power and relative tax savvy of the participants.

Example 2 Assume the same facts as in Example 1, except that Baker contributed property with a value in excess of basis. The entire discrepancy is allocable to the building. *293 For simplicity, assume that AB elects the alternative depreciation system and depreciates the building over 40 years. At formation, Abel's capital account for book and tax purposes will be \$500,000. Baker's book capital account will also be \$500,000 but his tax capital account will have a \$200,000 deficit (\$800,000 basis of property contributed - \$1 million debt relief). Section 704(c) results in depreciation allocations that will eliminate the \$700,000 disparity between Baker's book and tax capital accounts. Annual book depreciation is \$37,500 ($\$1,500,000 / 40$), which is allocated \$18,750 to each partner. Tax depreciation is \$20,000 ($\$800,000 / 40$). This is allocable \$18,750 to Abel and \$1,250 to Baker. As a result, Abel's tax and book capital accounts remain in parity while Baker's depreciation allocation will reduce his book-tax disparity by \$17,500 per year, or the entire \$700,000 discrepancy over the 40-year life of the building. If the ceiling rule had applied, depending on which Section 704(c) allocation method was chosen, the book-tax disparity may not have been totally eliminated. If AB were formed as an S corporation, both Abel and Baker would share equally in the \$20,000 tax depreciation, allowing Baker, in effect, to shift a portion of the pre-formation appreciation to Abel. Abel would not recoup the difference until he disposes of his stock.

The second marketing advantage that may be presented to equity investors is the ability to obtain a step up in basis in assets if they pay a premium over book value when they purchase an interest from existing members. Section 743 allows the LLC to elect to adjust the basis of its assets for the benefit of the contributing member. This is of heightened importance in light of Section 197. Section 197 provides 15-year straight-line recovery of certain intangible assets. In particular, goodwill, going-concern, and customer-based

intangibles (assets whose value are likely to exceed basis to a significant degree) qualify for this treatment. [FN32] Moreover, the restrictive anti-churning rules of Section 197(f)(9) do not apply to basis adjustments under Section 743. [FN33] Therefore, the partner triggering the Section 743 adjustment may obtain the benefits of Section 197 even though the partnership as a whole is ineligible.

Exit flexibility.

Subchapter K offers significant advantages to LLC members in exiting the business. Participants may desire to end their involvement for various reasons and exit strategies may be implemented in one of several ways. The LLC structure generally presents fewer tax obstacles than the S corporation form.

Disposition of a minority interest.

The relative advantage of LLCs over S corporations is most pronounced when a member holding a minority interest seeks to end involvement with the business. As discussed above, if the exiting member sells or exchanges his or her interest, any premium paid by the purchasing partner may be reflected in the inside basis of the assets under a Section 754 election. In many closely held firms, however, the LLC itself offers the only market for the interest. This may be the result of contractual restrictions, such as a mandatory redemption agreement, or may merely reflect market realities. LLC redemptions offers three advantages over S corporation stock redemptions.

1. Under Section 734, the LLC may elect to step up the basis of its assets for any premium paid to the departing member. Although Section 734 adjustments are commonly viewed as analogous to Section 743 adjustments, several distinctions between the two exist. Unlike Section 743 adjustments, the basis step up benefits all remaining members of the LLC. In addition, certain differences exist between the two in the mechanics of allocating the adjustments. [FN34] Section 734 transactions will also affect the members' capital accounts maintained for Section 704(b) purposes while Section 743 adjustments do not. [FN35] A distinction between the two adjustments is that the ability to amortize Section 197 assets may be precluded in the Section 734 context because the composition of the remaining members will be unchanged, causing the anti-churning rules to apply. [FN36]

