

**LIMITED LIABILITY
COMPANY
&
LIMITED LIABILITY
PARTNERSHIP**

BY

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LIMITED LIABILITY COMPANY (LLC)

DEFINITION OF L.L.C.

Organization formed under STATE law
Shields owners of the LLC known as “members” and management (may be members or “managers”) from personal liability for debts and liabilities of the LLC **entity**

STATE OPERATIONS

As a general rule, LLC statutes authorize the LLC to conduct business in the state in which it is formed, in other states and internationally.

Generally, the LLC statutes provide that the law of the place where the LLC was organized governs the organization, internal affairs and liabilities of the members of the LLC.

★ *Caution----- All 50 States and the District of Columbia have authorized the organization of LLC's. However, since this is such a relatively new form of doing business, it would be advisable to review LLC acts in states where the LLC's business will be conducted outside of the state in which it is formed to ensure that the other state recognizes foreign LLCs, particularly if the LLC is conducting a professional practice, insurance business or other highly regulated business that may not be authorized in a state that otherwise allows other foreign LLCs to do business.*

BASIC ATTRIBUTES OF L L C

- ✓ No limit on number of members (owners), although some states require at least two owners.
- ✓ LLC can have a corporate subsidiary - LLC may own any or all of the stock of a corporation.
- ✓ Generally, any legally recognized “person” may own an interest in an LLC. except a professional LLC where ownership rules are more restrictive.
- ✓ A non-resident alien or foreign country business organization may own an interest in an LLC
- ✓ LLC formed in the U S is not necessarily treated as a partnership in foreign countries (Canada for instance treats LLC as corporation)

LIMITED LIABILITY COMPANY (LLC)

IN GENERAL

LLCs are well suited for entrepreneurial businesses with small number of active investors. All members can enjoy limited liability protection while participating in the business.

LLC is also useful for family businesses that want to maintain control within the family, obtain liability protection and tax benefits of limited partnership, and restrict the transfer of voting rights outside the family.

DRAWBACKS OF LLCs

Must avoid certain corporate characteristics to be taxed as a partnership

Still some uncertainty about IRS applications of certain federal provisions

State tax treatment in states where LLC proposes to do business - possible income or franchise tax imposed on LLCs in some states (Florida and Texas)

CONVERSION OF PARTNERSHIP INTO LIMITED LIABILITY COMPANY (LLC)

Conversion does not terminate the partnership

Conversion is not a sale, exchange, or liquidation of any partnership interest

Partnership tax year does not close

LLC can continue to use partnership ID number.

Conversion may change some of partners' basis in their partnership interests if the partnership has recourse liabilities that become nonrecourse liabilities.

If a decrease in partner's share of liabilities exceeds the partner's basis, he or she must recognize gain on the excess.

The same rules apply if an LLC classified as a partnership is converted into a partnership.

LIMITED LIABILITY COMPANY (LLC)

TERMINOLOGY OF L L C

- ✓ **Members** - owner of an interest in LLC
Can not be a member unless prerequisite approval of the other members
- ✓ **Articles** - Articles of organization must be filed with Secretary of State or similar official containing basic information.
- ✓ **Operating Agreement** - adopted to provide details about the operation of the company and relationship of members to each other. (Similar to a partnership agreement) This may be referred to as “regulations” or “limited liability agreement” in different states.
- ✓ **Interests** - Members have “interests” in an LLC (as partners have “interests” in a partnership). **LLCs do not issue shares of stock.** Some LLC acts refer to interests as “certificated interests” but these are not stock certificates.
- ✓ **Capital Account** - Members in LLC taxed as partnership have “capital account” representing a member’s equity interest in the company. Equal to:
 - Capital contributions to the company (cash and FMV property)
 - Member’s allocable share of company’s income and gain each year (including tax exempt income)
 - Less distributions to member of cash or FMV property
 - Less member’s share of allocable tax losses, deductions and expenditures.
- ✓ **Management** - Members can either designate “managers” or reserve management to themselves. Unless otherwise agreed, members manage in accord with the proportionate interests in the LLC. Managers may function in a manner similar to a general partners.

LIMITED LIABILITY COMPANY (LLC)

CHOOSING THE RIGHT BUSINESS FORM

Choice depends upon many factors. No single “right” answer.

