

LLCs -- TAXATION ISSUES

INSTRUCTIONS: Review this information with your accountant/tax advisor before completing and returning the form entitled: *Information for LLC Formation*:

A. FOUR PART IRS “Looks like a Corporation” TEST:

To avoid taxation as a corporate status, you need to **FAIL at least two** of the following tests, (i.e. not have the following "characteristics of a corporation"):

1. Continuity of Life:

To ***FAIL***:

- a. Kill after ___ years, and
- b. Make death, insanity, etc. grounds to dissolve the LLC - except carry over for windup

NOTE: See:

A.R.S. § 29-733 *Events of Withdrawal* (Death)

A.R.S. § 29-734 *Withdrawal of Member* - How to Withdraw

A.R.S. § 29-781 *Dissolution* - Make Continuity After Withdrawal
only with unanimous consent of the remaining members.

2. Centralized Management:

Concentrating in a management group continuing sole and exclusive authority to make management decisions which do not require ratification of other members.

To ***FAIL***:

- a. Member Managed -- automatically *Fails*
- b. Manager Managed -- *Fails* if:
 - i. Managers own over 20%,
 - ii. Members retain right to ratify most business decisions, or
 - iii. Majority reserves the right to remove Manager (even one with a substantial interest) and convert the LLC to Member managed (but it *passes* if less than a majority have a substantially unrestricted right to remove the manager).

[NOTE: Compare this issue to the question of whether or not a member is considered a “manager” (i.e. one who, alone or together with others, is vested with the continuing exclusive authority to make the management decisions necessary to conduct the LLC’s business) for the test under Prop. Reg. 1.1402(A)-18 for whether or not a member pays self-employment tax.]

3. Limited Liability:

Automatic ***PASS*** – You can’t get around this one.

4. Free Transferability of Ownership Interests:

To ***PASS***:

If each member owning substantially all of the LLC has power to sell to 3rd party without consent of other members. (See A.R.S §§ 29-732 A, -733, -781 A3.)

To ***FAIL***:

Fail this test: [^]||

e.g. make sure at least 50% cannot be transferred freely.

B. SELF EMPLOYMENT TAX

Effective January 1995 the IRS has adopted Prop. Reg. 1.1402(A)-18 which addresses the issue of whether or not members (i.e. owners) of an LLC must pay the 15.3% self-employment tax where that LLC is properly classified as a partnership for federal tax purposes (i.e. that do not have the four "characteristics of a corporation" described on the attached sheet).

[For comparison purposes, it is important to note that with a subchapter S corporation a shareholder must first take a reasonable salary, which is subject to the 15.3% self employment tax, and then the balance can be paid as a bonus or distribution which is not subject to the tax.]

The question was whether LLC members should be treated as either:

limited partners -- who are normally subject to self employment tax on their distributive share of partnership income *only if received in the form of a guaranteed payment for services rendered*, (this format would be the manager-managed LLC),

or

general partners -- who typically subject to a self employment tax on all of their partnership income, (this format would be the member-managed LLC).

The new regulation essentially treats the member's income as it would a partner's income and generally provides that a member's self employment income includes the member's share of income or loss from any trade or business carried on by the LLC. However, a member's income is not a self employment income if the following two part test is satisfied:

- a. The member is not a manager of the LLC, and
- b. The LLC could have been formed as a limited partnership (rather than an LLC) in the same jurisdiction and the member could have qualified as a limited partner thereunder.

A manager is one who, alone or together with others, is vested with the continuing exclusive authority to make the management decisions necessary to conduct the LLC's business. [NOTE: Compare this "continuing exclusive authority" issue with the centralized management issue of the 4 part test to see if the LLC is really a corporation.] If the LLC has no managers, all members are treated as managers (and are thus all subject to self employment tax) even if some members have greater management authority than others under the applicable state statute and the LLC's controlling documents.

Because most states, if not all, preclude professionals from operating as limited partnerships, the second part of this test effectively bars a professional service LLC member from excluding any income from self employment tax.

The IRS plans to make Prop. Reg. 1.1402(A)-18 effective for a member's first tax year beginning on or after the date the regulation is published in final form (which will probably be late 1995 or early 1996). However, even then, it is the best guidance available for determining whether an LLC's members should pay SE tax on their income. In addition, the proposed regulation is consistent with previous unofficial guidance on the subject (see PLR 9432018).