2. An LLC has the almost unfettered ability to liquidate a member with property distributions without negative tax consequences. This is particularly helpful if the departing member wishes to take a particular business segment. Unlike S corporation distributions, no income or loss is recognized by an LLC as a result of property distributions. [FN37] The only consequence to the entity is the potential for triggering a Section 734 adjustment if the basis of the distributed property in ***294** the hands of the departing member differs from the LLC's basis in the property. [FN38] The recipient of a property distribution will recognize no gain or loss on the distribution except in certain circumstances when marketable securities are distributed or when only cash, unrealized receivables, and inventory are distributed. [FN39]

Several exceptions to the general non-recognition rules exist, the most significant of which applies to situations in which liquidating distributions result in a shift of so-called "hot assets" between the departing member and remaining members. The existence of these assets provides S corporations with a relative advantage in certain situations (discussed below). Another

exception applies when the distributed property was contributed by another member within five years of the distribution. [FN40]

3. Section 736 allows the parties to structure a portion of the payments as either distributive shares of LLC income or guaranteed payments, rather than payments for property. The practical effect of this is to allow an immediate writeoff of the purchase price represented by such payments. To the extent the payments are treated as payment for partnership property, the departing member has the added advantage of recovering his or her entire basis before reporting gain on the transaction. [FN41] In contrast, an S corporation shareholder entering into a deferred buy-out arrangement at best may report the gain on the installment method. Furthermore, both the corporation and the shareholder will need to concern themselves with the unpleasanties of the original issue discount rules.

Disposition of entire business.

If a business is disposed of by way of an asset sale, both forms yield similar results--entity level gain on the disposition of assets, which flows through to the owners. The corresponding increase in the members' or shareholders' bases assures the avoidance of a double tax. Of course, this assumes the S corporation is not subject to the built-in gains tax. When the transaction is structured as a sale of equity interests--either stock or membership interests--the similarity ends.

The purchase of all members' interests in an LLC will result in a termination of the LLC for tax purposes. [FN42] The LLC is deemed liquidated, so the purchaser obtains a step up in the basis of the assets under Section 734(b). Recently issued Proposed Regulations change the effects of a partnership liquidation but, as explained below, do not eliminate the potential for basis distortions. A purchase of stock will not affect the entity's continued existence nor will the purchaser enjoy a step up in the inside basis of the assets. As discussed in more detail below, however, an S corporation may actually have the advantage in this situation for two reasons. The seller of corporate stock may be at a distinct advantage over the seller of membership interests with respect to capital gain reporting, and a corporate purchaser may make a Section 338 election which, in some cases, may actually yield more favorable results than that yielded by the constructive partnership liquidation rules.

***295 Compensation Flexibility**

Both the restriction on the number of shareholders and the one class of stock requirement severely impede an S corporation in its ability to tailor compensation arrangements for its executives. Deferred compensation arrangements, such as phantom stock plans, will not violate these requirements and may provide a reasonably palatable substitute for equity. Many prospective employees may demand the real thing, however. Legally, contractual rights under a deferred compensation arrangement may offer less security than the property rights embodied in the equity itself. Perhaps more important is the distinction that may be drawn psychologically by the recipient.

Equity interests issued in exchange for services will result in taxable compensation to the recipient in both settings. If the equity interest is nontransferable and subject to

substantial risk of forfeiture, the taxable event will be postponed under Section 83, assuming no Section 83(b) election is made.

The LLC form offers two distinct advantages over S corporations. LLCs may tailor a capital interest to achieve its operational objectives. The capital interest may contain preferred returns or may be tied to the profitability of particular segments of the business. So long as the substantial-economic-effect Regulations are met, there is no limit to the creativity that may be exhibited. The one class of stock requirement nixes this possibility for the S corporation. An LLC can also issue an employee a profits interest without triggering immediate tax consequences. A profits interest is one where the recipient would receive nothing if the entity were liquidated at its FMV on the date the interest was received. The IRS has recently lifted the cloud of uncertainty that floated above these arrangements. [FN43]

The drawback to LLC compensatory equity issuances is that the LLC will be deemed to have sold a pro rata portion of its assets in exchange for services, [FN44] so the LLC will have a compensation deduction partially offset by gain on the sale of assets. As a corporate entity, an S corporation will obtain the compensation deduction without a deemed asset sale. [FN45] Additional flexibility is provided to S corporations in that they may offer the full complement of qualified employee fringe benefits to employees owning not more than 2% of the corporation's stock—a potentially valuable benefit to executives with minor equity holdings. [FN46]

Example 3. S corporation and LLC have identical balance sheets, presented below. Both entities wish to give an immediately vested, 10% capital interest to a key executive.