QUESTIONS TO BE ANSWERED:

- ▶ **Where will the business of the organization be conducted**
(Will a LLC be recognized in the foreign state or country?)

- ▶ **Who will own the organization?**
U. S. Residents, foreign citizens, individuals, corporations?
If corporations, LLCs or nonresident aliens will be owners - S corporation is not an option.

- ▶ **How many owners will there be?**
If only one owner
Some states recognize a one owner LLC
IRS determination for one member LLC may be sole proprietorship
If pass through taxation is desired, LLC should not be considered
Unless there are two or more members
Unless taxation as a C corporation is acceptable, the one member LLC should not be formed.
If more than 75 owners - can not be an S corporation.

- ▶ **How do owners expect to finance venture?**
If with debt - LLC may be preferable over S corporation because LLC members may more often include a portion of the LLC’s debt in basis of their interest
C or S corporation shareholders cannot include entity’s debt in basis of their stock even if they guarantee the debt.
If business will need to **retain a lot of earnings** for future capital needs, a C corporation may be preferable to LLC or S corporation if it’s tax bracket is significantly lower than that of its owners. (Be sure the accumulated earnings have reasonable necessity to avoid the accumulated earnings tax.) Since LLC members and S corporation shareholders pay tax on earnings whether or not distributed to them, they could be paying tax on income never received if the business can not or does not distribute the earnings.

- ▶ **Do the owners desire flow-through (pass through) taxation?**
“Flow through” is taxed to members of an LLC/partnership/or S corporation.
Partnership and LLC “pass through” may be subject to SE tax whereas S corporation “pass through” is not currently subject to SE tax.)

LIMITED LIABILITY COMPANY (LLC)

CHOOSING THE RIGHT BUSINESS FORM

QUESTIONS TO BE ANSWERED: (Continued)

- ▶ **Do organizers of the business expect to incur net losses?**
Heavy start up costs, front loaded tax depreciation, overhead in excess of revenues? If owners have income from other sources, participate actively in the business of the entity, or have passive income from other sources, - LLC or S corporation may be best choice of entity.
Regular Corporation losses do not pass through and are carried either back or forward to years when there are profits.

Note: LLC members have more basis against which losses may be used in their LLC interest than S corporation shareholders because LLC members can include their share of LLCs debt in their basis.

- ▶ **Do owners of the organization want to create various classes of equity interests or specially allocate the business income, losses, or other tax attributes to different owners?**

S Corporations may only have one class of stock

C Corporations may have any number of classes of stock but all

Of the holders of the same class of stock generally must be treated the same under state corporate law

LLC treated as a partnership for tax purposes can allocate the income, gains, losses, deductions, credits, or other item among the members in almost any method desired and may be inconsistent from one member to the next so long as the allocations have “substantial economic effect”.

- ▶ **Are the owners concerned about limited liability?**
- ▶ **Do the owners of the business plan to offer employee benefits to those owners who provide services?**

Significant advantage to C Corporation

- ▶ **Is the particular business regulated in a manner that dictates the form of business entity that must be used.**

Professional rules (law, medical, accounting professions?)

LIMITED LIABILITY COMPANY (LLC)

GENERAL TAXATION

An LLC can be taxed as a **“C”** Corporation under the IRC or as a pass-through **Partnership** for federal income tax purposes. (LLC can not be taxed as S Corp)

FRINGE BENEFIT TAXATION

Generally, a C Corporation can deduct fully the cost of health insurance and other qualified fringe benefits for all shareholder-employees and they do not have taxable income attributable to those economic benefits.

LLC taxed as a partnership rules similar to rules for S corporation 2 percent shareholders apply to all of the members of the LLC, regardless of the amount of their capital or profits interest in the LLC

A partner is not considered an “employee” under IRC various tax free employee benefits including group term life insurance, employee death benefits, accident and health plans, and meals and lodging.

Members in LLC can not participate in a cafeteria plan sponsored by the LLC.

TRANSFERABILITY OF INTEREST

LLC (taxed as a partnership) must lack free transferability of ownership interests. LLCs usually restrict transfer of ownership and most of them provide that members must approve any transfer of interest or admission of new members.