C. OTHER TAXATION & FORMATION ISSUES

(Attorney does this in documents, and accountant/tax advisor checks as well.)

Check these issues against noted §§ (Sections) of Operating Agreement:

1. Cash v. Accrual:

§§ 1.9 (k), 1.9 (q) and 6.6

Don't use cash basis if:

- a. Regular Corporation a Member, or
- b. If more than 35% of losses are allocable to "limited entrepreneurs"
e.g. non-managing members.

2. Prior or Future Services:

§§ 1.9 (e) and 2.1

May have adverse tax consequences,
i.e. member may be taxed for "income" of interest received through services

3. Promise of Future Contributions:

§§ 1.9 (e) and 2.2

Must be enforceable (in writing)

4. Limited Liability:

§§ 3.1

If Manager Managed, other Members are not agents of the LLC

5. Continuity of Life:

§§ 1.9 (u), 9.1 (a) (i), 9.1 (a) (v),

Be sure to:

- a. Kill after ___ years -- § 9.1 (a) (i)
- b. Make death, insanity, etc. grounds to dissolve the LLC -- § 1.9 (u), 9.1 (a) (v)
- except carry over for windup
- c. Make Continuity after Withdrawal
only with unanimous consent of the remaining members -- § 9.1 (a) (v)

6. Centralized Management:

§§ 2.1, 3.8, 4.3, 6.1

If Manager Managed, for tax reasons make:

- i. Managers own over 20%, -- §§ 2.1, 6.1
- ii. Members retain right to ratify most business decisions, -- §§ 3.3, 4.3
- iii. Majority reserves the right to remove Manager,
convert the LLC to Member managed -- §§ 3.8

7. Free Transferability of Ownership Interests:

Article VII

Do not let each member owning substantially all of the LLC has power to sell to 3rd party without consent of other members. (See A.R.S §§ 29-732 A, -733, -781 A3.)

e.g. make sure at least 50% cannot be transferred freely.

D. OBTAINING AN EMPLOYER IDENTIFICATION NUMBER = “EIN”:

To obtain an EIN for your LLC, you need to complete and submit to the IRS their Form Number SS-4 – *Application for Employer Identification Number*, (which is readily available with instructions from the IRS website). In doing so, you will need to choose the specific type of tax treatment you want. There are two basic approaches described below as “a.” and “b.”, and I strongly recommend that you discuss them in detail with your accountant/tax advisor. After that, making the appropriate choice on the form is easy to do with what is called the “check the box” provisions for “Line 8a” on form SS-4. Here are the three actual choices (also described in the IRS instructions for Line 8a), and an explanation of how to choose the one you want:

a. Taxation as Partnership or Sole Proprietorship:

For many people, one of the primary benefits of using an LLC is to have “pass through” income, so that, just like with a partnership, the income into the LLC is not taxed, and only the income that passes through to the members (owners) is taxed for income tax purposes.

In this case, you will make one of two choices on line 8a of Form SS-4:

1. If your LLC has two members, you can simply check the box for a “**partnership**”, or you may check the “**Other (specify)**” box, and write “*LLC to be filing a 1065*” on the line.
2. If the LLC has only one member, you should check the “**Other (specify)**” box, and write “*disregarded entity –single member LLC*” on the line.

b. Taxation as Corporation:

However, you may want to be taxed as a corporation so you can protect some of your income from self employment tax, and take advantage of other benefits given to corporations. If you do this, you will have to file corporate returns, not K-1s, each year. In addition, you will also need to timely file both Form 8832 to be taxed as a corporation, and also Form 2553 for a Subchapter S election if you also want to receive the benefits of “pass through” income.

In this case, you will make the following choice on line 8a of Form SS-4:

3. Whether the LLC has one or more members, you will check the “**Corporation (enter form number to be filed)**” box, and write “8832” on the line,

Because of the tax consequences, I strongly recommend that you have your accountant/tax advisor file these forms for you, and do so as soon as I receive your approved *Articles of Organization* back from the Corporation Commission and provided them to you. [I will not prepare or file these forms unless specific arrangements are made with me.]

Sincerely,



Noel J. Hebets
NJH:njh