Item	TAX BASIS	FMV
Current assets	\$100,000	\$100,000
Machinery and equipment	250,000	250,000
Land and building	750,000	900,000
Intangible assets	0	500,000
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Total	\$1,100,000	\$1,750,000

Both entities would obtain a \$175,000 compensation deduction. The LLC, however, will recognize a \$65,000 gain on the transfer of a 10% membership interest to its executive because the LLC will be deemed to have sold 10% of its assets. Both the deduction and the gain are allocable to the existing members. Although the assets deemed sold will obtain an FMV basis, this hardly makes up for the recognition of gain. Moreover, administrative complexity will be created as a result of the basis disparity, particularly Section 704(c) issues. No gain arises for the S corporation on the issuance of stock under Section 1032. If an interest in future profits was in question, neither the LLC nor the executive would incur immediate tax consequences.

Estate planning

The restrictions on who may own S corporation stock seriously impede wealth transfer planning for the corporation's shareholders. Because of the draconian nature of the federal estate and gift tax rates, the flexibility offered by LLCs is extremely important. The fact that most planning for S shareholders is post-mortem supports the notion that possibilities are limited before death. The only trusts that may own shares in an S corporation are those treated under Subchapter J as owned by an individual who is a citizen or resident of the U.S., voting ~~*296~~ trusts, qualified Subchapter S trusts, and, after 1996, electing small business trusts. [FN47] The addition of small business trusts will alleviate many problems for the estate planner because such trusts do contain the restrictive provisions of qualified Subchapter S trusts—although they may create income tax problems. [FN48] Qualified Subchapter S trust status is elective for trusts that meet very stringent and relatively inflexible income and corpus distribution requirements. Special rules are provided that will not disqualify a trust from holding the shares after the death of the deemed owner, but only for 60 days or, in certain circumstances, two years. [FN49] Testamentary trusts may also hold S corporation stock, but only for sixty days beginning on the date of transfer. [FN50] The new legislation extends the above 60-day periods to two years in all cases.

These narrowly drawn exceptions make it more difficult to plan wealth transfers with respect to S corporation stock than LLC interests. Ironically, one of the more popular techniques that is off limits to S corporation shareholders is the use of family limited partnerships. Properly drawn, these vehicles serve multiple goals, including the retention of control of the business in the hands of select individuals, the possibility of a minority discount valuation, and the potential for enhanced protection from creditors.

State taxes

It is difficult to provide useful generalizations as to relative advantages of S corporations and LLCs with respect to state taxes not only because of the disparity among state taxing schemes, but also because one form may provide advantages at the entity level while, at the same time, proving disadvantageous to the equity owners. At the entity level, several issues must be examined, including whether the state in question treats S corporations and LLCs as pass-through entities; whether taxes are imposed on capital stock or other non-income base; and whether LLCs are taxed as partnerships and, if not, whether an S election may be made for LLCs for state tax purposes.

If LLCs are taxed as partnerships for state tax purposes, the LLC will generally be preferable to an S corporation since many states impose non-income based capital stock or franchise taxes on corporations but not partnerships. Moreover, in many states the federal rules are followed, thereby allowing the Subchapter K tax advantages to flow down to the state level. Some states, however, may impose a minimum tax on LLCs (e.g., New York and Tennessee) so even here it is difficult to generalize. It is foolhardy not to investigate fully the state tax ramifications in all states in which the LLC may do business.