Corporations (except professional corporations) generally do not restrict the sale or transfer of stock by shareholders.

LIMITED LIABILITY COMPANY (LLC)

DIFFERENCE BETWEEN LLC AND GENERAL PARTNERSHIP

Formation

LLC - formed by filing Articles of Organization or similar document

General Partnership - Formed by agreement, which may be oral, and no state law requires filing of organizational documents.

(Note: Oregon law requires a copy of partnership agreement to be filed with the Dept of Revenue when partnership is first organized - very seldom is this enforced!!)

LLP - Not a form of doing business!! It is a form or registration of a general partnership but without joint and several liability for the partners.

Liability - Principal advantage of LLC over general partnership

LLC - no member is liable personally for debts or obligations of LLC other than those specifically guaranteed or assumed by the member unless the veil of liability protection can be pierced.

Partnership - Each general partner is subject to joint and several **personal** liability for all of the partnerships' liabilities.

(See LLP next page)

Management and Authority

Generally management about the same for LLC and partnership.

General partners or members have statutory authority to represent and act on behalf of the entity.

LLCs can designated managers and often provide that only the named managers have authority and power to bind the LLC to contract.

State Taxation

Some states impose an entity-level income tax on LLC -

Some states treat LLC same as partnerships (as opposed to corporation)

Allocation of Income and Distributions

Unless otherwise agreed, general rule for partnership is that each partner shares equally in the profit, losses and distributions of partnership

To the contrary, unless otherwise agreed, members in an LLC in many states share in those items in proportion to the value of their capital contributions to the LLC.

LIMITED LIABILITY COMPANY (LLC)

LIMITED LIABILITY COMPANY VS LIMITED PARTNERSHIP

Very similar - Both must be structured and operated carefully to ensure that they are taxed as partnerships for federal income tax purposes.

Several significant distinctions

- ★ **General partner liability** - A limited partner must have at least one general partner who is liable for all debts of the partnership. All of the members of an LLC normally are protected from personal liability (as are limited partners in limited partnership)

- ★ **Participation in Management** - Participation of limited partners in management of a limited partnership can result in loss of limited liability protection for that limited partner. No similar restriction exists on ability of LLC members to participate in management and control of the LLC.

LIMITED LIABILITY PARTNERSHIP

LLC VS. LIMITED LIABILITY PARTNERSHIP (LLP)

Principal difference is level of limited liability protection for owners of the entity. LLP provide limited liability as to **certain claims** (if certain requirements are met) but are taxed as a general partnership for all other purposes. LLP statutes only shield **each** partner from LLP liabilities for the malpractice of **another** partner in the LLP.

Each LLP partner thus remains liable for his or her own malpractice, the malpractice of people they directly control or supervise, and the LLP general debts, including trade payables, loans, lease obligations and other contracted liabilities.

Some LLP statutes, however, also protect against liability for contract obligations that are not personally guaranteed by the partner.

LLP is **not** a form of business organization
It is a form of registration of a general partnership
but without joint and several liability for partners.

LIMITED LIABILITY PARTNERSHIP

REGISTRATION OF L L P

Application must be filed with State.

California, Nevada, New York and Oregon require that ONLY PROFESSIONALS can form LLPs

Application must be executed by a majority of the partners or by one or more partners authorized to do so by the partners.

Application generally must include:

- ★ Name (Partnership name) which generally must include either words “registered limited liability partnership” or the abbreviation “LLP”
- ★ Activity - description of the business
- ★ Partners - Number of partners at time of application
- ★ Other items - some states require
 - Federal tax I.D. number
 - Address
 - Registered office or agent

Filing fee - Generally required to be paid to the State. Either a per partner fee or a flat filing fee. Could be required to pay annual renewal fee.
May be required to register with every foreign state and pay fees.

LLP - MALPRACTICE INSURANCE

Some states require LLP to carry liability insurance.

LIMITED LIABILITY COMPANY (LLC)

ADVANTAGES OF LLC OVER 'S' CORPORATION

The "S" Corporation, like the LLC, protects each owner from personal liability for the entity's debts under state law, and there is only one level of tax on the business income. The flow-through taxation method under "S" is not the same as the partnership method under Subchapter "K". There are many differences in the flow-through taxation of S corporations and LLCs taxed as partnerships.

