

Top Ten LLC Federal Tax Authorities

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Introduction

There are many hundreds of federal tax authorities potentially critical to tax accountants and lawyers in handling federal tax issues for their LLC clients. These authorities take the form of, among other things, Internal Revenue Code provisions; decisions by the Tax Court and other federal courts; U.S. Treasury Department temporary and final regulations; Internal Revenue Service proposed regulations; and IRS revenue procedures, revenue rulings and private letter rulings. And of course the list of these LLC federal tax authorities is constantly growing.

However, in my experience, the most important of these authorities are the 10 individual authorities and closely related pairs of authorities listed and briefly described below. In my view, every accountant and lawyer who handles LLC federal tax matters should have at least a general familiarity with each of these authorities.

1. The “Check-the-Box” Regulations

These regulations (technically known as the “Entity Classification Regulations,” and codified as Reg. Sections 301.7701-1 through 4) contain comprehensive rules determining the federal tax regimens potentially available to U.S. and foreign entities and providing rules for elections of these regimens by “eligible entities.”

2. The four principal Internal Revenue Code federal income tax regimens

Depending on the relevant facts, the Check-the-Box Regulations permit single-member and multi-member LLCs to be subject to federal tax treatment under any one of the four major federal tax regimens. These regimes are:

- Internal Revenue Code (the “Code”) provisions governing the federal income taxation of individuals;
- Federal income taxation under Subchapter C of the Code;
- Federal income taxation under Subchapter K of the Code (partnership taxation); and
- Federal income taxation under Subchapter S of the Code.

It is true that the tax items of most single-member LLCs are subject to federal tax treatment under the rules governing individuals and that the tax items of most multi-member LLCs are subject to federal tax treatment as partnerships. However, many single-member and multi-member LLCs are (or should be) taxable as S corporations; and a very few are (or should be) taxable as C corporations.

Thus, in order to be well equipped to handle LLC federal tax matters, tax accountants and lawyers must have a solid basic understanding of all four regimens and the regulations and other federal tax authorities that interpret and apply them.

3. Liability of LLC members for Social Security Taxes on their shares of LLC income

For many individuals who are members of LLCs (including both single-member and multi-member LLCs), the avoidance of Social Security Tax on their shares of LLC income is an important federal tax issue. In general, if these individuals are members of single-member LLCs classified as “disregarded entities” under the Check-the-Box Regulations, they must pay the Self-Employment Tax on the full amount of their LLC income except to the extent that this income consists of dividends, interest, capital gains, real estate rentals, or shares of limited partnership income. However:

- Under Prop. Reg. Section 1.1402(a)-2, they can achieve substantial lawful avoidance of the Self-Employment Tax if they are members of multi-member LLCs taxable as partnerships; and
- Under Rev. Rul. 59-221, 1959-1 C.B. 225 and other authorities, they can entirely avoid FICA taxes on their shares of the income of single-member and multi-member LLCs if these LLCs have elected to be taxable as S corporations.

4. Rules governing LLC employer identification numbers

The IRS instructions for the use of Form SS-4 (“Application for Employer Identification Number”) provide advice and rules on the issue of how to obtain employer identification numbers for single-member and multi-member LLCs.

5. Employment tax duties of single-member LLCs

TD 9356 (August 16, 2007), a document published by the U.S. Treasury Department, contains final regulations governing the duties of LLCs classified as “disregarded entities” under the Check-the-Box Regulations with respect to employment tax payments and reporting.

6. Conversions of single-member LLCs to two-member LLCs and vice versa

Rev. Rul. 99-5, 1996-6 I.R.B. 8, and Rev. Rul. 99-6, 1996-6 I.R.B. 6, set forth IRS rules governing the federal income tax consequences of, respectively:

- The conversion of single-member LLCs classified as disregarded entities to two-member LLCs classified as partnerships; and
- The conversion of two-member LLCs classified as partnerships to single-member LLCs classified as disregarded entities.

7. Filing obligations of husband-wife LLCs

Rev. Proc. 2002-69, 2002-2 C.B. 831 provides, in essence, that when a husband and wife are the members of a two-member LLC taxable as a partnership, the LLC must file a partnership tax return (i.e., IRS Form 1065) unless the husband and wife reside in a community property state.

8. Statutory conversions of state-law business corporations to LLCs

PLR 200528021 (released on July 7, 2005) and PLR 200748021 (released on December 2, 2005) hold, in essence, that, assuming that certain requirements are met, statutory conversions of state-law business corporations taxable under Subchapters C or S are tax-free reorganizations under IRC Section 361(a)(1)(F) and that the operating agreements of these entities are “governing provisions” for purposes of the Subchapter S single-class-of-stock rules.

9. Conversions of state-law partnerships to LLCs

Rev. Rul. 95-37, 1995-1 C.B. 130, provides that if a state-law general partnership taxable as a partnership converts to a multi-member LLC taxable as a partnership, then, if certain stated requirements are met (including a requirement that no liability of any partner may change in connection with the conversion), the conversion will not result in adverse partnership federal income tax consequences for the partnership or its partners. Thus, in essence, Rev. Rul. 95-37 provides that for federal tax purposes, the conversion will be treated for federal tax purposes as a non-event.

10. Treatment of managers of manager-managed multi-member LLCs under the passive activity loss ("PAL") rules

Under the PAL rules, limited partners are at a disadvantage relative to general partners. It is more difficult for a limited partner to be treated as “materially participating” in an activity, and therefore more difficult for a limited partner to deduct a share of the partnership’s losses. Under certain temporary regulations (Treas. Reg. Section 1.469-5T(e)(3)(i)(B)), it appears that a member of an LLC taxed as a partnership (including a member-manager) would be treated as a limited partner for purposes of the “material participation” rules, assuming that the member’s liability for LLC obligations is limited under the state of formation to a “determinable fixed amount.” Although these temporary regulations technically remain in place, they are not the last word. In a related context (the “aggregation” of activities for PAL purposes), final regulations imply that an LLC member who actively participates in management should not be treated as a limited partner. See Treas. Reg. Section 1.469-4(d)(3). The treatment of member-managers in the “aggregation” context arguably casts doubt on whether the treatment of member-managers for purposes of “material participation” represents the government’s current position. In addition, *Gregg v. United States*, 186 F.Supp. 2d 1123 (D. Or. 2000), should be strong authority for either rejecting Treas. Reg. Section 1.469-5T(e)(3)(i)(B), or for reading the regulation in a way that neutralizes its adverse implications for LLC member-managers.¹

¹ For the above explanation of the -4 and -5T rules, I am indebted to Robert Keatinge and Andrew Immerman for their posts in LNET-LLC, an internet discussion group on LLC law and tax.