At the equity owners' level, a different set of issues should be addressed. States vary in their treatment of partnership interests and S corporation stock for purposes of

establishing nexus. Owners who otherwise would not have sufficient nexus to be subject to a jurisdiction's tax may find their LLC membership will create such a nexus. In addition, in states that do not automatically piggyback federal S status (e.g., New Jersey, Pennsylvania, and Georgia) it may be advantageous for the corporation to resist electing state S status. If the corporation does not anticipate significant distributions, the corporate level state tax may be less than the individual tax that would have been imposed had an S election been made. This could be the result when, for example, the corporation apportions most of its income to low-tax-rate states. Finally, owners should not dismiss as inconsequential the administrative burdens of holding an interest in a pass-through entity operating in multiple jurisdictions. Whether the states differ in allowing composite filings for S corporations and LLCs, and whether distinctions are made between the two for nonresident tax withholding should also be considered.

Situational planning with S corporations

There are three possible reasons S corporations continue to be formed. One is that many S corporations are formed by default because of a lack of information by their promoters and advisors. Because the LLC is relatively new, many practitioners may not be that comfortable with, or even cognizant of, the LLC form. The other two reasons are situational factors, which may be categorized broadly along tax and non-tax lines.

Tax factors favoring an S corporation.

As the discussion above points out, in general, the LLC structure provides owners with a number of advantages when the time comes to dispose of their interests in the venture. An obvious advantage enjoyed by S corporation shareholders ***297** is the ability to exchange their shares tax free under the corporate reorganization provisions. LLC members may receive stock tax free only if the transaction qualifies under Section 351.

Also, gain on the sale of corporate stock is capital gain unless the corporation is a collapsible corporation. To be collapsible, a corporation must meet both an objective test based on income realization and a subjective test based on the intent of the promoters in forming or availing themselves of the corporation. [FN51] The collapsible corporation rules are relatively easy to avoid. If the collapsible corporation rules do not apply, the composition of the entity's assets is building for purposes of characterizing the gain from the sale or exchange of the corporate stock. Amendments made by the 1996 legislation would apply Section 751 to charitable contributions of S corporation stock for purposes of determining the capital gain component of charitable contributions, but otherwise Section 341 continues to govern this issue. [FN52]

In contrast, the Section 751 collapsible partnership rules contain no subjective test and automatically apply if the entity has "hot assets." "Hot assets" include unrealized receivables and substantially appreciated inventory. Unrealized receivables are accrued income items not yet recognized for tax purposes and income that would be treated as ordinary income under a host of recapture rules, including Section 1245. [FN53] Substantially appreciated inventory is inventory whose FMV exceeds 120% of its basis. [FN54] Inventory is defined expansively so that other items, not inventory in the

traditional sense, are included to increase the likelihood of meeting the 120% test. [FN55] If hot assets exist, any gain attributable to them is recharacterized as ordinary income. This recharacterization may also result in recasting an overall gain as a combination of ordinary income and capital loss.

Although Section 751 is not new, its application to LLCs may be particularly problematic. The proliferation of LLCs has expanded the reach of Subchapter K to industries that have traditionally used the corporate form. In particular, enterprises using the LIFO method for inventories may find that Section 751 gives back much of what the LIFO method provided in the way of tax benefits. Secondly, Section 197 is a new provision whose effect has not yet been felt by most firms. Because amortization deductions are subject to Section 1245 recapture, [FN56] it is likely that owners of firms with significant amortizable intangibles will find Section 751 an unwelcome intrusion into their tax strategies.

Example 4 Seller disposes of an LLC interest and S corporation stock. The asset composition of the two entities are similar. Both use the LIFO method of valuing inventory and the FMV of the seller's proportionate share of such inventory exceeds its LIFO value by \$100,000. The inventory's value exceeds its basis by more than 20%. Moreover, the entities have amortized Section 197 assets that have appreciated in value. Seller's share of such amortization is \$50,000. Seller realized \$500,000 from each sale and his adjusted basis in each asset was \$200,000. If the S corporation is not collapsible, the entire \$300,000 gain is a capital gain. The sale of the LLC interest will result in \$150,000 of capital gain and \$150,000 of ordinary income because of the hot assets.