Formation -Shareholders can transfer appreciated assets to a corporation tax free if shareholders are part of a "control group" of shareholders who own 80% of the voting stock or value of the stock in the corporation immediately after the transfer.

No similar control requirement for transfers of appreciated property to an LLC. Any member of an LLC may, at any time, transfer appreciated property to an LLC tax free.

Debt assumption

Shareholder reports taxable income to extent that corporation (S) assumes shareholder's liabilities in excess of shareholder's tax basis in any assets contributed to the corporation.

Because member's basis in LLC interest includes member's share of LLC liabilities, member can avoid any gain attributable to debt assumed by LLC in excess of member's tax basis in the property contributed.

Termination of Status

LLC can lose status as a partnership for tax purposes by amending LLCs Articles or Operating Agreement so that LLC no longer has at least two partnership characteristic.

S Corp can forfeit the S election immediately upon an event that causes the corporation to no longer meet statutory requirements.

LIMITED LIABILITY COMPANY (LLC)

ADVANTAGES OF LLC OVER 'S' CORPORATION (continued)

Flexible Capital Structure

LLC can have a variety of equity interests (as a tax partnership)

S Corporation has stringent qualification rules

One class of stock

Not more than 100 individuals or qualified trusts as shareholders

May not own 80% or more of the stock of another corporation

May not have other corporations, partnerships, non resident aliens as shareholders.

Allocations

LLC can specially allocate income, loss, deductions, and other tax items in any manner specified in the Operating Agreement and change the allocations, so long as they have “substantial economic effect”

S Corp must apportion the corporations income and loss per share per day and cannot specially allocate net income or loss or particular deductions or other items.

Contributions of Appreciated or Depreciated Property

S Corp may have advantage over LLC

When member contributes such property to LLC, the LLC must specially allocate the unrealized gain or loss (and associated depreciation) to adjust for the difference between the members basis in the property contributed and the property's fair market value.

Under some circumstances, the disguised sale rules of Code Section 707(b) and new Code Section 737 may cause the contributing member to recognize unrealized gain inherent in an item of contributed property.

Termination

LLC is terminated if 50% or more of LLC interests are transferred in any 12 month period.

No comparable provision for Sub S

LIMITED LIABILITY COMPANY (LLC)

ADVANTAGES OF LLC OVER 'S' CORPORATION (continued)

Inside Basis Step Up to Reflect Gain on Liquidation

Code Section 734 allows LLC to make election under Code Section 754 to step up the basis of the LLC's property when a member recognizes gain on the redemption member's interest.

This allows LLC to amortize and deduct the cost to redeem a member.

No comparable provision for Sub S - Shareholders obtain no tax advantages in connection with redemption of a shareholder

Inside Basis Step Up to Reflect Gain on Sale of Interest

LLC allowed to make a comparable election for a new member who purchases their interest from another member or receives the interest after death of a member. New member benefits from a step-up in the basis of the LLC's property to equal the new member's "outside basis" in their interest in the LLC. Danger here that the LLC (and later members) may suffer from a step down in the LLC basis in the LLC property.

Hot assets

When LLC member sells all or part of interest or receives a disproportionate distribution, the member must recognize ordinary income to the extent of the member's share of accounts receivable, depreciation recapture and other Code Section 751 "hot assets".

No comparable provision in Sub S

LIMITED LIABILITY COMPANY (LLC)

ADVANTAGES OF LLC OVER 'S' CORPORATION

Distribution of Property in Kind

Generally, neither LLC (taxed as partnership) or members recognize gain on distribution of appreciated property.

Exception: Member must report taxable income on distribution of property that had appreciated at the time the property was contributed to LLC by that member, if the property is distributed to another member within 5 years of the contribution.

LLC members do not recognize gain on liquidation of the company unless the LLC distributes cash to members in excess of respective member's basis in their interest.

S Corporation recognizes gain, which is passed through to shareholders on any distribution of appreciated property, including distributions in liquidation.