Another advantage enjoyed by S corporation shareholders is the ability to obtain ordinary loss treatment on the sale of Section 1244 stock. This benefit should not be exaggerated. It is limited to shareholders to whom the stock was originally issued and the benefits are capped at \$100,000 and \$50,000 annually, for joint and single filers, respectively. [FN57] In addition, its provisions apply only to stock issued before the corporation's capital and paid in surplus exceeded \$1 million. [FN58] Moreover, because S corporation losses reduce the basis of stock in the hands of the shareholders much—but not necessarily all—of the depreciation in the value of the stock will have already been reflected in the stock's basis. Finally, because Section 1244 is beneficial only if a loss ensues, this provision is difficult to introduce into the tax planning process. Most clients discount the possibility of loss.

Corporate status will facilitate a public offering. S corporations offer several advantages in this respect. The corporate form is the preferred form for public entities. With few exceptions, Section 7704 will tax a publicly traded LLC as a corporation. Also, the market is generally more comfortable with corporations *298 and the relative youth of LLCs will insure that this corporate bias will continue for some time.

While the flow-through status will be lost for both forms of business, it is far easier to shepherd an S corporation through a public offering. Although the termination of S status will require interim income and loss allocations and separate S and C year returns, neither the corporation's basis or holding period in its assets will be affected. In addition, the

entity will most likely avoid the legalities of asset transfers or contractual assignments. [FN59] On the other hand, an LLC will need to incorporate. The manner in which the LLC is incorporated can have significant effects on the assets' basis and holding periods. [FN60] To insure tax-free status, the incorporation and underwriting must be structured so that the Section 351 control test is met--a task made easier by recently issued final Regulations. [FN61] Moreover, assets and contracts must be transferred to a new entity, which may pose practical problems. These are not insurmountable issues for LLCs--merely more expensive and time consuming.

Basis adjustments.

Acquirers of LLC interests may obtain a basis adjustment to reflect the purchase price paid for the underlying assets. As discussed above, no such option is available for stock purchasers. When a corporate acquirer may avail itself of a Section 338 election, however, an S corporation may make a more attractive target. This is because of the byzantine nature of the Section 743 and 732 basis allocation rules. Section 338 provides that a corporate acquirer of 80% or more of the voting power and value of a target's stock may elect to treat the target as having sold its assets to a new corporation at FMV. Because the gain on the deemed asset sale is reportable by the acquirer, Section 338 is useful only in limited situations. [FN62] One is where the overall gain on the deemed sale is modest, but the target's asset composition is such that assets with a short recovery period are stepped up and long-lived or non-amortizable assets, such as land, are stepped down.

The purchase of 80% or more of an LLC will terminate the LLC for tax purposes, resulting in a deemed liquidation of the LLC and formation of a new one. [FN63] The basis of the assets in the new LLC will be determined by Section 732, which will result in the allocation of the purchase price to the assets received in the deemed liquidation based on the relative basis of the assets inside the LLC. The inside basis of the assets will already have reflected the purchase price paid either through an elective Section 743 adjustment or an elective Section 732(d) adjustment. These elective adjustments, however, may not eliminate basis distortions due to the mechanics of allocating the adjustments among the assets. In general, assets are divided into two classes, capital or Section 1231 assets and all others. [FN64] Among and within the classes, adjustments must all go in the same direction--all upward or all downward. [FN65] Consequently, assuming a premium purchase price, if particular assets have decreased in value, these decreases are not reflected in the basis of those assets but make their way into the basis of appreciated assets.

Recently issued Proposed Regulations modify the termination rules to treat the terminated partnership as contributing the assets to the new entity and then liquidating by distributing the partnership interests in the new entity. [FN66] Although this change will avoid the basis anomalies of Section 732 and simplify Section 704(c) accounting, it does not remove the distortion caused by the mechanics of Section 755 nor will it solve the accounting-method problems discussed below.

Example 5 The assets of an entity that have appreciated are limited to capital and Section 1231 assets. The company has goodwill and other customer- based intangibles

valued at \$10 million for which the company has a zero basis. The company also has land with a basis of \$500,000 that is now worth only \$200,000. If the entity is taxed under Subchapter K, a purchaser of all the partnership interests will be required to keep the land's basis at \$500,000 and, in effect, reduce the intangibles' basis by the \$300,000 depreciation in the land. Consequently, cost recovery deductions will be reduced and will not be recouped until the land is sold. In the context of a Section 338 election, a buyer would write down the land and adjust the intangibles to reflect their full value.

A buyer could easily avoid this result by acquiring the assets of the entity directly. A buyer may also avoid this result by requesting IRS permission to allocate the purchase in a fashion comparable to Section 1060. [FN67] Finally, Example 5 assumed the buyer did not want the result obtained. If the land were to be sold relatively quickly, the buyer may actually prefer this result.

~~*299~~ An often overlooked issue is the effect of constructive termination on the remaining participants in the entity. The Proposed Section 708 Regulations remove the basis distorting effect of Section 732(c) for remaining participants. However, the administrative burdens imposed by a constructive termination--including duplicative tax closings and new elections--are not trivial. In addition, a termination may result in the loss of favorable tax attributes even though asset basis issues may not be of concern. For instance, an existing LLC may have several historical LIFO layers. A termination of the partnership will result in a merging of the separate layers into a new base layer. As a consequence, in periods of rising prices, subsequent layer liquidations will result in cost of goods sold reflecting a lower average base year cost rather than the costs associated with more recent, higher-priced layers. In addition, entities eligible to use favorable ACRS recovery methods for realty will find themselves subject to the extended lives of MACRS. [FN68]

Administrative complexity.

The tremendous flexibility Subchapter K affords comes at the price of inordinate complexity. The maintenance of capital accounts under Section 704(b), tracking 704(c) allocations and 743 adjustments, and making sense of the debt allocation rules of Section 752 are merely some of the challenges. Complexity is never a reason to forgo tax benefits, but neither should the advisor ignore its cost. If many of the benefits of Subchapter K will go unused, Subchapter S is a viable alternative. Subchapter S is by no means straightforward but compared to Subchapter K, it offers simplicity.

Using inflexible rules as a shield.

Rigidly applied rules inevitably fail to reflect economic reality in all cases. Sometimes this failure is a friend of the tax planner. Obtaining a result that fails to make economic sense is supportable when a rule forces such a result. An opportunity for such planning is offered by the lack of a Section 704(c) type rule in the S corporation context. In the proper circumstances, income and loss shifting among shareholders may take place that would be unavailable to members of an LLC.

Example 6. Refer to Example 2 with Abel and Baker. In the S corporation context, Baker obtained \$17,500 of depreciation deductions he would not be entitled to under the Subchapter K provisions. In the right circumstances this may be desirable. If Abel has large NOL carryforwards, this result may be preferred. Alternatively, Abel may be a passive investor with significant unused passive losses. In either instance, Subchapter S offers the parties the ability to take advantage of its inflexibility.

Miscellaneous issues.

Several issues arise because the Code contains no provisions dealing explicitly with LLCs. The precise scope of LLC partnership tax treatment is not entirely clear. Fortunately, as time passes, more and more issues will be clarified. General partners are subject to self-employment tax on their distributive share of partnership trade or business income. [FN69] Limited partners are subject to the tax only to the extent they receive guaranteed payments attributable to services. [FN70] S corporation shareholders, as such, are not subject to self-employment tax. With the elimination of the earnings cap for the Medicare portion of the self-employment tax, S corporation shareholders are at a competitive advantage compared to general partners. Although shareholder-employees are subject to attack for receiving unreasonably low compensation, this advantage should hold when the corporation derives significant earnings from capital, including the human capital of non-shareholder employees.