Basis in Liabilities

LLC - member's tax basis includes a share of the LLC's debt to third party. S Corporation shareholder is not entitled to any increase in stock basis on S Corporation debt. (If shareholder loans the corporation money directly, may use loan as basis)

LLC members and S corporation shareholders may use entity's losses against other income only to extent of tax basis in their interests, shares and direct loans.

Taxes: NEW COMMENCING IN 2004:

LLC - generally, if involved in trade or business - each member subject to Self employment tax - **NOT SO NOW:**

NEW: In 2004 IRS ruled that it is NOT entitled to collect employment taxes from LLC members.

S Corporation shareholders are not subject to Self Employment Tax on dividend distributions from S corporation.

Guaranteed payments for services will be subject to Self Employment Tax.

NEW: In 2004: The IRS proposed regulations providing that, if a single member LLC that elects to be treated as a disregarded entity was previously treated as an association taxable as a corporation, it is treated as a separate entity for purposes of: federal tax liabilities of the LLC with respect to any taxable period for which the LLC was not disregarded; and federal tax liabilities of any other entity for which the LLC is liable. Prop. Reg. §301.7701-2.

LIMITED LIABILITY COMPANY (LLC)

ADVANTAGES OF S CORPORATION OVER LLC

- ▶ Only one owner (LLC generally must have two owners or more)
- ▶ Section 1244 stock allowing initial owners to claim ordinary loss on disposition of that stock if stock sold at a loss
- ▶ Distribution of cash in form of corporate dividends, not subject to SE tax
- ▶ Owners want to merge tax free with another corporation.

WHEN LLC SHOULD BE CHOSEN OVER ANOTHER FORM OF BUSINESS

- ▶ When there are at least two investors, but not a lot of investors
- ▶ Flow through tax treatment is desirable
- ▶ Fringe benefits for owners who are also employees are not a material consideration.

PROFESSIONALS- USE OF LLC

Many state bars have not authorized lawyers to practice through LLCs
California and Rhode Island prohibit the practice of any profession through an LLC in their state.

LIMITED LIABILITY COMPANY (LLC)

FILING REQUIREMENTS

Depending on its classification an LLC would file either form 1065 (Partnership) or 1120 (Corporation).

If an LLC has a single owner it would file Schedule C or C - EZ (1040)

If an LLC is NOT treated as a corporation and has 2 or more members, it is treated as a partnership.

One of the LLC members must sign the tax return.

CHECK THE BOX

Form 1065 page 2 - Schedule B - Must check whether “Limited Liability Company” (Electing to be treated as partnership) or “Limited Liability Partnership”

FAMILY LIMITED PARTNERSHIP

FAMILY MEMBERS

Grandparents, parents, children, grandchildren

May be trusts, custodianship, or other entities organized for benefit of family members.

PURPOSES OF F. L. P.

To reduce income, gift, and estate taxes

To protect assets from unnecessary liability exposure to creditors

Can provide substantial tax benefits and allow family business and assets to be transferred to succeeding generations in orderly and cost effective manner.

RECOMMENDATIONS FOR FAMILY LIMITED PARTNERSHIP

Restrict individuals ability to transfer a partnership interest to protect against creditors

REDUCTION OF FAMILY INCOME TAXES

Gifts annually by parents to children using annual exclusion - transfers income from the assets (partnership) to lower marginal rate. (Watch for kiddie tax!)

Paying reasonable salaries to children (child must also receive economic burden or benefit)

Through special allocations. If partnership is properly organized and operated, the partners can allocate specific items to parents (i.e. depreciation, losses, or amortization expenses)

Assets may be contributed to, or distributed from, the partnership without triggering capital gain recognition.

VALID BUSINESS REASONS FOR FORMING A FLP

Centralized management

Orderly development and management of partnership property

Retention of the property in the family

Asset protection from creditors

Instruction to younger generation members about investments and business involved

Pass through entity level tax treatment

FAMILY LIMITED PARTNERSHIP

TAXABLE GAIN TRIGGERED ON FORMATION OF F. L. P.

On transfer of appreciated property to partnership more than 80% of whose assets consist of readily marketable stocks or securities, including RICs and REITs held for investment, but excluding cash and nonconvertible bonds in the 80% calculation.

If persons transfers assets and liabilities to a partnership and is relieved of some of the liabilities, taxable gain is triggered to that extent

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