Proposed Regulations resolve the self-employment tax issue with respect to LLC members by focusing on the members' role in managing the LLC. A member will be treated as a limited partner for self-employment tax purposes if that member is not a manager, the LLC could have been formed as a limited partnership, and the member in question could have qualified as a limited partner under local law. [FN71] Exactly what rights and powers will make a member a manager is not clear, so some uncertainty still exists. In general, however, the S corporation form continues to offer advantages in this regard for owners active in the business.

As discussed previously in the context of Section 736 payments, certain tax results depend on the classification of a member along traditional³⁰⁰ limited liability classifications into which LLC members do not neatly fit. Two other examples of this phenomenon are the eligibility of LLCs to use the cash method and whether LLC members, for passive loss purposes, will be deemed limited partners. The cash method, if otherwise available, [FN72] will be off limits if the LLC is a "tax shelter." "Tax shelter" is broadly defined to include entities where more than 35% of the losses are allocable to limited partners or to persons not actively participating in management. [FN73] The IRS has ruled favorably on the ability of LLCs to use the cash method. [FN74] Unfortunately, its rationale has been inconsistent, so practitioners must continue to deal with this issue in a fact-specific manner.

The passive activity loss Regulations make it difficult for limited partners to meet the material participation requirements. In general, a limited partner will be a material participant only if he or she spends at least 500 hours in the business during the year. [FN75] S corporation shareholders are subject to less stringent rules in that meeting any

one of the threshold participation tests provided for in the Regulations is sufficient. [FN76] Although this issue will not pose concern for members working full time in the business, it may create problems for members with multiple business interests, none of which occupies at least 500 hours of their time. At this point, no direct guidance has been issued on how the material participation Regulations will be applied.

Non-tax issues.

Because the proliferation of LLCs is a relatively recent phenomenon, many non-tax legal issues remain unresolved. Moreover, many parties may be reticent in dealing with LLCs, effectively raising the cost of doing business for LLCs. With time, this problem should diminish but, for the present, it cannot be ignored.

Two of the more significant non-tax issues are how states will resolve conflict of laws and attempts to pierce the limited liability shield. Some states provide clear choice-of-law rules but many do not, thereby creating uncertainty as to whether foreign jurisdictions will apply the law of the domiciliary or their own. Corporate law has a well-developed body of law for piercing the corporate veil and imposing direct shareholder liability. One would expect an analogous body of law to develop for LLCs, but it is too early to say whether courts will find reasons to pierce an LLC. Similarly, because of the flexibility provided with respect to centralized management, the LLC form may create problems for members with respect to CERCLA liability.

Further uncertainty is created by lack of precise guidance with respect to members' duties to each other and to the entity. Duty of loyalty and care requirements are well-developed corporate concepts. Because LLCs resemble corporations in some respects but differ markedly in others, the extent that corporate law will be a relevant precedent is unclear. Corporations also offer greater certainty in retention and transfer of contractual benefits. The likelihood that an LLC will dissolve under state law is far greater than the likelihood of a corporate dissolution. This raises issue as to whether existing contracts, e.g., title insurance, may need to be amended. Barring a change in control provision in a contract, transfers of stock do not effect the corporation's contractual rights and obligations, while such changes may require the LLC to obtain third party consent to retain the contractual benefits. The novelty of the LLC form may also give the LLC difficulty in borrowing, or at least make it more expensive to do so, because lenders are not as familiar with the documentation required and the fact that the application of bankruptcy law to LLCs is not entirely clear.

Conclusion

In general, tax planners will prefer the LLC form of business over S corporations. The more flexible provisions of Subchapter K will generally offer LLC members a variety of tax benefits. Significant opportunities exist, however, for tax advisors, particularly in light of the improvements made by recent legislation, to find the exceptional cases where, despite all that has been said, S corporations will retain their vitality. As always, generalities are no substitute for fact-intensive tax planning.

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FN1 1995-1 CB 501.

FN2 Prop Reg. 301.7701-3(a).

FN3 Pub. L. No. 104-188, 8/20/96.

FN4 Section 1361(b)(1)(A).

FN5 See Section 7704.

FN6 Prop. Reg. 301.7701- 3(b)(1)(ii).

FN7 1994-2 CB 198.

FN8 Rev. Rul. 77-220, 1977-1 CB 263 .

FN9 Sections 1361(b) and (c).

FN10 Section 1361(b)(1)(B).

FN11 Section 1361(e)(1).

FN12 See Section 1446(b).

FN13 Section 1361(c)(4).

FN14 Section 1361(b)(1)(D).

FN15 See Section 1361(c)(5)(B).

FN16 Reg. 1.1361- 1(l)(4)(iii)(B)(1).

FN17 Section 752(b).

FN18 See Sections 722, 752(a).

FN19 See Reg. 1.752-3.

FN20 Section 1367(a).

FN21 Section 1361(b)(3)(B).

FN22 Section 1361(b)(3)(A).

FN23 Section 1361(d)(3)(F).

FN24 Section 752(b).

FN25 Section 731(a)(1).

FN26 Section 357(c)(1).

FN27 Section 704(b).

FN28 See Reg. 1.704-1(b)(2)(iii)(b) and (c).

FN29 Section 1366(a).

FN30 Reg. 1.704-3(b)(1).

FN31 Reg. 1.704-3(a)(6).

FN32 Section 197(d).

FN33 Section 197(f)(9)(E).

FN34 Compare Reg. 1.755-1(b)(1) with Reg. 1.755-1(b)(2).

FN35 Reg. 1.704-1(b)(2)(iv)(m)(4).

FN36 See Section 197(f)(9)(E).

FN37 Section 731(b).

FN38 See Sections 734(b)(1)(B) and (2)(B).

FN39 See Sections 731(a)(2) and (c).

FN40 Section 737(a).

FN41 Reg. 1.736-1(b)(1).

FN42 Section 708(b)(1)(B).

FN43 See Rev. Proc. 93-27, 1993-2 CB 343 .

FN44 See generally McKee, Nelson, and Whitmire, *Federal Taxation of Partnerships and Partners* (Warren, Gorham Lamont, 2d ed., 1990), ¶5.01

FN45 Section 1032; Reg. 1.1032-1(a).

FN46 Section 1372.

FN47 Sections 1361(c)(2)(A) and (d).

FN48 See Section 641(d).

FN49 Section 1361(c)(2)(A)(ii).

FN50 Section 1361(c)(2)(A)(iii).

FN51 Section 341(b)(1).

FN52 Section 170(e)(1).

FN53 Section 751(c).

FN54 Section 751(d)(1)(A).

FN55 Section 751(d)(2).

FN56 See Section 197(f)(7).

FN57 Section 1244(a) and (b).

FN58 Section 1244(c)(3)(A).

FN59 Section 1368.

FN60 See generally Rev. Rul. 84-111, 1984-2 CB 88 .

FN61 See Reg. 1.351-1(a)(3). Rev. Rul. 78-294, 1978-2 CB 141 is rendered obsolete.

FN62 Section 1362(e)(6)(C).

FN63 Section 708(b)(1).

FN64 See Reg. 1.755-1(a)(1)(i).

FN65 See Reg. 1.755-1(a)(1)(ii) and (iii).

FN66 See Prop. Reg. 1.708-1(b)(1)(iv).

FN67 Reg. 1.755- 1(a)(2).

FN68 Section 168(f)(5)(B)(i).

FN69 Section 1402(a).

FN70 Section 1402(a)(13).

FN71 See Prop. Reg. 1.1401(a)-18 .

FN72 See Section 448.

FN73 See Sections 448(d)(3), 461(i)(3)(B), 464(e)(2), and 1256(e)(3)(B).

FN74 See Ltr. Ruls. 9415005 and 9321047 .

FN75 Temp. Reg. 1.469-5T .

FN76 See generally Temp. Reg. 1.469-5T(a).

57 Tax'n for Acct. 289

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